Report No. 1351

New York State Bar Association Tax Section

Report on Proposed Regulations under Section 385

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Contents

I. INTRODUCTION

This report[1] comments on proposed regulations issued by the Treasury Department ("**Treasury**") and the Internal Revenue Service (the "**IRS**," and together with Treasury, the "**government**") on April 4, 2016, under Section 385 of the Code, concerning the tax treatment of debt instruments issued between related parties (the "**Proposed Regulations**").[2] The Proposed Regulations were issued simultaneously with a package of regulations under Sections 367, 956, 7701(l) and 7874 addressing inversions.

We understand the primary aims of the Proposed Regulations include (i) curtailing earnings stripping transactions by inverted corporations, and other taxpayers, and (ii) limiting the ability of U.S. multinationals to use intercompany debt in transactions designed to repatriate foreign earnings without current U.S. tax. While we appreciate the interests of the government in limiting these types of transactions, we nevertheless have significant concerns about several aspects of the Proposed Regulations.

The Proposed Regulations represent a substantial change from settled law, with far-reaching implications, the full breadth of which may not be grasped by taxpayers, or the government, for some time to come. For well-advised taxpayers, the Proposed Regulations in their current form would have significant and disruptive effects on ordinary commercial activities and on other transactions that may not implicate tax policy concerns. For other taxpayers, the Proposed Regulations—and, in particular, Prop. Treas. Reg. § 1.385-3—will often operate as a trap for the unwary, in which taxpayers may learn only after the fact that an intercompany loan with customary debt terms can cause adverse tax consequences, even if the loan would (absent the Proposed Regulations) clearly constitute debt for U.S. federal income tax purposes. The fact that the Proposed Regulations raise these issues may to some extent be unavoidable, since Section

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[2] References in this report to "**Section(s)**", unless otherwise stated, are to sections of the Internal Revenue Code of 1986, as amended (the "**Code**") and the regulations thereunder.

385 appears designed to distinguish between debt and equity based on a variety of factors germane to that analysis, rather than drawing the debt-equity distinction in a manner designed to achieve other tax policy goals.

We recognize the importance of the government's policy objectives in issuing the Proposed Regulations. However, we are concerned that Prop. Treas. Regs. §§ 1.385-1 and 1.385-2 both need to be substantially revised in order to operate properly. In addition, we strongly recommend that Prop. Treas. Reg. § 1.385-3 not be issued as a final regulation, due to the deep problems inherent in the proposed rule. We urge that the government instead put forward alternative guidance for taxpayers' and practitioners' review and comment.

A. Key Considerations

Section 385 was adopted in response to the lack of clear, consistent common law principles for drawing distinctions between debt and equity, a condition which provided grounds for frequent disputes between taxpayers and the government. Congress expected that Treasury and the IRS would promote the orderly administration of the tax laws, by providing "regulatory guidelines" for determining whether an interest in a corporation constitutes equity or debt.[3] It appears these guidelines were anticipated to be based on factors concerning the characteristics of an instrument issued by a corporation, and other facts related to the overall bundle of economic and legal rights and obligations that together compose the holder's relationship with the issuer.[4]

In this regard, there is a tension in how different provisions of the Proposed Regulations identify interests not appropriately treated as debt. Prop. Treas. Regs. §§ 1.385-1 and 1.385-2 both appear to begin with the basic premise that, if an intercompany instrument has the proper form, legal rights and economic characteristics, it is appropriately viewed as debt, even though it is issued between related parties. Prop. Treas. Regs. §§ 1.385-1 and 1.385-2 seek to impose discipline on a corporate group in ensuring that an instrument issued within the group is treated as debt only if it has the appropriate characteristics. By comparison, Prop. Treas. Reg. § 1.385-3 in significant respects departs from this premise. It takes the view that even classic debt, if issued by means of a distribution by a subsidiary to a parent, or other transactions the regulation identifies as similar, should be automatically classified as equity for tax purposes, notwithstanding that the same instrument entered into between third parties would be treated as debt and that the parties comply with its terms fully. Prop. Treas. Reg. § 1.385-3 thus is a substantial departure from the type of regulatory guidelines that had, until now, been anticipated would be adopted under Section 385. We give a brief overview of the proposed rules and the key issues they present below.

3 S. Rep. No. 91-552, at 138 (1969); *see also* H. Rep. No. 101-247, at 1235–36 (1989).

4 *Id*.

1. Prop. Treas. Regs. §§ 1.385-1 and 1.385-2

Prop. Treas. Reg. § 1.385-1(d) (the "**Part-Stock Rule**") authorizes the IRS to bifurcate a debt instrument issued within a group. Although bifurcation is an approach to the tax treatment of debt that is expressly contemplated as a possibility by Section 385, the government and taxpayers have found it difficult in the past to apply bifurcation. Among other challenges, it often may be hard to determine what the separate components of an instrument should be, how to value them, and, in the case of the non-debt component of the bifurcated instrument, how it should be treated for tax purposes. The Proposed Regulations do not articulate any principles of general application (including in transactions between unrelated parties) that would address these issues. Nor do they indicate what special considerations, if any, apply in the related-party context that would shape the bifurcation analysis and make it an effective tool to produce appropriate tax results. Consistent with an apparent basic motivation for the Proposed Regulations overall, it appears the Part-Stock Rule may be concerned largely with the overleveraging of a group member, which may result where there is not a third party to impose financial discipline. Assuming that is the case, the Part-Stock Rule should be expressly narrowed, at least for now, to apply only to that case. In its present form, it creates uncertainty that impedes orderly administration of the tax laws.

Prop. Treas. Reg. § 1.385-2, by comparison, does provide some specific guidance for taxpayers about prerequisites for treating an instrument issued within a corporate group as debt (the "**Documentation Rules**"). The rules mandate that a corporate group must maintain four types of contemporaneous documentation relating to an intragroup debt instrument, to establish that (1) the instrument provides for payment of a sum certain; (2) it provides for traditional creditor's rights; (3) there is a reasonable expectation the issuer will pay off the debt in full; and (4) amounts due under the instrument are timely paid or, in the event of non-payment, the holder exercises the reasonable diligence of a creditor. So long as some suggested clarifications are made, the first two of these requirements are reasonable and, to a significant extent, are familiar concepts grounded in prior law. The remaining two types of required documentation (establishing a reasonable expectation that the debt will be paid in full, and that the holder exercises reasonable diligence of a creditor in the event of non-payment) are also based on familiar concepts from prior law; but the rules do not give clear recognition to the reality that, if the issuer of an intragroup debt instrument becomes financially distressed after the time the debt is issued, the related lender may have only limited practical ability to pursue a creditor's remedies and, even though acting in the same manner a reasonable third-party creditor would, may nonetheless refrain from exercising its rights to the fullest. We believe Prop. Treas. Reg. § 1.385-2 is not meant to say that this reality will prevent intragroup debt from being respected as debt; and the regulation should be clarified to avoid doubt on the point.

However, the principal problems raised by the Documentation Rules are administrative, rather than substantive. The rules should generally require that documentation be prepared supporting the status of intercompany debt as true debt only upon issuance, repayment according to its terms, or events of default, rather than the broader range of dates that are specified in Prop. Treas. Reg. § 1.385-2. Also, it should be required that these documents be prepared by the time the tax return is due for the year in which a relevant event occurs, rather than within 30 or 120 days after the date of issuance or other relevant events provided in the Proposed Regulations. Moreover, the general requirements of the Documentation Rules should be relaxed to fit normal commercial practice for short-term intragroup financings, including loans under cash pooling arrangements and trade payables for property and services provided by affiliates.

As currently drafted, the Documentation Rules would apply to instruments issued on or after the date the rules are published in final form. We recommend that the rules instead apply only to instruments issued at least a few months after the rules are finalized. Particularly if the large number of potential testing dates is retained, and the deadline for preparing at least some of the necessary documentation is kept at 30 days after a relevant event, it may realistically be difficult for taxpayers to implement the Documentation Rules in a timely fashion. Although the reasonable cause exception in the Documentation Rules might provide some relief, it would seem preferable to choose an effective date that is less likely to cause frequent reliance on that exception. In addition, even if the rules are modified in the manner we have recommended, groups may still often need lead time to assess the final rules and coordinate their internal tax, finance and legal functions in order to be able to generate appropriate documentation and ensure that the terms of instruments are consistent with the final Documentation Rules.

2. Prop. Treas. Reg. § 1.385-3

As noted, Prop. Treas. Reg. § 1.385-3 recharacterizes debt issued within a corporate group as equity, if the debt is issued by means of a distribution by a subsidiary corporation to its parent or other specified types of transactions (the "**Per Se Stock Rules**"). Prop. Treas. Reg. § 1.385-3 is meant to limit earnings stripping, E&P repatriation and other types of planning opportunities of concern to the government.[5] We have serious concerns regarding the Per Se Stock Rules, and we strongly recommend against issuing this proposed regulation in final form.

[5] The Treasury Fact Sheet that discusses the Proposed Regulations highlights the importance of earnings stripping as a motivation for Prop. Treas. Reg. § 1.385-3: "Under current law, following an inversion or foreign takeover, a U.S. subsidiary can issue its own debt to its foreign parent as a dividend distribution. The foreign parent, in turn, can transfer this debt to a low-tax foreign affiliate. The U.S. subsidiary can then deduct the resulting interest expense on its U.S. income tax return at a significantly higher tax rate than is paid on the interest received by the related foreign affiliate. In fact, the related foreign affiliate may use various strategies to avoid paying any tax at all on the associated interest income. When available, these tax savings incentivize foreign-parented firms to load up their U.S. subsidiaries with related-party

For many of us, the problems with Prop. Treas. Reg. § 1.385-3 are rooted in the choice of Section 385 as the statutory provision under which to issue rules curbing the types of planning that are of concern to the government. First, it does not appear that Congress (or, in their prior proposed regulations under Section 385, Treasury and the IRS) envisioned that the overall tax planning strategies of the borrower or lender would drive the analysis under Section 385 or the factors to determine whether an instrument issued by a corporation is debt or equity.[6] Prop. Treas. Reg. § 1.385-3 is drafted in a manner that appears, at least implicitly, to acknowledge this point. By its terms, the regulation seeks to identify in a neutral fashion (*i.e.*, not expressly limited to cases involving earnings stripping, E&P repatriation or other specific tax planning strategies) certain cases where intragroup debt should not be respected as debt for tax purposes.

However, the circumstance that triggers recharacterization of debt as equity under Prop. Treas. Reg. § 1.385-3—*i.e.*, the fact that the debt was created in a particular type of transaction between group members, without reference to other factors—represents, to many of us, a second significant departure from the types of debt/equity factors that Congress and, until now, Treasury and the IRS appear to have assumed would be used in regulations under Section 385. In contrast with current law, Prop. Treas. Reg. § 1.385-3 treats otherwise identical instruments, with the

debt. Today's action makes it more difficult for foreign-parented groups to quickly load up their U.S. subsidiaries with related-party debt following an inversion or foreign takeover, by treating as stock the instruments issued to a related corporation in a dividend or a limited class of economically similar transactions."

Consistent with these statements in the Treasury Fact Sheet about Prop. Treas. Reg. § 1.385-3, the preamble to the Proposed Regulations (the "**Preamble**") states: "In many contexts, a distribution of a debt instrument similar to the one at issue in *Kraft* lacks meaningful non-tax significance, such that respecting the distributed instrument as indebtedness for federal tax purposes produces inappropriate results. For example, inverted groups and other foreign-parented groups use these types of transactions to create interest deductions that reduce U.S. source income without investing any new capital in the U.S. operations." Preamble to the Proposed Regulations, Notice of Proposed Rulemaking, *Treatment of Certain Interests in Corporations as Stock or Indebtedness*, REG–108060–15, at 20917 The Preamble adds that "In addition, U.S.-parented groups obtain distortive results by, for example, using these types of transactions to create interest deductions that reduce the earnings and profits of controlled foreign corporations (CFCs) and to facilitate the repatriation of untaxed earnings without recognizing dividend income." *Id*.

6 It is clear from the 1969 legislative history that Congress was aware that taxpayers frequently used debt to reduce the corporate tax base. In particular, Congress noted this benefit as one of the circumstances contributing to an increasing trend at the time to finance corporate mergers and acquisitions with debt. S. Rep. No. 91-552, at 137. Congress appears to have taken it as a given this tax motivation would be present in many cases, and directed Treasury and the IRS to provide regulatory guidelines based on other factors, having to do with the economic and legal nature of the relationship between an issuer and a holder of an instrument, in order to characterize the instrument as debt or stock. Congress simultaneously issued Section 279 as a separate provision, intended to provide mechanical rules that would automatically lead to particular outcomes concerning corporate interest deductions. *Id*. at 139- 144.

economic characteristics and legal terms of traditional debt, differently solely because they were issued in different types of transactions.[7] Moreover, to the extent transaction types are chosen as a proxy for cases where policy concerns related to particular types of tax planning are employed, the resulting rule will easily, perhaps inevitably, be over- or under-inclusive (or both).

Because Prop. Treas. Reg. § 1.385-3 attempts in a single provision to address a variety of tax issues (*e.g.*, earnings stripping by foreign-parented multinational groups and repatriation planning by U.S.-parented multinational groups), the over- and under-inclusiveness problems noted above are exaggerated. A given transaction type may facilitate one kind of tax planning but not another.

Third, in the cases where Prop. Treas. Reg. § 1.385-3 applies, it treats an intragroup instrument as stock—even though this treatment in many cases does not appear to provide a more fitting explanation of the parties' transaction than treatment as debt, and even though many of the tax consequences that flow from equity treatment may not be logical or appropriate consequences in view of the basic nature of the parties' transaction. This appears to be an inevitable result of the decision to deem an instrument to be stock without regard to the economic and legal features of the instrument, and also of the fact that application of Section 385 to an instrument causes it to treated as debt or equity for all purposes of the Code. While the Code includes numerous provisions that treat debt-like equity as debt (*e.g.*, Sections 351(g) and 1504) and treat equity-like debt as equity (*e.g.*, Section 163(i), Section 163(l)), each such provision applies for the limited purposes under the Code that are necessary to further the particular goals of the provision. Notably, no provision of the Code that limits interest deductions does so by treating an instrument as equity for all purposes.

Although we believe that Section 385 is not an ideal statutory provision for issuing guidance to address earnings stripping and the other planning techniques that motivated the government in issuing Prop. Treas. Reg. § 1.385-3, many of us allow for the possibility that an appropriately targeted regulation could be issued under Section 385 to address at least some of these concerns. However, Prop. Treas. Reg. § 1.385-3 is a deeply problematic rule, due to its overbreadth and the often arbitrary results it produces. The proposed regulation identifies a corporation's distribution of a debt instrument to a closely related shareholder as the paradigmatic case where the form of the debt instrument should not be respected, based on the proposition that such a distribution typically lacks real-world significance. That proposition is debatable, if the debt has economic terms that would be acceptable to an unrelated party (indeed, the proposed

7 *Cf.* William T. Plumb, Jr., *The Federal Income Tax Significance of Corporate Debt: A Critical Analysis and a Proposal*, 26 TAX L. REV. 369, 537, 551-552 (1971) (noting that among "factors of questionable pertinence to the issue" of debt/equity classification, are the questions of whether parties "arbitrarily designated" newly invested capital as partly debt and partly equity, and whether the loan was created in a transaction where capital was invested rather than a recapitalization or debt dividend).

regulation can apply even when a large portion of an issuance of debt is actually held by third parties). However, even if this argument is accepted, the proposed regulation sweeps in a wide range of other trigger transactions that have economic and practical consequences that are substantially different from a subsidiary's distribution of debt to a parent and do not fairly resemble such a distribution.

For example, an intragroup loan made to a highly creditworthy entity to provide short-term working capital, or to satisfy a regulatory requirement, will often be recharacterized as equity under Prop. Treas. Reg. § 1.385-3, if the borrower happens coincidentally to engage in a proscribed transaction during the relevant 6-year window of time (say, an acquisition of an affiliate's assets in a tax-free reorganization). This is true notwithstanding that the loan may have none of the economic or legal features typically associated with stock; the transaction in which the loan is issued may clearly have substance, and may bear no economic resemblance to a debt distribution by a subsidiary to its parent; and none of the policy concerns underlying Prop. Treas. Reg. § 1.385-3, or other tax policy concerns, may be present in such a case. This overbreadth is particularly troubling because, as noted above, the recharacterization of the instrument as stock is for all purposes of the Code—the result may be not just a conversion of interest, and principal, payments into dividends, but a far-reaching chain of collateral tax consequences, including creation of tax liability for third parties that have not participated in (and, for that matter, may not be aware of) the transactions in which the debt that is recharacterized was created.

We thus strongly urge that Prop. Treas. Reg. § 1.385-3 not be adopted. We appreciate, as noted, the government's significant concerns leading to its proposal of the rule, and we offer below several possible approaches the government could pursue in order to address those concerns.

B. Possible Alternatives to Prop. Treas. Reg. § 1.385-3

1. First Option: Rules Expressly Targeting Inverted Corporations and Other Problem Cases

One possibility would be to issue guidance under Section 385 that expressly targets debt issued as part of particular types of tax planning identified as problematic. The most obvious would be debt issued by an inverted U.S. corporation to its foreign parent or a foreign affiliate, where the debt is not issued as part of a transaction that increases the total assets of the group in U.S. corporate solution. Another specific target might be debt issued by a first-tier CFC to U.S. affiliates, in a transaction that does not result in an increase in the CFC's asset base. This approach would, clearly, be a departure from the historic approach under Section 385 above of not looking to the parties' tax planning as a factor in debt/equity analysis. Treasury and the IRS however could consider whether the seriousness of the policy issues they now confront, in a contemporary context, merits breaking new ground. Such an approach would have the considerable advantage of applying only to the precise cases that raise the policy concerns which have motivated the government to act.

2. Second Option: Guidance Based on the Group's Third-Party Debt:Equity Ratio

A second alternative would be to adopt rules under Section 385 that, consistent with Section 385(b)(3), focus on the debt:equity ratio of a corporation issuing debt within a worldwide group.[8] For example, the regulation could provide that debt will not be recast as equity where both: (a) immediately following the issuance of the debt being tested, the issuer has a debt:equity ratio that is no higher than the worldwide group's third-party debt:equity ratio; and (b) the yield on the issuer's debt being tested does not exceed the blended yield on the group's third-party debt.[9] This approach would be somewhat similar to the Administration's recent proposals on group excess interest expense,[10] although the metrics that are used (debt:equity ratio, and reasonableness of the interest rate) would be traditional ones for a debt-equity analysis under general tax principles.[11] Under such an approach, a group member would be free to issue internal debt that represented a reasonable portion of its capital structure; although this debt would not be loaned directly by third parties, it would represent a broadly sensible allocation of the economic burden of the group's third-party borrowing.

This approach would represent significantly less of a departure from the historic approach to debt:equity analysis, than Prop. Treas. Reg. § 1.385-3 does. This approach also would tend to mitigate the wide-ranging collateral consequences of characterizing an instrument as stock under Section 385, by allowing a corporation to incur intragroup debt up to a logical limit.

We note that because Prop. Treas. Reg. § 1.385-3 does not incorporate any type of exception based on the corporate group's debt:equity ratio, it tends to create incentives that might be viewed as in tension with the basic goal of preventing inappropriate earnings stripping, and that conceivably may not have been intended. First, a foreign-parented group will have an incentive to load up a newly formed U.S. subsidiary with the maximum possible amount of intercompany debt that can plausibly be respected as debt under general U.S. tax principles, due to the difficulty under Prop. Treas. Reg. § 1.385-3 of inserting additional leverage into the U.S. subsidiary after it is initially formed and capitalized. Second, a foreign-parented group also will have an incentive, where commercially feasible, to push down the maximum possible amount of third-party debt to U.S. subsidiaries, with a guarantee from the parent if requested by the lenders.[12] A U.S.-

[8] Section 385(b)(3) lists "the ratio of debt to equity of the corporation" as one of the factors that regulations may take into account in distinguishing between debt and stock.

[9] *See* Stephen E. Shay, *Mr. Secretary, Take the Tax Juice Out of Corporate Expatriations*, 144 TAX NOTES 473 (July 28, 2014).

[10] *See* STAFF OF THE JOINT COMM. ON TAX'N, GENERAL EXPLANATIONS OF THE ADMINISTRATION'S FISCAL YEAR 2017 REVENUE PROPOSALS 2–4 (Feb. 2016).

[11] *See* Plumb, *supra* note 7, at 470–73.

[12] *Cf.* Plantation Patterns, Inc. v. Comm'r, 462 F.2d 712 (5th Cir. 1972).

parented group will also have somewhat similar incentives (subject to maximizing the tax benefit of interest deductions) in the case of a newly formed CFC.

Treasury and the IRS logically would need to address a series of choices if they design a rule under Section 385 that is based on a group's debt:equity ratio, including the following. We would be pleased to assist the government in analyzing these issues and developing guidance:

1. It would need to be determined how debt and equity would be computed. Possibilities include fair market value (based on appraisals, or other evidence as to value); U.S. tax basis of assets, and computation of liabilities under U.S. tax principles; and/or computations based on the group's audited financial statements (somewhat similar to the rule for measuring whether the threshold for application of Prop. Treas. Reg. § 1.385-2 has been met).[13]

2. Presumably, the debt:equity ratio test would be applied only as of the date the instrument being tested is issued, with no subsequent retesting unless the instrument undergoes a significant modification. In that case, rules could be developed to prevent manipulation of the debt:equity ratio; for example, rules that look to the group's average debt:equity ratio as of the end of the preceding few financial reporting periods; and rules that take into account expected material changes in the capital structure of the issuer.

3. In addition to a third-party debt:equity ratio, a second test might be included in the rules that looks to a coverage ratio: for example, the group's ratio of EBITDA:debt service. This could help to address cases where, although a corporation may appear to have a sufficient asset base to support additional debt, it does not have a ready source of cash to pay debt service.

4. The government could consider whether any departures from the mechanical ratio test(s) would be justified in some cases, based on a borrower's particular circumstances: for example, being in an industry different than that of most of the other group members; or facing local market conditions different than most other group members.

5. Special rules could apply in the case of financial institutions or other specific industries.

6. We agree with the government that the concerns motivating the Proposed Regulations are less likely to arise in the context of debt issued between two members of the same consolidated group, than in other contexts. An exemption for this debt

[13] Prop. Treas. Reg. § 1.385-2(a)(2), (a)(4)(iv).

from the debt:equity ratio tests, corresponding to that in Prop. Treas. Reg. § 1.385-1(e), could be provided.

7. Rules would need to be provided dealing with the treatment of an instrument, or portion of an instrument, recharacterized under this test. These would be the same basic issues as are discussed in Part XI with respect to of Prop. Treas. Reg. § 1.385-3. As noted, the fact that a corporation would be able to issue intragroup debt up to a reasonable ceiling would mitigate these issues.

It would appear that rules based on a corporate group's third-party debt:equity ratio, if properly constructed, could provide a logical response to concerns about earnings stripping. The analysis is more complicated, however, in the case of concerns about repatriation planning, or transactions otherwise seen to inappropriately shift CFCs' E&P. An approach based on a debt:equity ratio would prevent excessive, non-economic leveraging of a CFC to repatriate E&P (or otherwise manipulate E&P). Such an approach would, however, allow CFCs to issue intragroup debt freely up to formulaic limits. As the report explains (in Parts VII – IX), Prop. Treas. Reg. § 1.385-3 is a not particularly effective means of limiting this planning. That is true regardless of how heavily levered a CFC may be; and, in that respect, a test based on a CFC's debt:equity ratio might be seen as an incremental improvement on the proposed regulation. However, at a more basic level, the concept of dealing with CFC repatriation structures and other CFC planning through a single, uniformly applicable set of rules that also is meant to address earnings stripping, may simply not be an effective one in addressing issues pertaining to CFCs. Instead, the government could consider issuing other types of guidance, potentially under Sections 301, 956 or 7701(l), to address CFC planning techniques. For example, the possibility could be explored of guidance to treat an upstream loan by a lower-tier CFC to a first-tier CFC, when made with a principal purpose of funding a distribution by the first-tier CFC to a U.S. shareholder, as an investment in U.S. property under Section 956.[14] Alternatively, or in addition, guidance might be considered under Sections 301 or 7701(l) to address cases where a first-tier CFC incurs intragroup debt to fund a distribution by it to a U.S. parent and, as part of a plan, the first-tier CFC later receives distributions from a lower-tier CFC in order to fund repayment of that debt; in these cases, the transaction might be recharacterized in a manner that causes the upper-tier CFC's distribution to its U.S. parent to be treated as not occurring, until the debt is repaid.

3. Third Option: Put Forward a Substantially Narrower Rule that Retains Elements of Prop. Treas. Reg. § 1.385-3 for Public Review and Comment

A third possibility would be to continue with some of the elements of Prop. Treas. Reg. § 1.385-3, but to significantly reduce the reach of the proposed regulation, and to better tailor it to curtailing the types of planning that have motivated the government to issue it. We offer a se-

[14] *Cf*. Treas. Reg. § 1.956-1T(b)(4) (existing rule dealing with certain conduit structures).

ries of detailed proposals for doing so in this report; the key ones are summarized below. This approach would lack advantages of the two possibilities described above: even if narrowed in the manner we suggest, it still would not expressly target the precise types of tax planning of concern to the government and, thus, would have a significantly broader scope than the first approach we have described; and it also would continue to recast debt as equity based solely on a single factor (the type of transaction in which the debt is issued) that is not tied to the economics of the instrument, thus departing from previously understood Section 385 principles, and would seek to address all the policy concerns that the government is facing by means of a single, uniform mechanical set of rules rather than differentiated rules to deal with (on the one hand) earnings stripping and (on the other hand) repatriation and other CFC planning, by contrast to the second approach.

Our key recommendations under this approach would be:

First, transactions between foreign corporations should be excluded from Prop. Treas. Reg. § 1.385-3. A loan between two foreign corporations that are not CFCs, almost by definition, should not lead to the type of planning that apparently has motivated Prop. Treas. Reg. § 1.385-3. In addition, disapplying Prop. Treas. Reg. § 1.385-3 to transactions between a CFC and another foreign corporation (CFC, or non-CFC) will not cause corporate groups to gain meaningful additional opportunities to repatriate E&P (or manipulate CFCs' E&P) beyond those available to them under the proposed regulation as currently drafted. As noted above, in order to address E&P planning techniques involving CFCs, the government could consider a separate set of rules that is designed specifically to achieve that purpose.

Second, although the government's stated focus in Prop. Treas. Reg. § 1.385-3 is on note distributions and other intercompany debt created in transactions in which the equity capital of EG members is reduced, Prop. Treas. Reg. § 1.385-3 does not exclude transactions where, in connection with an issuance of intragroup debt, the borrower receives an infusion of equity capital from a member of the group that offsets any distribution or other capital reduction. Prop. Treas. Reg. § 1.385-3 should take contributions of equity capital into account.

Third, Prop. Treas. Reg. § 1.385-3 has two prongs. A general rule (the "**General Per Se Rule**") recharacterizes debt as stock if the debt is issued as a distribution by a subsidiary to a parent, as consideration for an acquisition of stock of another group member, or as consideration for an acquisition of assets of another group member in a tax-free reorganization. In addition, a second rule (the "**Funding Rule**") recharacterizes debt issued for cash or other property as equity, if the debt is issued with a principal purpose of funding a distribution by the issuing corporation to its shareholder, or funding payments by the issuing corporation of consideration for the acquisition of stock or a group member or of assets of a group member in a tax-free reorganization. For purposes of the Funding Rule, if a corporation makes a distribution or engages in any of the other types of trigger transactions, then debt issued by that corporation within the 72-month period beginning 36 months before, and ending 36 months after, the date of a distribution or acquisition, is conclusively presumed to have been issued with a principal purpose of funding the relevant transaction (the "**72-Month Per Se Rule**"). The Funding Rule—although ostensibly an anti-avoidance rule to bolster the General Per Se Rule—in fact is responsible for a disproportionate share of the issues created by the regulation. It applies to a wide range of transactions which are economically dissimilar to the distribution of a note and the other transactions covered by the General Per Se Rule; and typically, the Funding Rule applies automatically whenever one of the transactions described in the rule occurs, even though there appears to be no policy reason for recharacterizing debt as equity in many of these transactions.

We strongly recommend that the Funding Rule be significantly scaled back. It should no longer contain any provision which automatically requires recharacterization, like the 72-Month Per Se Rule. Instead, the Funding Rule should apply only when an intragroup loan is made with a principal purpose of achieving substantially the same economic result as a distribution or other transaction that is subject to the General Per Se Rule. (As a very simple example, the Funding Rule would apply where, pursuant to a plan, a parent makes a loan to a subsidiary, which then makes a distribution in the same amount to the parent.) This change would limit the scope of the Funding Rule to transactions that are economically similar to the paradigmatic cases that the General Per Se Rule is meant to capture. Although this would be our preferred approach, a workable alternative could be to replace the 72-Month Per Se Rule with a rebuttable presumption, which would apply where an intragroup loan is made within one to two years before or after a distribution or other triggering transaction. That rebuttable presumption in favor of recharacterizing a loan as equity, would be accompanied by rebuttable presumptions in favor of *not* recharacterizing a loan as equity, if it is made within one to two years before or after a distribution or other triggering transaction, but is made pursuant to common types of transactions that present limited or no potential for abuse (*e.g.*, cash pooling arrangements; or purchases of an EG member's debt by an affiliate that is a securities dealer).

Fourth, to the extent Prop. Treas. Reg. § 1.385-3 contains any anti-avoidance rules, they should be precisely and clearly articulated so that they do not have the inadvertent effect of significantly broadening the regulation. In this connection, we note that the current combination of a mechanical operative rule for which purpose is irrelevant (the 72-Month Per Se Rule), and an anti-avoidance rule that is triggered when a taxpayer engages in a transaction to which the regulation applies with a purpose of reducing U.S. taxes, is likely to lead to arbitrary, one-sided results.

While the above would be key features of a narrower regulation that retains some basic elements of Prop. Treas. Reg. § 1.385-3, we stress that it would be critical to make many other changes, which are described below in this report, in order to avoid replicating in the scaled-back rule significant technical problems and anomalous results produced under the existing proposal.

4. Effective Date Considerations

Under any of the three possible approaches just described, the government inevitably would be producing complex, nuanced rules to deal with difficult technical and policy issues. Under the second and third of these approaches, the rules by their terms would apply not just to taxpayers that engage in behavior specifically identified by the government as having a significant potential for abuse, but a large number of other taxpayers as well that are engaged in commercial activities in the ordinary course of business or otherwise in transactions with limited potential for inappropriate results. In view of the difficulty of the issues, the novelty of the basic approach the government would be taking, and the potential for serious disruption of ongoing commercial activity due to (even seemingly minor) choices made in designing the rules, we strongly recommend that the government not issue such guidance in a form that would have current application, at least to the large majority of taxpayers. Rather, it would be important for taxpayers and practitioners to have an opportunity to review and comment on the guidance formulated by the government, before the guidance becomes effective. If Treasury and the IRS determine there are limited, clearly identified classes of taxpayers as to whom it is urgent to issue guidance with a current effective date in order to forestall potential abuse, such as inverted corporations, the government could make the new guidance currently effective only as to those taxpayers, in the form of temporary regulations, while either leaving the rules in proposed form for the large majority of affected taxpayers or, possibly, issuing the rules with an effective date for the large majority of affected taxpayers that is several years from now, with generous transition and grandfathering rules and with an expressly stated expectation that the rules may be further revised following comment by the public.

With that overview as a backdrop, we proceed to list below the specific recommendations made in the report. In making these recommendations, we should note the report does not analyze the validity of the Proposed Regulations, and nothing we say is meant to imply a view on that issue. Rather, we only analyze ways in which we think the Proposed Regulations could be modified to make them more consistent with their stated intent, while reducing the likelihood of unexpected application to, and adverse impact on, transactions not undertaken for the purposes at which the Proposed Regulations are aimed.

II. BACKGROUND

A. Section 385

Congress enacted Section 385 in the Tax Reform Act of 1969 in recognition of the difficulties in distinguishing between debt and equity instruments. Section 385 gave the Secretary of the Treasury broad authority to determine whether an interest in a corporation is treated as debt or stock. The statute was initially enacted as part of a larger attempt by Congress to limit the use of debt issued to shareholders in exchange for, or in addition to, stock in a corporate merger.[15] In addition to Section 385, the Tax Reform Act of 1969 included the enactment of Section 279, which limited the interest deduction available to a corporation with respect to its "corporate acquisition indebtedness." Nevertheless, Congress recognized that the debt-equity line-drawing problem also exists in other, non-merger contexts.

Rather than addressing interest deductions as in Section 279, Section 385 gives Treasury the authority to issue regulations to determine whether an instrument is debt or equity. Section 385 lists five factors that may be taken into account by regulations in determining with respect to a particular factual situation whether a debtor-creditor relationship exists, although no particular factor or weighting is mandated.[16]

The Section 385 grant of authority remained unexercised by Treasury for more than a decade. On March 24, 1980, Treasury published proposed regulations under Section 385.[17] These proposed regulations were revised and finalized on December 31, 1980 and were made effective with respect to instruments issued after April 30, 1981 (the "**1980 Regulations**").[18] The 1980 Regulations recharacterized debt instruments as equity based on a number of factors, including (1) whether the debt instruments were issued to stockholders in substantially the same proportion as stock holdings, (2) whether the debt instruments derive a substantial amount of value from "equity like" features, such as conversion features or contingent payments, and (3) whether the issuer and the holder of the debt instrument generally acted as independent parties (*e.g.*, with respect to the interest rate, the permitted leverage, diligence upon an issuer default).[19]

Although the 1980 Regulations were finalized, they were never applicable to any debt instruments. On May 4, 1981, after receiving several significant comments, the 1980 Regulations

[15] S. Rep. No. 91-552, at 137 (1969) ("It is a difficult task to draw an appropriate distinction between dividends and interest, or equity and debt. Although the problem of distinguishing debt from equity is a longstanding 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 acquisitions purposes.")

[16] Tax Reform Act of 1969, Pub. L. 91-172, § 415(a). The five factors are: (1) whether there is a written, unconditional promise to pay on demand or on a specified date a sum certain in money in return for an adequate consideration in money or money's worth and to pay a fixed rate of interest; (2) whether there is subordination to or preference over any indebtedness of the corporation; (3) the ratio of debt to equity of the corporation; (4) whether there is convertibility into the stock of the corporation; and (5) the relationship between holdings of stock in the corporation and holdings of the interest in question. The factors listed in the statute as passed in 1969 have not been amended or modified in any way since.

[17] Prop. Treas. Reg. §§ 1.385-1 to -12, 45 Fed. Reg. 18959, 18973 (Mar. 24, 1980).

[18] Treas. Reg. §§ 1.385-1 to -10, 45 Fed. Reg. 86438, 86459 (Dec. 31, 1980).

[19] *Id*.

were amended to apply to instruments issued after December 31, 1981.[20] On January 5, 1982, Treasury published significant revisions to the 1980 Regulations in the form of revised proposed regulations.[21] To provide the opportunity for comment on the revised proposed regulations, the 1980 Regulations were further amended to apply to instruments issued after June 30, 1982, with the expectation that revised final regulations would be published before then.[22] The 1980 Regulations were amended on July 2, 1982 to apply to instruments issued 90 days after the publication of revised regulations, in order to provide Treasury and the IRS with additional time to respond to the comments on the 1982 proposed regulations.[23] No revised regulations were published. On July 6, 1983, Treasury withdrew the 1982 proposed regulations and proposed the withdrawal of the 1980 Regulations.[24] On November 3 1983, the 1980 Regulations were withdrawn, without having been applicable to any debt instrument.[25]

On December 19, 1989, with no implementing regulations then effective, Congress amended Section 385(a) to expressly authorize Treasury to treat an instrument as "in part stock and in part indebtedness," rather than solely as one or the other.[26] The amendment was made in recognition of the fact that "[i]nstruments often possess some debt-like and some equity-like characteristics and thus cannot readily be classified under present-law principles either wholly as debt or wholly as equity."[27] The legislative history indicates that the amendment was viewed as a clarification rather than a substantive revision.[28]

In 1992, Congress added new paragraph (c) to Section 385, which requires a holder of an interest in a corporation to treat that interest as equity or debt in accordance with the corporation's treatment, unless the holder discloses its inconsistent treatment on its federal income tax return.

B. Other Debt-Equity Guidance

In the absence of administrative guidance, the factors for determining whether an instrument is properly classified as debt or equity have largely been determined by case law. By 1969,

20 46 Fed. Reg. 24945, 24946 (May 4, 1981).

21 47 Fed. Reg. 147, 148 (Jan. 5, 1982).

22 *Id.*

23 47 Fed. Reg. 28915, 28916 (July 2, 1982).

24 48 Fed. Reg. 31054 (July 6, 1983).

25 48 Fed. Reg. 50711, 50712 (Nov. 3, 1983).

26 Omnibus Budget Reconciliation Act of 1989, Pub. L. 101-239, § 7208(a)(1) – (2).

27 16 Legislative History of the Omnibus Budget Act of 1989, Pub. L. 101-239, 103 Stat. 2106, at S13132.

28 *Id*.

one tax commentator identified at least 38 different factors considered by different courts,[29] and the list has not shrunk since that time. One often-cited case lists sixteen factors relevant to the debt-equity analysis.[30] Another frequently cited case, decided a few years later, lists thirteen factors relevant to its debt-equity analysis, which differ in significant respects from the earlier case just referenced.[31] Numerous other cases have utilized some of the factors listed in those cases, or new factors;[32] and the IRS, for its part, has published guidance listing several non-exclusive factors relevant to the analysis.[33]

[29] *See* Robert S. Holzman, *The Interest-Dividend Guidelines*, 47 TAXES 4 (1969); *see also* Plumb, *supra* note 7, at 530.

[30] Fin Hay Realty Co v. Comm'r, 398 F.2d 694 (3d Cir. 1968). Although this case is often cited, it was not the first case to turn the debt-equity analysis into a list of factors. *See, e.g.*, Wilbur Security Co. v. Comm'r, 279 F.2d 657 (9th Cir. 1960); John Kelley Co. v. Comm'r, 326 U.S. 521 (1946); Gilbert v. Comm'r, 262 F.2d 512, 514 (2d Cir. 1959); Gokey Prop., Inc. v. Comm'r, 34 T.C. 829, 835 (1960), *aff'd*, 290 F.2d 870 (2d Cir. 1961); Brake & Elec. Sales Corp. v. United States, 185 F. Supp. 1, 3 (D. Mass. 1960), *aff'd*, 287 F.2d 426 (1st Cir. 1961).

The sixteen factors listed in *Fin Hay Realty* are: (1) the intent of the parties; (2) the identity between creditors and shareholders; (3) the extent of participation in management by the holder of the instrument; (4) the ability of the corporation to obtain funds from outside sources; (5) the "thinness" of the capital structure in relation to debt; (6) the risk involved; (7) the formal indicia of the arrangement; (8) the relative position of the obligees as to other creditors regarding the payment of interest and principal; (9) the voting power of the holder of the instrument; (10) the provision of a fixed rate of interest; (11) a contingency on the obligation to repay; (12) the source of the interest payments; (13) the presence or absence of a fixed maturity date; (14) a provision for redemption by the corporation; (15) a provision for redemption at the option of the holder; and (16) the timing of the advance with reference to the organization of the corporation.

[31] Est. of Mixon v. United States, 464 F.2d 394 (5th Cir. 1972). The thirteen factors in *Estate of Mixon* are: (1) the names given to the certificates evidencing the indebtedness; (2) the presence or absence of a fixed maturity date; (3) the source of payments; (4) the right to enforce payment of principal and interest; (5) participation in management flowing as a result; (6) the status of the contribution in relation to regular corporate creditors; (7) the intent of the parties; (8) "thin" or adequate capitalization; (9) identity of interest between creditor and stockholder; (10) source of interest payments; (11) the ability of the corporation to obtain loans from outside lending institutions; (12) the extent to which the advance was used to acquire capital assets; and (13) the failure of the debtor to repay on the due date or to seek a postponement.

[32] *See*, *e.g.*, Thompson v. Comm'r, 73 T.C. 878 (1980); TIFD III-E, Inc. v. United States, 459 F.3d 220 (2d Cir. 2006); Laidlaw Transp., Inc. v. Comm'r, 75 T.C.M. 2598 (1998); Notice 94-47, 1994-1 C.B. 357.

[33] Notice 94-47, 1994-1 C.B. 357. The eight factors are: (1) whether there is an unconditional promise on the part of the issuer to pay a sum certain on demand or at a fixed maturity date that is in the reasonably foreseeable future; (2) whether holders of the instruments possess the right to enforce the payment of principal and interest; (3) whether the rights of the holders of the instruments are subordinate to the rights of general creditors; (4) whether the instruments give the holders the right to participate in the management of the issuer; (5) whether the issuer is thinly capitalized; (6) whether there is identity between the holders of the

Whatever the number of factors cited, the case law makes clear that no one characteristic is determinative, and each characteristic must be weighted as appropriate based on the particular facts and circumstances of the case.[34]

The fact-specific nature of the analysis has led some courts to abandon the listing of factors in favor of an attempt to return to first principles. For example, the court in *Nestlé Holdings, Inc. v. Commissioner*,[35] considered three fundamental questions in determining whether an instrument was properly treated as debt: (1) whether there was an intention to create a debt; (2) whether there was a reasonable expectation of payment; and (3) whether the arrangement was consistent with the economic reality of a debtor-creditor relationship.[36] The multitude of debt-equity factors also has tended to make it somewhat more difficult to predict the outcome of cases involving more complex securities.[37]

C. The New Proposed Regulations under Section 385

As indicated above, the Proposed Regulations contain three key sets of rules: (1) the Part-Stock Rule, which permits the government in some cases to treat a debt instrument issued within a corporate group as in part stock and in part debt;[38] (2) the Documentation Rules, which require taxpayers to maintain documentation establishing certain material facts related to debt issued within a group;[39] and (3) the Per Se Stock Rules, which require that instruments issued within a group that would qualify as debt under general tax principles be treated as stock in specified circumstances.[40] Following a description of key principles and defined terms that apply to all three sets of rules, each set of rules is summarized below.

instruments and stockholders of the issuer; (7) the label placed on the instruments by the parties; and (8) whether the instruments are intended to be treated as debt or equity for nontax purposes.

34 *See, e.g.*, Universal Castings Corp. v. Comm'r, 9 AFTR 2d 1588 (7th Cir. 1962); John Kelley Co., 326 U.S. at 530 ("[N]o one characteristic… can be said to be decisive in the determination of whether the obligations are risk investments in the corporations or debts."); Fin Hay Realty Co., 398 F.2d at 694; Gilbert, 262 F.2d at 514; Gokey Prop., Inc., 34 T.C. at 835; Brake & Elec. Sales Corp., 185 F. Supp. at 3; Laidlaw Transp., Inc. v. Comm'r, 75 T.C. Memo 2598 (1998).

35 70 T.C.M. 682 (1995).

36 *Id., citing* Litton Bus. Sys. Inc. v. Comm'r, 61 T.C. 367 (1973).

37 *See, e.g.*, PepsiCo Puerto Rico, Inc. v. Comm'r, T.C. Memo 2012-269 (2012) (IRS challenged taxpayer's classification of hybrid securities; Tax Court considered thirteen debt-equity factors, and agreed with the taxpayer's treatment of the arrangement as equity).

38 Prop. Treas. Reg. § 1.385-1(d).

39 Prop. Treas. Reg. § 1.385-2.

40 Prop. Treas. Reg. § 1.385-3; *see* Prop. Treas. Reg. § 1.385-4.

1. General Principles and Defined Terms

The Proposed Regulations generally apply to debt instruments between two members of an expanded group (an "**EG**").[41] Instruments that are in form debt, and are between two EG members, are referred to as expanded group instruments (or "**EGIs**").

The term expanded group is generally defined by reference to Section 1504(a), with some changes that are specific to the Proposed Regulations. An EG is a group of corporations where (1) a common parent owns directly or indirectly at least 80% of the stock (by vote or value) of at least one other group member, and (2) at least 80% of the stock (by vote or value) of each corporate member is owned directly by one or more other corporate members.[42] Unlike a Section 1504 affiliated group, members of an EG can include tax-exempt corporations, insurance companies, foreign corporations, S corporations, corporations held indirectly (for example, through partnerships), and other entities that are excluded from the definition of affiliated group under Section 1504(b).[43]

For purposes of the Proposed Regulations, stock is treated as owned indirectly if it is owned by application of the attribution rules of Section 304(c)(3).[44] That section generally applies the attribution rules of Section 318, but with the following modifications: (1) shareholders are treated as owning their proportionate ownership of the stock owned by a corporation in which the shareholders have a 5% or greater interest, and (2) a corporation is treated as owning the stock owned by its 5% or greater shareholders in proportion to the shareholders' holdings in the corporation (but if a shareholder holds 50% or more of the stock of the corporation, that corporation is treated as owning all the stock owned by the shareholder).[45] The other downward attribution rules of Section 318 apply, which means that a partnership is treated as owning all of the stock owned by its partners, regardless of the percentage interest of its partners.[46]

The Proposed Regulations generally do not apply to debt between members of a consolidated group. All the members of a consolidated group are treated as a single corporation for purpose of applying the rules in the Proposed Regulations.[47]

If a debt instrument (or portion thereof) is deemed to be exchanged for stock under the Proposed Regulations, the holder is treated as having realized an amount equal to the holder's

41 Preamble, at 20919.

42 Prop. Treas. Reg. § 1.385-1(b)(3).

43 *Id.*; Preamble, at 20919.

44 Prop. Treas. Reg. § 1.385-1(b)(3)(ii).

45 Section 304(c)(3).

46 *Id.*

47 Prop. Treas. Reg. § 1.385-1(e).

adjusted basis in the instrument (or portion thereof) as of the date of the deemed exchange.[48] The issuer of the instrument is treated as having retired the instrument (or portion thereof) for an amount equal to the instrument's adjusted issue price as of the date of the deemed exchange.[49] This exchange therefore would generally be treated as a nontaxable transaction, for both holder and issuer, subject to the potential for exchange gain or loss under Section 988.[50] Neither party to the transaction accounts for any accrued but unpaid qualified stated interest or any Section 988 exchange gain or loss on this interest.[51]

2. The Part-Stock Rule

The Part-Stock Rule authorizes the IRS to treat an EGI that is issued between members of a modified expanded group (a "**MEG**") as in part debt and in part stock to the extent that an analysis, as of the issuance of the EGI, of the relevant facts and circumstances concerning the EGI under general federal tax principles results in a determination that the EGI is properly treated as in part indebtedness and in part stock.[52]

An MEG is generally determined in the same manner as an EG, but with the 80% ownership threshold reduced to 50%.[53] Additionally, if 50% of the capital or profits interests in a partnership are owned directly or indirectly by other members of the MEG, that partnership is treated as a member of the MEG.[54] Finally, any person that owns 50% of the value (without regard to voting power) of the stock of an MEG group member is treated as a member of the MEG.[55]

The Part-Stock Rule is effective for debt instruments issued (or deemed issued as a result of an entity classification election made) on or after the date the Proposed Regulations are published in final form.[56]

[48] Prop. Treas. Reg. § 1.385-1(c).

[49] *Id*.

[50] *Id*.

[51] *Id*. Although not entirely clear, it appears this rule means that an accrual method EG member is not entitled to a deduction for the accrued interest if it is the borrower, and is not required to include such interest income (or increase its basis in the debt by such interest) if it is the lender.

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

[53] Prop. Treas. Reg. § 1.385-1(b)(5).

[54] Indirect ownership for this purpose is determined by treating parent entities as owning the assets of their subsidiary entities in proportion to ownership interests. Prop. Treas. Reg. § 1.385-1(b)(4)–(5).

[55] Prop. Treas. Reg. § 1.385-1(b)(5).

[56] Prop. Treas. Reg. § 1.385-1(f).

3. The Documentation Rules

Taxpayers meeting certain threshold tests are required under the Documentation Rules to prepare certain contemporaneous documentation with respect to EGIs.[57] This documentation is not a substitute for the other requirements set forth in the case law for treating an instrument as indebtedness.[58] Rather, the documentation is a minimum requirement in order for the IRS to respect the taxpayer's classification of the instrument.[59] If the Documentation Rules are not satisfied, the instrument will be treated as equity.[60] However, the Documentation Rules cannot be used affirmatively by the taxpayer.[61] Consequently, if a principal purpose of the taxpayer's failure to comply with the Documentation Rules is to reduce the federal tax liability of a member of the EG, the taxpayer's noncompliance with the rule would not cause an EGI to be treated as equity.[62]

The rule does not apply to small taxpayers.[63] More specifically, the rule applies only if (1) stock of a member of the EG is traded on (or subject to the rules of) an established financial market within the meaning of Treas. Reg. § 1.1092(d)-1(b); (2) total assets of the EG or any EG member exceed $100 million on any applicable financial statements, or (3) total annual revenue of the EG or any EG member exceeds $50 million on any applicable financial statement.[64]

For each EGI that is subject to the Documentation Rules, the following written documentation must be prepared within 30 days of the date the EGI is issued:[65] (1) documentation establishing that the EGI issuer has an unconditional and legally binding obligation to pay a sum

[57] Prop. Treas. Reg. § 1.385-2(a)(1).

[58] *Id*.

[59] *Id*.

[60] *Id*.

[61] Prop. Treas. Reg. § 1.385-2(e).

[62] *Id*.

[63] Prop. Treas. Reg. § 1.385-2(a)(2).

[64] An applicable financial statement is a financial statement of an EG member that lists the assets and revenue of that member and that was prepared within 3 years prior to the date the instrument at issue becomes an EGI. An applicable financial statement is (1) a financial statement required to be filed with the Securities and Exchange Commission, (2) a certificated audited financial statement that is accompanied by a report of an independent certified public accountant (or similar independent professional, in the case of a non-U.S. entity) that is used for purposes of credit, reporting to shareholders, partners or similar persons, or any other substantial non-tax purpose, or (3) any financial statement required to be provided to any government or governmental agency. *Id*.

[65] Prop. Treas. Reg. § 1.385-2(b)(3). These documentation rules apply when an instrument is treated as an EGI when issued. It appears that the rules also apply to an instrument that becomes an EGI after it is issued. *See* Prop. Treas. Reg. § 1.385-2(b)(3)(ii)(A).

certain on demand or at one or more fixed dates; (2) documentation establishing that the EGI holder has rights similar to those of a creditor to enforce the obligation;[66] and (3) documentation containing information establishing a reasonable expectation that the issuer will be able to meet its obligations under the EGI.[67] In the case of an instrument deemed redeemed and reissued under Treas. Reg. § 1.1001-3, new documentation establishing the issuer's reasonable expectation of repayment must be prepared.[68]

In addition to the above, documentation must be maintained recording each payment of principal or interest due under the EGI.[69] If the issuer does not make a payment of interest or principal that is due and payable under the terms of the EGI, documentation must be maintained evidencing the holder's reasonable exercise of the diligence and judgment of a creditor.[70] These documents must be prepared within 120 days of the payment due date or the event of default, as applicable.[71] The documents must be retained 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.[72]

Revolving credit agreements and cash pooling arrangements are subject to special documentation rules, discussed in detail later in this report.[73]

An EGI that is treated as stock as a result of the application of the Documentation Rules is generally treated as stock as of the date the instrument is issued or becomes an EGI.[74] If, on the other hand, the EGI is recharacterized as a result of the behavior by the issuer or holder after the EGI is issued, the EGI will be recharacterized as stock as of the date of that behavior.[75]

If an equity EGI that would be treated as indebtedness but for the Documentation Rules ceases to be an EGI, the issuer is treated as issuing a new debt instrument to the holder in ex-

66 Rights of a creditor typically include the right to trigger an event of default or acceleration of the payment of principal of the EGI. The EGI must also provide for a right to the assets of the issuer that is senior to the rights of shareholders in the case the issuer is dissolved. Prop. Treas. Reg. § 1.385-2(b)(2)(i)–(ii).

67 Prop. Treas. Reg. § 1.385-2(b)(2)(v).

68 Prop. Treas. Reg. § 1.385-2(b)(2)(iii); Prop. Treas. Reg. § 1.385-2(b)(3)(ii)(B).

69 Prop. Treas. Reg. § 1.385-2(b)(2)(iv)(A).

70 Prop. Treas. Reg. § 1.385-2(b)(2)(iv)(B).

71 Prop. Treas. Reg. § 1.385-2(b)(3).

72 Prop. Treas. Reg. § 1.385-2(b)(4).

73 *See* Part VII.B.

74 Prop. Treas. Reg. § 1.385-2(c)(3)(i).

75 Prop. Treas. Reg. § 1.385-2(c)(3)(ii).

change for the equity EGI immediately before the transaction that causes the equity EGI to cease to be an EGI.[76]

An EGI of an entity that is disregarded from a member of the EG that is treated as equity under the Documentation Rules is treated as equity of the disregarded entity.[77] Consequently, if the EGI is not owned by the disregarded entity's single shareholder, the disregarded entity will become a partnership as a result of a recharacterization under these rules.[78]

For purposes of the Documentation Rules, a partnership that is 80% owned (either by capital or profits) directly or indirectly by members of an EG (a "**Controlled Partnership**") is treated as a member of the EG, and can therefore be treated as holding or issuing an EGI.[79] An EGI of a partnership that is treated as equity under the Documentation Rules is treated as equity of the partnership.[80] Indirect ownership for this purpose is determined by applying constructive ownership principles in accordance with Section 304(c)(3), presumably by applying the rules of Section 304(c)(3) as if the interests in the partnership were stock in a corporation.

The Documentation Rules are effective for debt instruments issued (or deemed issued as a result of an entity classification made) on or after the date the Proposed Regulations are published in final form.[81]

4. The Per Se Stock Rules

Under the Per Se Stock Rules, certain debt instruments (or portions thereof) are automatically recharacterized as equity even if they would otherwise be treated as indebtedness for tax purposes.[82] The rules cannot, however, be used affirmatively by the taxpayer.[83] Consequently, if a principal purpose of the taxpayer's transaction is to reduce the federal tax liability of a member

[76] Prop. Treas. Reg. § 1.385-2(c)(2)(ii).

[77] Prop. Treas. Reg. § 1.385-2(c)(5). By contrast, debt of a disregarded entity recharacterized under the Per Se Stock Rules is treated as stock of the EG member that owns the entity. Prop. Treas. Reg. § 1.385-3(d)(6).

[78] *Id*.

[79] This treatment of partnerships as separate entities is in contrast to the treatment of partnerships under the Per Se Stock Rules, which treat partnerships as aggregates of partners. Prop. Treas. Reg. § 1.385-2(c)(6)(i); Prop. Treas. Reg. § 1.385-3(d)(5)(i).

[80] By contrast, debt recharacterized as equity under the Per Se Stock Rules is treated as stock of the corporate partner to whom the EGI is allocated, as discussed in further detail below, rather than as equity of the partnership. Prop. Treas. Reg. § 1.385-2(c)(6)(ii); Prop. Treas. Reg. § 1.385-3(d)(5)(ii).

[81] Prop. Treas. Reg. § 1.385-2(f).

[82] Prop. Treas. Reg. § 1.385-3(a).

[83] Prop. Treas. Reg. § 1.385-3(e).

of the EG by triggering the application of the Per Se Stock Rules, the Per Se Stock Rules do not apply.[84]

The Per Se Stock Rules contain two key provisions: the General Per Se Rule, and the Funding Rule. Pursuant to the General Per Se Rule, a debt instrument issued between members of an EG will be treated as stock if the instrument is issued (1) in a distribution, (2) in exchange for stock of a member of the EG, other than in an exempt exchange,[85] or (3) in exchange for property in an asset reorganization, but only to the extent that an EG member receives the instrument with respect to its stock of the transferor corporation. For purposes of the Per Se Stock Rules, an asset reorganization is any reorganization other than a reorganization described in Section 368(a)(1)(B) or (a)(1)(E).[86]

In addition, under the Funding Rule, a debt instrument must be treated as stock if it is issued by a corporation (the "**funded member**") to a member of its EG with a principal purpose of funding any of the following types of actions by the funded member: (1) a distribution of property by the funded member to a member of the EG, other than certain distributions of stock pursuant to an asset reorganization; (2) an acquisition of stock of an EG member, other than in an exempt exchange, by the funded member from an EG member in exchange for property (other than stock of an EG member); or (3) an acquisition of property by the funded member in an asset reorganization, but only to the extent that a member of the EG that is a party to the reorganization receives boot in the reorganization with respect to its stock in the transferor corporation.[87] In the remainder of this report, "**distributions and acquisitions**" means distributions and acquisitions by an EG member of the kinds described in either the General Per Se Rule or the Funding Rule.

For purposes of the Funding Rule, a debt instrument generally is treated as issued by the funded member with a principal purpose of funding a distribution or acquisition based on a review of all the facts and circumstances.[88] Nevertheless, the 72-Month Per Se Rule represents a key exception to this general approach. If a debt instrument is issued by the funded member

[84] *Id*.

[85] An exempt exchange is a stock acquisition in which the transferor and transferee are parties to an asset reorganization and either (1) Section 361(a) or (b) applies to the transferor of the stock and the stock is not transferred by issuance, or (2) Section 1032 or Treas. Reg. § 1.1032-2 applies to the transferor and the stock is distributed by the transferee pursuant to a plan of reorganization. Prop. Treas. Reg. § 1.385-3(b)(2)(i)-(ii).

[86] Prop. Treas. Reg. § 1.385-3(b)(2), (f)(1).

[87] Prop. Treas. Reg. § 1.385-3(b)(3). The Proposed Regulations provide that a distribution or acquisition by the funded member will not be recharacterized for tax purposes, as a result of the recharacterization of the debt instrument subject to the Per Se Stock Rules to equity. Prop. Treas. Reg. § 1.385-3(b)(3)(vi).

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

within the 72-month period beginning 36 months before, and ending 36 months after, the date of a distribution or acquisition, then the instrument is irrebuttably presumed to have been issued with a principal purpose of funding that distribution or acquisition, unless the debt instrument arises in the ordinary course of the funded member's trade or business.[89]

There are three exceptions to the application of the Per Se Stock Rules. First, a debt instrument otherwise subject to recharacterization under the Per Se Stock Rules is recharacterized only to the extent the amount of the debt exceeds the current-year earnings and profits of the funded member (the "**Current E&P Exception**").[90] Second, a debt instrument otherwise subject to recharacterization under the Per Se Stock Rules is recharacterized only if the aggregate amount of all debt instruments subject to the Per Se Stock Rules exceeds $50 million (the "**$50 Million Exception**").[91] Third, the Funding Rule will not be triggered by a funded member's acquisition of stock issued to it by a corporation in its EG in exchange for the funded member's contribution of property to that EG member, as long as the funded member holds over 50% (by vote and value) of the stock of that corporation[92] for at least three years following the stock acquisition (the "**Stock Acquisition Exception**").[93] If the Stock Acquisition Exception applies, the corporation whose stock is acquired is generally treated as the successor to the funded member, but only to the extent of the amount contributed to that corporation by the funded member, and only with respect to any debt instrument (not otherwise treated as equity under the Per Se Stock Rules) issued by the funded member within 36 months before or after the acquisition of that corporation's stock.[94]

[89] Prop. Treas. Reg. § 1.385-3(b)(3)(iv)(B)(1)-(2). To meet the ordinary course of business exception, the debt instrument must be issued in connection with the purchase of property or the receipt of services to the extent it reflects an arm's length obligation to pay an amount that is currently deductible by the issuer under Section 162 or currently included in the funded member's cost of goods sold or inventory. Prop. Treas. Reg. § 1.385-3(b)(3)(iv)(B)(2).

[90] Prop. Treas. Reg. § 1.385-3(c)(1).

[91] If the $50 million threshold is exceeded in a later year, the entire principal amount of each debt instrument is subject to recharacterization, but only as of the date the threshold is passed. Prop. Treas. Reg. § 1.385-3(c)(2).

[92] Eligibility for the Stock Acquisition Exception is determined by taking into account direct and indirect ownership by applying the principles of Section 958(a) (looking through both foreign and domestic subsidiary entities in proportion to the parent's stock ownership). Prop. Treas. Reg. § 1.385-3(c)(3).

[93] If the acquirer fails to meet the ownership requirement at some time after the stock of the applicable corporation has initially been acquired, then the Stock Acquisition Exception is no longer satisfied, and a debt instrument issued within 36 months before or after the date of the stock acquisition that would otherwise treated as debt, can be recharacterized as equity. The recharacterization occurs as of the date that the "more than 50%" ownership requirement fails to be satisfied. *Id*.

[94] Prop. Treas. Reg. § 1.385-3(f)(11)(ii).

A successor of the funded member is treated as the funded member for purposes of determining whether a distribution or acquisition that triggers the Per Se Stock Rules has occurred.[95] A successor is the acquiring corporation in a transaction described in Section 381(a) in which the funded member is the distributor or transferor. Special rules apply to spin-off transactions.[96]

The Per Se Stock Rules also contain an anti-abuse provision, which states that a debt instrument is treated as stock if the instrument is issued with a principal purpose of avoiding the application of the Per Se Stock Rules. This rule also applies to instruments that are not debt instruments, if they are issued with the principal purpose of avoiding the application of the Per Se Stock Rules.[97]

A debt instrument that is treated as stock under the Per Se Stock Rules is generally treated as stock when the debt instrument is issued.[98] However, if the instrument is treated as stock as a result of a distribution or acquisition that occurs after the date the instrument is issued, the instrument will generally be treated as stock as of the date of the distribution or acquisition.[99] If the issuer or holder of a debt instrument treated as stock under the Per Se Stock Rules ceases to be members of the same EG, then the debt instrument is treated as reissued immediately prior to the transaction that causes the holder or issuer to leave the EG.[100] In such a case, every other debt instrument issued between members of the EG is retested under the Per Se Stock Rules to determine whether the instrument is recharacterized as stock.[101] An instrument recharacterized as stock as a result of such a retesting is deemed exchanged for stock as of the date of the retesting.[102]

As noted above, members of a consolidated group are treated as a single corporation for purposes of the Proposed Regulations.[103] Accordingly, debt instruments issued between mem-

[95] Prop. Treas. Reg. § 1.385-3(b)(3)(v). The single exception is that a distribution by a target entity treated as a successor of a funding entity under the Stock Acquisition Exception to that funding entity does not trigger the Funding Rule. Prop. Treas. Reg. § 1.385-3(f)(11)(ii).

[96] Prop. Treas. Reg. § 1.385-3(f)(11). *C.f.* Treas. Reg. § 1.382-2(a)(5), (6).

[97] The Proposed Regulations contain examples involving transactions where the taxpayer avoids the rules by issuing a debt instrument to an entity that is not a member of the EG. Prop. Treas. Reg. § 1.385-3(b)(3)(v). *See*, *e.g.*, Prop. Treas. Reg. § 1.385-3(g)(3), Ex. 9.

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

[99] Prop. Treas. Reg. § 1.385-3(d)(1)(ii).

[100] Prop. Treas. Reg. § 1.385-3(d)(2).

[101] Prop. Treas. Reg. § 1.385-3(d)(2); s*ee*, *e.g.*, Prop. Treas. Reg. § 1.385-3(g)(3), Ex. 7.

[102] Prop. Treas. Reg. § 1.385-3(d)(1)(iv); s*ee*, *e.g.*, Prop. Treas. Reg. § 1.385-3(g)(3), Ex. 7.

[103] *See* Prop. Treas. Reg. § 1.385-1(e); Prop Treas. Reg. § 1.385-4(a).

bers of a consolidated group are not subject to the Per Se Stock Rules.[104] If a debt instrument is sold by a member of a consolidated group to a member of the EG that is not also a member of the consolidated group, the debt instrument is deemed to be newly issued in exchange for the property received by the transferor, for purposes of the Per Se Stock Rules.[105] If a debt instrument is issued between members of the consolidated group, and the issuer or the holder leaves the consolidated group but remains a member of the EG, then: (1) if the debt instrument would have been treated as stock had the Per Se Stock Rules applied within a consolidated group, the debt instrument is treated as exchanged for stock immediately following the exit by the issuer or holder of the debt instrument from the consolidated group; and (2) if the debt instrument would not otherwise be treated as stock under the Per Se Stock Rules had the rules applied within a consolidated group, the debt instrument may still be treated as stock if a distribution or acquisition occurs within three years of the issuance of the debt instrument within the consolidated group.[106]

For purposes of the Per Se Stock Rules, a Controlled Partnership is treated as an aggregate of its partners.[107] Consequently, an EG member that owns an interest in a Controlled Partnership is treated as owning a share of the Controlled Partnership's assets, and as having issued debt equal to its share of the Controlled Partnership's debt, in the same proportion as the Controlled Partnership's allocation of profits.[108] If the Controlled Partnership issues a debt instrument to a member of the EG that is, under the rule just described, treated as having been issued in part by an EG member that is a partner in the Controlled Partnership, and that part of the relevant debt is recharacterized as equity under the Per Se Stock Rules, then the EG member that holds the debt instrument is treated for U.S. federal income tax purposes as owning stock of the partner EG member (as opposed to an interest in the Controlled Partnership) as a result of its ownership of the debt.[109]

If a debt instrument that is issued by a disregarded entity is treated as equity under the Per Se Stock Rules, that instrument is treated as stock of the disregarded entity's owner.[110] Therefore

[104] Prop. Treas. Reg. § 1.385-1(e).

[105] Prop. Treas. Reg. § 1.385-4(b)(2); *see, e.g.*, Prop. Treas. Reg. § 1.385-4(d)(3), Ex. 1 and 2.

[106] Prop. Treas. Reg. § 1.385-4(b)(1).

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

[108] *Id*.

[109] Prop. Treas. Reg. § 1.385-3(d)(5)(ii).

[110] Prop. Treas. Reg. § 1.385-3(d)(6).

a disregarded entity would not be converted into a partnership as a result of the application of the Per Se Stock Rules.[111]

The Per Se Stock Rules are generally effective for debt instruments issued (or deemed issued as a result of an entity classification election made) on or after April 4, 2016, but only distributions or acquisitions that occur on or after April 4, 2016 are taken into account for purposes of applying these rules.[112] In addition, where a debt instrument issued before the date the regulations are finalized would otherwise be treated as stock under the Per Se Stock Rules, the debt instrument will be treated as debt until 90 days after the Proposed Regulations have been issued in final form.[113]

III. SUMMARY OF RECOMMENDATIONS

1. Prop. Treas. Reg. § 1.385-3 should not be finalized. Instead, the government should put forward more targeted guidance to address the planning that is of concern to it for public review and comment. *Parts I, page 1, and VIII, page 77.*

2. In the rules defining an EG, Prop. Treas. Reg. § 1.385-1(b)(3)(i)(B) should be revised to state that the term "directly or indirectly" will be substituted for "directly" both in Section 1504(a)(1)(B)(i) and (B)(ii), rather than just in (B)(i). Thus, both Section 1504(a)(1)(B)(i) and (B)(ii) would be deemed to refer to stock "owned directly or indirectly," rather than just stock "owned directly." This change would help clarify that subsidiaries that are indirectly 80% owned by EG members, through non-EG members, are included in the EG, as is apparently intended. *Part IV.A, page 39.*

3. In the rules defining an EG, the downward attribution rules (Section 318(a)(3)) should be modified, so that they apply only where 80% of an entity is owned (directly or constructively) by the person from whom attribution is sought. The same 80% threshold should be used, regardless of whether the subsidiary to which ownership is attributed is a partnership, a trust, or a corporation. In addition, where a subsidiary is owned 80% or more, the downward attribution rules should attribute 100% of the stock owned by the parent to the subsidiary. By comparison, where the 80% threshold is not satisfied, proportionate attribution under Section 304(c)(3)(B)(ii)(II) should not be imposed. *Part IV.B, page 41.*

4. It should be clarified that even though an entity can be a member of multiple EGs, any particular EG can have only a single common parent. Accordingly, where a corporation is

[111] *See id.*; Preamble to the Proposed Regulations (the "**Preamble**"), Notice of Proposed Rulemaking, *Treatment of Certain Interests in Corporations as Stock or Indebtedness*, REG–108060–15, at 20912, 20927.

[112] Prop. Treas. Reg. § 1.385-3(h)(1)–(2).

[113] Prop. Treas. Reg. § 1.385-3(h)(3).

owned 80% by vote by one parent and 80% by value by another parent, and the two parents are not otherwise related, the two parents should not be members of the same EG merely by virtue of owning shares of that corporation. *Part IV.C, page 43.*

5. The definition of MEG should be modified to apply to groups with a chain of ownership of greater than 50%, rather than exactly 50% ownership. In addition, in the definition of MEG, changes should be made corresponding to recommendations 2–4 above. *Part IV.D, page 43.*

6. Assuming Prop. Treas. Reg. § 1.385-1(d) (the Part-Stock Rule) is concerned largely with cases where an MEG member may only be able to partially repay an EGI, the Proposed Regulations should be revised to eliminate the Part-Stock Rule as a standalone provision. Instead, this rule should be incorporated into the portion of the Documentation Rules that requires the preparation of documentation evidencing a reasonable expectation of repayment, in Prop. Treas. Reg. § 1.385-2(b)(2)(iii). Specifically, a taxpayer should be considered to have satisfied this requirement in the Documentation Rules, with respect to that portion of the amounts due under an EGI that the issuer is reasonably expected to repay; and the remainder of the instrument should be treated as equity. *Part V.A, page 45.*

7. If the concerns that underlie the Part-Stock Rule are significantly broader than the types of cases described in recommendation 6, then Prop. Treas. Reg. § 1.385-1(d) should state clearly the principles that will be relevant to determinations of whether to bifurcate an EGI, and how to split up the instrument’s terms between the debt and equity components. In addition, the government should consider whether the principles adopted in the Part-Stock Rule to bifurcate debt will be applicable only to debt between members of a MEG, or should have more general relevance. *Part V.A, page 45.*

8. If the Part-Stock Rule remains a separate rule and is not incorporated into the Documentation Rules as proposed in recommendation 6, then Treasury and the IRS should add operating rules to the Part-Stock Rule that are generally similar to the operating rules that apply under the Documentation Rules. In particular, operating rules should be provided to address the situation of a person that is not a corporation, but is treated as an MEG member under Prop. Treas. Reg. § 1.385-1(b)(5) because such person owns at least a 50% interest in another MEG member. These operating rules should confirm that the Part-Stock Rule only applies to EGIs where the issuer is a corporation in the MEG or is a non-corporate entity majority owned by corporations in the MEG (to the extent of such corporations’ ratable ownership). *Part V.B, page 49.*

9. The government should clarify how the Documentation Rules are intended to fit with the framework established by existing case law for analyzing whether an instrument is debt or equity. That is, the government should explain the extent to which the Documentation Rules only provide a requirement to prepare documents showing that the debt satisfies certain debt-

equity factors as articulated under current law, rather than imposing new substantive requirements. In general, the rules should establish only requirements to prepare documents, rather than substantive rules. A few specific suggestions along these lines are provided for the first two of the four types of documentation required under the Documentation Rules (*i.e.*, documentation supporting that there is a sum certain payable at a fixed date, and that the holder has creditor's rights). *Part VI.A, page 51.*

10. The Documentation Rules should provide more detailed guidance about the nature and contents of the required documentation to establish a reasonable expectation of ability to repay the EGI (the third type of required documentation). This could take the form either of specific minimum requirements as to what the documentation should consist of, or illustrative examples of sufficient documentation. It should be confirmed that the relevant documentation can be provided by third parties (*e.g.*, a financial institution) or by internal staff, including internal tax personnel; but, regardless of who prepares the documentation, the EG should be viewed as standing behind the documentation's accuracy and thoroughness. *Part VI.A.2, page 55.*

11. Under the Documentation Rules, ability to pay is reevaluated if the EGI is deemed reissued under Treas. Reg. § 1.1001-3. It should be clarified that at the time of a significant modification, as long as a related-party lender can demonstrate that a third party would have agreed to the modification on terms that are not substantially less favorable to the borrower, the lender is not subject to any additional documentation obligations. *Part VI.A.2, page 55.*

12. In the Documentation Rules concerning reasonable exercise of the diligence of a creditor (the fourth required type of documentation), it should be acknowledged that related parties often have legal considerations that differ from those applicable to unrelated parties due to their related status: for example, fraudulent conveyance laws or similar legal rules may apply to a related-party lender that would not apply to a third party. It should be confirmed that an evaluation of the sufficiency of a related-party lender's actions should take into account these differences in legal status. In other words, the Documentation Rules should compare the related-party lender's actions with those expected from an unrelated party operating under the same legal framework or constraints as the related-party lender. *Part VI.A.3, page 57.*

13. Prop. Treas. Reg. § 1.385-2(b)(3)(ii) should provide that for purposes of the first three types of documentation (sum certain, creditor's rights, and ability to repay), a "relevant date" will occur only at the time an instrument is issued by one member of the EG to another member, taking into account deemed reissuances under Treas. Reg. § 1.1001-3. Thus, the date when an old-and-cold debt instrument becomes an EGI should not be a relevant date for providing documentation required under the Documentation Rules, unless the EGI undergoes a significant modification under Treas. Reg. § 1.1001-3 at such time. Also, a change in the issuer of an EGI should not be a relevant date, if that change does not result in a significant modification. *Part VI.A.3, page 57.*

14. Instead of providing that documentation must be prepared within 30 days of a relevant date (in the case of the first three types of documentation) or 120 days after a relevant date (in the case of the fourth type), the Documentation Rules should provide that the required documentation must be prepared by the due date for the filing of the first U.S. tax return of an EG member that will be impacted by the treatment of the EGI as debt or equity. *Part VI.B.1, page 58.*

15. It should be clarified who must prepare and maintain the applicable documentation under the Documentation Rules. *Part VI.B.1, page 58.*

16. If the Documentation Rules are extended to apply to instruments that are not indebtedness in form, they should only apply to instruments which, if recharacterized under general tax principles, would typically be treated as stock of the issuer. *Part VI.B.2, page 61.*

17. Instruments for which treatment as debt is specifically contemplated by a provision of the Code or regulations should be exempted from the Documentation Rules and the Per Se Stock Rules. *Part VI.B.2, page 61, and IX.C.3(a), page 106.*

18. The Documentation Rules should only apply to EGIs that are issued at least a few months after the rules are finalized. *Part VI.B.3, page 63.*

19. The government should clarify and expand the special Documentation Rules in Prop. Treas. Reg. § 1.385-2(b)(3)(iii) dealing with cash pooling arrangements, in order to better fit with the fact that, typically, each borrowing by an EG member pursuant to such an arrangement is not separately documented and is not subject to a separate credit evaluation. *Part VII.B, page 66.*

20. The government should include provisions in the Documentation Rules that are similar to those referenced in recommendation 19, for other short-term ordinary-course financing, such as payables for intragroup provision of goods or services. *Part VII.B, page 66.*

If the government opts to continue with some form of the Per Se Stock Rules, then the changes to the Proposed Regulations described in recommendations 21–56 should be made:

21. The Per Se Stock Rules should be revised to give favorable treatment to short-term intragroup loans made pursuant to cash pooling arrangements. The specific nature of the revisions that should be made to the rules will depend on which of our broader recommendations about the Per Se Stock Rules are accepted. In particular, if recommendation 27 below is accepted (to replace the 72-Month Per Se Rule with a rebuttable presumption in favor of treating a loan as made for a principal purpose of funding a distribution or acquisition, if the loan is made within a period of 1 to 2 years before or after a distribution or acquisition), then the rules should provide a rebuttable presumption in favor of <u>not</u> treating loans made pursuant to a cash pooling arrangement as having a principal purpose of funding a distribution or acquisition. Limitations should be provided in order to ensure that the rebuttable presumption just described for loans pursuant to a

cash pooling arrangement is not available for long-term loans that are not tied to temporary working capital requirements or liquidity needs. For this purpose, a long-term loan could be defined as one paid after more than one year. *Part VII.C, page 68.*

22. In the case of all short-term (one year or less) debt between EG members issued outside a cash pooling arrangement, favorable rules should apply that are parallel to those described in recommendation 21. However, these favorable rules should not apply to a short-term loan by a U.S. EG member to a first-tier CFC. In addition, these rules should not apply to short-term debt that is issued as consideration for a purchase of EG stock from an EG member or for an acquisition of assets from an EG member in an asset reorganization. *Part VII.D, page 75.*

23. Transactions between foreign EG members should be excluded from the Per Se Stock Rules. For this purpose, an EG member should not be treated as foreign, if it has a U.S. branch that represents a large part of its assets. *Part IX.A.1, page 88.*

24. Under the Per Se Stock Rules, a debt instrument should be recharacterized as stock only if, and to the extent that, the amount of the debt eligible to be recharacterized by reason of a distribution or acquisition exceeds the amount of equity capital received by the EG member issuing the debt from other EG members in transactions connected with the distribution or acquisition. *Part IX.A.2, page 92.*

25. The 72-Month Per Se Rule should be eliminated. *Part IX.B.1, page 94.*

26. In addition to eliminating the 72-Month Per Se Rule, the Funding Rule should be narrowed, so that it applies only in the event that a loan of cash or property is made between EG members with a principal purpose of accomplishing the same economic result as a distribution or acquisition described in the General Per Se Rule. Stated differently, the Funding Rule should apply only where (x) the funded EG member incurs intragroup debt and uses the proceeds to make a distribution or pay consideration in an acquisition, and (y) the EG member that receives the distribution or the acquisition consideration also provides (directly or indirectly) to the funded member the assets used to make that distribution or to pay that consideration, as part of an overall plan. *Part IX.B.2, page 97.*

27. In addition to eliminating the 72-Month Per Se Rule, if recommendation 26 is not accepted, then other changes should be made to the Funding Rule. Specifically, the Funding Rule should be revised to provide a rebuttable presumption in favor of treating a borrowing of cash or property by an EG member, as having been incurred with a principal purpose of funding a distribution or acquisition by such EG member, if the borrowing and the distribution or acquisition occur within a period of, say, one to two years. That presumption should yield to countervailing rules that would, at least presumptively, carve out from the Funding Rule debt incurred in the borrower's conduct of conventional commercial activities that are unlikely to be used for U.S.

tax avoidance. This would include the rules referenced in recommendations 21 and 22 above and recommendations 28–30 below. *Part IX.B.3, page 99.*

28. The government should provide favorable treatment under the Per Se Stock Rules for intragroup debt issued in connection with the acquisition of a target corporation's stock or assets from an unrelated seller, or in connection with post-acquisition integration of a recently acquired corporation's stock or assets into the EG. More specifically, the Per Se Stock Rules should exempt intragroup debt issued by an EG member (M) if (i) M's equity capital does not decrease as a result of issuing the debt, (ii) the issuance of the debt is part of a plan, pursuant to which either (a) M acquires assets (including stock of a corporation) from an unrelated party, or (b) M acquires assets (including stock of a corporation) that recently have been acquired directly or indirectly by any other member of the EG from an unrelated party, and (iii) the unrelated party receives as consideration for the relevant assets, from any member of the EG, cash, notes or rights to future payments at least equal to the principal amount of the intragroup debt. *Part IX.C.1, page 101.*

29. The government should provide favorable treatment under the Per Se Stock Rules for intragroup debt issued in connection with a disposition of stock or assets outside the EG. Specifically, the Per Se Stock Rules should exempt intragroup debt issued by M if (i) M's equity capital does not decrease as a result of issuing the debt, (ii) the issuance of the debt is part of a plan pursuant to which M acquires assets (including stock of a corporation) from other EG members that are worth the principal amount of the debt, and (iii) M ceases to be a member of the EG shortly afterward and continues to hold the assets described in (ii). *Part IX.C.1, page 101.*

30. If it is established that an EG member is issuing a debt instrument in exchange for cash, services or property in the conduct of its normal business activities, on terms appropriate for those activities, then there should be a rebuttable presumption that the debt instrument is not issued with a principal purpose of funding a distribution or acquisition (and thus is not subject to the Funding Rule). Final regulations should provide specific examples of transactions that are covered by the presumption, as well as examples of the types of adverse facts that would overcome the presumption. *Part IX.C.2, page 103.*

31. For purposes of the Funding Rule, an intragroup debt instrument should not be treated as having a principal purpose of funding a distribution or acquisition, if the federal tax laws expressly link that distribution or acquisition by the funded EG member with a specific source of funds other than the proceeds of the issuance of the debt. For example, Treas. Reg. § 1.1032-3 expressly links a subsidiary's acquisition of stock of a parent with a deemed cash payment of consideration by the subsidiary to the parent for such stock. In view of this, a loan to that subsidiary from another EG member logically should not be viewed as funding the acquisition by the subsidiary of stock of the parent. *Part IX.C.3(b), page 108.*

32. A distribution made by an EG member under Section 305(a), 332, 336(b) or 355, or any distribution by an EG member of "old and cold," non-fungible property that it has owned for a substantial period of time, should not be treated as an event that could cause the Funding Rule to apply to debt issued by that EG member. *Part IX.C.3(c), page 109.*

33. The government should clarify the circumstances in which the anti-abuse rule in Prop. Treas. Reg. § 1.385-3(b)(4) is intended to apply. It should be expressly confirmed that choosing to borrow from an unrelated third party, rather than from an EG member, in order to fund a distribution or acquisition does not trigger the anti-abuse rule. In addition, it should be clarified that debt instruments subject to the anti-abuse rule are recharacterized as stock only to the extent they are issued and held by members of the same EG. *Part IX.D.1, page 111.*

34. The government should eliminate the rule in Prop. Treas. Reg. § 1.385-3(e) preventing affirmative use of the Per Se Stock Rules. Alternatively, if the government rejects that recommendation, then the "no affirmative use" rule should be clarified in several respects. It should be confirmed whether the rule applies, in a case where one EG member receives a benefit, which is offset by another EG member's loss of a larger tax benefit, as a result of the recharacterization of debt under the Per Se Stock Rules. In addition, the government should clarify at what point in time it must be determined whether the EG has a principal purpose of applying the rules to achieve a tax benefit; more specifically, it should be confirmed that an EG's purpose will be determined based on the facts as of the time the intragroup debt in question is issued, and that a principal purpose will not be found to exist unless it is reasonably expected as of such time that the EG will achieve a non-*de minimis* net benefit due to application of the Per Se Stock Rules. Also, when determining the benefit considered to arise due to application of the Per Se Stock Rules, it should be considered whether the issuer of the debt could have instead issued an equity instrument with comparable terms, or taken other actions, such that the EG would be expected to achieved the same net benefit without additional costs. *Part IX.D.2, page 111.*

35. Any future guidance issued in place of the proposed Per Se Stock Rules should not be effective immediately, at least for the large majority of taxpayers. Instead, such guidance either should be issued entirely in proposed form, or else should have immediate application only to limited, clearly defined categories of taxpayers engaged in what is seen as abusive structuring—inverted corporations, for example—with other taxpayers receiving an opportunity to review and comment on the rules before they become more broadly effective. *Part IX.E, page 115.*

36. The Current E&P Exception should be applied based on the amount of the prior year's current E&P, or based on an average of prior years' current E&P. *Part X.A, page 116.*

37. The government should give consideration to expanding the scope of the Current E&P Exception, so that it includes an EG member's total undistributed E&P for all periods after

the effective date of the final regulations in which it was a member of the same EG, as it is on the date the exception is applied to a given debt instrument. *Part X.A, page 116.*

38. It should be clarified that the Current E&P Exception applies to protect intragroup debt instruments that are issued during a taxable year, without taking into account distributions or acquisitions by the EG member of cash or property that may never be relevant under the Per Se Stock Rules (*i.e.*, distributions of cash or property that are not yet linked under the Funding Rule to the issuance of a debt instrument that would, but for application of the Current E&P Exception, be recharacterized as equity). *Part X.A, page 116.*

39. If an EG exceeds the dollar threshold for the $50 Million Exception, but can show reasonable cause for being unaware that it has done so, then: (1) the intragroup debt protected by the $50 Million Exception should continue to be covered by the exception so long as the EG, within a relatively short time (say, 90 days) after becoming aware of exceeding the $50 million threshold, reduces to $50 million or less the amount of debt that would be subject to recharacterization under the Per Se Stock Rules; and (2) if the EG fails to reduce the amount of such debt to $50 million within the applicable time period, then the debt should be deemed to be converted to equity at time the EG became aware the threshold was exceeded (rather than the earlier time when the relevant distribution or acquisition occurred). *Part X.B, page 119.*

40. The Stock Acquisition Exception should be broadened to cover most cases in which an EG member pays with cash or property to buy EG stock, and that EG member continues after the stock purchase to have an indirect ownership interest (through one or more EG members) in the cash or property given as consideration. *Part X.C, page 120.*

41. The Proposed Regulations should provide that, when a debt instrument is recharacterized as stock under the Per Se Stock Rules, the consequences will be as follows:

a. The stock will not be recast as a type of interest other than stock, under common-law principles that treat some equity with debt-like characteristics as not being stock for federal tax purposes. *Part XI.A.1, page 123.*

b. The stock will not be treated as fast-pay stock. *Part XI.A.2, page 123.*

c. An EG member's holding period in such stock should not be treated as tolled under Sections 246 and 901(k) as a result of the fact that the stock gives the holder creditor's rights against the issuer. *Part XI.A.3, page 124.*

d. For purposes of determining whether the 10% voting stock requirement in Section 902 is satisfied with respect to dividends on the stock, Section 304(c)(3) attribution rules will apply. *Part XI.A.4, page 125.*

e. The stock will not be treated as a splitter arrangement for purposes of Section 909. *Part XI.A.5, page 126.*

f. The stock will be treated as preferred stock for purposes of Section 305, or as stock that is subject to Sections 306 or 351(g), depending on its economic features. The government should consider whether to issue guidance under Section 351(g)(4) to the effect that debt that is recharacterized under the Per Se Stock Rules, and that as recharacterized is nonqualified preferred stock, will be treated as not stock for purposes of the ownership tests in Sections 368(c) and 1504. *Part XI.A.6, page 127.*

g. The application (or non-application) of Treas. Regs. §§ 1.988-5 and 1.1275-6, Section 954(c)(1)(D) and Section 1221(a)(4) in respect of that stock should be described in the final regulations. *Part XI.A.7, page 128.*

h. If the issuer of the stock is a U.S. EG member and the holder is a foreign EG member, then the final regulations should describe the analysis that the U.S. EG member must perform to determine the appropriate rate of U.S. withholding tax payable on dividends under an applicable treaty. *Part XI.A.8, page 128.*

i. Final regulations should set forth the consequences for the issuer and the holder where part, but not all, of a debt instrument is recharacterized as stock under the Per Se Stock Rules. The government should consider whether, and to what extent, the principles adopted here should correspond to the approach taken under the Part-Stock Rule. *Part XI.A.9, page 129.*

42. When the issuer or holder of a recharacterized debt instrument ceases to be a member of the EG, the deemed exchange of stock for debt that is contemplated by Prop. Treas. Reg. § 1.385-2(c)(2)(ii) and Prop. Treas. Reg. § 1.385-3(d)(2) should normally be treated as a redemption that is a sale or exchange under Section 302(a). *Part XI.B, page 130.*

43. When an instrument has been recharacterized as equity, and an EG member sells the instrument outside the EG, the EG member should be treated as having sold the deemed equity to the third-party acquirer in a Section 1001 transaction. The third-party acquirer, however, should be treated as having acquired a debt instrument in that transaction. *Part XI.B, page 130.*

44. The consequences of a redemption of debt that has been recharacterized as stock under the Per Se Stock Rules should be specified in final regulations. *Part XI.B, page 130.*

45. In the Per Se Stock Rules, it should be confirmed that aggregate treatment was not intended for partnerships other than Controlled Partnerships, and that loans to non-controlled partnerships by EG members thus are not within the scope of the Per Se Stock Rules. If there are cases where a loan to a non-controlled partnership could be recharacterized under the anti-abuse rule in Prop. Treas. Reg. § 1.385-3(b)(4), then one or more examples to that effect should be included in final regulations. *Part XII.B.1, page 134.*

46. The Per Se Stock Rules should provide that, in a case where debt issued by a Controlled Partnership to an EG member is recharacterized pursuant to Prop. Treas. Reg. § 1.385-3(d)(5) as equity of an EG member that is a partner in such partnership (an "**EG Partner**"), the "appropriate adjustments" that must be made include treating that EG Partner as having made a loan to the Controlled Partnership, in an amount that is equal to the loan that has been recharacterized as equity of such EG Partner. Under this approach (which we refer to as the "deemed conduit" approach in the report), the total amount of debt on the Controlled Partnership's books does not change; only the identity of the lender would change. *Part XII.B.1* – 6, *pages 134–143.*

47. Application of the Per Se Stock Rules to an EG Partner depends on what portion of a loan made by another EG member to the Controlled Partnership is attributable to that EG Partner. Prop. Treas. Reg. § 1.385-3(d)(5) attributes a portion of such a loan to the EG Partner based on its interest in partnership profits. Consideration should be given to using an approach under Prop. Treas. Reg. § 1.385-3(d)(5) that is based on allocation of debt to an EG Partner under Section 752 principles. *Part XII.B.7, page 146.*

48. The definition of Controlled Partnership in Prop. Treas. Reg. § 1.385-1(a)(1) looks to whether EG members own at least 80% of the capital or profits interests in the partnership. For purposes of measuring the partners' profits interests, consideration should be given to the use of a reasonable estimate of the partners' aggregate profit shares over time, in order to prevent frequent "flips" in and out of an EG. In addition, instead of having the definition refer to percentages of capital interests in the Controlled Partnership, consideration should be given to allowing the use of a metric focused on cumulative shares of profit. Failing adoption of such a rule, consideration should be given to allowing taxpayers leeway to ignore small or transitory shifts in capital that result in one or another partner exceeding 80% of total capital accounts. *Part XII.C.1, page 153.*

49. Prop. Treas. Reg. § 1.385-3(d)(5) should have no application to cases where there is a Controlled Partnership that is not subject to Subchapter K. *Part XII.C.2, page 156.*

50. There are no time limitations on the definitions of predecessor and successor in Prop. Treas. Reg. § 1.385-3(f)(11)(i), resulting in an extension of the Funding Rule well beyond the 6-year period in the 72-Month Per Se Rule. Because the predecessor/successor rules should operate consistently with the scope of the Funding Rule, they should be limited and consistent with the Funding Rule provided in the final regulations. If our recommendation to eliminate the 72-Month Per Se Rule (recommendation 25) is accepted, then the determination of whether a member is a predecessor or successor should be determined by looking at whether there is a principal purpose to avoid the Per Se Stock Rules. If our recommendation 25 is not adopted, then the predecessor/successor rules should be limited consistent with the timeframe chosen for the 72-Month Per Se Rule. *Part XIII.A.2, page 158.*

51. The government should consider whether every spin-off that qualifies under both Section 368(a)(1)(D) and Section 355, including a transaction of this type in which the distributing and controlled corporations both remain within the EG, should be carved out from the predecessor/successor rules. *Part XIII.A.2, page 158.*

52. The Per Se Stock Rules should be revised to eliminate the possibility that multiple loans will be recharacterized as equity on account of the same distribution or acquisition. More specifically, when a debt is recharacterized as equity under the Per Se Stock Rules, the deemed issuance of that equity, a transfer of that deemed equity within the EG, or an actual or deemed redemption of that equity should not be treated as a distribution or acquisition to which the Per Se Stock Rules can apply. *Part XIII.B, page 159.*

53. Prop. Treas. Reg. **§** 1.385-3(d)(2) provides that when a debt instrument recharacterized as equity under Per Se Stock Rules ceases to be held within the EG, other intragroup loans that have been made to the issuer of that instrument must be re-tested, to determine whether any of those loans should now be treated as equity by reason of having been made within 3 years of the distribution or acquisition that had previously caused the original instrument to be recharacterized. This rule should be eliminated. *Part XIII.B, page 159.*

54. The government should clarify when a corporation's status as a member of an EG will be tested for purposes of the Per Se Stock Rules. In the case of a corporation that, as part of a transaction or series of related transactions, becomes a member of an EG, it should normally be treated as a member of that EG, for purposes of testing whether its transactions with members of such EG are subject to recharacterization under the Per Se Stock Rules. Conversely, a corporation should normally be treated as a member of an EG for purposes of analyzing a transaction between it and another group member under the Per Se Stock Rules even if, as part of a plan, it will shortly be leaving the group. *Part XIII.C, page 162.*

55. It should be clarified that in order for the Per Se Stock Rules to apply, a corporation's issuance of a debt instrument and a distribution or acquisition must both occur while the corporation is a member of the same EG (or is treated under the rules described in recommendation 54 as being a member of that EG). If that recommendation is adopted, then the rules also should address a case where multiple corporations move from one EG to another, with an issuance of debt occurring among those corporations when they are all members of one of the EGs and a distribution or acquisition occurs when they are all members of the other EG. *Part XIII.C, page 162.*

56. Technical corrections should be made to Prop. Treas. Reg. § 1.385-3(g)(3), Example 12. *Part XIII.D, page 164.*

57. The government should clarify the manner in which Prop. Treas. Reg. §1.385-1(e) interacts with other Code provisions and regulations, when analyzing a transaction between one

or more members of a consolidated group, and corporations in the EG that are outside the consolidated group. Specifically, the government should expressly confirm that the appropriate order of operations is first, to apply provisions of the Code and regulations other than the Proposed Regulations, treating the members of the consolidated group as separate entities for purposes of applying those rules; and then, to apply the Proposed Regulations to the transaction as it is characterized under those other provisions of the Code and regulations, treating the members of the consolidated group as a single corporation for purposes of applying the Proposed Regulations and determining whether to recast an intragroup debt instrument as equity. *Part XIV, page 164.*

58. For purposes of the Part-Stock Rule and the Documentation Rules, a loan between a member of the consolidated group, and a Controlled Partnership wholly owned by members of the same consolidated group, should be disregarded. This would be the same result as applies under the Per Se Stock Rules. *Part XIV, page 164.*

59. If a departing member of a consolidated group owes debt to, or holds debt of, another member of the consolidated group, and the departing member remains in the EG, then the debt instrument generally should be treated for purposes of the Per Se Stock Rules as being reissued immediately following the member's departure from the consolidated group. This would be consistent with the treatment of a debt instrument that is sold (or otherwise transferred) by a member of a consolidated group to an EG member that is not part of the consolidated group. The only exception to our proposed rule is that, if the debt instrument was issued by or to the departing member of the consolidated group as part of a plan that included the member's departure from the consolidated group, then the debt should be recast as stock when the member departs from the consolidated group, if it would have previously been recast as stock had the exception for debt between consolidated group members not applied. *Part XIV, page 164.*

60. A foreign EG member should not be subject to the Part-Stock Rule or the Documentation Rules for debt issued to another foreign EG member, at a time when both of them were not CFCs and were not required to file U.S. tax returns. An exception should be provided to cover a case where the original transaction between the foreign EG members, and a later transaction whereby one or both of those corporations becomes a U.S. corporation, CFC, or subject to U.S. tax return filing obligations, occur with a view to avoiding the Proposed Regulations. For purposes of these rules, a foreign corporation that is not a CFC, and that files only a protective U.S. income tax return on which it does not report effectively connected income (or, in the case of a foreign corporation eligible for treaty benefits, reports only income not connected with a U.S. permanent establishment) should be treated the same as a corporation not required to file a U.S. tax return. *Part* XV*, page 168.*

61. The Proposed Regulations should not be broadened to cover debt issued by blocker corporations to funds, beyond the coverage already provided by the rules as currently drafted. *Part XVI, page 170.*

IV. DEFINITION OF EXPANDED GROUP

The "expanded group" concept provides the fundamental threshold of relatedness which Treasury and the IRS decided to be appropriate for imposition of the more stringent debt-equity rules in the Proposed Regulations. As discussed above, an EG is an affiliated group as defined in Section 1504(a), but taking into account the entities that would otherwise be excluded from an affiliated group under Section 1504(b). In addition, the requirement under Section 1504(a)(1)(B)(i) that the common parent own 80% of the stock of at least one member corporation is modified to include both direct and indirect 80% ownership, by vote or value. The requirement under Section 1504(a)(1)(B)(ii), that each corporate member of the group (other than the common parent) be directly owned at least 80% by another corporate member, was not modified to include "indirect" ownership. For purposes of the Proposed Regulations, stock is treated as owned indirectly if it is owned by application of the attribution rules of Section 304(c)(3), which applies the attribution rules of Section 318, with the modifications discussed in further detail above.

A. Direct versus Indirect Ownership in a Chain of Related Corporations

In defining the EG, Treasury and the IRS built on the definition of affiliated group but attempted to capture corporate entities that are economically related even where there is no single corporation that is directly owned 80% or more by a common parent, as long as there is a corporate parent with indirect 80% ownership of at least one member of the group. The expansion of the concept of an affiliated group was apparently a reflection of the fact that the Proposed Regulations were intended to address the "incentives for related parties to engage in transactions that result in excessive indebtedness,"[114] and that parties can be related even if they are not connected by a direct chain of corporate ownership.

As noted, although the common parent prong of the EG test utilizes indirect ownership, the prong to determine group corporate membership by its terms does not. This difference between the two prongs appears to lead to results that are inconsistent with the basic intent of the Proposed Regulations.

> *Example 1.* C wholly owns S1. S1 wholly owns S2.[115]

> *Example 2.* C wholly owns S1, which owns 79% of S2. S1 also owns 50% of another corporation that owns the remaining 21% of S2.

[114] *See* Preamble, at 20914.

[115] In examples in this report, unless stated otherwise, all entities are treated as corporations for U.S. federal income tax purposes. In addition, entities the names of which include "US," "F," or "CFC" are, respectively, domestic, foreign, or controlled foreign corporations. Unless specifically stated, the corporations in the examples are not members of the same consolidated group.

In Example 1, each of C, S1 and S2 are members of the EG, since C, the common parent, directly owns 80% or more of S1, and S1 directly owns 80% or more of S2. In Example 2, however, it is not clear whether S2 is a member of the EG. On one hand, for purposes of Section 1504(a)(1)(B)(i), concerning whether the group's parent owns 80% or more of at least one other group member, C is deemed to own more than 80% of S2, due to the Section 318(a)(2) attribution rules.[116] On the other hand, Section 318 attribution literally is applied only for purposes of determining whether Section 1504(a)(1)(B)(i) is satisfied, and not whether Section 1504(a)(1)(B)(ii) is satisfied (requiring that each EG member be at least 80% owned by one or more other EG members). One might read the Proposed Regulations as deliberately drawing a distinction here, with the result that S2 must be directly owned by one or more other group members, in order to be a member of the EG.[117] However, this result seems unwarranted. Economically, C and S1 have exposure to more than 80% of S2's stock, since S1 is exposed to 79% of S2 directly, and to 10.5% of S2 though its 50% interest in the third party.

In addition, because Controlled Partnerships are treated differently under the Documentation Rules and the Per Se Stock Rules, a requirement that corporate members of an EG (other than the common parent) must be directly owned 80% or more by other corporate members creates ambiguity in certain cases.

> *Example 3*. C wholly owns S1, which owns 90% of LP, a limited partnership. LP owns all the shares of S2.

In this example, LP is a Controlled Partnership, and for purposes of the Documentation Rules would be a member of the EG that includes C and S1, but under the definition of EG, S2 would not appear to be a member of the EG for purposes of these rules. However, under the Per Se Stock Rules, a Controlled Partnership is treated as the aggregate of its owners, and each owner is treated as owning its proportionate share of the assets of the Controlled Partnership. This suggests that S2 might be treated as a member of the EG for purposes of the Per Se Stock Rules, even if it was not treated as a member of the EG under the Documentation Rules.[118]

[116] See Section 304(c)(3)(B)(i) and Section 318(a)(2)(C), which attribute a pro rata portion of the S2 stock owned by the related corporation to S1.

[117] Since the related corporation is not a member of the group, S2 is not 80% directly owned by members of the group.

[118] See Prop. Treas. Reg. § 1.385-3(g)(3), Ex. 13 (concluding that a corporation owned by a Controlled Partnership is a member of the EG, for purposes of the Per Se Stock Rules).

We note that adopting an approach that relies on the Controlled Partnership look-through rule in the Per Se Stock Rules may undermine the intended scope of the definition of EG. While a corporation owned by a Controlled Partnership would be treated as owned pro rata by its EG partners, stock ownership would not be attributed through a partnership that was not a Controlled Partnership, under such an approach.

We recommend modifying Prop. Treas. Reg. § 1.385-1(b)(3)(i)(B) to state that the term "directly or indirectly" is substituted for "directly" both in Section 1504(a)(1)(B)(i) and (B)(ii). The remainder of this Part IV assumes that this was the intention of the Proposed Regulations.

B. Downward Attribution under Section 318

Indirect ownership for purposes of establishing an EG means ownership by applying the attribution rules of Section 318 as modified by Section 304(c)(3).[119] Section 318(a)(2) attributes stock held by subsidiary entities to their owners ("**upward attribution**"). Section 318(a)(3) attributes stock held by owners to their subsidiary entities ("**downward attribution**").[120] Section 318(a)(5) generally provides, with limited exceptions, that stock considered as owned by an entity by application of upward attribution or downward attribution is treated as actually owned for purposes of reapplying the attribution rules to treat that stock as owned by another person.[121]

Downward attribution is generally more expansive than upward attribution. Upward attribution, if it applies, is proportionate to the parent's ownership interest in the subsidiary.[122] In contrast, downward attribution can apply to attribute 100% of the stock owned by a parent to a subsidiary. Specifically, Section 318(a)(3), as modified by Section 304(c)(3), provides that a subsidiary corporation is treated as owning a share of stock held by the parent corporation that is proportionate to the parent's ownership interest in the subsidiary, if that ownership is more than 5% but less than 50%. However, if the parent's ownership interest in its corporate subsidiary is 50% or more, all of the stock held by the parent is attributed to the subsidiary. In addition, a partnership is treated as owning all of the stock owned by its partners, regardless of the ownership percentages of the partners.

The application of downward attribution in the context of an EG and the Proposed Regulations can yield some surprising results.

> *Example 4*. P1 and P2 are each large, publicly traded corporations that are the common parents of their consolidated groups.

[119] Prop. Treas. Reg. § 1.385-1(b)(3)(ii).

[120] Section 318(a)(4) provides that an option to acquire stock is treated as actual ownership of stock, which can then be attributed upward and/or downward under Section 318(a)(5). Treasury and the IRS should consider limiting option attribution, given the economic difference between direct ownership and owning an option. Option attribution has been limited in some cases (*e.g.*, Section 871(h)(3)(C)), but not in others (*e.g.*, Sections 304 and 958(b)).

[121] An important exception to this rule is that there is no upward attribution after downward attribution (although there can be further downward attribution). Section 318(a)(5)(C).

[122] Upward attribution from corporations applies if the parent owns a 5% or greater interest in the subsidiary. Section 304(c)(3)(B)(i). Upward attribution from partnerships applies if the parent owns an interest in the partnership, no matter how small. Section 318(a)(2)(A).

> P1 and P2 have no relationship to each other, except that they have entered into a joint venture (LP) with other industry participants to develop a product or service. P1's and P2's interests in LP are of small value, compared to the value of the stock of their respective consolidated groups. LP is treated as a partnership for U.S. federal income tax purposes.

Under the downward attribution rules, LP is treated as owning all of the stock owned by its partners. Consequently, LP is treated as owning all of P1's subsidiaries, and all of P2's subsidiaries. Furthermore, because LP is treated as owning 100% of P1's subsidiaries, each of P1's subsidiaries are treated as owning all of the stock treated as owned by LP—including the stock in P2's subsidiaries. Similarly, P2's subsidiaries are treated as owning all of P1's subsidiaries. Applying the EG rules, each of the first-tier subsidiaries of P1 and P2 would be common parents of an EG that includes all of the subsidiaries of P1 and P2. These subsidiaries would also be members of the respective EGs of which P1 and P2 are the parents.

Although P1 and P2's respective ownership interests in JV are not stated in the example above, even small percentage interests in a partnership could cause large corporate groups having no other relationship to each other to be treated as members of an EG. This is a significant trap for the unwary. In addition, unlimited downward attribution appears to expand the Proposed Regulations beyond the concern that motivated them, because small partners in a partnership, with different and diverse shareholder bases, are not in fact related parties that have "enhanced incentives … to engage in transactions that result in excessive indebtedness."[123] In fact, in extreme cases, they may not even be aware of, or be able to determine, their relationship.

We recommend that the downward attribution rules be modified to apply only where 80% of an entity is owned, directly or constructively, by the person from whom attribution is sought. Because the EG definition is apparently intended to capture entities that are closely related economically or by voting control, we see no reason for a different threshold depending on the status of the subsidiary as a partnership, through the application of Section 318(a)(3)(A); as a trust, through the application of Section 318(a)(3)(B); or as a corporation, through the application of Section 318(a)(3)(C). Our recommended restriction would ensure that downward attribution applies only when the subsidiary to which stock ownership is attributed is closely related to its parent. This approach is consistent with the basic choice in the regulation to define EG membership by reference to Section 1504, with its 80% requirement.

If a subsidiary is owned 80% or more directly or constructively, we think it is appropriate that the downward attribution rules attribute 100% of the stock owned by the parent to the subsidiary. However, where the 80% threshold is not satisfied, we do not think that proportionate

[123] Preamble at 20914.

attribution under Section 304(c)(3)(B)(ii)(II) should be imposed. Proportionate attribution would increase the complexity of the rules for seemingly little benefit.

C. Multiple Common Parents

Because a corporation can be a member of an EG if it is owned 80% either by vote or by value, it is possible for a single subsidiary to have two otherwise unrelated corporate parents that would each meet the requirements to be treated as a common parent of the EG, one by vote and the other by value.

> *Example 5*. P1 and P2 are each large, publicly traded corporations that are the common parents of their consolidated groups.
>
> P1 and P2 have no relationship to each other, except that they each own an interest in USS1. P1 owns high-vote low-economics preferred stock carrying 80% of the total voting power of USS1, and 20% of the value. P2 owns common stock carrying 80% of the value of USS1 and 20% of the voting power.

In Example 5, USS1 would be part of an EG with P1 and with P2, each of which would be common parents. While it is not entirely clear from Section 1504 and the Proposed Regulations, it is possible that P1 and P2 could be treated as co-common parents of a single EG, in which case P1, P2 and all of their respective subsidiaries would be included in the same EG, without the application of downward attribution. As discussed in Part IV.B above, it seems surprising that otherwise unrelated corporate groups, such as P1's and P2's respective subsidiaries, could be treated as part of the same EG just because they are investors in a single subsidiary.

Treasury and the IRS should clarify that even though an entity can be a member of multiple EGs, any particular EG can have only a single common parent. Accordingly, in Example 5, USS1 would be a member of an EG with P1 as the common parent and also a member of an EG with P2 as the common parent; but P1 and P2 (and each of their subsidiaries) would not belong to a single EG merely by virtue of their joint ownership of USS1.

If Treasury and the IRS revised the attribution rules in the definition of EG to provide that attribution to and from a corporation is based solely on value, as in Section 318(a)(2)(C) and Section 318(a)(3)(C), rather than vote or value, that would also resolve the issue just described, as well as generally simplifying the attribution rules.

D. Modified Expanded Group

The MEG is determined by applying the rules for determining an EG, except substituting 50% ownership where an EG would require 80% ownership. Consequently, all of the concerns raised in Parts IV.A, IV.B and IV.C above apply equally to the determination of an MEG.

Because an MEG only requires 50% ownership by vote or by value, it is possible for a single subsidiary to have two otherwise-unrelated corporate parents that would each meet the requirements to be treated as a common parent of the MEG:

> *Example 6*. P1 and P2 are each large, publicly traded corporations that are the common parents of their consolidated groups. P1 and P2 have no relationship to each other, except that they each own a 50% interest by vote and by value in USS1.

In Example 6, USS1 is part of an MEG with P1 as the common parent and each of P1's subsidiaries, and a second MEG with P2 as the common parent and each of P2's subsidiaries. [124] While we recognize that it is also possible for a corporation to be a member of multiple EGs (see Example 5, above), membership in multiple MEGs will be much more common, since it would occur in any 50-50 joint venture with corporate partners. It is not clear that this result is intended.

For ease of administration, we recommend that the MEG rules be modified to apply to groups with a chain of ownership of greater than 50%, rather than exactly 50% ownership. This will ensure that an entity can be part of an MEG with at most one group of related entities (or, if attribution is performed both on the basis of vote and value, and those are held in different proportions, at most two groups), similar to the rules for EGs. Downward attribution in an MEG should also be applied in the manner described in Part IV.B above, with a more-than-50% threshold, rather than an 80% threshold.

Under special rules applicable to the definition of an MEG, if a person (as defined in Section 7701(a)(1)) is treated, under the rules of Section 318, as owning at least 50% of the value of the stock of the MEG member, the person is treated as a member of the MEG.[125]

It is not clear whether this expansion of the definition of MEG only applies to a person treated under the rules of Section 318 as owning 50% of the stock of an MEG member, and not to a person owning such stock directly. For example, assume partnership LP owns all of the stock of two corporations, S1 and S2. S1 and S2 are consequently members of an EG, as a result of downward attribution. Although LP directly owns all of the stock of S1 and S2, LP owns neither corporation through application of Section 318. On the other hand, if LP owned all of S1 and S1 owned all of S2, then LP would me a member of the MEG, because LP would be treated as owning all of the stock of S2 through Section 318. It is not clear why these two cases should be distinguished.

We recommend expanding the definition of MEG under Treas. Reg. § 1.385-1(b)(5) to include persons that directly (not just indirectly) own stock of an MEG member in excess of the relevant threshold.

[124] This example assumes that the recommendation in Part IV.C is accepted, and the P1 and P2 groups are not part of a single MEG as a result of the investment.

[125] Prop. Treas. Reg. § 1.385-1(b)(5). This rule only applies to 50% ownership by value, not vote.

V. THE PART-STOCK RULE

The Part-Stock Rule authorizes the IRS to bifurcate an EGI that is issued between members of a MEG into debt and equity components. The bifurcation is authorized to the extent that an analysis, as of the issuance of the EGI, of the relevant facts and circumstances concerning the EGI under general federal tax principles results in a determination that the EGI is properly treated as in part indebtedness and in part stock.

A. Bifurcation Principles

The Preamble states that the Part-Stock Rule was promulgated because, as explained in the legislative history to the 1989 amendment to Section 385, "'there has been a tendency by the courts to characterize an instrument entirely as debt or entirely as equity.' No regulations have been promulgated under the [1989] amendment, however, and this tendency by the courts has continued to the present day….the Treasury Department and the IRS have determined that the interests of tax administration would best be served if the Commissioner were able to depart from the all-or-nothing approach where appropriate to ensure that the provisions of the Code are applied in a manner that clearly reflects the income of related taxpayers."[126] However, the Proposed Regulations by their terms appear to authorize the IRS to bifurcate a debt instrument only in those cases where "general federal tax principles results in a determination that the EGI is properly treated for federal tax purposes as indebtedness in part and stock in part."[127] This wording appears to be in tension with the notion that the proposed rule departs from existing law. As noted above, there is a history of administrative consideration, and rejection, of rules that would bifurcate debt instruments.[128] While there is some older case law bifurcating debt instruments with equity-like payments,[129] other authority suggests that debt with payments tied to the performance of stock generally ought not to be split into two instruments.[130] There does not appear

126 Preamble, at 20914.

127 Prop. Treas. Reg. § 1.385-1(d)(1).

128 *See* Notice of Proposed Rulemaking, *Debt Instruments With Original Issue Discount; Contingent Payments*, 56 Fed. Reg. 8308 (Feb. 28, 1991) (proposing the bifurcation of certain contingent payment debt instruments); Notice of Proposed Rulemaking, *Debt Instruments with Original Issue Discount; Contingent Payments*, 59 Fed. Reg. 64884, 64885 (Dec. 16, 1994) (rejecting the previous bifurcation approach in response to the comments roundly criticizing them).

129 *See, e.g.*, Farley Realty Corp. v. Comm'r. 279 F.2d 701 (2d Cir. 1960); Richmond, Fredericksburg & Potomac R.R. Co. v. Comm'r, 528 F.2d 917 (4th Cir. 1975).

130 Treas. Reg. § 1.1273-2(j) ("The issue price of a debt instrument includes any amount paid for an option to convert the instrument into stock (or another debt instrument) of either the issuer or a related party (within the meaning of section 267(b) or 707(b)(1)) or into cash or other property in an amount equal to the approximate value of such stock (or debt instrument)."); Rev. Rul. 2002-31, 2002-1 C.B. 908 (contingent

to be significant precedent existing at present that interprets general tax principles in a different manner, more amenable to bifurcation, where the parties to a debt instrument are related.

While the Proposed Regulations thus are not phrased as clearly as they might be, it appears to us they are best interpreted as giving the IRS broader discretion than existing bifurcation authority provides (the IRS does not need explicit regulatory authority to treat a debt instrument in accordance with existing case law, and interpreting the Proposed Regulations to do no more than this would render them essentially meaningless). However, the Part-Stock Rule does not elaborate on the principles that it will use, in any particular case, to determine whether an EGI should be bifurcated. We recommend that, in the final version of the Part-Stock Rule, Treasury and the IRS should expressly articulate the criteria that will be utilized to make these decisions.[131] The IRS's interpretation and application of these principles in a particular taxpayer's case would be entitled to deference by the courts.[132]

In this connection, we note that the Proposed Regulations indicate that the Part-Stock Rule may apply to a taxpayer that can only show there is a reasonable expectation of payment of a portion (but not all) of the amounts due under the terms of the debt instrument.[133]

> *Example 7*. Information concerning a $5 million EGI demonstrates that the issuer of the EGI cannot reasonably be expected to repay more than $3 million of the principal amount as of the issuance of the EGI.

convertible debt); Notice 2002-36, 2002-1 C.B. 1029 (same); Chock Full O'Nuts Corp. v. United States, 453 F.2d 300 (2d Cir. 1971).

[131] Clarity is particularly appropriate given the broad application of these rules, which are not restricted to large corporate groups or large transactions, such as the Documentation Rules, but rather apply to all EGIs between members of an MEG.

[132] *See* Mitchell v. Comm'r, 775 F.3d 1243, 1249 (10th Cir. 2015) (where a Treasury regulation is ambiguous, the Commissioner is generally entitled to deference, even if that interpretation appears in a legal brief in a court case arising out of an audit, unless there is "reason to suspect that the interpretation does not reflect the agency's fair and considered judgment on the matter in question"); Union Carbide Corp. v. Comm'r, 697 F.3d 104, 109 (2d Cir. 2012) (same). Notwithstanding the significant degree of judicial deference that would be given to the IRS's application of the rule, it still would be extremely beneficial for principles to be clearly articulated in the Part-Stock Rule, so as to better enable taxpayers to predict, in advance of an audit, the likelihood that the Part-Stock Rule would apply to a particular instrument.

[133] *See* Prop. Treas. Reg. § 1.385-1(d) (second sentence) ("For example, if the Commissioner's analysis supports a reasonable expectation that, as of the issuance of the EGI, only a portion of the principal amount of an EGI will be repaid and the Commissioner determines that the EGI should be treated as indebtedness in part and stock in part, the EGI may be treated as indebtedness in part and stock in part in accordance with such determination, provided the requirements of §1.385-2, if applicable, are otherwise satisfied and the application of federal tax principles supports this treatment."). The Preamble gives an example corresponding to Example 7 in the text as an illustration. Preamble, at 20919.

The second sentence of the Part-Stock Rule indicates that in Example 7, the IRS may treat $3 million of the principal amount of the EGI as indebtedness and the remaining $2 million principal amount as stock.

From this sentence, it appears that Prop. Treas. Reg. § 1.385-1(d) may be concerned largely with the overleveraging of a group member that may result, where there is not a third party to impose financial discipline. Assuming this is the case, then in view of the potential wide application and difficulty of administering the Part-Stock Rule as currently drafted, we recommend that the government revise the Proposed Regulations to eliminate the rule as a standalone provision. Instead, the government should incorporate this rule into the portion of the Documentation Rules that requires the preparation of documentation evidencing a reasonable expectation of repayment, in Prop. Treas. Reg. § 1.385-2(b)(2)(iii) (discussed further below). Specifically, a taxpayer would be considered to have satisfied this requirement in the Documentation Rules, with respect to that portion of the amounts due under an EGI that the issuer is reasonably expected to repay; and the remainder of the instrument would be treated as equity. Under this approach, the government's ability to bifurcate an instrument would be limited, but it would be relatively clear to taxpayers when the rule is expected to apply.[134] The same types of documentation required to show a reasonable expectation of repayment in full, could generally be relied on to show an expectation of partial repayment; and the government would give some specific guidance on the standards or methods that could appropriately be used to establish an ability to repay a particular portion of the debt.

[134] By folding the Part-Stock Rule into the Documentation Rules, the Part-Stock Rule would apply to EGIs between members of an EG (as opposed to an MEG). We recognize that this would have the practical effect of limiting the scope of the rules, because of the higher ownership threshold necessary to be a member of an EG relative to an MEG. However, there does not appear to be a principled reason to distinguish between the 80% ownership threshold relevant for the Documentation Rule and the 50% ownership threshold used in the Part-Stock Rule. A number of the same questions appear to be pertinent for purposes of the analysis under both sets of rules (e.g., whether an instrument provides for a sum certain and a fixed payment schedule, and whether there is a reasonable expectation of repayment).

When discussing the choice of 50% as the ownership threshold for the Part-Stock Rule, rather than a higher threshold, the Preamble suggests that a corporation can issue "excessive indebtedness" to a related party without the need for "special cooperation" between the parties; and it also notes that a 50% threshold is used in other contexts involving related party rules in the Code. However, these statements in the Preamble do not provide a clear explanation of why the lower threshold is necessary for the Part-Stock Rule in particular, while 80% is used in the Documentation Rules, and the Per Se Stock Rules. The rules would be simplified by adopting a common 80% EG standard throughout the Proposed Regulations. This approach would have the added benefit of rendering irrelevant the technical issues concerning the definition of MEG that are identified above in Part IV.D, and the issues concerning whether EGIs that have a non-corporate MEG member as the issuer or holder are subject to the Part-Stock Rule as discussed below in Part V.B.

However, if the concerns that underlie the Part-Stock Rule are significantly broader than the fact pattern described above, then another potential approach would be to provide that the rule applies in cases where only a portion of an EGI meets the criteria set forth in existing case law for being treated as debt. If Treasury and the IRS intend to adopt this approach, this should be explicitly stated in the Part-Stock Rule. Treasury and the IRS should state clearly the principles that will be relevant to determinations of whether to bifurcate an EGI, and how to split up its terms between the debt and equity components.

In this regard, the Part-Stock Rules as drafted would not apply to hybrid instruments, and also would appear not to apply to bifurcate instruments into debt and some type of interest other than stock. Thus, it is not clear whether (apart from the case of over-leverage discussed above) in practice the Part-Stock Rule would often apply, other than in cases where an instrument provides economic terms giving the holder elements of equity risk or return. To the extent the Part-Stock Rule reflects a desire to craft and apply principles that would bifurcate instruments based on whether they have selected economic terms that can be viewed as equity-like, we note the potential challenges associated with such an undertaking. [135] We have previously analyzed the possibility of bifurcating a debt instrument with equity elements, and have suggested that bifurcation may not be feasible because (among other reasons) it is often difficult to separately value the equity component that is implicit in the debt.[136]

Regardless of the approach adopted, Treasury and the IRS should consider whether the principles adopted by the Part-Stock Rule to bifurcate debt are applicable only to debt between

[135] *See, e.g.*, Farley Realty Corp., 279 F.2d at 701 (payment pursuant to lender's right to share in appreciation of mortgaged property could not be deducted as additional interest on mortgage loan); Richmond, Fredericksburg & Potomac R.R. Co., 528 F.2d at 917 (permitting the taxpayer to deduct as interest a portion of the payments on the instrument that were guaranteed, while treating as dividends amounts paid in excess of the guaranteed amount); *cf.* Treas. Reg. § 1.1275-4(b)(4)(vi), *Ex. 2* (debt instrument issued by a corporation linked to its gross receipts treated as a single contingent payment debt instrument). *But see* note 117 *supra* (regulations proposed in 1991 to bifurcate an instrument providing for contingent payments, withdrawn in 1994); Section 163(l) (interest deduction denied on debt where a substantial amount of the principal or interest is required to be determined, or at the option of the issuer or a related party is determined, by reference to the value of the equity of the issuer or a related party); Treas. Reg. § 1.1273-2(j) (not bifurcating convertible debt instruments).

[136] N.Y. ST. BA. ASSN TAX SEC., *Taxation of Straight and Contingent Convertible Debt* (Rep. No. 1022, 2002). This report was issued in response to Notice 2002-36, 2002-1 C.B. 1029, which requested comments on the treatment of convertible debt instruments.

In addition, as summarized earlier in Part II, the government has previously considered, and ultimately not adopted, rules bifurcating debt instruments with equity-like components. In describing criticisms that led Treasury and the IRS to abandon a bifurcation approach in Treas. Reg. § 1.1275-4, Treasury and the IRS noted that according to commentators, "there is rarely a unique set of components into which a contingent payment debt instrument can be bifurcated." 59 Fed. Reg. 64884–85 (Dec. 16, 1994).

members of a MEG, or should apply more generally.[137] If those principles are adopted from case law, there is ample authority for applying the same general debt-equity factors to third-party debt and related-party debt, subject to additional scrutiny in the context of related parties.[138]

B. Operating Rules

If the Part-Stock Rule remains a separate rule and is not incorporated into the Documentation Rules as discussed in the previous section, then we recommend that Treasury and the IRS add operating rules to the Part-Stock Rule that are generally similar to the operating rules that apply under the Documentation Rules. We think that it is more appropriate to analogize operating rules from the Documentation Rules than from the Per Se Stock Rules, because the operating rules in the Per Se Stock Rules contain particular complexities that are necessary to address the Funding Rule.

In particular, operating rules are needed to address the situation of a person that is not a corporation, but is treated as an MEG member because such person owns at least a 50% interest in another MEG member.

> *Example 8*. Individual owns Trust, which owns (in addition to other material assets) over 50% of the stock of Corp A. Corp A owns over 50% of Partnership, which owns all the stock of Corp B. Individual loans $100 to Trust, $200 to Corp A, and $300 to Partnership.

In Example 8, it is not entirely clear which of these loans is intended to be subject to the Part-Stock Rule. On one hand, Individual, Trust, Partnership and the two corporations each appear to be members of an MEG, and each of the loans appears to be an EGI described in Prop. Treas. Reg. § 1.385-1(d)(2), *i.e.*, an EGI between two MEG members. However, the Part-Stock Rule by its terms allows the IRS to treat such an EGI as "in part indebtedness and in part stock"; the reference to "in part stock" suggests the regulation is designed to apply where the issuer of the instrument is a corporation. That is consistent with the reference in Section 385 itself to "an interest in a corporation." On balance, the intent appears to be for the Part-Stock Rule to be broad enough to apply to Individual's loan to Corp A, but not to Individual's loan to Trust.[139]

[137] Neither *Farley Realty Corp*. nor *Richmond, Fredericksburg & Potomac Railroad* considered the relationship of the relevant taxpayer to the holders of the instrument under consideration as relevant to the court's conclusion.

[138] PepsiCo Puerto Rico, Inc. v. Comm'r, T.C. Memo 2012-269 (2012) (noting that transactions between related parties "are susceptible of manipulation and, accordingly, warrant a more thorough and discerning examination for tax characterization purposes.").

[139] This intent is further corroborated by the government's acknowledgement in the Preamble that Section 385 is meant to address the characterization of interests in corporations. *See* Preamble, at 20914.

Individual's loan to Partnership appears to fall somewhere between the cases of the other two loans. On one hand, treating Partnership as a member of the MEG is consistent with the approach taken to Controlled Partnerships in the Documentation Rules; and, under those rules, a loan to a Controlled Partnership is subject to the Documentation Rules. Thus, it would seem that at least a portion of Individual's loan to Partnership, corresponding to Corporation A's proportionate interest in Partnership, could reasonably be treated as being subject to the Part-Stock Rules. However, it is not clear whether this is the intended result. In addition, to the extent a non-corporate member of the MEG is a partner in Partnership, it would seem that such non-corporate member's share of Individual's loan to Partnership probably ought not to be subject to the Part-Stock Rule.[140]

In order to clarify these points, the final regulations should confirm that the Part-Stock Rule only applies to EGIs where the issuer is a corporation in the MEG or is a non-corporate entity majority owned by corporations in the MEG (to the extent of such corporations' ratable ownership). The Part-Stock Rule would otherwise impose an inappropriate burden.

Additional recommended operating rules include:

- *Exit from MEG.* It should be clarified that the Part-Stock Rule applies only while an EGI is held by members of the MEG. If either the issuer or the holder of the EGI leaves the MEG, or if the EGI is transferred to a holder that is not a member of the MEG, then rules similar to those that apply to an EGI treated as equity under the Documentation Rules should apply.[141]

- *Disregarded Entities.* The rules should provide that an EGI recharacterized as partially stock under the Part-Stock Rule will be treated as equity of the disregarded entity, rather than stock of the parent.[142]

- *Exit from Consolidated Group.* It should be clarified that a debt instrument that is between two members of a consolidated group is not subject to the Part-Stock Rule, but upon the exit of either the issuer or the holder of the debt instrument, is treated as issued at that time for purposes of the Part-Stock Rule.[143]

[140] In Example 8, the MEG includes two corporations. It is not entirely clear from the definitions of "expanded group" and "modified expanded group" in Prop. Treas. Reg. § 1.385-1(b)(3) and (4) whether an MEG can exist without at least two corporate members—the corporate parent, described in Section 1504(a)(1)(B)(i) (as incorporated by reference in the definitions of EG and MEG), and a corporate subsidiary, described in Section 1504(a)(1)(B)(ii) (as incorporated by reference in the definitions of EG and MEG)).

[141] *See* Prop. Treas. Reg. § 1.385-2(c)(2).

[142] *See* Prop. Treas. Reg. § 1.385-2(c)(5).

[143] *See* Prop. Treas. Reg. § 1.385-2(c)(4).

VI. THE DOCUMENTATION RULES

A. Required Documents

A taxpayer that is subject to the Documentation Rules is required to maintain written documentation with respect to an EGI that: (1) establishes that the EGI issuer has an unconditional and legally binding obligation to pay a sum certain on demand or at one or more fixed dates; (2) establishes that the EGI holder has rights similar to those of a creditor to enforce the obligation; (3) contains information establishing a reasonable expectation that the issuer will be able to meet its obligations under the EGI; and (4) records each payment of principal or interest on the EGI or, in the event the issuer fails to make a payment of principal or interest that is due and payable under the terms of the EGI, evidences the holder's reasonable exercise of the diligence and judgment of a creditor.

If the necessary documents are timely prepared, "general federal tax principles apply to determine whether, or the extent to which, the EGI is treated as indebtedness for federal tax purposes."[144] On the other hand, if the necessary documents are not timely prepared and properly maintained,[145] the EGI will be treated as stock.[146]

The stated purpose of the Documentation Rules is to "impose discipline on related parties by requiring timely documentation and financial analysis that is similar to the documentation and analysis created when indebtedness is issued to third parties."[147] While the rules are apparently not intended to alter the case law's view of the importance of the various debt-equity factors, "the Proposed Regulations do require a degree of discipline in the creation of necessary documentation, and in the conduct of reasonable financial diligence indicative of a true debtor-creditor relationship, that exceeds what is required under current law."[148]

It is not entirely clear from the Documentation Rules how the requirements imposed by the rules are meant to interact with the existing framework of debt-equity authorities. At least three approaches appear possible. The first is that the Documentation Rules are purely procedural requirements, to provide evidence of the existence of four of an EGI's debt-like characteristics. Under this approach, all substantive evaluation of the evidence provided under the Documenta-

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

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

[146] Treas. Reg. § 1.385-2(b)(1)(i). However, the IRS is not compelled to treat the EGI as debt if the IRS determines that the taxpayer failed to comply with the Documentation Rules with the principal purpose of reducing the federal tax liability of any member of the EG or any other person relying on the characterization of the EGI as indebtedness. Prop. Treas. Reg. § 1.385-2(d).

[147] Preamble, at 20916.

[148] Preamble, at 20916.

tion Rules (and all other relevant evidence), and any determination of the instrument's status as debt or equity, will occur as a separate second step. The Documentation Rules merely establish a requirement to produce supporting documentary evidence, as a precondition to proceeding with this substantive analysis.

This approach would generally be consistent with existing case law,[149] which holds that no subset of the array of debt-equity factors should be substantively evaluated independently of all the other factors in determining whether an instrument should be treated as debt.[150] While the Documentation Rules do isolate four debt-equity factors for which some contemporaneous documentation must be produced in order for the EGI to be respected as debt, the satisfaction of these factors with the required supporting materials leaves a court free to evaluate, under the framework established by existing case law, whether those four factors have been satisfied or not as well as how important those four factors are compared to all the other relevant factors.

Alternatively, the second approach is that the Documentation Rules require not only materials supporting the existence of four debt-like indicia for an EGI, but also a substantive evaluation of those four factors. At some points in the Proposed Regulations (for example, the requirement that documentation must contain information evidencing a "reasonable" expectation that the issuer will meet its obligations under the EGI, and the requirement for the holder's "reasonable" exercise of the diligence of a creditor following a default), it appears this type of substantive evaluation might be required by the Documentation Rules. Under this approach, existing case law must be applied to determine whether each of the four debt-equity factors being documented supports the treatment of the EGI as indebtedness. If, and only if, the documentary evidence is sufficient to cause the four debt-equity factors (construed in accordance with existing case law) to support treatment of the EGI as debt, then the Documentation Rules permit the analysis to proceed to the next step, consisting of an evaluation of all remaining substantive factors relevant to the debt-equity analysis. This approach results in a bigger departure from existing law

[149] The Documentation Rules, no matter how interpreted, are not entirely consistent with existing case law, since they require the preparation of contemporaneous documentation in order for an EGI to be respected as indebtedness. In contrast, a number of cases have concluded that formal documentation, while helpful, is not controlling. *See, e.g.,* Gooch Lumber Sales Co. v. Comm'r, 49 T.C. 649, 656 (1968) ("The absence of a written debt instrument, security, or provision for payment of interest is not controlling; formal evidences of indebtedness are at best clues to proof of the ultimate fact."); Byerlite Corp. v. Williams, 286 F.2d 285, 290 (C.A. 6, 1960); Diamond Bros. Co. v. Comm'r, 322 F.2d 725, 732 (3d Cir. 1963) (concluding that the absence of formal documentation is not relevant where the lender controlled the borrower and could make repayments to itself at will).

[150] *See, e.g.,* John Kelley Co., 326 U.S. at 530 ("[N]o one characteristic… can be said to be decisive in the determination of whether the obligations are risk investments in the corporations or debts."); Hardman v. United States, 827 F.2d 1409 (9th Cir. 1987) (11 factors); Est. of Mixon, 464 F.2d at 402; Fin Hay Realty Co., 398 F.2d at 694; Gilbert, 262 F.2d at 514 ; Gokey Prop., Inc., 34 T.C. at 835; Brake & Elec. Sales Corp., 185 F. Supp. at 3; Laidlaw Transp., Inc. v. Comm'r, 75 T.C.M. 2598 (1998).

than the first alternative, because the Documentation Rules under this view identify four "super-factors" that each must support the treatment as debt in order for an EGI to be characterized as such.

The third approach is that the Documentation Rules impose new substantive requirements, which although they may build on principles of existing case law, ultimately are not (or at least, are not entirely) defined by reference to the existing case law. Although not entirely clear, statements in the Preamble suggest this type of departure from current law may not be the intention of the Proposed Regulations.[151]

Treasury and the IRS should clarify how the Documentation Rules fit within the framework established by existing case law. There is an argument that the second of the above three approaches is the approach contemplated by Treasury and the IRS, as noted above. However, providing for a two-part substantive analysis of debt/equity status (first, as to each of the four "super-factors," and second, as to all of the factors taken in combination) would represent a significant change in direction, in a complicated area of the law that has the benefit of many years of established case law. While the benefit of requiring contemporaneous documentation is readily understandable, the benefit of this type of change in the substantive analysis is harder to identify. In addition, the penalty imposed if the Documentation Rules are not satisfied—per se recharacterization of the debt instrument—seems somewhat harsh if, for example, the taxpayer prepares each of the four categories of documents, but ultimately fails to win on the substantive merits in one of the categories. A taxpayer would be penalized for not correctly anticipating all four sets of potentially difficult judgment calls, if the Documentation Rules required a favorable substantive analysis of these criteria.[152] While the reasonable cause exception of Prop. Treas. Reg. § 1.385-2(c)(1) provides some protection for taxpayers that inadvertently fail to prepare the necessary documentation, it is not clear that the exception would be available for documentation that fails the substantive analysis.

By comparison, the first approach above (which does not require a separate substantive evaluation of the four underlying debt-equity factors being documented) has the benefit of being most consistent with existing law, and with the suggestion in the Preamble that the Documentation Rules are not meant to alter existing principles of law. This approach also appears to fit well with the severe consequence of failing to satisfy the Documentation Rules. A taxpayer's failure

[151] *See* Preamble, at 20916 ("the proposed regulations do not intend to alter the general case law view of the importance of these [four] essential characteristics of indebtedness").

[152] To the extent that the revisions that we propose below to these four criteria are adopted, thus making them clearer and more consistent with preexisting law, that would tend to make the approach of requiring a separate substantive analysis of these four criteria somewhat less unpredictable and potentially unfair. We nevertheless believe it would be preferable to adhere more closely to current law by not providing for super-factors that outweigh all other factors in importance.

to produce a sufficient minimum quantity of documents in support of four traditional criteria of debt might be seen as justifying being forced to treat the instrument as equity.[153] On balance, we believe this to be the best approach.

1. Required Documentation – Categories 1 and 2: Sum Certain Payable on a Date Certain (or on Demand); and Creditors' Rights

The first two types of required documents are documentation evidencing an unconditional obligation to repay a sum certain on demand or at a fixed date, and documentation evidencing rights similar to typical creditors' rights.

With respect to the obligation to document that the EGI has a sum certain payable at a fixed date, we recommend that Treasury and the IRS clarify that existing case law governs the terms that an EGI should have in order to satisfy this requirement. Thus, although a fixed maturity date is generally required under existing debt-equity principles, the Tax Court has previously concluded that debt with a maturity date that is ascertainable is also considered to have a "fixed maturity date" even if the maturity date can change under certain circumstances.[154] Similarly, case law and rulings hold that an instrument can meet the requirement for payment of a "sum certain" even though the amount of a portion of the payments provided for in the instrument is subject to material contingencies.[155]

[153] Instead of automatically recharacterizing an EGI that fails to satisfy the Documentation Rules as equity, one possible alternative would be to provide that such a failure is a weighty, but not dispositive, factor in the debt/equity analysis of the instrument under Section 385. That is, the absence of some or all of the necessary documentation would be taken into account as a factor, along with all the traditional factors, when evaluating whether the instrument is debt or stock; and the rules would require that the absence of such documentation must be given significant weight, in the analysis of all the factors. This approach might lead to less harsh results than the current rules do, although it also would be more complicated to apply.

[154] *See* PF Scheidelman & Sons, Inc. v. Comm'r, T.C. Memo 1965-31 ("The test, however, is not limited to whether such a date is fixed. It may be satisfied by showing that the date is determinable or ascertainable on the date of the issuance of the notes."). In *PF Scheidelman & Sons*, the Tax Court considered debt that was payable on demand in 10% installments. Although the debt was not a demand note (because the lender could not demand a total repayment at once), the debt was treated nonetheless as having an ascertainable maturity, and therefore a "fixed maturity date" for purposes of the debt-equity test. *See also* Cleveland Adolph Mayer Realty Corp., 6 T.C. 730, 737-38 (1946), *rev'd on another issue*, 160 F.2d 1012 (6th Cir. 1947).

[155] *See, e.g.*, Treas. Reg. § 1.1275-4 (regulations regarding contingent payment debt instrument); Treas. Reg. § 1.1275-5 (regulations regarding variable rate debt instrument); DAVID C. GARLOCK, FEDERAL INCOME TAXATION OF DEBT INSTRUMENTS, ¶ 102.03[A] ("Practitioners are generally comfortable that an instrument that promises a sum certain of at least 90 percent of the issue price will not fail to qualify as debt on this ground, but the level of confidence drops off rapidly as the percentage decreases.").

As to the second requirement, we similarly presume the Documentation Rules are not meant to alter standards under current law concerning a creditor's rights, and we recommend that the government clarify this as well. In this connection, it has long been accepted that, where the form of an instrument is such that applicable local law gives the holder of an instrument creditor's rights, superior to those of a shareholder, it is not necessary for the holder's rights themselves to be set forth in the instrument. To avoid unnecessary work (going beyond "the documentation and analysis created when indebtedness is issued to third parties"), it would be useful for the regulations to state that an instrument that meets the first documentation requirement and that, under applicable law, does not need to provide additional specific terms in order for the holder to have and be able to enforce the rights of a creditor, senior to shareholders, will be treated as satisfying the documentation requirement concerning creditor's rights.

The regulations should also confirm that instruments that provide for stable expected payments of interest and principal, and that provide for effective means of enforcement in the event of a default, but do not provide for traditional creditors' rights, would not be recharacterized under this rule. For example, securitization transactions often involve investment-grade notes that do not provide holders with conventional creditors' rights against the borrower, although they do have other rights designed to ensure that the notes will be repaid. Rights to foreclose on collateral, or to force the issuer to sell or dispose of assets, and other terms designed to ensure the holder can procure payment following a default, should all be taken into account in determining whether a holder has a creditor's rights. It should not be dispositive that the instrument is nonrecourse or provides for only limited recourse to the borrower.

2. Required Documentation – Category 3: Ability to Repay

The third mandated category of written documentation is evidence that, as of the date the EGI was issued, the issuer's financial position supported a reasonable expectation that the issuer will be able to meet its obligations under the EGI. It is not clear from the Proposed Regulations how persuasive, comprehensive or detailed the documentation must be in order to satisfy this requirement. It is also not clear whether the documentation can or should be prepared by, or used in, an internal non-tax function of the EG, or whether the documentation could be prepared by the EG's internal tax function specifically for the purpose of satisfying these rules.[156]

We recommend that Treasury and the IRS provide more detail in the Documentation Rules about the standards that documentation must meet regarding ability to repay. If this approach is adopted then, consistent with our recommended approach described above (*i.e.*, clarifying that the Documentation Rules require preparation of contemporaneous documentation,

[156] The Proposed Regulations imply that the documentation need not be prepared by a third party. *See* Prop. Treas. Reg. § 1.385-2(b)(2)(iii) (discussing additional requirements "[i]f any member of an expanded group relied on any reports or analysis prepared by a third party…").

rather than imposing substantive requirements), we propose that it should be sufficient for purposes of the Documentation Rules to provide materials that would support a conclusion that a reasonable expectation of repayment existed, rather than requiring a conclusion that a reasonable expectation in fact did exist.

In addition, more detailed guidance about the nature and contents of the required documentation should be provided. This could take the form either of specific minimum requirements as to what the documentation should consist of, or illustrative examples of sufficient documentation. The final regulations should clarify that documentation supporting the borrower's ability to obtain third-party financing on substantially similar terms should be sufficient to satisfy this requirement.[157] For example, a letter from a third-party financial institution indicating it would be willing to lend on substantially similar key terms should generally be sufficient, as should a letter from a financial institution that it expects it would successfully place debt with substantially similar key terms with third-party investors. However, involvement of a third party in the preparation of the documentation should expressly not be required. Instead, the final regulations should clarify that the relevant documentation may be prepared by employees of the issuer's EG, including the group's internal tax function.[158] Regardless of whether the relevant documentation is prepared by the EG or external advisors, the final regulations should make clear that the EG members affected by the treatment of the instrument as debt rather than equity are viewed as standing behind the documentation's accuracy and thoroughness.

In addition, the final regulations should clarify that the borrower's ability to refinance the debt at maturity should be taken into account in determining the borrower's ability to repay, as a refinancing often occurs in the case of actual third-party debt rather than repayment out of internally generated funds.[159]

Unlike the first two required types of documentation, the third type is reevaluated if the EGI is deemed reissued under Treas. Reg. § 1.1001-3. This requirement represents a deviation from Treas. Reg. § 1.1001-3(f)(7), which provides that for purposes of determining whether an instrument is debt or equity for tax purposes, the financial deterioration of the obligor between the date the debt is issued and the date the debt is modified is not taken into account. While some

[157] *See* Nestlé Holdings, Inc. v. Comm'r, 70 T.C.M. 682, 702 (1995); Litton Bus. Sys., Inc. v. Comm'r, 61 T.C. 367, 379 (1973).

[158] *See* Treas. Reg. §1.6662-6(d)(2)(ii)(A)(4) (whether transfer pricing analysis under a Section 482 specified method was performed by an employee of the taxpayer, rather than a third party, is not determinative of whether the taxpayer reasonably selected and applied that method, so long as the analysis is thorough, objective, and well-reasoned).

[159] *See, e.g.*, Green Bay Structural Steel v. Comm'r, 53 T.C. 451 (1969) ("Refinancing to the best of our knowledge is an accepted business practice and we see nothing wrong with it if reasonable in the context of the particular facts . . . .").

departure from this principle may be appropriate, and consistent with caselaw, [160] in order to ensure that the lender acts in the same manner as a third-party creditor would, the proposed rule arguably goes beyond this. Third-party lenders may restructure debt even if they do not expect full repayment based on the borrower's deteriorated financial condition, in order to mitigate their losses if the borrower has a recovery that is significantly better than expected. As long as a related-party lender can demonstrate that a third party would have agreed to the modification on terms that are not substantially less favorable to the borrower, the lender should not be subject to any additional documentation obligations. To adopt a different approach would be contrary to the principle in the Preamble that the Documentation Rules are designed to require related parties to prepare documentation similar to that prepared in connection with third-party lending transactions.[161]

3. Required Documentation – Category 4: Reasonable Exercise of the Diligence of a Creditor

The fourth type of required documentation is a record of each payment of principal or interest on the EGI and, if the issuer fails to make a payment of principal or interest that is due and payable, evidence of the holder's reasonable exercise of the diligence and judgment of a creditor. The evidence of the reasonable exercise of the diligence and judgment of a creditor includes "evidence of the holder's efforts to assert its rights under the terms of the EGI, including the parties' efforts to renegotiate the EGI or to mitigate the breach of an obligation under the EGI, or any change in material terms and conditions of the EGI, such as maturity date, interest rate, or obligation to pay interest or principal, and any documentation detailing the holder's decision to refrain from pursuing any actions to enforce payment."[162]

In line with our comments above, we recommend that Treasury and the IRS clarify how this rule fits within the framework of existing case law. If the first approach outlined above in Part VI.A is adopted, Treasury and the IRS should clarify that the documentation requirement does not actually involve a substantive evaluation of the sufficiency of the holder's actions following a default, but rather that the requirement is satisfied if records are maintained that establish the actions (if any) that the holder took to exercise the rights of a creditor and the decision making process behind those actions, and that would be supportive of a conclusion that such actions were reasonable, without requiring a conclusion that a reasonable expectation in fact did exist.

[160] *See* Laidlaw Trans. Inc. v. Comm'r, 75 T.C.M. 2598 (1998).

[161] Preamble, at 20915–16.

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

We also recommend that the Proposed Regulations should provide examples of cases where a holder "refrains from pursuing any actions to enforce payment,"[163] in addition to examples of a holder asserting its rights under the terms of an EGI. Existing regulations acknowledge that a lender may choose to stay collection or temporarily waive an acceleration clause,[164] and the Proposed Regulations should also explicitly provide for this possibility.

Although existing case law considering the reasonableness of the parties' actions takes into account the related status of the parties,[165] statements in the Preamble imply that the Documentation Rules should not take this into account;[166] and we assume the Documentation Rules evaluate the sufficiency of a lender's actions following a default by comparing the lender's actions to those expected by an unrelated party. The Documentation Rules should recognize, however, that related parties often have legal considerations that differ from those applicable to unrelated parties due to their related status: for example, fraudulent conveyance laws or similar legal rules may apply to a related-party lender that would not apply to a third party. Treasury and the IRS should acknowledge that an evaluation of the sufficiency of a related-party lender's actions should take into account these differences in legal status. In other words, the Documentation Rules should compare the related-party lender's actions with those expected from an unrelated party operating under the same legal framework and constraints as the related-party lender. A lender's consideration of, and exercise of restraint in light of, these limitations should still be treated as the reasonable exercise of the diligence and judgment of a creditor.

B. The Documentation Rules – Additional Issues

1. Testing Dates and Document Maintenance Rules

We recommend below several simplifications and clarifications to the rules that govern the deadlines for preparing required documentation and the maintenance of the documentation after it is prepared.

163 *See* Prop. Treas. Reg. § 1.385-2(b)(2)(iv)(B).

164 Treas. Reg. § 1.1001-3(c)(4)(ii).

165 Scottish Power v. Comm'r, T.C. Memo. 2012-172; *see* Wilshire & W. Sandwiches, Inc. v. Comm'r, 175 F.2d 718, 720–21 (9th Cir. 1949) (stating no adverse inference should be drawn from a party's failing to demand payment immediately when due from a related party), *rev'g* a Memorandum Opinion of that Court. The Proposed Regulations, as currently drafted, only require evidence of "the holder's reasonable exercise of the diligence and judgment of a creditor," and not necessarily that of a third-party creditor. Prop. Treas. Reg. § 1.385-2(b)(2)(iv)(B).

166 "The proposed regulations are intended to impose discipline on related parties by requiring timely documentation and financial analysis that is similar to the documentation and analysis created when indebtedness is issued to third parties." Preamble at 20916.

The Documentation Rules require the four categories of documentation just described to be prepared shortly after specific "relevant dates" occur. These dates are different for the first two types of required documentation, the third type of documentation, and the fourth type of documentation.

The relevant dates for both of the first two types of documentation are defined in Prop. Treas. Reg. § 1.385-2(b)(3)(ii)(A) as (1) the date on which a member of the expanded group becomes an issuer of a new or existing EGI, without regard to any subsequent deemed issuance of the EGI under Treas. Reg. § 1.1001-3, and (2) in the case of an instrument that becomes an EGI subsequent to its issuance, whether because of a transfer of the instrument from outside the EG or because of a transfer outside a consolidated group, the date on which it becomes an EGI. This definition yields a number of unexpected results.

First, where old-and-cold debt outstanding between third parties becomes an EGI without undergoing a significant modification in its terms under Treas. Reg. § 1.1001-3, it is not clear why it should be tested under the Documentation Rules at such time. According to the Preamble, the Documentation Rules "are intended to impose discipline on related parties by requiring timely documentation and financial analysis that is similar to the documentation and analysis created when indebtedness is issued to third parties."[167] If the applicable documentation was not prepared when the debt was issued to a third party, it is not clear why it should be required when the debt is transferred with no significant change in terms.[168]

Second, the Proposed Regulations are ambiguous regarding whether an acquisition by an EG of a debt instrument that already was an EGI in a different EG (for example, a case where an EG buys some corporations that were members of a different EG, including both the issuer and the holder of an EGI) causes a debt instrument to "become an EGI" within the meaning of Prop. Treas. Reg. § 1.385-2(b)(3)(i)(A). It is not clear why such a transfer should trigger a relevant date, if the requirements for the first two types of documentation had been satisfied when the EGI was originally issued in the first EG.

[167] Preamble at 20915, 20916.

[168] This is particularly true in a case where a portion of the issuance of debt continues to be held by third parties, after a portion of the debt becomes an EGI (for example, where a securities dealer that is a member of an EG acquires debt of an affiliate from a third-party in the ordinary course of its dealer activities).

It could be asked whether, if debt becomes an EGI at a time when the borrower's financial condition has deteriorated, those circumstances justify retesting the debt under the Documentation Rules at that time. The argument would be that in these circumstances, there is in substance a repayment of the old debt, coupled with issuance of a new EGI within the group. This point could be addressed if, in addition to a significant modification of a debt instrument under Treas. Reg. § 1.1001-3 being a testing date (as recommended in the text), the date of a deemed reissuance under Treas. Reg. § 1.108-2(g), in connection with a direct or indirect acquisition of debt by a party related to the borrower that triggers recognition of COD income, also is a testing date.

Third, it appears the deemed reissuance of an EGI under Treas. Reg. § 1.1001-3 does not result in a relevant date, even though that regulation is intended to capture significant modifications to debt instruments. Consequently, certain significant modifications, such as a change in the calculation of interest or principal payments or in maturity, do not trigger a relevant date even though they are directly relevant to the first two types of required documentation.

On the other hand, the change of an issuer between two members of the EG appears to result in a relevant date for purposes of the first two categories of documentation, even though in some circumstances (such as certain mergers) the change of issuer would not be treated as a significant modification.[169] It is not clear why an EGI should be retested solely because the obligation under the EGI was transferred between members of the group, particularly where existing Treasury Regulations conclude that the terms of the EGI have not changed significantly as a result of that transfer.

The third type of required documentation has different relevant dates under Prop. Treas. Reg. § 1.385-2(b)(3)(ii)(B). For this documentation, a relevant date occurs when a member of the EG becomes an issuer with respect to an EGI and any later date on which an issuance of the EGI is deemed to occur under Treas. Reg. § 1.1001-3.[170]

We recommend that the relevant dates for purposes of all of the first three types of required documentation be the same.[171] A relevant date should occur for purposes of these three types of documentation only at the time an instrument is issued by one member of the EG to another member, taking into account deemed reissuances under Treas. Reg. § 1.1001-3. For these purposes, an applicable instrument issued between members of a consolidated group that leaves the consolidated group (either because the debt instrument is transferred or because the issuer or holder of the debt instrument leaves the consolidated group) and becomes an EGI is deemed to be newly issued as an EGI. We believe the dates just described are the ones on which material

[169] *See* Treas. Reg. § 1.1001-3(e)(4).

[170] Prop. Treas. Reg. § 1.385-2(b)(3)(ii)(B). Unlike Prop. Treas. Reg. § 1.385-2(b)(3)(ii)(A), clause (B) does not specify whether the EGI is "new or existing." It is not clear why this language changed between the two clauses.

The Documentation Rules provide that, for the fourth type of required documentation, the relevant dates are, in the case of a payment required under the terms of the instrument, the payment due date, and in the event of a default, the date on which the default occurs. Prop. Treas. Reg. § 1.385-2(b)(3)(ii)(C), (D). We believe these relevant date rules are reasonable as currently drafted.

[171] For avoidance of doubt, the recommendation in the text does not apply to the determination of relevant dates for purposes of the fourth documentation requirement (related to payments of principal and interest and the reasonable exercise of the diligence of a creditor upon a default). As indicated in footnote 171, the rules concerning relevant dates for the fourth documentation requirement are reasonable, and should remain as drafted.

events occur that logically could impact the analysis of these three factors. It thus would seem reasonable to expect EG members to keep these dates in mind for purposes of complying with the Documentation Rules. This approach seems preferable to the current one, which as explained above requires attention to dates on which, frequently, nothing will happen that will impact the first three requirements in the Documentation Rules.

The Documentation Rules provide that the documents related to these requirements must be prepared within 30 days after each relevant date, and that documents related to the fourth requirement must be prepared within 120 days after a relevant date. These may prove to be short deadlines, particularly when triggered by unexpected relevant dates. In this connection, we note that Treasury and the IRS have taken a different approach with respect to transfer pricing documentation: documents supporting an arm's length transaction do not need to be prepared until the federal income tax return for the relevant year is filed.[172] The transfer pricing approach involves reasonably contemporaneous preparation of documents supporting the positions taken on relevant tax returns; we believe the same approach could be employed in the Documentation Rules, without compromising their effectiveness. We recommend requiring that, following the occurrence of a relevant date for an EGI, the documentation mandated under the Documentation Rules must be prepared by the due date for the filing of the first U.S. tax return of an EG member that will be affected by the treatment of the EGI as debt or equity.

Finally, we recommend that the Documentation Rules clarify who must prepare and maintain the applicable documentation.[173] The rules do not impose the documentation preparation or maintenance requirements on any particular entity in the EG, and it would be logical to provide expressly that any one or more members of the EG to which the U.S. tax treatment of an EGI is relevant may prepare and maintain (on behalf of all members of the EG) the documents needed to meet these requirements.

2. Application of Documentation Rules to Instruments that are Designated as Debt by Statute and to Instruments that are Not Debt in Form

The Preamble requests comments regarding whether instruments that are not indebtedness in form should be subject to the Documentation Rules, and the specific requirements that should apply.[174]

If the rules are extended to require documentary evidence that instruments which are not debt in form meet the four criteria referenced in Prop. Treas. Reg. § 1.385-2, it may be possible

172 Treas. Reg. § 1.6662-6(d)(2)(iii)(A).

173 The Documentation Rules require that documentation be maintained for all taxable years that an EGI is outstanding and until the period of limitations expires for any return with respect to which the treatment of the EGI is relevant. Prop. Treas. Reg. § 1.385-2(b)(4).

174 Preamble, at 20920.

to prepare and maintain documentation similar to that prepared for an instrument that is debt in form. However, that documentation would likely be prepared expressly to satisfy the Documentation Rule, as a transaction that is not debt in form would not naturally have the same documentation that would be expected in a transaction that is debt in form.[175] For example, there may not be an agreement that specifically provides for a sum certain payable on demand or at a fixed date, and the lender's right to the repayment of principal may be protected other than through traditional creditors' rights. Regulations would need to address how the Documentation Rule would be satisfied in transactions that are not intended to be treated as debt in form.

In addition, Section 385 by its terms authorizes only regulations to determine whether an interest in a corporation should be treated as stock or debt (or part-stock and part-debt). It is not clear, however, that the recharacterization of a transaction that is not debt in form into equity of the issuer would be appropriate in all cases. For example, if a "repo" is not treated as debt due to a failure to satisfy the documentation requirements, it is not clear whether the transaction should be treated as a purchase and sale of the underlying asset, rather than as stock of the party that is the seller under the repo. In theory, the recharacterization rule for instruments that are not, in form, debt could be drafted in an open-ended manner, providing simply that the instrument will be recharacterized as appropriate in view of all the facts and circumstances, if the documentation is not maintained. However, an open-ended rule of this type would not appear to assist in limiting disputes between the IRS and the taxpayer as intended by the Proposed Regulations, where multiple recasts are reasonable. In addition, it is not entirely clear that Section 385, with its focus on dividing instruments between debt and stock of the issuer, contemplates this type of more open-ended rule.

Thus, we recommend that if the Documentation Rules are extended to apply to instruments that are not indebtedness in form, they should be extended only to cover instruments which, if recharacterized under general tax principles, would typically be treated as stock of the issuer.[176]

In addition, as discussed further in Part IX.C.3(a) below, we recommend that instruments for which treatment as debt is specifically contemplated by a provision of the Code or regulations should be exempted from the Documentation Rules.

[175] In the case of a "repo", for instance, the 1996 SIFMA Master Repurchase Agreement explicitly provides that "the parties intend that all Transactions hereunder be sales and purchases and not loans".

[176] Arguably, notional principal contracts with nonperiodic payments represent a special case, and ought to be subject to the Proposed Regulations, because it is possible to achieve a result similar to a cash borrowing, by using a notional principal contract with a large upfront prepayment. *See* Part IX.C.3(a) for a further discussion of these arrangements.

3. Effective Date

As noted, the Documentation Rules apply to EGIs issued on or after the date the rules are published in final form. We recommend that the rules instead apply only to instruments issued at least a few months after the rules are finalized. Particularly if the large number of potential testing dates is retained, and the deadline for preparing at least some of the necessary documentation is kept at 30 days after a testing date, it may realistically be difficult for taxpayers to implement the Documentation Rules in a timely fashion. Although the reasonable cause rule provides some relief, it would seem preferable to choose an effective date that is less likely to cause frequent reliance on this rule. In addition, even if the rules are modified in the manner we have recommended, groups may still often need lead time to assess the final rules and coordinate their internal tax, finance and legal functions in order to be able to generate appropriate documentation and ensure the terms of EGIs are consistent with the final Documentation Rules.

VII. CASH POOLING AND SIMILAR ARRANGEMENTS

The Preamble requests comments on whether special rules are warranted for cash pools, cash sweeps, and similar short term funding arrangements for managing cash of an EG.[177] After first summarizing below the key features of cash pooling arrangements and describing the reasons why these arrangements are prevalent in corporate groups, we suggest revisions to Prop. Treas. Reg. §§ 1.385-2 and 1.385-3 in order to make the rules more compatible with these arrangements and similar short-term funding arrangements. As currently drafted, the Proposed Regulations would significantly interfere with the treasury objectives that these structures are typically used to achieve.

A. Overview of Common Cash Pooling Arrangements

Corporate groups very frequently take a centralized approach to managing the deployment of cash within the group and to hedging risks associated with the group's treasury and finance functions. Often, a particular subsidiary (or, in some cases, a particular subsidiary for each geographic region where the group operates) will be designated as a treasury center which is specifically dedicated to these tasks. In a cash pooling arrangement, the treasury center, typically together with a third-party financial institution, manages centrally the group's cash. There are two basic types of cash pooling arrangements, (i) physical cash pooling and (ii) notional cash pooling. There are a number of differences between these two types of arrangements.[178]

[177] Preamble, at 20915, 20929.

[178] In addition to the operational differences described below, only one type of pooling may be available in a particular jurisdiction (due to banking, exchange control and other regulatory restrictions), and some countries do not allow any type of pooling arrangement.

In a physical cash pooling arrangement (also sometimes referred to as a zero balance arrangement, or a cash sweep), several group members will open accounts with the same financial institution. At pre-established frequent intervals (usually daily, although in some cases weekly, monthly, or quarterly intervals might be used), the bank automatically moves cash from the accounts of group members that have positive account balances, to the account of the treasury center (this account is sometimes called the pool leader's account or the header account). The bank then automatically moves cash from the header account into the accounts of group members that have negative account balances. If, after this process, the header account has a positive balance, the financial institution pays interest on that balance; or, if the header account balance is negative, the treasury center is charged interest. These cash movements typically are automated rather than manual, as automation provides significantly greater efficiency and limits possibilities for error.

For purposes of the tax laws of the United States and other countries, a physical cash pooling arrangement like the one just described typically is viewed as creating loans to the treasury center from the other group members with positive balances, and from the treasury center to the group members with negative account balances. Interest typically is accrued on these loans. Loans are repaid automatically through the sweep mechanism as cash becomes available to the borrower, with balances shifting each time a periodic sweep occurs.

A group not infrequently will have separate treasury centers in different regions where it does business. This is due to bank regulatory restrictions on cross-border movement of funds, and is also due to the fact that a physical cash pooling arrangement is generally conducted in a single currency. Thus, for example, a multinational group may have separate treasury centers for Europe and for Asia.

While separate treasury centers are established for different geographic areas, it would be unusual to establish multiple treasury centers to serve the same area—for example, one providing short-term working capital finance and another providing medium-term or long-term funding. This is because a key reason for organizing a treasury center is to achieve efficiency through a single centralized point of control (or a handful of points of control) over the group's cash, with there preferably being as few such control points within the group as possible subject to the regulatory and currency issues referenced above. In addition, centralizing the group's cash facilitates the group's ability to hedge currency and other risks.[179]

Groups normally use cash pooling arrangements solely or primarily to fund the short-term cash needs of group members in their ongoing business activities. If a group member has

[179] It should be noted that, often, a group will finance a material acquisition from a third party through a corporate structure established specifically for the acquisition, which will be separate from the group's treasury center.

medium- or longer-term funding needs, a common practice would be for the treasury center not to provide financing for those needs through the cash pool but, instead, to remove cash from the pooling arrangement and enter into a separate loan agreement with the group member needing the cash. Frequently, a group would finance a member's short term cash needs for a relatively short period, such as up to one year, through the normal pool arrangement, with borrowings of a longer duration being entered into outside the pool.

As noted, cash movements in a pooling arrangement are executed automatically, and neither the treasury center nor the financial institution operating the arrangement confirms the financial condition of each participating group member each time funds are advanced in a cash pooling arrangement. If a group member participating in a pooling arrangement becomes financially distressed, the treasury center generally would remove that group member from the arrangement, in order to better conserve the group's cash; however, in cases where an insolvent group member is eliminated from the pool, elimination may not occur for some period of time, until it is clear that the group member is unlikely to repay its borrowings. At longer intervals—frequently annually—many groups prepare financial forecasts for internal use which indicate the current and expected near-term financial performance of different businesses and companies within the group

The second basic type of cash pooling arrangement is often referred to as notional or virtual cash pooling. Such an arrangement resembles physical cash pooling, in that participating group members typically all establish accounts with the same financial institution, and the treasury center acts as the pool leader. However, that is where the similarities end. In a notional pooling arrangement, cash is not swept out of, or deposited into, any group member's account by the financial institution. Each group member retains its own account relationship with the bank and its own deposit or overdraft balance. On each measurement date, the financial institution determines whether each group member has a positive, or negative, balance in its account and aggregates the account balances. If the aggregate is positive, then the financial institution pays the treasury center an amount of interest on that positive amount; or, if the aggregate is negative, then the treasury center must either borrow from the financial institution, or from some other corporation in the group (*e.g.*, the parent) in order to increase the negative amount to zero.

Because group members each continue to have their own individual overdrafts and deposits directly with the bank, notional pooling arrangements are generally treated for U.S. and foreign tax purposes as loans from the financial institution operating the pool to group members that have negative account balances, and to the financial institution by group members that have positive account balances. Group members account through transfer pricing adjustments among themselves for the absence of interest payable to the financial institution on members' negative account balances; the absence of interest receivable from the financial institution on members' positive account balances; and payments of interest to, or by, the pool header on the notional aggregate balance.[180]

Notional pooling arrangements sometimes can be conducted in more than one currency. However, a group that has adopted notional pooling often would have multiple treasury centers, each devoted to a different region, as with physical pooling.

In a notional pooling arrangement, each participating group member typically pledges its account in support of the obligations of the treasury center and the other members to the financial institution under the pool. As in a physical pooling arrangement, medium- and long-term funding needs are often addressed separately from the pool by loans from the treasury center.

In all pooling arrangements, the participating group members will normally each enter into a separate account agreement with the financial institution operating the pool. In addition, the participating members normally enter into an agreement among themselves specifying the key terms of the pooling arrangement, including the frequency of sweeps and the mechanism for calculation and payment of interest among the participating members. Corporate groups do not produce separate agreements or other documentation each time cash moves between pool members. Instead, the financial institution tracks each participating member's account balance on each sweep date, and regularly provides this information to the group; and the group computes accruals of interest on the balances.

Although many corporate groups use cash pooling arrangements along the lines described above to manage group cash and short-term funding needs, these are not the only structures that a multinational group may use for these purposes. For example, financial institutions use a number of techniques to provide internal short-term financing to affiliates within the group, in a manner that complies with applicable banking and other regulations and meets business needs in different countries. Other corporate groups also sometimes use short-term intragroup loans to deal with members' needs for cash in their routine business operations.

B. Tailoring the Documentation Rules to Cash Pooling Arrangements

We recommend that the government clarify and expand the special rules in Prop. Treas. Reg. § 1.385-2(b)(3)(iii) dealing with cash pooling arrangements, in order to better fit with the fact that, typically, each borrowing by an EG member pursuant to the arrangement is not separately documented and is not subject to a separate credit evaluation.

[180] Alternatively, in some notional pooling arrangements, the financial institution may pay interest to, and receive interest from, each participating group member at the same rate. This has the same economic effect as the result described in the text, although it is optically more consistent with the treatment of the arrangement as a series of deposits and borrowings between the financial institution on one hand, and each EG member on the other.

In general, the Documentation Rules require that documents showing an obligation to pay a sum certain, creditor's rights, and reasonable expectation of repayment be prepared within 30 days after an EGI is issued.[181] A special rule is included in the provisions about the deadlines for preparation of documents, to the effect that for revolving credit agreements and cash pooling arrangements, within 30 days after "the execution of the legal documents governing the EGI and the date of any amendment to those documents that provides for an increase in principal amount," documentation with respect to that EGI (presumably establishing the three factors just mentioned) must be prepared. In addition, a further special rule (under the heading "revolving credit agreements and similar agreements") is provided to the effect that "if an EGI is not evidenced by a separate note or other writing executed with respect to the initial balance or any increase in principal balance (for example, an EGI documented as a revolving credit agreement or an omnibus agreement that documents open account obligations)," the requirement to maintain documentation of an obligation to pay a sum certain is met "only if the material documentation associated with the EGI, including all relevant enabling documentation" is prepared in accordance with Prop. Treas. Reg. § 1.385-2.[182] A separate special rule (under the heading "cash pooling arrangements") is also included, stating that if an EGI is issued pursuant to a cash pooling arrangement, the requirement to maintain documentation of an obligation to pay a sum certain is satisfied only if the material agreements governing the ongoing operations of the arrangement (including agreements with the third-party financial institution operating the arrangement for the group) are prepared in accordance with Prop. Treas. Reg. § 1.385-2.[183]

Despite its positioning in the timing rules, and the reference in its heading to revolving credit agreements, Prop. Treas. Reg. § 1.385-2(b)(3)(iii)(A) appears to apply to cash pooling arrangements, because each loan pursuant to these arrangements is not evidenced by separate documentation. This provision appears to acknowledge that, in such a case, the first documentation requirement, concerning a sum certain, is satisfied if (the regulation says "only if", but presumably this is intended to describe both a necessary and a sufficient condition) the enabling documents are prepared and maintained in accordance with Prop. Treas. Reg. § 1.385-2. This is an appropriate result for a cash pooling arrangement. It makes sense for the group to prepare and maintain the cash pooling agreement, and to maintain a record of each group member's accession to that agreement at the time it first becomes a participant in the pool; the same is true for each account agreement that a member signs with the financial institution operating the arrangement. However, it is not appropriate, given the nature of these arrangements, to require a separate loan agreement with respect to each borrowing made under the arrangement. Instead, a clear, regularly updated schedule of the amounts owed to, and by, each pool participant from

[181] Prop. Treas. Reg. § 1.385-2(b)(3)(i), (ii)(A)–(B).

[182] Prop. Treas. Reg. § 1.385-2(b)(3)(iii)(A).

[183] Prop. Treas. Reg. § 1.385-2(b)(3)(iii)(B).

time to time should be sufficient. Although Prop. Treas. Reg. § 1.385-2(b)(3)(iii)(A) refers only to the first of the four Documentation Rules, logically the documentation just described should also satisfy the second requirement (concerning creditors' rights), assuming that applicable local law does not require more to establish such rights, and the fourth requirement (concerning payment of amounts due) as well. This should be clarified in the final regulations.

Prop. Treas. Reg. § 1.385-2(b)(3)(iii)(B), which appears immediately after the provision just discussed and is described as specifically addressed to cash pooling arrangements, does not acknowledge that a separate loan agreement need not be prepared for each borrowing under such an arrangement; rather, by its terms, it purports only to add a requirement to the general documentation rules applicable to all EGIs, namely that the agreements governing the pool's operations must be timely prepared. It is not entirely clear whether the cash pooling rule is intended to complement, or to supersede, the rules in Prop. Treas. Reg. § 1.385-3(b)(3)(iii)(A). We recommend that the government clarify that the requirements for a cash pooling arrangement under Prop. Treas. Reg. § 1.385-3(b)(3)(iii) are precisely as we have described in the preceding paragraph, and that paragraph (B) does not alter that result or impose any additional requirements.

In addition, the requirement to prepare documentation showing a credit evaluation each time a loan is made is not compatible with cash pooling arrangements, given the automatic operation of a pooling arrangement and the frequency with which loans are made. One practical approach, which we believe would achieve the purposes of Prop. Treas. Reg. § 1.385-2, would be to require a credit evaluation to be documented when a member first signs up to participate in the pool, and thereafter to require a documentation of a further credit evaluation when a member becomes (or is reasonably anticipated to become in the near term) insolvent. Alternatively, a credit evaluation could be made for each participant on (say) an annual basis.

We note that similar considerations apply for other types of short-term financing within a group. For example, when a corporation acquires goods or services from a member of its EG in the ordinary course of business in exchange for a receivable, it should be clarified that formal loan documentation and a contemporaneous credit evaluation are unnecessary, assuming the receivable is expected to be, and is, paid (whether in cash or via setoff) shortly after the transaction.

C. Revising the Per Se Stock Rules to Accommodate Cash Pooling and Other Short-Term Funding Arrangements

We strongly recommend that Treasury and the IRS revise the Per Se Stock Rules to give favorable treatment to short-term intragroup loans that are expected to be repaid in full, in cash or via setoff, by the borrower. In our view, most such loans should not be subject to recharacterization under the Per Se Stock Rules (subject to certain limited restrictions, described below, that are principally designed to ensure that rules giving favorable treatment for short-term financing do not provide protection for what are, in reality, long-term intragroup loans). We believe that favorable treatment of short-term cash loans is warranted for compelling practical, and substantive, reasons, which quickly become apparent in considering cash pooling arrangements like those described above.

> *Example 9.*[184] USP owns CFC Holdco, which in turn owns several operating subsidiaries: CFC 1, CFC 2, CFC 3, and CFC 4. In addition, CFC Holdco owns a foreign Finco, which is a treasury center that heads a cash pooling arrangement for the group. In 2017, pursuant to the cash pooling arrangement, Finco lends $100 to CFC 1 for use as working capital, and CFC 1 repays the loan a few weeks later. Near the end of 2017, CFC1 distributes $10 to CFC Holdco. CFC1 has no current year E&P in 2017.

Several aspects of Example 9 appear to make this a sympathetic case. Finco lends cash to CFC1 for use as working capital, and not for purposes of funding a distribution or acquisition by CFC1. As is common for cash pooling arrangements, and further evidencing the purpose just described, CFC1 repays the loan in full shortly afterward.[185] CFC1 does not make its distribution until a later time. Thus, as a practical matter, there does not seem to be a significant question whether the loan is part of a plan that encompasses making the later distribution; nor does it seem there can be a question whether the loan has funded the distribution, since it has been repaid in full before the distribution is made. In addition, USP does not appear to be deriving any U.S. tax advantage from these transactions. Finally, if CFC1 had simply waited until early 2018 to make its distribution, then no portion of Finco's loan would be recast as equity.[186] Nevertheless, under the facts of Example 9, a minimum of $10 of Finco's loan is recast as equity.[187]

[184] In all the examples in this report that deal with the Per Se Stock Rules, it is assumed, for sake of simplicity, that the $50 Million Exception is not available. We believe that often it would be necessary in practice for taxpayers to make that assumption when analyzing the impact of these rules.

In addition, unless expressly stated otherwise, it is assumed in all examples related to the Per Se Stock Rules that neither the anti-abuse rule for debt instruments issued with a principal purpose of avoiding the application of the Per Se Stock Rules (Prop. Treas. Reg. § 1.385-3(b)(4)), nor the rule prohibiting affirmative use of the Per Se Stock Rules (Prop. Treas. Reg. § 1.385-3(e)), is applicable. As discussed further in Part IX.D below, it is unclear in what circumstances those provisions are meant to apply.

[185] A cash pooling loan generally does not have a stated due date. Nevertheless, in practice, loans pursuant to cash pooling arrangements are normally short-term.

[186] *See* Prop. Treas. Reg. § 1.385-3(d)(1)(ii). Under this rule, if CFC1 makes a distribution in a year (2018) following the year when CFC1 received the loan from Finco (2017), then that loan is not recharacterized until the date in that later year when the distribution is made. However, since CFC1 has fully repaid the loan to Finco during 2017, there is no loan left to recharacterize when CFC1 makes its distribution in 2018.

[187] As described further in Part XI.B below, it appears that under the Proposed Regulations as drafted, all $100 of the loan in fact must be recast as equity, although it is not clear that this is intended.

Among other consequences, as a result of the recast, at least a portion of the interest on Finco's loan, as well as the repayment of the principal amount, will be treated as Section 301 distributions. Section 954(c)(6) often would prevent an immediate income inclusion for USP, to the extent these distributions by CFC 1 to Finco are treated as dividends. However, as discussed further in Part XI.A.4, it appears that CFC 1's foreign tax pool may be reduced on account of those dividends; and although Finco's E&P will be increased, it appears it may not have an increase to its foreign tax credit pool on account of CFC 1's foreign taxes. Thus, ultimately, USP will be subject to U.S. tax it would not otherwise have had to pay, even though the transaction does not involve any potential for abuse.

In fact patterns involving cash pooling that are even slightly less straightforward than Example 9, it quickly becomes very difficult to apply Prop. Treas. Reg. § 1.385-3.

> *Example 10*. The EG members are the same as in Example 9. In 2017, CFC 4 distributes $100 to USP when CFC 4 has no current year E&P.
>
> In 2019, as a result of profitable operations, each of CFC 1, CFC 2 and CFC 3 lends $75 (total: $225) to Finco through the cash pooling arrangement. Also in 2019, CFC 4 needs working capital for use in its business. To fund this, CFC 4 borrows $150 from Finco through the cash pooling arrangement. Because of the Year 2017 distribution, $100 of this borrowing is per se equity of CFC 4 under Prop. Treas. Reg. § 1.385-3(b)(3)(ii)(A). This sets off a chain reaction:
>
> 1. Finco has now acquired $100 of stock in an EG member (CFC 4), which itself is a funded transaction under Prop. Treas. Reg. § 1.385-3(b)(3)(ii)(B).
> 2. As a result, $100 of Finco's loans owed to CFC 1, 2 and/or 3 become equity of Finco.
> 3. To make the determination of which balances turn into equity, the taxpayer would have to review all cash flows under the cash pooling agreement between CFCs 1,2, 3 and 4 and Finco and decide which of the outstanding balances were issued first. Suppose this review indicates the loans were made to Finco by in the following order: CFC 1 - $50, CFC 2 - $25, CFC3 - $25 (and after these loans were made, CFC 1, CFC 2 and CFC 3 loaned Finco an additional $25, $50, and $50, respectively and in that order, to get to the ending $75 balance with each entity).
> 4. As a result, CFC 1 owns $50 of Finco equity, CFC 2 owns $25 of Finco equity, and CFC 3 owns $25 of Finco equity.

5. Suppose that later in 2019, CFC 1 receives $50 of cash from Finco for normal business operations, with this cash movement being effectuated by a repayment by Finco of its receivable owing to CFC 1.

6. Because this receivable is equity, a portion of the repayment would be treated as a redemption by Finco of its stock, which is a per se transaction that will turn more "debt" of Finco (held by some combination of CFC 1, 2 and 3) into equity, under Prop. Treas. Reg. § 1.385-3(b)(3)(ii)(A).

7. Here, if Finco has a payable of $75 to CFC 1 ($50 of which is deemed equity and $25 is deemed debt), and repays $50 of it, it possibly can be treated as redeeming $33 of stock and repaying $17 of debt. (Prop. Treas. Reg. § 1.385-3 does not address how to perform this allocation; a pro rata allocation would appear to be one reasonable possibility, as discussed below in Part XI.)

8. This deemed redemption of stock by Finco would have the iterative effect of turning more existing Finco debt into equity, because Finco has now engaged in a Prop. Treas. Reg. § 1.385-3(b)(3)(ii)(A) transaction. Indeed, each repayment by Finco to any of CFC 1, 2 or 3 would essentially have this iterative effect, because each entity owns a single instrument that is treated as part debt and part equity in Finco, and so each repayment becomes a part redemption, and thus a part Prop. Treas. Reg. § 1.385-3(b)(3)(ii)(A) transaction.

9. Similar problems arise, if, for example, CFC 4 repays $100 of its loan. Again, although there is no operative rule, because CFC 4 has a "debt" of $150 to Finco, of which $100 is stock and $50 is debt, it appears reasonable to conclude that $66 is in repayment of the $100 "equity" (*i.e.*, a redemption) and $34 is a repayment of debt. Here, again, CFC 4 has engaged in another funded transaction under Prop. Treas. Reg. § 1.385-3(b)(3)(ii)(A) (a distribution to Finco), which would have the effect of converting some portion of its remaining debt owed to Finco into equity (and thus, causes Finco to have acquired more "equity" in CFC 4, a funded Prop. Treas. Reg. § 1.385-3(b)(3)(ii)(B) transaction, which then converts some Finco debt to equity, and so forth).

10. To fully assess any of the above consequences, each entity involved would have to first fully compute its current year E&P, and then play out all of the various transactions in hindsight after determining the effect (if any) of the current E&P exception (*e.g.*, if CFC 4 has current E&P when it repays $100 of its loan, perhaps the piece that is a redemption then moves current E&P to Finco, which then effects the consequences of the Finco repayment/redemption transactions).

For both taxpayers and the government, the task of administering and monitoring the application of the Per Se Stock Rules in cases like Example 10 could quickly become highly burdensome (sometimes prohibitively so). It could logically be asked, in view of that burden, how likely it is that application of the Per Se Stock Rules will curtail the types of tax planning that the rules are apparently intended to prevent. As discussed further below in Part VIII, it appears that one of the purposes of the Per Se Stock Rules is to prevent groups from using intercompany loans as part of strategies to manipulate the location of E&P in a U.S.-parented group and, thus, repatriate foreign cash without U.S. taxation of the CFCs' profits.[188] However, application of Prop. Treas. Reg. § 1.385-3 in cases like the above example appears to do little, or nothing, to lessen the efficacy of this planning.

> *Example 11*. The EG members are the same as in Examples 9 and 10. Finco lends \$100 to CFC Holdco, which has no current or accumulated E&P, and CFC Holdco shortly afterward makes a \$100 return of capital distribution to USP.

In Example 11, Finco's loan to CFC Holdco will be treated as stock of CFC Holdco. However, the treatment of CFC Holdco's cash distribution to USP will remain unchanged from what it would have been, if the Per Se Stock Rules had not applied. In addition, a later repayment by CFC Holdco of the loan from Finco would appear generally not to result in Subpart F income for USP, so long as Section 954(c)(6) applies.[189]

Indeed, in these fact patterns, application of the Per Se Stock Rules may actually facilitate a nontaxable repatriation of foreign cash to USP:

> *Example 12*. USP owns CFC Holdco, which in turn owns CFC Finco and CFC Opco. CFC Opco manufactures and sells a product and has periodic short-term cash needs. Due to these needs, on three separate occasions in 2017, CFC Opco borrows \$100 in cash from CFC Finco on a short-term basis, each time repaying the loan in full. CFC Opco has no current E&P for 2017, although it does have \$300 of accumulated E&P. Before the end of 2017, CFC Opco makes a distribu-

[188] *See* note 203 below.

[189] *Compare* Preamble, at 20917, giving an example that involves a distribution of a note by a first-tier CFC to its U.S. parent. A key difference between the example in the Preamble, and Example 11, is that if the Proposed Regulations applied to the note distribution to the U.S. parent in the Preamble, then the General Per Se Rule would recharacterize the note distributed to the U.S. parent by the CFC as equity. This would prevent the U.S. parent from executing its repatriation planning effectively. No similar result is obtained in Example 11.

In Example 11, it should be noted that although CFC Holdco's repayment of the recharacterized loan it has received from Finco will not result in Subpart F income, such repayment may result in elimination of foreign taxes in CFC Holdco's foreign tax pool, thus eventually resulting in added U.S. tax for USP in the event the E&P is repatriated to it.

> tion or acquisition of a sufficient size to cause the entire $300 of loans to be recast as equity. [190] Then, at the beginning of 2018, CFC Opco distributes $300 to CFC Holdco.
>
> Each time one of these loans is repaid, CFC Finco is treated as receiving a dividend. CFC Opco's accumulated E&P thus decreases to $0 by the end of 2017. In addition, it appears that CFC Holdco should increase its basis in its CFC Opco stock by $300 under Treas. Reg. § 1.302-2(c). Thus, the distribution by CFC Opco to CFC Holdco in 2018 will be a return of capital distribution under Section 301(c)(2), assuming CFC Opco has no current E&P in 2018. CFC Holdco can then distribute the cash to USP as a return of capital distribution, provided CFC Holdco has no E&P.

Thus, although various technical means could be envisaged to attack manipulation of CFCs' E&P, it does not appear that recharacterization of a treasury center's loan to a CFC under Section 385 is an effective weapon for doing so.

For completeness, it might be asked whether application of Prop. Treas. Reg. § 1.385-3 would be more efficacious in the case of a foreign-parented group, where Finco is a non-CFC foreign subsidiary and the borrower through the cash pool is USS, a U.S. subsidiary. In principle, USS might use the loan proceeds to pay a dividend to its foreign parent, a result that could be seen as enabling the type of earnings stripping Prop. Treas. Reg. § 1.385-3 is meant to combat. However, we note that a loan to USS through a cash-pooling arrangement seems ill-suited to achieving meaningful earnings stripping: the interest rate typically is quite low, given the short-term nature of the funding; and USS will need to generate sufficient cash to repay the loan in full, shortly after it has been made. These features of a cash pooling loan indicate fairly strongly that it is, in fact, a means of financing working capital needs and ordinary business operations, and not a vehicle for tax planning.

We thus believe strong reasons exist for giving favorable treatment to loans made pursuant to cash pooling arrangements for purposes of Prop. Treas. Reg. § 1.385-3.

As explained in Part IX.A and IX.B, we recommend that if the government puts forward rules in the future based on the Per Se Stock Rules, those rules should carve out loans between foreign EG members, and should narrow the Funding Rule. More specifically, the reformulated Funding Rule would apply only when an intragroup loan is made as part of an overall plan whereby (x) the funded EG member uses the debt proceeds to make a distribution or pay consideration in an acquisition, and (y) the EG member that receives the distribution or the acquisition consideration also provides (directly or indirectly) to the funded member the assets used to make

[190] As indicated in the discussion of Example 9 and discussed in detail in Part XIII.B, such distribution or acquisition potentially could be for an amount much smaller than $300, under the rules as currently drafted.

that distribution or pay that acquisition consideration, thereby achieving substantially the same economic result as a distribution or acquisition by the funded EG member that is described in the General Per Se Rule. One important salutary consequence of these proposed changes would be that common cases like Examples 9 and 10 would not run afoul of Prop. Treas. Reg. § 1.385-3. That result would follow naturally, without a need for special rules specifically dealing with cash pooling: cash pooling arrangements among CFCs would be among the broad class of foreign-to-foreign debt instruments not subject to the Per Se Stock Rules; and, other loans pursuant to cash pooling would typically not be made with a principal purpose of achieving the economic result of a debt-funded distribution, or a debt-funded acquisition.

By comparison, if, instead of adopting our recommendation, the government were to retain the 72-Month Per Se Rule, possibly modifying it to be a rebuttable presumption (as discussed in Part IX.B.3), we believe that specifically tailored rules would be appropriate, providing relief for cash pooling loans. In particular, the rules should provide a favorable presumption that loans made pursuant to a cash pooling arrangement are not entered into with a principal purpose of funding a distribution or acquisition, and thus are presumptively not subject to the Funding Rule. Such a presumption would be appropriate, in view of the widespread use of pooling and similar arrangements and the low potential they present for abuse.

We recognize that if this type of favorable presumption is provided, there is a possibility that a group could seek to use the rule to protect what is, in substance, a long term loan made for reasons other than working capital or liquidity needs, which appropriately would be subjected to the same standard as other intragroup loans for purposes of determining whether to recast it is equity under the Funding Rule.[191] Limitations should be included to deter that behavior. For instance, because corporations often regard a loan that remains outstanding for not more than one year as the natural outside duration for borrowings made through a cash pool, the favorable presumption should be limited to a borrowing of a given amount for at most one year, by the end of which time it should be repaid in full. If desired, the one-year rule could be backstopped by a provision to the effect that, if an EG member owes debt with a total face amount of $*x* to a treasury center and/or other EG members for (say) at least 80% of the time over (say) a 2-year period, then the normal rules of Prop. Treas. Reg. § 1.385-3 would apply to the debt that makes up this $*x* balance, instead of any special favorable presumption.

Alternatively, the rules might provide that borrowings by an EG member pursuant to a cash pooling arrangement would be entitled to the benefit of a favorable presumption, so long as

[191] *Cf.* Jacobs Engineering v. United States, 79 AFTR 2d 97-1673 (C.D. Cal. 1997), *aff'd w/o published opinion,* 168 F.3d 499 (9th Cir. 1999); Notice 88-108, 1988-2 C.B. 445. A taxpayer engaging in this behavior potentially could facilitate the non-taxable repatriation of E&P; but in view of the low interest rate on the loan, it appears somewhat unlikely the arrangement could be used for substantial earnings stripping, despite the longer length of the borrowing.

the daily average balance of the EG member's borrowings under the arrangement does not exceed $*x* for the taxable year, and no such borrowings are outstanding on at least (say) 45 days during the year. For this purpose, $*x* would be a figure determined by reference to a formula set forth in the regulations: for example, a specified percentage of the EG member's average annual operating cashflow for the preceding few years. This would be intended to serve as a rough proxy for amounts required by the borrower for working capital or liquidity needs.

We emphasize that, in a case where an EG member is a borrower under a cash pooling arrangement much of the time over a period of multiple years, and thus falls outside the type of favorable presumption described above, there are nevertheless strong reasons not to automatically recast loans to the EG member through the cash pool as equity. Often, due to macroeconomic factors in a particular subsidiary's home country, the stage of development of the subsidiary's business, or the financial performance of its business, that subsidiary may prove to be a net borrower for significant, non-consecutive stretches of time within a period of a few years. As an economic matter, it may be entirely justifiable to fund these cash needs, which are unrelated to any distribution or acquisition by the borrowing EG member, through a series of shorter term borrowings and repayments. We believe that these cases provide a good illustration of the reasons for not adopting a per se rule like the 72-Month Per Se Rule and, instead, adopting a purpose-based test for application of the Funding Rule.

Conversely, where a borrower under a cash pooling arrangement does fit within our recommended favorable presumption, but a closer review of the facts reveals that the borrower is really just using the pooling arrangement to obtain funds in order to make a distribution or acquisition, the presumption would be overcome; and the loan would be recharacterized as equity under the Funding Rule.

D. Application of Per Se Stock Rules to Other Short-Term Intragroup Funding Arrangements

As indicated above, although cash pooling arrangements are common, corporate groups engage in numerous other arrangements as well to provide short-term funding to group members for use in their business operations. Financial institutions, for example, use numerous arrangements to provide overnight or other short-term financing to their affiliates in different countries. In addition, corporate groups not infrequently may manage their cash through other arrangements some of which may be less centralized than a cash pool. In all these cases, the key points made above are equally applicable: these short-term cash loans are made to achieve business objectives; they are not a particularly flexible means for achieving the types of tax planning that the Per Se Stock Rules apparently are meant to address, in view of these loans' low interest rate, short duration and repayment in cash; and applying the Per Se Stock Rules, while doing little to prevent behavior of concern to the government, will often substantially disrupt routine business transactions and impose a heavy administrative burden on both taxpayers and the government.

We thus strongly recommend that all short-term loans, not just loans through a cash pooling arrangement as such, be eligible for the favorable treatment described in Part VII.C above.

Consistent with the observation we made in Part VII.C, assuming that our recommendations described in Parts IX.A and IX.B are adopted, thus narrowing the scope of the Per Se Stock Rules (and the Funding Rule in particular), we believe that short-term intragroup debt incurred for non-tax related reasons would typically not be subject to recharacterization under Prop. Treas. Reg. § 1.385-3, without the need for special presumptions or other rules.

However, if, instead of adopting these recommendations, the government were to retain the 72-Month Per Se Rule, possibly modifying it to be a rebuttable presumption, then we believe that special rules would be appropriate. Specifically, short-term intragroup loans should be presumed not to be incurred with a principal purpose of funding a distribution or acquisition and, accordingly, should presumptively be excluded from the Per Se Stock Rules.

The limitations that we have described, treating certain arrangements as in reality longer-term financing, rather than short-term loans tied to working capital or liquidity needs, also should be applied beyond the context of cash pooling arrangements.

In addition, we note that, in the case of a short-term loan by a U.S. EG member to a first-tier CFC, there exists a potential to use the Funding Rule to prevent repatriation planning, in a manner not possible in other cases: if such a loan is recast as equity, then repayment of that loan at a time when the CFC has E&P will result in a redemption treated under Section 302 as a dividend to the U.S. EG member.[192] In the case of a cash pooling arrangement, this fact pattern typically will not arise. U.S. EG members normally do not belong to a cash pooling arrangement together with CFCs, due to, among other reasons, the potential for Section 956 issues.[193] However, outside the context of cash pooling, it is possible that a U.S. EG member could make a short-term loan to a first-tier CFC to fund a return of capital distribution. We believe that such a loan properly would be excluded from the favorable presumption for short-term loans that we have recommended, and instead should be evaluated based on the principal purposes for making the loan, under the Funding Rule (as revised per our proposals in Parts VIII and IX).

While the discussion above generally has focused on short-term loans in which cash is advanced to the borrower, we believe the basic principles apply equally to all short-term intragroup debt that is payable in cash. To illustrate:

[192] *Cf.* Falkoff v. Comm'r, 604 F.2d 1045 (7th Cir. 1979) (short-term loan used to finance CFC's cash dividend to U.S. shareholder at year-end; loan repaid at the beginning of the following year).

[193] In principle, a U.S. EG member could participate in a cash pooling arrangement without facing Section 956 issues, if it was solely a lender to the pool. However, given the automated nature of pooling arrangements, any meaningful uncertainty over whether the U.S. corporation could end up as a borrower would, in practice, tend to support leaving the U.S. EG member out of the pool.

Example 13. EG member 1 sells a manufacturing plant to EG member 2 as a step in an internal restructuring, in exchange for a note that is promptly paid off in cash by EG member one or more days later, at a subsequent step in the restructuring.

Example 14. Same facts as Example 13, except the note is paid off in cash at the close of business on the same day as the manufacturing plant is transferred.

The Funding Rule by its terms applies to the note in Example 13 and, seemingly, in Example 14 as well. All of the observations made above in support of giving other short-term loans favorable treatment under the Funding Rule, however, apply equally to those examples. The same would be true, it appears, for an intragroup purchase of any other types of property or services in exchange for short-term debt (or an account payable), save for a purchase of EG stock or an acquisition in an asset reorganization where the debt is issued as boot (both of which are covered by the General Per Se Rules). In addition, the same limitations as described above also ought to apply to favorable treatment of notes issued in these transactions.

VIII. THE PER SE STOCK RULES: BASIC CONSIDERATIONS

The Per Se Stock Rules represent a significant change in current law concerning the classification of corporate interests as debt or equity, providing a highly complex matrix of rules, unconnected to the economic or legal terms of an interest, to make that distinction within an EG. The rules would significantly impact the U.S. tax treatment of a wide range of transactions, a number of which (like the ones just discussed in Parts VII.C and VII.D) involve common activities for corporate groups. Depending on the precise structure used for an intragroup transaction, application of the Per Se Stock Rules either can have potentially beneficial effects for an EG, of a type that may not have been intended in some cases, or can trigger consequences that appear disproportionately harsh, again, in ways that may not have been intended.

While the policy goals that underlie the Per Se Stock Rules are understandable, we have substantial concerns about these rules. If adopted, we believe they would apply in an overly broad matter and create serious collateral problems for taxpayers, while having only mixed success in limiting the types of transactions of concern to the government.

A. Scope of the Rules

Some examples will help in beginning to illustrate the range of collateral consequences that can flow from recharacterizations under Prop. Treas. Reg. § 1.385-3, in fairly commonplace types of transactions. We consider in greater depth later in the report a number of the specific issues raised by these examples, but an initial presentation of them may help in giving an overall sense of the scope of, and the types of follow-on effects created by, the Per Se Stock Rules.

Example 15. Intragroup Financing. Suppose that USP directly owns 2 subsidiaries, USS and CFC Holdco; and CFC Holdco in turn owns CFC Opco. USS makes several loans to CFC Opco to finance its business needs; and CFC Opco pays a distribution to CFC Holdco (out of accumulated E&P) within the 3 years before or after those loans are made. Each of USS's loans will be recast as stock, and repayment of each loan will be treated as a dividend. It appears USS may not be entitled under Section 902 to receive any indirect foreign tax credits with respect to these dividends. Instead, it appears a portion of the foreign taxes in CFC Opco's foreign tax pool may be eliminated each time such a dividend is paid.

Example 16. Acquisition Structuring. Alternative (A): Parent owns Sub 1 and Sub 2. Parent borrows $1,000 from third parties and lends $1,000 to Sub 1, which buys the shares of Target for $1,000 from a third party. Target owns an operating business and all the shares of TS. Following the acquisition, Sub 2 borrows $400 from Parent, and Target sells TS for $400 to Sub 2. Target distributes the $400 to Sub 1, which repays the $400 of the $1,000 loan it owes to Parent. On these facts, the $400 loan by Parent to Sub 2 is a funding loan recast as stock under Prop. Treas. Reg. § 1.385-3(b)(3). Target's sale of TS to Sub 2 is a Section 304 transaction. The result should be the same under Prop. Treas. Reg. § 1.385-3(b)(3), if TS checks the box immediately after being acquired by S2; in that case, the transaction should be treated as an asset reorganization.[194] However, if TS was already a disregarded entity at the time Sub 1 acquired Target, it appears that Parent's $400 loan to Sub 2 would not be recast.

Alternative (B): The facts are the same as in (A), except that after Sub 1 buys Target, Target sells TS to Sub 2 for a $400 note. Target distributes that note to Sub 1, which uses it to repay $400 of the $1,000 loan it owes to Parent. The $400 note issued by Sub 2 as consideration for its purchase of TS is recast as equity under the General Per Se Rule. Target's sale of TS is not a Section 304 transaction. Instead, the Sub 2 note is recast as nonvoting stock of Sub 2, Target is treated as exchanging the stock of TS for Sub 2 nonvoting stock in a taxable transaction and recognizes gain or loss.

Alternative (C): As an alternative to the transaction structure described in (A), if Sub 2 had bought TS directly from Target for $400 prior to the acquisition of Target, with Target then distributing the $400 to the unrelated seller before the closing and Sub 1 then buying Target for $600, then Parent's $400 loan to Sub 2 would not have been recast as equity. If Sub 2 were a U.S. corporation, it would

[194] *See* Rev. Rul. 2004-83, 2004-2 C.B. 157; Prop. Treas. Reg. § 1.385-3(b)(3)(ii)(C).

be entitled to claim deductions for interest paid, and would not be subject to Section 301 treatment when the debt is repaid.

Example 17. Acquisition Structuring. Parent borrows $800 from an unrelated lender and uses the proceeds, plus $200 of its own funds, to buy Target from unrelated sellers for $1,000. Parent then transfers Target to Sub 1, with Sub 1 assuming the $800 of acquisition indebtedness.

In the absence of the Per Se Stock Rules, Parent's transfer of Target to Sub 1 would be treated as an exchange that is not subject to Section 304. In order to apply the Per Se Stock Rules, however, it is necessary to understand the exact manner in which Sub 1's assumption of the $800 debt in the exchange is characterized; and that characterization is not entirely clear. In particular, it appears Sub 1 conceivably might be viewed as issuing an $800 debt instrument to Parent, which then transfers that debt instrument to its creditors in satisfaction of the $800 debt that Parent owes them. Under this characterization, the $800 debt instrument would be treated as equity under Prop. Treas. Reg. § 1.385-3, since it is issued by Sub 1 to Parent as consideration for an acquisition of stock of an EG member. Then, when Parent transfers that debt to Parent's unrelated creditors, it immediately is exchanged back into debt of Sub 1, in a redemption. The result under Section 302 would appear to be a deemed $800 Section 301 distribution by Sub 1 to Parent (notwithstanding the fact that, under Section 304(b)(3)(B) in the absence of Prop. Treas. Reg. § 1.385-3, there would be no such distribution).

Example 18. Check the Box Election. Parent owns 2 subsidiaries, A and B, which are not members of a consolidated group. A's equity has a value of $200, and B has loaned $100 to A. A checks the box within 3 years after the loan is made. Although not entirely clear, it appears that the resulting deemed liquidation of A may be a "distribution" by A to Parent,[195] and thus B's loan to A may be recast as equity under Prop. Treas. Reg. § 1.385-3. More specifically, it appears the loan could be treated as equity of A. Depending on the facts, the liquidation may be a tax-free transaction for Parent only, tax-free for both Parent and B, or taxable for both parties.

Example 19. Transfer Pricing Adjustment. Parent owns Sub 1 and Sub 2, which are not part of a consolidated group with Parent. In 2017, Sub 1 sells products to Sub 2 in the ordinary course of business, at what the EG believes to be an appropriate transfer price. In 2020, Sub 1 borrows from an EG member. Thereafter, the IRS audits 2017, and concludes that the transfer price was too low under Section

[195] *See* Prop. Treas. Reg. § 1.385-3(f)(4), (f)(11).

482. No correlative adjustment is made, and thus the excess of the arm's length price, over the actual price paid, is characterized as a Section 301 distribution by Sub 1 to Parent.[196] All or part of the loan to Sub 1 in 2020, consequently, must be treated as stock, assuming the Current E&P Exception does not apply.

Example 20. Fast-Pay Stock. Parent owns Sub 1 and Sub 2. Sub 1 lends $100 to Sub 2, with the principal amount being payable in multiple installments on specified dates over the term of the loan. Sub 2 distributes $100 to Parent shortly afterward, in a year when it has no current E&P.

Sub 1's loan is recast as equity under the Funding Rule. The payments of principal during the term of the loan are treated as Section 301 distributions, and will be dividends if Sub 2 has sufficient current or accumulated E&P in the years the payments are made. These dividends represent a return of, and not just a return on, Sub 1's $100 investment in the loan. Thus, it appears the loan may be "fast-pay stock" within the meaning of Treas. Reg. § 301.7701(l)-3(b)(2). If Sub 2 is a RIC or REIT, or if the IRS determines that a principal purpose of the arrangement is avoidance of a federal tax, the stock can be recast as debt or some other type of "financing instrument" under the fast-pay stock rules. In addition, the transaction involving the fast-pay stock is a listed transaction.

It should be noted that if the loan provides for a single principal payment at maturity, the analysis appears to be the same as described, because the principal payment would be treated as a Section 301 distribution pursuant to Section 302(d). These points are discussed further in Part XI.A.2 below.

Example 21. Securitization. Parent forms Issuer (a subsidiary not part of a consolidated group) which issues investment grade notes to the public in a securitization transaction. There is initially some difficulty in placing the notes and, as a result, Parent itself acquires and holds for a time some of Issuer's notes. Subsequently, Issuer makes a distribution to Parent in excess of current E&P, pursuant to the terms of the "waterfall" in the note indenture that Issuer has entered into governing the terms of its notes. Parent then sells the notes it holds to third-party investors.

The notes held by Parent will be treated as equity of Issuer as a result of Issuer's distribution to Parent, under Prop. Treas. Reg. § 1.385-3(b)(3). Immediately before Parent sells the notes to third parties, the equity of Issuer is converted back to debt, potentially resulting in a deemed dividend for Parent. It would appear that

[196] *See* Rev. Rul. 69-630.

these notes are a new issue of notes.[197] If the notes do not constitute a qualified reopening,[198] then the issue price of the notes will be determined for these notes as of the date Parent sells the notes to the third-party investors. Thus, these notes will not be fungible with the remainder of the notes Issuer has issued. It is unclear how Issuer will comply with the legending requirement in the OID rules under Treas. Reg. § 1.1275-3(b), if the notes have been issued in physical form.

Example 22. Notes Offering; Dealer Affiliate. Sub, a member of an EG, plans to issue notes to the public. Within the past 3 years, Sub has made a distribution to Parent other than out of Sub's current E&P. Dealer, a member of the same EG, acts as one of the initial purchasers of the Sub notes. Dealer sells some of the Sub notes to third-party investors and holds the rest for some period, before selling them in the market. Similar to the preceding example, the Sub notes held by Dealer will be treated as stock of Sub, which will be deemed to have been redeemed in exchange for debt when Dealer sells debt to the public, resulting in a different issue price for otherwise fungible Sub notes unless the qualified reopening rules apply. Also, Dealer will have a Section 302 redemption treated under Section 301 as a dividend, to the extent of Sub's E&P.

Example 23. REIT with OP and TRS. REIT owns 80% of OP, with unrelated parties owning the remaining 20% of the OP interests. OP wholly owns TRS. TRS distributes a note as a dividend. Under Prop. Treas. Reg. § 1.385-3(f)(5), REIT is treated as directly owning 80% of TRS, which is a member of the EG; and 80% of TRS's note distribution is recast as equity under the General Per Se Rule. The remaining 20% of the note is treated as debt, notwithstanding that it is pari passu with the portion of the note treated as equity. TRS's taxable income is increased as a result of the treatment of 80% of the coupon payments as non-deductible dividends. Absent an agreement among the parties to the contrary, the minority OP unit holders bear 20% of the economic cost of that increase in taxable income, and REIT bears (only) the remaining 80%.

In addition to the above, we also note some additional potential collateral consequences of intragroup debt being recharacterized under the Per Se Stock Rules. In some cases, the consequences for the taxpayer—as well as for other, unrelated parties—can be highly adverse.

- *S corporations, REITs and RICs*. Application of the rules may result in disqualification of S corporations, REITs, and RICs, including in cases where Prop. Treas. Reg. § 1.385-3 if applied literally could dictate a result inconsistent with a Congressionally

[197] Treas. Reg. § 1.1275-1(f)(1).

[198] *See* Treas. Reg. § 1.1275-2(k).

mandated standard or safe harbor such as the straight debt safe harbor (S corporations) or the TRS rules (REITs).

- *Section 1504*. A subsidiary in a consolidated group may be deconsolidated if, for example, debt that the subsidiary owes to a foreign EG member is recharacterized as stock under Prop. Treas. Reg. § 1.385-3. It appears this stock generally would be preferred stock; however, it might not always have the features described in Section 1504(a)(4), *e.g.*, if the stock is treated as issued at a material discount to its redemption price or liquidation premium, thus causing the stock not to meet the requirements of Section 1504(a)(4)(C) (at most a "reasonable" redemption or liquidation premium).[199]

- *Section 382*. A loss corporation could undergo an ownership change, if debt is recast as stock other than Section 1504(a)(4) preferred stock.

- *CFC status*. A recast of debt owed by a foreign EG member may cause it to become, or cease to be, a CFC. In addition, the rules have the potential to create Subpart F income for the U.S. shareholders of a CFC that is an EG member, including U.S. shareholders who are not EG members (and who may have limited or no ability to control the transactions resulting in the recast of debt as equity under Prop. Treas. Reg. § 1.385-3). For example, suppose FP owns 60% of Forco (worth 60), USS (a subsidiary of FP) owns 20% (worth 20), and a U.S. co-investor owns the remaining 20% (worth 20). USS makes a 21 loan to Forco. If that loan is recast as stock due to actions of Forco (*e.g.*, a pro rata distribution to its shareholders in a year when it does not have current E&P), then Forco will become a CFC.

- *Impact on application of Sections 332/351/368 to corporate transactions*. It may be more difficult for an intragroup restructuring to satisfy the "control" requirements of Section 351 and 368, or the 80% of vote-and-value test in Section 332, as a result of a recast of debt as equity under Prop. Treas. Reg. § 1.385-3.

- *Hybrid instruments*. Application of these rules likely will result in the creation of a significant number of cross border hybrid instruments. There is a tension between that result and the recent effort by the OECD (endorsed by the United States) to limit the ambit of these hybrids (BEPS Action 2). Even if it is assumed that countries proceeding to implement Action 2 will be able to combat hybrid structures effectively, it

[199] *Cf*. CCA 201152016 ("Today, it remains unclear what constitutes an 'unreasonable redemption premium' for purposes of applying Section 1504(a)(4)(C). In fact, commentators have advised taxpayers to request a private letter ruling in advance of any transactions relying on the operation of Section 1504(a)(4)(C) in order to obtain more definitive guidance on the status of what constitutes a unreasonable redemption premium.").

appears Prop. Treas. Reg. § 1.385-3 will likely put that to the test, with uncertain results (and an uncertain response from the other OECD countries). In addition, as discussed further below, Prop. Treas. Reg. § 1.385-3 potentially may result in many new Section 909 splitter transactions (although, in a number of these cases, the potential concern underlying the splitter rules would be absent).

- *Treaties.* An EG member may cease to meet the requirements of an applicable treaty's limitation on benefits article, if debt of the EG member is recharacterized as equity. The Per Se Stock Rules also may alter how the provisions of Treas. Reg. § 1.881-3 (the anti-conduit rules) apply to transactions between EG members.

- *Tax-exempt entities*. Prop. Treas. Reg. § 1.385-3 sometimes may apply to cases involving loans to, or by, tax exempt entities in a manner that is in tension with specific standards set forth in the Code (for example, Section 512(b)(13), treating interest payments to a tax-exempt entity by a taxable affiliate as UBTI).

In view of the range and potential seriousness of the consequences for taxpayers of a recharacterization under the Per Se Stock Rules, we believe it is important to consider how precisely the rules have been structured to achieve their intended purposes. We describe below what we believe to be the core objectives of the rules, and propose revisions to the structure of the rules that we believe could help both taxpayers and the government apply the rules more easily and in a more targeted manner to achieve the government's key goals.

B. Basic Structure and Purpose of the Per Se Stock Rules

The Preamble suggests that the Per Se Stock Rules are motivated to a significant extent by cases in which an EG member uses an intercompany loan to make a leveraged distribution. The government's concern appears to be that this leveraging of an EG member often will have little real economic impact: there is no third-party lender to impose discipline on the EG member; and the EG member is not acquiring any new assets from outside the group. Yet, notwithstanding this limited economic impact, the group would (but for the Per Se Stock Rules) be able to use the issuance of the debt to create U.S. tax benefits, including by creating interest deductions for the issuer.[200] Inverted companies, for example, can benefit through earnings stripping enabled by the inverted U.S. corporation's distribution of a note to its new foreign parent, a technique squarely addressed by the Proposed Regulations.[201]

[200] Preamble, at 20917–18.

[201] In addition to creating interest deductions, a distribution of a note by a U.S. subsidiary of a foreign parent might also aid in earnings stripping in other ways. For example, if a foreign parent forms a new U.S. subsidiary to acquire an unrelated U.S. corporate group, in exchange for foreign parent stock, the new U.S. subsidiary normally will become the parent of a new consolidated group together with the acquired U.S.

The Per Se Stock Rules reach beyond straightforward distributions in the pursuit of their objective of curtailing earnings stripping and other perceived inappropriate behavior, to catch broadly similar transactions. For example, if an inverted U.S. corporation issues a note as consideration to purchase newly issued stock from its foreign parent, that transaction would not be covered by Treas. Reg. § 1.367(b)-10, if the purchase does not occur as part of a triangular reorganization, or if a dividend from the U.S. corporation to its foreign parent would not be subject to U.S. withholding tax or U.S. net income tax.[202] However, such a transaction would be addressed by the Per Se Stock Rules. Application of the rules to transactions like the one just mentioned can be seen as a logical extension of the attack on leveraged distributions, because the transaction, particularly if the U.S. subsidiary executes a dividend waiver and does not plan to dispose of the parent stock, appears economically akin to a distribution.

Especially when viewed from the perspective of curtailing earnings stripping, a number of the decisions in the Per Se Stock Rules to reach other particular types of transactions also can be explained. Aside from the use of hook stock of a foreign parent in order to leverage up a U.S. subsidiary in a multinational group (as described above), an EG might be able to achieve what is arguably a similar result through cross-chain sales of stock of a U.S. subsidiary. For example, in a case where (somewhat similar to the facts in Example 16 Alternative (B) above) FP owns USS 1 and USS 2, and FP sells USS1 to USS2 for a note, FP has managed to introduce additional leverage into its U.S. subsidiaries without introducing new assets into U.S. corporate solution or, arguably, making any other truly substantive changes. The same could also be said where, immediately after the transaction just described, USS1 elects to be treated as a disregarded entity of USS2, thus transforming the transaction to a D reorganization.[203]

corporations. At the time of the acquisition, the acquiring U.S. subsidiary will have no E&P, and under Treas. Reg. § 1.1502-33, the pre-acquisition E&P of the acquired U.S. corporations will not tier up to the acquiring U.S. subsidiary. Thus, if the acquiring U.S. subsidiary is able to distribute a note to the foreign parent, before the acquired U.S. corporations generate material post-acquisition E&P that would tier up under Treas. Reg. § 1.1502-33, the distribution will not treated as a dividend. That result will be advantageous if the foreign parent is not entitled to the benefit of a U.S. tax treaty that fully eliminates U.S. withholding tax on dividends from the U.S. subsidiary.

Apart from being used for earnings stripping, leveraged distributions also facilitate planning for E&P repatriation from a U.S. parent's CFCs under current law, and possibly also other transactions to manipulate E&P within a group of CFCs, and the Preamble indicates the Per Se Stock Rules are aimed at limiting opportunities for such planning. *See* Preamble, at 20916–17.

[202] Treas. Reg. § 1.367(b)-10(a)(1), (a)(2)(ii).

[203] As noted above, the Preamble indicates that, apart from earnings stripping, one of the reasons for including stock acquisitions and asset reorganizations within the scope of Prop. Treas. Reg. § 1.385-3, is to deal with concerns about inappropriate manipulation of the E&P of EG members that are CFCs. *See* Preamble, at

The Per Se Stock Rules recharacterize debt issued as consideration in these intragroup stock sales and asset reorganizations even though, often, these transactions are, economically, unlike a distribution of a note. When one EG member buys a controlling stake in another in exchange for a note, the purchasing corporation does not decrease its equity value; and it acquires (through owning a controlling stake in the target) additional assets it did not own before. If the acquiring corporation owns no real assets, other than what it acquires in the transaction, then the overall effect may be to lever up the target's assets. However, this is not the case where the acquiring corporation does own material other property. The same is true where a corporation that owns real assets issues debt as consideration when it acquires another EG member in an asset reorganization. Notwithstanding the fact that these transactions are economically distinguishable from distributions by a corporation of its own debt, the important consideration for the government appears to be that, in its view, these transactions tend to lend themselves particularly well to creating interest deductions and other U.S. tax benefits with few or no costs or other real impacts on the group.[204] It may also be relevant in the government's view that, when looking at the acquiring EG member and the target on a combined basis, the transaction has increased debt and reduced corporate equity. The government appears to distinguish such transactions from cases where an EG member issues debt within the group to finance a purchase of assets in a non-reorganization transaction, perhaps because a purchase of assets could generally result in recognition of gain by the seller and meaningful U.S. tax costs, more often than an intragroup stock sale or reorganization would.[205] (An asset purchase also would not result in a leveraging up of the acquiring and selling EG members when viewed on a combined basis.)

Importantly, the government also appears to distinguish the distributions and acquisitions covered by the Per Se Stock Rules from transactions where an EG member incurs intragroup debt in order to finance a purchase of assets from an unrelated third party. In these cases, the debt can be seen as having real substance, because the borrower invests the proceeds in expanding the group's overall operations; for example, when a U.S. subsidiary borrows from a foreign affiliate to invest in the group's U.S. operations, the effect normally is to increase the overall amount of the EG's U.S. assets and income, rather than just creating interest expense for the U.S. members of the group.[206]

The overall result of these rules is to cover a collection of dissimilar transactions. Besides being economically different, they can have disparate tax consequences: a debt distribution is

20917–18. To the extent this is the case, it appears this goal has been only partially achieved in the rules in Prop. Treas. Reg. § 1.385-3 applicable to those transactions. See Part IX.A.1 below.

[204] *See* Preamble, at 201917–18.

[205] *See* Preamble, at 201924. An asset sale by a foreign corporation without a U.S. branch would not result in U.S. tax costs, assuming it was not a CFC.

[206] *See* Preamble, at 20917.

covered regardless of whether it would be treated for tax purposes as a Section 301 distribution, or a Section 302(a) redemption; stock acquisitions similarly are covered regardless of whether made pursuant to a transaction treated as a Section 301 distribution pursuant to Section 304; and asset reorganizations are included regardless of whether they provide for boot treated as a dividend pursuant to Section 356. The only common thread that appears to link the transaction types together is that, in the certain circumstances, they can be used by a foreign parent for earnings stripping from its U.S. subsidiaries or, perhaps, by a U.S. parent to manipulate the E&P of its CFCs.

The Preamble suggests that, in the government's view, the distributions and acquisitions described in the Per Se Stock Rules tend to have little substance and to be motivated largely by achieving U.S. tax advantages, and that it is thus appropriate to respond by recharacterizing debt as equity automatically in almost all cases when it is issued in these transactions.[207] The Proposed Regulations provide no exception in cases where a distribution or acquisition is not, in fact, entered into with a purpose of obtaining U.S. tax benefits. Thus, while the discussion in the Preamble indicates that Prop. Treas. Reg. § 1.385-3 is designed primarily as a weapon against inappropriate planning for inbound and outbound transactions in an EG, the Per Se Stock Rules also apply in instances when there appears to be no policy justification, for example, to transactions between foreign corporations whether or not either of them is a CFC and whether or not the transaction would (if respected) be likely to improve any party's U.S. tax position beyond what it would be if no transaction took place and to transactions between U.S. non-consolidated corporations, again whether or not the transactions (if respected) would improve the parties' U.S. tax position.

We have significant concerns about the indiscriminate nature of the Per Se Stock Rules. It seems hard to justify an assumption that the broad range of transactions covered by the rules are typically entered into for little or no reason and have little or no practical effect, other than achieving U.S. tax benefits, regardless of the surrounding circumstances. The lack of a more targeted approach is particularly problematic in view of the far-reaching collateral consequences of falling within the rules, as described in Parts VII and VIII.A. We thus urge the government not to finalize the Per Se Stock Rules and, instead, to pursue alternative forms of guidance.

[207] *See*, *e.g*., Preamble, at 20917 ("The factors discussed in *Kraft* and *Talbot Mills*, including the parent-subsidiary relationship, the fact that no new capital is introduced in connection with a distribution of debentures, and the typical lack of a substantial non-tax business purpose, support the conclusion that the issuance of a debt instrument in a distribution is a transaction that frequently has minimal or nonexistent non-tax effects….any non-tax effects of a distribution of a debt instrument to an affiliate are often minimized or eliminated, allowing the related parties to obtain significant federal tax benefits at little or no cost. Accordingly, based on these considerations, the Treasury Department and the IRS have determined that in fact patterns similar to *Kraft* it is appropriate to treat a debt instrument as stock."); *see also id.* at 20917–18 (making similar statements about intragroup stock sales and asset reorganizations).

By comparison, rules that expressly target earnings stripping by a foreign parent following an inversion, or inappropriate repatriation planning by a U.S. parent, would avoid sweeping in large numbers of irrelevant cases; as discussed in Part I.B, this would be a considerable improvement over the currently proposed rules, even though this also would be a significant departure from the tax law's traditional approach to debt:equity analysis.

Alternatively, another possibility described in Part I.B, which also would represent a reasonable response to earnings stripping, would be to recharacterize intragroup debt as equity to the extent the issuer has debt in excess of the third-party debt:equity ratio of the worldwide corporate group. This approach would be based more firmly on traditional debt:equity factors than the Per Se Stock Rules are; and the potentially serious consequences of a recharacterization under the rules would be mitigated, to some extent, by the fact that a corporation could issue intragroup debt up to a reasonable ceiling. If greater restrictions on E&P planning for CFCs were desired, then the government could consider issuing separate guidance under Sections 301, 956 or 7701(l) specifically addressed to that planning, as described in Part I.B; given the Per Se Stock Rules' limited effectiveness as a means of addressing that planning, this approach could achieve better results than the current proposed rules would.

If the government instead decides to retain the basic approach taken in the Per Se Stock Rules, then we strongly recommend that they be put forward in a substantially narrowed form for additional review and comment by the public. We propose in Part IX several changes to the Per Se Stock Rules that are designed to allow the government to achieve its key objectives, while limiting the opportunities for unanticipated adverse collateral consequences. Briefly, the intended cumulative effect of our proposed changes is for the Per Se Stock Rules to apply principally to an EG member's issuance of intragroup debt in non-ordinary course transactions that are intended to, and do, result in a reduction of the issuer's equity capital, and that impact the U.S. tax reporting of at least one EG member. We believe these transactions are the ones possessing by far the most potential for the abuses the government is seeking to attack.

As a more specific overview:

First, we propose that Treasury and the IRS limit the reach of the Per Se Stock Rules. They should not apply to foreign-to-foreign transactions, because these transactions do not implicate the policy objectives of the rules, and application of the rules to such transactions has the potential for substantial disruption of normal commercial activities.

Second, the rules should not apply to distributions and acquisitions that are matched by contributions of equity capital to the distributing or acquiring corporation which it retains for use in its operations. This exception will help ensure that, as apparently intended, the Per Se Stock Rules do not catch cases where the borrower under an intercompany loan invests in its operations, rather than using the loan to increase the leverage in its capital structure.

Third, we strongly urge that the government limit the scope of the Funding Rule, which in its current form is responsible for a disproportionate share of the most serious collateral consequences created by the rules. The 72-Month Per Se Rule should be removed. Our preference would be to make a broader change to the Funding Rule so that it applies only when a loan of cash or property is made between EG members with a principal purpose of accomplishing the same economic result as a distribution or acquisition described in the General Per Se Rule. If our preferred approach is not adopted, then the Funding Rule should provide for a rebuttable presumption that a loan occurring within, say, one to two years of a distribution or acquisition has a principal purpose of funding that transaction.

Fourth, the final regulations should provide favorable treatment for a range of garden-variety business transactions, and other transactions that realistically have little if any potential for abuse.

Fifth, the antiabuse provisions in the Per Se Stock Rules should be narrowed and clarified, so that they serve to protect, rather than potentially significantly broadening, the scope of the rules.

Given the complexity of the rules and the departure they represent from longstanding prior law, we believe that any future guidance issued should not be effective immediately, at least for the large majority of taxpayers. Instead, as discussed below, this guidance either should be issued entirely in proposed form, or else should have immediate application only to limited, clearly defined categories of taxpayers engaged in what is seen as abusive structuring—inverted corporations, for example—with other taxpayers receiving an opportunity to review and comment on the rules before they become more broadly effective.

IX. CHANGES TO REDUCE THE SCOPE OF THE PER SE STOCK RULES

A. Limiting the Rules to Transactions that Involve a U.S. Taxpayer and a Reduction in Equity Capital

1. Carving Out Foreign-to-Foreign Transactions

We recommend that the Per Se Stock Rules not apply to loans, distributions, or acquisitions between foreign EG members, except where a member has a U.S. branch representing a large part of its assets. This exclusion should not interfere to a meaningful extent with the government's ability to achieving its policy objectives, and will help significantly in limiting the practical issues the rules could otherwise create.

A debt distribution, or other "distribution-like" transaction between foreign EG members that do not have U.S. branches, logically cannot facilitate U.S. earnings stripping by the EG member making the distribution or acquisition. In addition, if that EG member is a CFC, its ability to repatriate cash to U.S. EG members, without current inclusion by them of dividend income, is unlikely to be greater if it issues debt to a foreign affiliate, than if it issues stock to the foreign affiliate. As indicated by Example 12 in Part VII.C above, if a first-tier CFC that has no E&P acquires cash or property from another CFC, in exchange for the issuance of stock to such CFC, the first-tier CFC continues to have no E&P. It thus is in a position to distribute the cash or property to its U.S. shareholders as Section 301(c)(2) nontaxable recovery of capital, and then in a later year use property distributed to it by other CFCs to redeem the stock, with such redemption generally not resulting in Subpart F income due to Section 954(c)(6). The results would be essentially the same, if the first-tier CFC had borrowed from another CFC; or if the first-tier CFC had been funded by an equity or debt investment by a foreign EG member that is not a CFC.

In addition, a lower-tier CFC may be able to reduce its E&P by issuing a note to another CFC in the EG.

> *Example 24.* USP owns CFC Holdco, which has no current or accumulated E&P. CFC Holdco owns 2 chains of CFCs: CFC 1, which owns CFC 2; and CFC 3, which owns CFC 4. CFC 3 has $100 of accumulated E&P. CFC 1 sells CFC 2 to CFC 3, in exchange for a $100 note.

Absent the Per Se Stock Rules, the result under Section 304 would be to reduce CFC 3's E&P by $100. CFC 3 then could make a nontaxable return of capital distribution to CFC Holdco under Section 301, assuming CFC Holdco had sufficient basis in the stock of CFC 3. The Per Se Stock Rules would apply here to prevent CFC 3's E&P from being reduced in Example 24. However, if CFC 3 received a debt or equity investment of $100 cash from an affiliate, it could use that cash to buy the stock of CFC 2 from CFC 1, with the precisely the same consequences under Section 304 as would apply in the absence of the Per Se Stock Rules. If CFC 3 owned, or was able to acquire from an affiliate, a non-cash asset with a tax basis approximately equal to value (*e.g.*, a $100 note from an intercompany loan that had previously made to some other EG member), then CFC 3 also could transfer that asset to CFC 1 as consideration in the Section 304 transaction. Alternatively, CFC 3 could lend $100 to CFC Holdco (or acquire hook stock of CFC Holdco), if it was desirable for CFC 3 to move cash or property to its shareholder without moving E&P.[208]

[208] It is possible to conceive of variations on Example 24. For instance, CFC 1 might have low-taxed E&P; CFC 2 might have high-taxed E&P; and CFC 3 might have $100 of low-taxed E&P. Absent the Per Se Stock Rules, CFC 3 could buy the stock of CFC 2 for a note, with the result under Section 304 being that CFC 1 would end up with its own and CFC 3's low-taxed E&P; and CFC 3, now with zero E&P, would own CFC 2, with its high-taxed E&P. As in Example 24, application of the Per Se Stock Rules would prevent that result; but, a range of alternative transactions would be available that would allow CFC 3 to buy the stock of CFC 2 with the same results under Section 304 as just described.

Thus, application, or non-application, of the Per Se Stock Rules to transactions between CFCs (or between a CFC and a foreign EG member that is not a CFC) appears not to have a meaningful impact on strategies for nontaxable repatriation of the CFC's profits to U.S. EG members, or other transactions designed to move E&P between CFCs. As noted above in Part I.B.2, Treasury and the IRS could consider issuing separate guidance specifically designed to address these issues.

By comparison to the cases described above, a foreign EG member that has a U.S. branch is subject to U.S. net income tax and, thus, it might be asked whether it should be treated the same as a domestic EG member for purposes of the Per Se Stock Rules. However, a foreign corporation with a U.S. branch generally allocates interest expense to income from that branch using a formulary method provided in Treas. Reg. § 1.882-5. Where the foreign corporation also owns substantial assets that are not part of the U.S. branch, the requirement to use this formulary method tends to make it difficult to disproportionately leverage the U.S. branch in order to artificially reduce its effectively connected income. We believe that, in such a case, none of the debt owed by the foreign corporation should be subject to the Per Se Stock Rules, since the principal concern motivating the Per Se Stock Rules would appear to be absent. For this purpose, we believe a foreign corporation's assets outside the U.S. branch ought to be viewed as substantial if, for example, they represent (as computed under the principles of Treas. Reg. § 1.882-5) at least 50% of the foreign corporation's total assets.

If a foreign corporation with a U.S. branch is entitled to the benefit of a U.S. tax treaty, and uses a formulary method to allocate interest expense to the branch pursuant to the business profits article of the treaty,[209] then it would appear that the same logic should apply (*i.e.*, the requirement to use a formula to allocate debt and interest expense to the U.S. branch should help to frustrate efforts to artificially lever up the U.S. branch).

Accordingly, exclusion of transactions between foreign EG members from the Per Se Stock Rules does not seem to interfere meaningfully with the ability of the rules to achieve the policy objectives motivating them. As described further in Part XIV below, exclusion of these transactions also has significant practical advantages for taxpayers and the government: it eliminates the need to keep, or in some cases reconstruct, records supporting the U.S. tax analysis as to whether a particular foreign-to-foreign loan should be characterized as equity under the Per Se Stock Rules, where there might be no documents prepared in the normal course of the relevant EG members' regular activity that would provide a ready source of the necessary information. In addition, exclusion of foreign-to-foreign loans would have the practical effect of placing cash pooling among CFCs, and among non-CFC foreign EG members, outside the Per Se Stock Rules,

[209] *See*, *e.g.*, Technical Explanation to Art. 7 of the U.S. Model Income Tax Treaty (2006) (stating that a treaty resident can allocate interest expense to its U.S. branch by taking into account the risk-weighted value of the U.S. branch's assets relative to the company's worldwide assets).

as well as many other ordinary-course commercial transactions in which these group members engage.

Indeed, these practical benefits suggest a broader substantive point. The Per Se Stock Rules as currently drafted apply neutrally. That is, they apply regardless of the U.S. tax characteristics of the EG members that are the borrower and lender as domestic or foreign, taxable or tax-exempt, profitable or loss-making. Our proposal represents a departure from that basic approach. However, in many cases, there may be foreign regulatory, tax, accounting or other objectives that a foreign-to-foreign loan, distribution or acquisition achieves, with U.S. tax considerations being secondary, or non-existent (as is the case for cash pooling by foreign EG members, for example). Thus, the fact that a debt instrument is foreign-to-foreign, or is used to fund a foreign-to-foreign distribution or acquisition, can be seen as a favorable factor that merits being taken into account, in support of respecting the loan as debt. The Preamble notes that debt issued in a distribution or acquisition often may have limited significance apart from U.S. tax. That generalization would appear to be of questionable accuracy in the case foreign-to-foreign transactions.

Further, the approach we have described appears to be generally consistent with the United States' obligations under non-discrimination provisions in its treaties. In essence, these provisions require that a U.S. resident be entitled to deduct interest paid to a resident of the treaty partner on the same conditions as would apply if the payee were a U.S. resident.[210] Our proposal does not prevent that from being the case.

In addition to excluding foreign-to-foreign transactions from the Per Se Stock Rules, Treasury and the IRS could consider excluding other transactions as well that are between EG members of a like U.S. tax status: for example, U.S. C corporations that are not members of a consolidated group, or U.S. tax-exempt entities. Another commentator has proposed such an approach, and it appears to us to have some material potential benefits.[211] Considerations in reviewing and implementing such an approach would include how similar the U.S. tax profiles of the two EG members should be, in order for them to be considered of a like tax status;[212] and what impact (if any) excluding such transactions will have on the treaty non-discrimination analysis of the Per Se Stock Rules. At a minimum, it appears to us that modifying the rules to exclude foreign-to-foreign debt from the Per Se Stock Rules would be a substantial, salutary change.

[210] *See* U.S. Model Income Tax Treaty, Art. 24(1), (4), (5) (2006); U.S. Model Income Tax Treaty, Art. 24(1), (4), (5) (2016).

[211] *See* James M. Peaslee, Letter to the IRS Re: IRS REG-108060-15 (Section 385 Proposed Regulations), May 18, 2016, at 6.

[212] *See, e.g.,* Kraft Foods Co. v. Comm'r, 232 F.2d 118 (2d Cir. 1956) (loan by a loss-making U.S. parent C corporation to profitable, non-consolidated U.S. C corporation subsidiary), discussed in the Preamble.

2. Carving Out Transactions that Do Not Result in a Reduction in Equity Capital

We recommend that the Per Se Stock Rules should be limited such that a debt instrument will be recharacterized as stock only if, and to the extent that, the amount of the debt eligible for recharacterization under the Per Se Stock Rules by reason of a distribution or acquisition exceeds the amount of equity capital received by the EG member issuing the debt from other EG members in transactions connected with the distribution or acquisition.

This proposal follows from the basic observation that Prop. Treas. Reg. § 1.385-3 appears to be intended to address transactions where issuance of intercompany debt does not provide any new capital to the issuer.[213] By comparison, Prop. Treas. Reg. § 1.385-3 apparently is not meant to apply, where the issuer does receive real new capital from its affiliates.[214] The Per Se Stock Rules do not, for example, prevent a corporation from borrowing $100 in cash from members of its EG, where the corporation does not make related distributions or acquisitions, but instead uses the cash to buy assets or operate its business. It appears somewhat arbitrary to penalize the corporation if, instead, it borrows $100, receives a $20 equity capital contribution, and distributes $20 to its shareholder.

More specifically, when applying the Funding Rule, it appears appropriate to inquire whether a distribution or acquisition funded by a loan was made as part of a plan that included an equity capital contribution.

In addition, it would appear reasonable to provide for symmetrical treatment under the General Per Se Rule, consistent with our comments elsewhere trying to achieve consistency to the extent possible between the treatment imposed by the General Per Se Rule and the Funding Rule. Thus, if the facts of the above example are changed so that instead of borrowing $100, receiving a $20 capital contribution, and distributing $20 in cash, the corporation borrows $80 of cash, distributes a $20 note, and receives a $20 capital contribution, the results should remain the same (*i.e.*, no recharacterization).

If, contrary to our recommendation, the 72-Month Per Se Rule is retained in the final version of the regulations, then the above principle could also be added as a limitation on that rule. Specifically, if an EG member would potentially fall within the 72-Month Per Se Rule due to a borrowing within 3 years before (or after) a distribution or acquisition, then amount of debt that would otherwise be recharacterized would be reduced by the amount of equity capital received by the borrowing member from others in the EG within the same three-year period. (In a case where a loan is made after—but less than three years after—a distribution or acquisition, there

[213] Preamble, at 20917–18.

[214] *See* Treasury Fact Sheet ("The Proposed Regulations generally do not apply to related-party debt that is incurred to fund actual business investment, such as building or equipping a factory.").

may not yet be complete certainty as to the amount of capital contributions that will be made to the borrowing member over the remainder of the three-year period. In that situation, in interest of administrability, we would recommend determining whether to recharacterize the loan based on the amount of capital contributions that, as of the time the loan is extended, are planned to be made over the remainder of the 3-year period.)

Similar to the approach in the Proposed Regulations matching a particular borrowing with a particular distribution or acquisition for purposes of the 72-Month Per Se Rule, a transaction infusing equity capital into the borrower would first be matched against the earliest borrowing by the issuer that otherwise would be recharacterized under the per se rule.[215] In addition, distributions that are subject to the Current E&P Exception would be disregarded, for purposes of comparing the amount of equity capital to the amount distributed during the relevant period.

In order to ensure the above proposals fit with the overall scheme of the Proposed Regulations, it appears that an equity capital contribution of stock of an EG member, or of assets of an EG member pursuant to an asset reorganization, should not be taken into account for purposes of these proposals. As noted in Part VIII.B, an EG member's acquisition of such stock or assets differs from a distribution of a note, because these transactions result in the purchaser owning valuable new assets, with no diminution in its net worth. However, Treasury and the IRS have made the decision to apply equity treatment to intragroup debt that is issued in connection with these acquisitions. It would be consistent with that basic approach to disregard these acquisitions, when measuring equity capital contributions for purposes of reducing the amount of debt that is recast as equity under the Per Se Stock Rules. For example, if P contributes P shares worth $100 to the capital of S, and S distributes a $100 note to P as part of the plan, the contribution of the P shares should not prevent the note from being recharacterized as equity under the Per Se Stock Rules.

In addition, the government could consider further limitations to ensure the basic approach we have suggested is not used to reach results that could be seen as inappropriate from a policy perspective. For example, suppose FP owns USS1 and USS2, which are accordingly not members of the same consolidated group. If USS1 contributes $100 of cash to USS2 in exchange for USS2 shares, and USS2 then distributes a $100 note to FP, then the exception that is proposed above would potentially apply, even though the overall result would be that no new assets have entered U.S. corporate solution and USS2 now has $100 of new debt outstanding to FP. In order to prevent such results, a limitation could be added to our proposed rule: in the case of a foreign-parented group, a contribution of equity capital by one U.S. EG member to another U.S. EG member could be disregarded, for purposes of testing whether a debt instrument issued to a

[215] *See* Prop. Treas. Reg. § 1.385-3(b)(3)(iv)(B)(3)–(4).

foreign EG member by the U.S. EG member that received such capital contribution should be recharacterized. Similarly, in the case of a U.S. parented group with CFCs, it could be considered whether to add a limitation that an equity capital contribution by a foreign EG member to a CFC should be disregarded, for purposes of testing a debt instrument issued to a U.S. EG member by the CFC receiving the capital contribution.

B. Limiting the Reach of the Funding Rule

Although the Funding Rule is positioned in the Preamble and the Proposed Regulations as a means to prevent avoidance of the General Per Se Rule, the Funding Rule in fact sweeps in a substantially broader array of cases than the general rule, due principally to the unusually long reach of the 72-Month Per Se Rule. The Funding Rule as currently configured is responsible for many of the most serious of the technical problems raised by Prop. Treas. Reg. § 1.385-3 that are discussed in Parts VII through XIII of this report: the widespread potential application of the Per Se Stock Rules to cash pooling loans (Part VII.C and VII.D) and other ordinary course intragroup finance transactions (Part IX.C); the far-reaching recharacterization of an EG member's loan to a Controlled Partnership (Part XII); the seemingly unintentionally broad definition of a successor (Part XIII.A); the possibility that the Funding Rule could apply where a corporation borrows while in one EG and makes a distribution or acquisition while in another EG (Part XIII.C); and the potential for cascading recasts of different intragroup debt instruments as equity (Part XIII.B). The breadth of the Funding Rule also puts significant pressure on the Current E&P Exception and other exceptions provided in the Proposed Regulations (Part X), and focuses attention repeatedly on some of the seemingly arbitrary consequences of holding and disposing of intragroup debt that has been recharacterized under the Per Se Stock Rules (Part XI), including the potential for duplicative dividend inclusions (Part XI.B).

Particularly if the government is seeking to issue guidance in the near term, we thus believe it will be important to narrow the Funding Rule. An indispensable starting point will be to remove the 72-Month Per Se Rule. Our preferred approach would be to couple that removal with a broader overhaul of the rule, to the effect that a loan of cash or property to an EG member will be recharacterized only when the loan is made with a view to accomplishing the same economic result as a distribution or acquisition subject to the General Per Se Rule. Alternatively, at a minimum, the 72-Month Per Se Rule should be replaced with a rebuttable presumption as to whether a debt is linked with a distribution or acquisition.

1. Removal of the 72-Month Per Se Rule

The Preamble explains the Funding Rule as designed to prevent taxpayers from manipulating internal flows of funds in a manner that avoids engaging in a distribution or acquisition described in the General Per Se Rule, but that economically is essentially similar to such a transaction. The Preamble states:

> The Treasury Department and the IRS have determined that the policy concerns implicated by the transactions described in Sections C.2 through C.3 of this Part IX [*i.e.*, those described in the General Per Se Rule] are also present when a corporation issues a debt instrument with a principal purpose of funding certain related-party transactions. Specifically, the Proposed Regulations treat a debt instrument issued for property, including cash, as stock when the debt instrument is issued to an affiliate with a principal purpose of funding (1) a distribution of cash or other property to a related corporate shareholder, (2) an acquisition of affiliate stock from an affiliate, or (3) certain acquisitions of property from an affiliate pursuant to an internal asset reorganization. Without these funding provisions, taxpayers that otherwise would have issued a debt instrument in a one-step transaction described in Sections C.2 through C.3 of this Part IX would be able to use multi-step transactions to avoid the application of these Proposed Regulations while achieving economically similar outcomes.[216]

The Proposed Regulations implement this intent by providing a rule that an intragroup loan is recharacterized as equity where it is made with "a principal purpose" of funding these distributions and acquisitions.[217] As noted above, the Proposed Regulations further provide that, in general, the existence of such a principal purpose is determined based on all the facts and circumstances.[218]

However, the rules for determining whether a principal purpose exists then go on to state that, except in the case of ordinary-course trade payables for goods or services that are currently deductible under Section 162 (or taken into account in computing cost of goods sold or inventory), the 72-Month Per Se Rule will apply to all intragroup debt issued within the 3 years before or after a distribution or acquisition. The government offers the following rationale:

> The Treasury Department and the IRS have determined that this non-rebuttable presumption is appropriate because money is fungible and because it is difficult for the IRS to establish the principal purposes of internal transactions. In the absence of a per se rule, taxpayers could assert that free cash flow generated from operations funded any distributions and acquisitions, while any debt instrument was incurred to finance the capital needs of those operations. Because taxpayers would be able to document the purposes of funding transactions accordingly, it would be difficult for the IRS to establish that any particular debt instrument was incurred with a principal purpose of funding a distribution or acquisition. The exception discussed in Section C of this Part IX for distributions and acquisitions that do not exceed current

[216] Preamble, at 20918.

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

[218] Prop. Treas. Reg. § 1.385-3(b)(2)(iv)(A).

> year earnings and profits would accommodate many ordinary course distributions and acquisitions, providing significant flexibility to avoid the application of this per se rule. The Treasury Department and the IRS have determined that this exception, together with the exception for a tainted debt instrument that does not exceed $50 million, also discussed in Section C of this Part IX, appropriately balance between preventing tax-motivated transactions among members of an expanded group and accommodating ordinary course transactions.[219]

Several points about this rationale are worth noting. First, the quoted text seeks to justify the 72-Month Per Se Rule on the ground that "money is fungible." However, the rule does not, in fact, take the approach that money is fungible. That is, the rule does not examine all sources and uses of cash for the funded EG member over the 72-month period, and allocate intragroup debt incurred by the EG member ratably to all of its uses of cash during that period, including any distribution or acquisition completed by the EG member that is described in Prop. Treas. Reg. § 1.385-3. Instead, the rule automatically matches the intercompany loan solely with the distribution or acquisition. To the extent this automatic matching can be explained, it would appear the explanation must be that it is a rule of convenience in establishing the taxpayer's bad intent: a rule that is designed to overcome the fact that "it is difficult for the IRS to establish the principal purposes of internal transactions."

However, this explanation does not justify a decision to include a per se rule with no exception for transactions where an impermissible principal purpose is clearly not present. In the example in Part VII concerning cash pooling and in Examples 15, 16, 18, 19, 20, 21 and 22 above, for instance, it appears difficult to escape a conclusion that the intragroup loans in question have not been made to fund distributions or acquisitions described in Per Se Stock Rules, even taking into account the IRS's challenges in verifying, upon audit, the real motivations behind a group's internal transactions. In all of those examples, application of the Per Se Stock Rules can have substantial negative consequences for the taxpayer, notwithstanding that fact that the taxpayer has done nothing at odds with what appear to be the core objectives of the Per Se Stock Rules. In all of those examples, those bad consequences could be avoided, if the regulation provided for even a cursory review of the objective facts. To avoid seemingly arbitrary results of this kind, having little or no apparent policy justification, we strongly recommend removing the 72-Month Per Se Rule from Prop. Treas. Reg. § 1.385-3.

We urge the government to take this step whether or not Prop. Treas. Reg. § 1.385-3, when finalized, contains the Current E&P Exception and $50 Million Exception referenced in the wording quoted above. The fact that those exceptions may help taxpayers in some cases avoid the costs imposed by what is otherwise a flawed rule, does not provide a justification for the 72-Month Per Se Rule; rather, it merely holds out the hope of containing to some extent the 72-

[219] Preamble, at 20923, 20924.

Month Per Se Rule's problematic consequences. In addition, as discussed in detail below, we note that neither the Current E&P Exception nor the $50 Million Exception, as currently drafted, provide significant relief to taxpayers.

2. Preferred Approach: Limiting the Funding Rule to Transactions with a Principal Purpose of Achieving the Same Result as the General Per Se Rule

We recommend that the elimination of the 72-Month Per Se Rule be accompanied by an overall narrowing of the Funding Rule, so that the rule applies only in the event that a loan of cash or property is made between EG members with a principal purpose of accomplishing the same economic result as a distribution or acquisition described in the General Per Se Rule. Stated differently, the Funding Rule would apply only where (x) the funded EG member incurs intragroup debt and uses the proceeds to make a distribution or pay consideration in an acquisition, and (y) the EG member that receives the distribution or the acquisition consideration also provides (directly or indirectly) to the funded member the assets used to make that distribution or pay that acquisition consideration, as part of an overall plan.

This approach is specifically intended to limit the scope of the Funding Rule as currently drafted. As noted above, the Funding Rule appears to be responsible for a large share of the adverse collateral consequences created by the Per Se Stock Rules. Narrowing the Funding Rule in practice means eliminating, or containing to modest levels, most of these problems.

While the recommended approach has that substantial practical benefit, we believe it also is a principled rule, since it limits the Funding Rule to cases that are essentially similar in substance to one of the transactions that is subject to the General Per Se Rule.

> *Example 25*. FP owns US1 and US2. US1 lends $100 of its own money to US2, which distributes $100 to FP.

In a case like Example 25, as another commentator has observed,[220] the economic effect of the transaction is different from a distribution of a note by US2 to FP. The Preamble indicates that such a distribution has little non-tax impact on the parties. However, it is hard to conclude that the parties' positions have not really changed in Example 25: US1, which is not a shareholder of US2, ends up with the US2 note and $100 less cash, and FP ends up holding $100 of cash it did not have before. Arguably, these results could be explained by treating US2 as distributing its note to FP, with FP then selling the note to US1 for cash. However, it is not obvious that characterization more accurately reflects the transaction's substance than the steps the parties actually chose. The Preamble indicates the rationale for the Funding Rule is to prevent taxpayers from

[220] *See* James M. Peaslee, Letter to the IRS Re: IRS REG-108060-15 (Section 385 Proposed Regulations), May 18, 2016, at 9–10.

using multistep transactions to achieve results economically similar to those that trigger the General Per Se Rule, but it does not appear that Example 25 is such a transaction.

> *Example 26*. Same as Example 25, except that FP contributes to US1 the $100 that it then lends to US2 (or, alternatively, after US2's distribution to FP, FP then contributes the $100 to US1).

In this Example 26, the transaction is more similar to a distribution by US2 of a note to FP, followed by a capital contribution of that note by FP to US1. Under this view, the note should be recharacterized as equity, unless some exception applies. Treatment of this transaction would seem to be in line with the basic purpose of the Funding Rule described above.[221]

For purposes of determining whether cases with more complex facts than Example 26 involve a circular flow of assets that would trigger the Funding Rule, we believe factors could be listed in the regulations that are based on, for example, the anti-conduit rules (Treas. Reg. § 1.881-3). Thus, the amount of time between transactions among a series of EG members, the ability of each EG member to transfer cash or assets in the absence of receiving a transfer from another EG member in the chain, an EG member's transfer or receipt of assets in the ordinary course of its business (*e.g.*, as a treasury center), and the amount of tax saved by virtue of respecting a debt instrument rather than recharacterizing it, might all be circumstances taken into account.[222]

Some simplifying assumptions also could be provided to facilitate the analysis. It already is the case that all members of a consolidated group are treated as a single corporation, for purposes of the Proposed Regulations.[223] We believe a similar rule could be adopted to treat all foreign EG members that are not CFCs as a single corporation, for purposes of determining whether the standard described above for applying the Funding Rule is satisfied.

> *Example 27*. FP owns FS and USS. FS lends $100 of its own money to USS, which distributes $100 to FP.

This example involves the same economic relationships as Example 25 above. However, it can be concluded that the status of FS as foreign rather than domestic makes a meaningful dif-

[221] In Example 26, the total U.S. tax base has not decreased: US1 and US2 have the same total amount of assets and income immediately following the transaction, as they would have had if it had not occurred. However, if US1 has NOL carryforwards and US2 is profitable, the loan may still result in a U.S. tax benefit. *Cf.* Kraft Foods Co., 232 F.2d at 118.

In addition, as discussed elsewhere, the Per Se Stock Rules apply generally, regardless of whether the U.S. tax base in fact would in fact be reduced in a particular case if the rules did not apply. It is consistent with that basic approach for the Funding Rule to apply in a case like Example 26.

[222] *Compare* Treas. Reg. § 1.881-3(b)(2).

[223] Prop. Treas. Reg. 1.385-1(e).

ference here. It is true that there is a real distinction between the $100 of cash ending up in FP, rather than in FS, just as in Example 26; however, the costs or benefits associated with that difference in the location of the cash may prove to be relatively small, compared with the potential benefit of stripping earnings from USS. Thus, it could be concluded that it is reasonable to treat FP and FS as a single corporation, for purposes of determining whether the Funding Rule as we have formulated should apply in this case. Under this approach, USS would be treated as borrowing $100 from an EG member, and then making an offsetting distribution to that same EG member, thereby triggering the Funding Rule. (For avoidance of doubt, for all purposes other than determining whether the Funding Rule applies here, FP and FS would continue to be treated as two separate corporations).

The Funding Rule as thus revised would be structured in a manner that fits its stated purpose as an anti-avoidance provision. While, as noted, it would be narrower in application than the current Funding Rule, we view that as a significant advantage from a policy and administrability perspective, because it is likely to produce far fewer cases in which corporate taxpayers whose actions do not implicate the purposes of the Per Se Stock Rules are subjected to arbitrary, often harsh results.

3. Alternative Approach: Replacing the 72-Month Per Se Rule with Several Rebuttable Presumptions

If the government decides not to follow our recommendation in Part IX.B.2 above to reconfigure the Funding Rule as a targeted anti-avoidance provision, then we recommend that the 72-Month Per Se Rule be replaced by a rebuttable presumption, preferably with a shortened time period: say, a period of 1 to 2 years. Such an approach would be more in line with a number of other rules that adopt a period of time as a proxy for determining whether two transactions are linked by a common plan.[224] By comparison, the use of a 72-month period (significantly longer

[224] *See, e.g.*, Treas. Reg. § 1.108-2 (determining COD consequences from an indirect acquisition of a related party's debt based on whether the entity acquiring the debt acquired the debt in anticipation of becoming related to the lender; per se assumption that the debt was acquired in anticipation of becoming related where the acquirer becomes related less than 6 months after making the acquisition, and a disclosure obligation (but no per se rule or presumption) where the acquirer becomes related between 6 and 24 months after acquiring the debt; Treas. Reg. § 1.355-7 (discussions within 2 years before or after a spin-off regarding an acquisition are a factor in determining whether an acquisition is part of a "plan or series of related transactions" together with the distribution); Treas. Reg. § 1.367(a)-2T(c)(1) (foreign active trade or business exception to Section 367(a) does not apply where as part of the same transaction, the transferee transfers the relevant property to another person; a transfer within 6 months is deemed to be part of the same transaction); Treas. Reg. § 1.707-3 (a transfer of property to (or from) a partnership is presumed, on a rebuttable basis, to be part of a disguised sale if made within 2 years before or after a distribution by (or contribution to) the partnership; the opposite rebuttable presumption applies, if the transactions occur over 2 years apart); Section 7874(c)(3) (the transfer of substantially all of a U.S. corporation's assets to a for-

than in these analogous rules) together with an irrebuttable presumption (normally avoided in these rules), in cases where there could frequently be a real commercial purpose for the related transactions independent of tax planning, is unusually harsh, and seems difficult to justify.

If the Funding Rule is revised to provide a rebuttable presumption in favor of linking a borrowing and a distribution or acquisition that occur close together in time, then that presumption should yield to countervailing rules that would, at least presumptively, carve out from the Funding Rule debt incurred in the borrower's conduct of conventional commercial activities that are unlikely to be used for U.S. tax avoidance. An example would be an intragroup debt instrument that meets the requirements of the proposed short-term debt rules described in Part VII.C or VII.D above, or that meets the requirements of the proposed ordinary-course transaction rules described in Part IX.C below.

We also note that if the government opts to convert the 72-Month Per Se Rule to a rebuttable presumption, the government could consider requiring a taxpayer to schedule on its annual income tax return (1) each member of the taxpayer's EG that has completed a distribution or acquisition during the year, and all intragroup debt incurred by that EG member in the (say) 2 years preceding that transaction, as well as (2) all debt incurred during the year by an EG member that made a distribution or acquisition within the past (say) 2 years. In the interest of placing reasonable limits on taxpayers' and the government's administrative burden, such a disclosure obligation should have exceptions for intragroup debt that qualifies for the favorable rules described in the preceding paragraph. As a practical matter, we believe a requirement to disclose non-ordinary course distributions may help to deter taxpayers from taking aggressive positions under the Funding Rule and could aid in efficient auditing of that rule.

C. Granting Relief for Ordinary-Course Transactions, and Other Transactions with a Low Potential for Abuse

We recommend that the Per Se Stock Rules be revised to carve out, or provide favorable presumptions for, a number of fairly routine intragroup transactions, which typically are undertaken for reasons unrelated to achieving the type of potentially inappropriate results that are of concern to the government, as well as some additional types of transactions that have little or no likelihood of achieving these results. We believe our proposed exceptions or presumptions would be based on readily measurable requirements, satisfaction of which typically could easily be con-

eign corporation, in one or more transactions within 2 years before or after the U.S. corporation's stockholders have ownership of at least 60% of the foreign corporation's stock by reason of their owning stock of the U.S. corporation, is deemed to be part of a plan to achieve such ownership of the foreign corporation); Treas. Reg. § 1.7874-10T (non-ordinary course distributions made by a U.S. corporation within up to 3 years before an inversion are generally disregarded, when measuring the equity value of the U.S. corporation for purposes of applying the Section 7874 ownership tests).

firmed or disproved. Inclusion of these exceptions could significantly reduce the burden for both taxpayers and the government connected to complying with the Per Se Stock Rules and monitoring that compliance.

1. Acquisitions and Dispositions by the EG

As noted above, the government appears to distinguish the distributions and acquisitions covered by the Per Se Stock Rules from transactions where an EG member incurs intragroup debt in order to finance a purchase of assets from an unrelated third party. In these cases, the debt can be seen as having real substance, because the borrower invests the proceeds in expanding the group's overall operations.[225] However, as drafted, the regulations draw a key distinction between the direct acquisition by an EG member of stock or assets of a target from a third party, and an acquisition of stock or assets by an EG member followed by subsequent internal transfers to other EG members in order to integrate different segments of the acquired businesses into the portions of the EG where those segments are most appropriately held. While internal debt issued by an EG member in connection with a direct acquisition of stock or assets from a third party is respected under the Per Se Stock Rules (as in Example 16 Alternative (C) above), debt incurred in connection with post-acquisition integration typically will not be (as in Examples 16 Alternatives (A) and (B)).

In theory, an EG might avoid issues simply by opting always to have the appropriate group members buy directly from the unrelated seller. Often, however, for reasons unrelated to tax (*e.g.*, regulatory requirements, requirements imposed by the third-party lenders providing the buyer's acquisition financing, or the parties' desire for certainty and simplicity in completing the necessary transactions at the closing), it may be important to the parties to transfer shares of only one entity at the closing.

Integration of the various subsidiaries or branches held by that entity in a post-closing restructuring achieves a result that is substantively similar to a direct purchase by the relevant EG members from the third party and, we believe, merits similar treatment under the Per Se Stock Rules. We thus recommend an exception to the Per Se Stock Rules for intragroup debt issued by an EG member (M) with principal amount $*x*, if (i) M's equity capital does not decrease as a result of issuing the debt, (ii) the issuance of the debt is part of a plan, pursuant to which either (a) M acquires assets (including stock of a corporation) from an unrelated party, or (b) M acquires assets (including stock of a corporation) that recently[226] have been acquired directly or indirectly

[225] *Cf.* Preamble, at 20917 (noting that "inverted groups and other foreign-parented groups use these types of transactions to create interest deductions that reduce U.S. source income *without investing any new capital in the U.S. operations*") (emphasis added).

[226] More specifically, a time period comparable to that referenced in Part IX.B.3above (*i.e.*, 12 to 24 months) could be used.

by any other member of the EG from an unrelated party, and (iii) the unrelated party receives as consideration for the relevant assets, from any member of the EG, cash, notes or rights to future payments at least equal to $*x*. Such a transaction would appear not to implicate the concerns underlying the Per Se Stock Rules, because M's issuance of intra-group debt is funding its real investment in new assets from outside the group.[227]

We note that similar basic considerations can arise in a case where a group completes internal transfers of stock or (in asset reorganizations) assets of EG members in preparation for a group's disposition of a business. Direct dispositions by EG members of the relevant stock or assets to unrelated parties, in exchange for debt issued by those parties, are not covered by the Per Se Stock Rules; but the regulation does reach transactions financed by intragroup debt that serve to assemble the stock or assets within a single entity, in order to facilitate a disposition outside the group. Similar to our observation in the context of acquisitions, such an internal restructuring often occurs for reasons wholly unrelated to the types of tax planning that apparently motivated the Per Se Stock Rules.

We recommend an exception from the Per Se Stock Rules for intragroup debt issued by M with principal amount $*y* if (i) M's equity capital does not decrease as a result of issuing the debt, (ii) the issuance of the debt is part of a plan pursuant to which M acquires assets (including stock of a corporation) from other EG members that are worth $*y*, and (iii) M ceases to be a member of the EG shortly afterward[228] and continues to hold the assets described in (ii). Here, the debt has, in essence, been issued by M as part of the consideration for a real transfer of assets outside the group. In our view, such an issuance of debt is substantively different from a distribution of a note or other transaction that the regulations are designed to capture.

It might be asserted that such an exception is largely unnecessary, because debt issued in these situations would often be settled at or prior to the group's disposition of M. To the extent the debt has been recast as equity, the settlement would generally be treated under Section 302 as a sale or exchange of the equity, with largely the same consequences (*i.e.*, a sale or exchange) as if the debt had been respected as such. However, assuming the instrument is settled in the manner just described, there does not seem to be a compelling reason for the group in such a case to have to accept the potentially disadvantageous consequences of a recharacterization during the period between the issuance of the instrument and its settlement (*e.g.*, any disadvantages result-

[227] We propose that this rule be an unqualified exception, rather than just a presumption, because it would be a limitation on the General Per Se Rule, not just the Funding Rule. As the General Per Se Rule automatically applies to recharacterize debt when specified requirements are met, it appears that an exception to such rule that operates in similar fashion would be appropriate. In addition, it would seem appropriate to provide a corresponding flat exception from the Funding Rule (rather than just a presumption) when these requirements are met.

[228] Again, a period corresponding to that referenced in Part IX.B.3above could be used.

ing from characterization of any coupon payments as dividends rather than interest). In addition, if the instrument is recharacterized, and then remains outstanding after the disposition has occurred, the group faces the possibility that the tax treatment of the disposition transaction will be impacted:

> *Example 28*. Parent forms Spinco and contributes assets to it in exchange for stock and debt securities of Spinco. Spinco also acquires stock of various subsidiaries of Parent from other subsidiaries of Parent, in exchange for cash or other property. Parent then distributes Spinco to its shareholders (who are not members of the EG), in a transaction intended to qualify under Sections 355 and 361.

Absent the proposed exception, the debt securities issued by Spinco to Parent would be treated as Spinco stock, to the extent of the value of the EG member stock acquired by Spinco from Parent's subsidiaries; [229] and that stock would be treated as having been redeemed (apparently in a transaction treated as a sale or exchange under Section 302(a)) immediately before the spin-off. It is difficult to find a justification for these results in the policies underlying the Per Se Stock Rules.

2. Funding that an EG Member Obtains in the Ordinary Course of its Business Activities

In designing the final version of the Per Se Stock Rules, a key consideration should be providing appropriate relief to EG members that borrow within the group in commonplace transactions occurring in the ordinary course of the borrower's business activities, for reasons that have no relation to the types of tax planning that apparently underlies the rules. If our primary recommendation described in Part IX.B.2 is adopted, and the Funding Rule is revised to be an anti-avoidance rule focused on loans made with a view to achieving the same economic result as a distribution or acquisition covered by the General Per Se Rule, then it appears highly unlikely to us that these ordinary-course extensions of credit within an EG would fall within that revised Funding Rule. As noted, in our view this is a significant advantage of adopting such a rule. However, if our recommendation is not adopted and, instead, the 72-Month Per Se Rule is converted into a rebuttable presumption, then other changes should be made to the regulations to provide favorable treatment for ordinary-course transactions, as described below.

At present, Prop. Treas. Reg. § 1.385-3(b)(3)(iv)(B)(2) provides a narrow exception from the 72-Month Per Se Rule. The per se rule does not apply to debt arising in the ordinary course of the issuer's trade or business in connection with the purchase of property or services, to the extent that the debt reflects an obligation to pay an amount that is currently deductible under Section 162 or currently included in the issuer's cost of goods sold or inventory, provided the

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

amount at no time exceeds the amount that would be ordinary and necessary to carry on the issuer's business if it was unrelated to the lender. If this exception is satisfied, then under the terms of the regulation the issuer, although excepted from the 72-Month Per Se Rule, remains subject to the general "a principal purpose" standard in the Funding Rule.

We recommend broadening the ordinary course exception, and we propose that an issuer satisfying this exception would receive favorable treatment under the Funding Rule. More specifically, the regulations could state that, if it is established that an EG member is issuing a debt instrument in exchange for cash, services or property in the conduct of its normal business activities, on terms appropriate for those activities, then the Funding Rule would be presumed not to apply, unless the facts clearly establish the loan was entered into with a principal purpose of funding a distribution or acquisition. In such a case, there would seem to be solid grounds for concluding the debt is normally not issued with a principal purpose of funding a distribution or acquisition, in view of the parties' reason for issuing the debt, the use of the funds, and the suitability of the terms for financing the applicable activity: the same basic facts that underpin the existing ordinary course exception in the Per Se Stock Rules. Thus, providing a presumed exception from the Funding Rule would aid in efficient administration of the Per Se Stock Rules, without significantly impairing the government's ability to achieve the goals of those rules.[230]

The type of favorable presumption just described would be helpful in several of the examples given in Part VIII.A above, as well as other frequent, relatively straightforward cases:

- The positive treatment that we have recommended in Parts VII.C and VII.D above for short-term financing within an EG to fill members' working capital needs would fit squarely within our proposed ordinary course rule.
- If an EG member is a financial institution that issues debt to another EG member in the ordinary course of business on market terms (for example, a certificate of deposit issued by a bank on its normal terms offered to customers, or a derivative treated as a debt instrument for U.S. tax purposes issued on normal market terms), the debt would be covered by our ordinary course presumption.
- If a regulator oversees a corporation's conduct of its business, and the corporation is required by the regulator to borrow from an EG member, it would seem appropriate to presume the loan has been incurred in the normal course of the corporation's business activities, and thus is excepted from the Funding Rule. For example, bank

[230] If, contrary to our recommendation, the 72-Month Per Se Rule is retained in its current form, then our proposed ordinary course exception should provide an automatic exclusion of covered transactions from the Funding Rule. If the rules are designed on the premise that purpose-based inquiries should be avoided to the maximum possible extent, that premise should apply to exceptions from the rules as well.

regulatory authorities might require intragroup loans as part of the capital structure of local operating subsidiaries of a financial institution.

- In the event a distressed corporation completes a workout either under supervision of a court or government agency, or through negotiations with its third-party creditors, and as part of the terms of the workout the corporation issues, or modifies the terms of, intragroup debt, it would seem appropriate to apply the normal course presumption that we have proposed. The debt issuance or modification in the workout is designed to help stabilize the corporation's financial condition and, thus, better enable it to conduct its regular business activities.

- In the securitization example in Part VIII.A (Example 21), the issuer is issuing notes in the ordinary course of its functions as an asset financing vehicle. In such cases, it is not uncommon for the issuer's equity to be predominantly (and sometimes entirely) held by the sponsor of the securitization or an affiliate, causing the issuer to be a member of the sponsor's EG. In addition, if the issuer has difficulty placing all the notes it issues with third-party investors, the sponsor may decide to acquire a portion of the debt and sell that portion to third party investors at a later time. If a distribution on the equity tranche is made within 3 years of the securitization transaction, then absent an exception from the Funding Rule, it is possible that the debt held by the sponsor or its affiliate (which may well be investment-grade debt) could be recharacterized as equity. In addition, as noted in Example 21, if a portion of the debt that is held by a member of the EG were recharacterized as equity and the remaining portion of the debt were held by third parties, this could present fungibility issues to the securitization issuer and its noteholders. These results would be unexpected, in the common case of a securitization where the debt is publicly traded (within the meaning of Treas. Reg. § 1.1273-2(f)), the debt receives investment grade ratings, and the equity distributions are made as a result of performance of the underlying investments held within the securitization vehicle under a waterfall. If the ordinary course presumption that we propose is added to the Per Se Stock Rules, these issues should typically be eliminated: the facts clearly indicate that the debt is issued to meet the asset financing purposes for which the issuer was formed, and is not intended to provide funding for a distribution or acquisition within the EG.

- Similar points can be made about the dealer affiliate example in Part VIII.A (Example 22). There, an EG member has issued debt to the public to finance its cash needs. The terms of the debt are set by the market. A dealer affiliate has purchased some of that debt at initial issuance in the course of its business as a dealer; it has made this purchase not to facilitate a distribution or acquisition by the borrower, but rather simply to help make an orderly, favorable market in the issuer's notes. On these facts, it is appropriate to view the issuer's issuance of some notes to the dealer affiliate as part of the issuer's normal capital markets activity, and thus to presume the issuance will be excluded from the Per Se Stock Rules. As in Example 21, this approach has the considerable practical advantage of eliminating concerns about fungibility.

- To the extent an intragroup loan is made to finance a securities dealer's operations, and the dealer purchases publicly traded stock of an EG member in the normal course of its activities, that transaction also should be presumed to be excluded from the Per Se Stock Rules.
- An intragroup loan made to give an EG member funds to buy stock of a publicly traded EG parent, which stock is used to compensate that EG member's employees, should be covered by the proposed ordinary course rule.

If the government decides to presume that intragroup debt issued in ordinary course transactions is excluded from the Funding Rule, then we believe it would be useful to include several specific examples in the regulations along the lines of those listed above, to show when the favorable presumption applies. Examples also would be helpful indicating the types of adverse facts that would overcome the presumption. Alternatively, if (contrary to our recommendation) the government finds the concept of a broader ordinary course rule unattractive, it could simply provide a series of narrower presumptions tied to specific cases listed above.

3. Harmonizing the Per Se Stock Rules with Treatment Specifically Contemplated by Other Provisions of the Code or Treasury Regulations

In a range of cases, the Code or regulations contemplate a specific treatment of an instrument or a transaction which is at odds with the treatment that would be required under the Per Se Stock Rules. These conflicts between the Per Se Stock Rules and other provisions of the federal tax law may be unintended in many cases. We describe below ways in which the Per Se Stock Rules can be modified to harmonize them with other federal tax rules.

(a) Instruments for which treatment as debt is contemplated by other provisions should not be recharacterized as stock

Prop. Treas. Reg. § 1.385-3 by its terms appears to be broad enough to recharacterize as stock a number of instruments for which treatment as debt is specifically contemplated under various preexisting Code provisions and regulations. As a preliminary matter, it is not clear whether Section 385 contemplates that Treasury and the IRS would issue rules to override a more specific provision in the Code that mandates that a particular instrument or transaction be treated as indebtedness. In addition, even if Section 385 does contemplate the issuance of such regulations it is not clear whether the Proposed Regulations ought to be construed as an exercise of that authority.

Moreover, instruments for which debt treatment is specifically indicated by provisions of the Code or Treasury regulations would seem normally not to lend themselves to the types of inappropriate planning the Per Se Stock Rules are designed to prevent. Thus, we recommend that the Proposed Regulations expressly state that they do not apply to recharacterize these instruments as equity. Examples include leases treated as including a loan pursuant to the regulations under Section 467; receivables and payables attributable to correlative adjustments under Section 482;[231] production payments under Section 636(a) or (b); "straight debt" described in Section 1361(c)(5); straight debt described in Section 856(m)(2) held by a REIT; and REMIC regular interests as defined in Section 860G(a)(1). [232]

For similar reasons, these instruments should also be expressly excluded from the scope of the Part Stock Rule and the Documentation Rules.

Arguably, notional principal contracts with nonperiodic payments represent a special case, and ought to be subject to the Proposed Regulations. It is possible to achieve a result similar to a cash borrowing, by using a notional principal contract with a large upfront prepayment. On the other hand, an upfront payment is amortized over the life of the notional principal contract and treated as a series of cash-settled futures to purchase the payments made by the counterparty.[233] Such an arrangement linking the loan component of the contract to a derivative with net payments that could swing in either direction is arguably different from an ordinary debt instrument and appropriately not subject to these regulations.

[231] *See* Treas. Reg. § 1.482-1(g); Rev. Proc. 99-32.

[232] We note that Prop. Treas. Reg. §1.385-3(b)(4) states that "an interest that is not a debt instrument for purposes of this section and §1.385-4 (for example, a contract to which section 483 applies or a nonperiodic swap payment) is treated as stock if issued with a principal purpose of avoiding the application of this section or §1.385-4." It appears that perhaps the government intends that a "debt instrument" for purposes of the Per Se Stock Rules will include only an instrument of a type that could be subject to Treas. Reg. 1.385-2 (*i.e.*, debt in form). *See* Preamble at 20922 ("Section 1275(a) and §1.1275-1(d) generally define a debt instrument as any instrument or contractual arrangement that constitutes indebtedness under general principles of federal income tax law. *Thus, the term debt instrument for purposes of proposed §§1.385-3 and 1.385-4 means an instrument that satisfies the requirements of proposed §§1.385-1 and 1.385-2* and that is indebtedness under general principles of federal income tax law. The Treasury Department and the IRS plan to amend §1.1275-1(d) to coordinate §1.1275-1(d) with the regulations under section 385 when the proposed regulations are finalized.") (emphasis added). In that case, some of the types of arrangements described in the text would not be subject to the Per Se Stock Rules. However, the government's intent in this regard is not entirely clear; and the definition of "debt instrument" as currently drafted in Prop. Treas. Reg. §1.385-3(f)(3) does appear broad enough to cover a contractual arrangement treated as debt for U.S. tax purposes, notwithstanding the contrary indication in Prop. Treas. Reg. §1.385-3(b)(4). As noted in the text, we recommend that the point be expressly addressed in the final regulations.

[233] *See* Treas. Reg. § 1.446-3T(g)(4).

(b) The Funding Rule should not be applied when doing so would conflict with treatment of a transaction provided elsewhere in the Code or Treasury Regulations

In a number of cases, federal tax rules specify a treatment of a transaction that links a distribution or acquisition that is described in the Funding Rule with a specific source of funds other than an intragroup loan. In these cases, it seems anomalous to apply the Funding Rule. In view of the logical inconsistency that such an approach would entail, and in view of the limited scope for inappropriate planning that these transactions appear to present, we recommend that the Funding Rule not apply to these transactions.

Treas. Reg. § 1.1032-3 illustrates this point. Suppose, for example, that USP owns US1 and CFC. US1 loans CFC $70, and USP contributes $30 of USP stock to CFC. CFC then acquires FT for $70 of cash and $30 of USP stock. Under Treas. Reg. § 1.1032-3, CFC would be treated as purchasing $30 of USP stock for cash, which would be a prohibited acquisition under Prop. Treas. Reg. § 1.385-3(b)(3)(ii)(B). Similar results would occur where CFC compensates employees with USP stock. In our view, this treatment is inappropriate, because the cash CFC used for its notional purchase of USP stock in these cases is deemed by Treas. Reg. § 1.1032-3 to have come from USP as a capital contribution. It appears to us that the Per Se Stock Rules should not apply in such a case.

Another example is a significant modification of an intragroup debt instrument under Treas. Reg. § 1.1001-3, where the term of the instrument is not materially extended. In such a case, the issuer has issued the modified debt in exchange for property—the old debt. The Funding Rule thus potentially would apply to the loan. However, it seems reasonable to treat the modified debt as having been issued to retire the old debt, rather than to generate new proceeds that could fund a distribution or acquisition. If, and only if, the old debt would be treated as issued with a principal purpose of funding such a transaction, should the taint carry over to the modified debt for purposes of the Funding Rule. However, one potential exception to this approach, would be a case where the term of the modified debt is significantly extended: say, extended to the point the extension would by itself be a significant modification under Treas. Reg. § 1.1001-3. In such a case, the modified debt could reasonably be viewed as essentially financing activities of the borrower during the extended term.

Correlative adjustments under Section 482, as in Example 19, also demonstrate our point. In a case like that example, where a receivable and payable are set up in connection with the application of Section 482 and as a result there is a deemed distribution by the EG member that sold goods or services at a below-market price, the distribution is naturally viewed as being funded by the extra purchase price that is deemed under Section 482 to have been received by seller. It does not seem logical in a case like Example 19 to view the deemed distribution as being funded by an intragroup loan that has been made to the seller.

(c) *The Funding Rule should not be applied to distributions under Sections 305(a), 332, 336(b) or 355, or distributions involving old and cold property of the distributing corporation*

The Funding Rule is based on the premise that in substance, an intragroup loan to an EG member in connection with that member's distribution of cash or property (or its use of cash or property to pay consideration in certain acquisitions) is quite similar to the types of distributions and acquisitions covered by the General Per Se Rule. However, this premise appears not to hold in the case of a number of types of distribution transactions.

A "distribution" is broadly defined in the Per Se Stock Rules to include any distribution made by a corporation with respect to its stock.[234] This would appear to include distributions made under Sections 305(a), 332 and 355. If an EG member distributes its stock under Section 305(a), however, its owners do not realize income, because in substance they have not received anything they did not own previously; and by the same token, the corporation's net worth has not decreased. It does not appear that such a distribution should be viewed as fungible with a corporation's distribution of a note.

An actual or deemed liquidation of a subsidiary into a parent, as in Example 18 in Part VIII.A, also does not appear to similar to a distribution of a note. In Example 18, the intragroup loan to the subsidiary potentially could be seen as funding the subsidiary's liquidating distribution, causing the Funding Rule to apply. However, since the parent corporation assumes the subsidiary's debt in the liquidation, that result appears unwarranted. The debt is correctly viewed as not having been used to fund a distribution by the subsidiary to the parent; instead, the parent ought to be treated as having assumed the debt, in a transaction in which it essentially steps into the shoes of the subsidiary under Sections 332, 381 and Treas. Reg. § 1.1001-3(e)(4)(i)(B). (The Per Se Stock Rules as drafted arguably already take this approach, in the case of a liquidation governed by Section 332: in such a case, the parent would be treated as a "successor" to the liquidated subsidiary under Prop. Treas. Reg. § 1.385-3(f)(11)(i) and thus, it might be asserted, the subsidiary's distribution to the parent is really just a distribution by a legal entity to itself, *i.e.*, a non-transaction which ought to be disregarded under the rules. However, even if such an approach is intended, a case like Example 18 raises an additional issue. If one tests whether the 80% ownership requirement in Section 332 is satisfied *before* one applies the Per Se Stock Rules, then the liquidation satisfies that requirement. However, if the 80% ownership requirement is tested *after* first tentatively recasting the debt under the Per Se Stock Rules, then the requirement might not be met in this example—because the debt would account for over 20% by value of A's stock. The Per Se Stock Rules should be clarified regarding these points.)

[234] Prop. Treas. Reg. § 1.385-3(f)(4).

In addition, for reasons similar to those just described in the case of a Section 332 liquidation, if an EG member distributes assets in a Section 331 liquidation to a shareholder that assumes liability for debt of the liquidated corporation, then to the extent of the amount of debt assumed, the liquidated corporation should not be treated as making a distribution that could trigger the Funding Rule. In substance, the shareholder assuming the debt has purchased the relevant assets. Only to the extent the assets' value exceeds the debt assumed should a distribution be treated as occurring.

A Section 355 spin-off that is not part of a "D" reorganization is also a distribution for purposes of the Funding Rule; and here, unlike the various transactions described above, an EG member has actually made a gratuitous distribution of something of value, reducing its net worth. However, it is difficult to view the transaction as logically connected to a loan of cash or property by an EG member to the distributing corporation. Almost by definition, the distributing corporation is spinning off business assets that it has long held (through the controlled corporation), with a non-tax reason for the spin-off. The distributing corporation also has not contributed to the controlled corporation the cash or property that has been loaned to it by the lending EG member; such a contribution would cause the spin-off to be a "D" reorganization. Instead, the distributing corporation has either retained that cash or property, or disposed of it other than through the spin-off transaction. It thus would appear that the spin-off should not logically be viewed as linked to the loan to the distributing corporation, or as substantively similar to a distribution by the distributing corporation of a note or the other transactions triggering the Funding Rule.

Indeed, a similar point can be made any time an EG member distributes an old-and-cold, non-fungible corporate asset. Such a distribution represents a permanent substantive change in the asset base of the distributing EG member, as well as a change in the asset base of its shareholder. It is difficult to view that transaction (together with a loan of cash or other property to the distributing EG member) as being substantively similar to a distribution of a note or of cash or the recently borrowed property. Similarly, if one EG member buys from another, in exchange for a note, non-fungible property (other than EG stock) that has long been held by the selling EG member, such a note would seem logically not a natural candidate to be linked with a distribution of cash (or property other than that just acquired) by the purchasing EG member.

We note that, if the Funding Rule is revised in line with our preferred approach described in Part IX.B.2, then it would be quite unlikely that the revamped rule would cause an intragroup loan to be recharacterized as a result of the borrower making any of the types of distributions described above.

Alternatively, if the Funding Rule is revised by adopting a rebuttable presumption as described in Part IX.B.3, that also should help to ensure a borrower does not become subject to the Funding Rule by reason of making these distributions. Nevertheless, we believe clear rules on these points would tend to help both taxpayers and the government, and we thus recommend that the rebuttable presumption be supplemented with a statement that none of the above cases counts as a distribution for purposes of the Funding Rule.

D. Clarification of Anti-Abuse and Affirmative Use Rules

1. The Anti-Abuse Rule

An anti-abuse rule applies to debt instruments issued with a principal purpose of avoiding the application of the Per Se Stock Rules. [235] While the provision lists a number of transactions that would not be covered by the Per Se Stock Rules, there is no description of the abusive result that is the target of this provision.

Taxpayers may engage in a number of transactions that may be structured to avoid the application of the Per Se Stock Rules, but that do not appear to raise any of the concerns expressed in the Preamble. For example, a taxpayer may borrow from an unrelated third party in order to fund a dividend distribution. A primary reason for borrowing from a third party might sometimes be to avoid the application of the Per Se Stock Rules. Treasury and the IRS should explicitly provide that borrowing from an unrelated third party, rather than an EG member, in order to fund a distribution or acquisition does not run afoul of the anti-abuse rule.[236] Treasury and the IRS should also clarify that debt instruments subject to the anti-abuse rule are recharacterized as stock only when they are issued and held by members of the same EG.[237]

In addition, we propose that Treasury and the IRS draft a more targeted anti-abuse rule. The implementation of many of the recommendations in this report will have the effect of making the Per Se Stock Rules more precise; logically, a secondary effect of these changes should be that the anti-abuse rule can be made more precise as well.

2. Prohibition on Affirmative Use of the Per Se Stock Rules

Under Prop. Treas. Reg. § 1.385-3(e), the Per Se Stock Rules do not apply where an EG member enters into a transaction that otherwise would be subject to the rules, with a principal

[235] Prop. Treas. Reg. § 1.385-3(b)(4).

[236] Third-party borrowings should not be subject to the anti-abuse rule, even if guaranteed by another member of the EG, provided that the borrower is creditworthy. *Cf.* Plantation Patterns, Inc., 462 F.2d at 712 (debt of a subsidiary guaranteed by its shareholder is treated as debt of the shareholder, where the subsidiary would otherwise not have been able to borrow without a capital contribution by the shareholder).

[237] *See* Prop. Treas. Reg. § 1.385-3(d)(2) (the general rule that a debt instrument subject to the Per Se Stock Rules ceases to be treated as stock when it leaves the EG is subject to the anti-abuse rule discussed above). The potential for debt of an unrelated third party borrower to be treated as equity based on the intentions of the borrower would have significant and far-reaching ramifications to frequent lenders, such as banks.

purpose of reducing the U.S. tax liability of any member of the EG by disregarding the treatment of a debt instrument that otherwise would apply under general tax principles. We recommend eliminating this rule in view of its significant potential to create uncertainty and one-sided outcomes.

The Per Se Stock Rules take the general approach of automatically recharacterizing an intragroup debt instrument as stock based on objective factors: the relationship between the issuer and the holder, and the type of transaction in which the debt is issued. A taxpayer's subjective reasons for issuing the debt are generally ignored. As indicated above, the Preamble suggests this approach was taken because, in the government's view, the types of transaction in question often have limited substance and are motivated by obtaining U.S. tax benefits. In addition, in the context of the 72-Month Per Se Rule, the Preamble suggests it can be difficult to discern a taxpayer's true motives. Prop. Treas. Reg. § 1.385-3(e), however, moves beyond objective factors, and instead looks to the taxpayer's principal purposes for entering into a transaction. This appears inconsistent with the basic approach the government has adopted. In effect, the rules provide for a review of a taxpayer's purposes for entering into a transaction if, and only if, such a review could result in an additional U.S. tax cost for the EG. We see no logical, fair rationale for this asymmetry in the rules.

We note that, even if our proposed changes to the Per Se Stock Rules described above in Part IX are adopted, the same basic asymmetry will remain, unless Prop. Treas. Reg. § 1.385-3(e) is eliminated. After our changes are made, it would continue to be the case that an intragroup debt instrument is recharacterized when it is issued pursuant to a distribution or acquisition described in the General Per Se Rule, without regard to whether the transaction is motivated by, or likely to achieve, tax savings based on the circumstances of the particular transaction. In addition, the Funding Rule, as it would be reformulated under our recommendations, would not ask whether the taxpayer has acted with a purpose of saving U.S. taxes; it would only ask whether the taxpayer has acted with an intent to achieve an economic result essentially similar to a transaction described in the General Per Se Rule. Moreover, our proposed favorable rules for ordinary-course transactions would not require an intensive inquiry into purpose; rather, they would look to whether a particular transaction occurs in the normal course of the taxpayer's business, or otherwise is a specific type of transaction that carries a low risk of abuse.

By comparison to the factual review required under those recommended rules, the inquiry into purpose contemplated by Prop. Treas. Reg. § 1.385-3(e) will often be a particularly difficult one. When an intragroup debt instrument is recharacterized under the Per Se Stock Rules, the consequences can unfold over a period of several years, and will depend on the taxpayer's future income, E&P, foreign tax credits and other attributes, which may be difficult to predict with a high degree of certainty. Because the recharacterization can have collateral consequences not just for the issuer and holder of the recharacterized instrument, but for other EG members as well that participate in transactions with either of them, it often will be necessary to predict these future tax consequences (or realistic range of potential consequences) for several EG members. In addition, for each of these corporations, it would appear necessary to determine both the anticipated consequences if the Per Se Stock Rules apply, and the consequences in at least one counterfactual situation, where the instrument is respected as debt. It also would appear relevant, at least in some cases, what the U.S. tax consequences would have been if the issuer had issued preferred stock with terms similar to those of the instrument – and also, potentially, the consequences of other realistic alternatives available to the EG. The analysis involved in answering these questions would appear frequently to be both complex and speculative, creating real possibilities for confusion when taxpayers prepare their returns and for disagreements during IRS audits.[238] The

[238] By comparison, the history of the Section 367 regulations applicable to triangular reorganizations provides an indication of the potential challenges involved in such a determination. In 2008, the government adopted Treas. Reg. § 1.367(b)-14T to address transactions in which a subsidiary acquired stock of its parent in exchange for property and used that stock as consideration in a reorganization, and the parent or the acquiring subsidiary were foreign. In general, the rules deemed the subsidiary to have made a distribution to its parent equal to the amount of property given by the subsidiary as consideration for the parent stock. Under a priority rule, if the amount of dividend income recognized under Section 301(c)(1) with respect to that distribution exceeded the amount of gain (if any) the target's shareholders otherwise would have recognized under Section 367(a), the target's shareholders were exempted from the application of Section 367(a). *See* Treas. Reg. § 1.367(a)-3(b)(2)(i)(C) in T.D. 9400 (May 27, 2008). In 2011, the government issued Treas. Reg. § 1.367(b)-10 to replace Treas. Reg. § 1.367(b)-14T; and the priority rule in the Section 367(a) regulations was revised at that time to take into account both Section 301(c)(1) dividend income and Section 301(c)(3) gain. Treas. Reg. § 1.367(a)-3(b)(2)(iv). In the 2011 preamble, the government stated that: "One commentator noted that the priority rule applies simply based on comparing the amount of gain that would be recognized under section 367(a)(1) with the amount of the dividend that would result under the 2008 regulations, without regard to the amount of resulting U.S. tax. The commentator stated that in some cases it may be more appropriate for the priority rule to take into account the amount of resulting U.S. tax. The commentator cited, as an example, a case where P is foreign, S and T are domestic, T is owned by a U.S. person, and any dividend received by P from S under the 2008 regulations would not be subject to U.S. tax as a result of an applicable treaty. … The IRS and Treasury Department recognize that in some cases it may be appropriate for the priority rule to take into account the amount of resulting U.S. tax. However, the IRS and Treasury Department do not believe it would be administrable to take into account the resulting U.S. tax in all cases, because this could require consideration of numerous tax attributes of various parties, including P, S, and the shareholders of T. To address this concern, the scope of the final regulations is modified such that the final regulations do not apply [*i.e*., the priority rule is not available] in two additional cases." These two cases were based on objective factors that broadly indicated whether Section 301(c)(1) income and Section 301(c)(3) gain was subject to U.S. tax, or not.

Ultimately, in Notice 2014-32, the government indicated that it would revise the Section 367 rules, so that the priority rule would apply only where the Section 301(c)(1) dividend income and Section 301(c)(3) gain are in fact subject to U.S. tax (or a U.S. shareholder is subject to U.S. tax on a corresponding amount of Subpart F income). This history, however, tends to illustrate the extent to which there can be difficulty involved in deciding how to measure, and compare, different parties' U.S. tax costs, even in the context of a need to perform this analysis adds significantly to the already necessary (but, often, comparatively straightforward) inquiry under Prop. Treas. Reg. § 1.385-3(e) into the group's reasons for the transaction apart from U.S. tax.

We thus propose eliminating the prohibition on affirmative use in Prop. Treas. Reg. § 1.385-3(e).

If, however, the government opts to retain this rule, we recommend that it be clarified in several respects. First, as drafted, the standard looks to whether there is a principal purpose for any member of the EG to receive a tax benefit from application of the regulation. Thus, if one EG member receives a benefit, which is offset by another member's loss of a larger tax benefit as a result of the recharacterization of debt under the Per Se Stock Rules, it appears that the rules might not apply. It is not clear to us whether this result was intended, and we propose that Treasury and the IRS reword the rule to avoid uncertainty on this point.

Second, the government should expressly state at what point in time it must be determined whether the EG has a principal purpose of applying the rules to achieve a tax benefit. A related issue is whether it matters if the EG's ability to achieve the benefit is subject to material uncertainty, due to factors beyond the group's control. The rule as currently drafted suggests, and we believe it would be reasonable to confirm, that the EG's purpose should be determined based on the facts as of the time the debt in question is issued, and that a principal purpose should not be found to exist unless it is reasonably expected as of such time that the EG will achieve a non-*de minimis* net benefit due to application of the Per Se Stock Rules.

Third, as indicated above, when determining the benefit considered to arise due to application of the Per Se Stock Rules, we believe it should be considered whether the issuer of the debt could have instead issued an equity instrument with comparable terms, or taken other actions, such that the EG would have been expected to achieved the same amount of net benefit without additional costs.

For example, as previously discussed, it appears that in some fact patterns a U.S. parent may actually end up able to repatriate its CFCs' cash with a lower U.S. tax cost if the Per Se Stock Rules apply to recharacterize a loan between the CFCs as equity, than if the loan were not recharacterized—with the ultimate conclusion in this regard depending on the precise details concerning the E&P and other tax attributes of the borrower CFC and lender CFC at the times interest and principal payments are made on the loan. To the extent the CFCs are operating CFCs whose E&P and foreign tax pools cannot be easily predicted at the time the loan is made, it appears that fact should carry significant weight when determining whether Prop. Treas. Reg. § 1.385-3(e) applies; and the EG's ability to have the lender CFC (or some other CFC) invest in

discrete transaction occurring at a single point in time like a reorganization being tested under the priority rule.

preferred stock of the borrower CFC, without greater U.S. tax or other costs (*e.g.*, non-U.S. taxes) than investing in debt recharacterized as stock under the Per Se Stock Rules, also should be an important consideration. Final regulations should clearly indicate the government's view on these points.

E. Effective Date

The Per Se Stock Rules are proposed to be effective for debt issued on or after April 4, 2016 that remains outstanding 90 days after final regulations are issued, and for distributions or acquisitions occurring on or after April 4, 2016.

If, as strongly recommended, the government puts forward alternative forms of guidance instead of finalizing the currently proposed rules, the new guidance almost inevitably would contain complex, nuanced provisions to deal with the difficult technical and policy issues involved. This would be equally true for a set of rules that retain core concepts of the Per Se Stock Rules while reducing the scope of the rules, as described above, or for guidance that adopts an entirely different approach, as described in Part I.B.2 (outlining potential rules based on an EG's third-party debt:equity ratio). Given the complexity of the issues, the lack of familiar precedent for the type of guidance involved, and the potential for serious disruption of ongoing commercial activity depending on how the rules are designed, we strongly recommend that the government not issue any such guidance in a form that would have current application, at least to the large majority of taxpayers. Instead, it would be important for taxpayers and practitioners to have an opportunity to review and comment on the next round of guidance formulated by the government, before it becomes effective.

If Treasury and the IRS determine there are limited, clearly identified classes of taxpayers as to whom it is urgent to issue guidance with a current effective date in order to forestall potential abuse, such as inverted corporations, the government could make the new guidance currently effective only as to those taxpayers, in the form of temporary regulations. For the large majority of affected taxpayers, the rules could be left in proposed form. Alternatively, the government could consider an approach in which the rules are issued as final regulations for all taxpayers, but the effective date for the large majority of affected taxpayers—all except, say, inverted corporations—is not until several years after the date of issuance, with generous transition and grandfathering rules and with an expressly stated expectation that the rules may be further revised following comment by the public.

X. EXCEPTIONS TO THE PER SE STOCK RULES

A. Current E&P Exception

We recommend that the Current E&P Exception be modified to provide taxpayers with certainty of its application. The amount of current E&P is not ascertainable until after the end of the taxpayer's taxable year. Taxpayers will therefore not be certain of the availability of the Current E&P Exception at the time intragroup loans are issued or distributions or acquisitions are undertaken. In light of the difficulty in complying with the Proposed Regulations and the likely desire for taxpayers to seek the protection of the Current E&P Exception, we recommend that the Current E&P Exception apply based on the amount of the prior year's current E&P, or an average of prior years' current E&P. By comparison, Sections 855 and 858, which generally allow RICs and REITs to pay out prior year E&P several months after their year-end, are examples of mechanisms that are intended to deal with the difficulty in paying out current E&P during the year in which it is earned.

In addition, we recommend that consideration be given to expanding the scope of the Current E&P Exception, so that it includes an EG member's total undistributed E&P for all periods after the effective date of the final regulations in which it was a member of the same EG, as it is on the date the exception is applied to a given loan. In this regard, as currently drafted, the Current E&P Exception places a premium not only on the amount of E&P earned in a particular tax year, but also on the time frame in which such E&P must be "used." For example, if S earns $100 of E&P in each of Year 1 and Year 2, and $0 of E&P in Year 3, there is no obvious reason why S should be subject to disparate treatment depending on whether S distributes to P a $100 note in each of Year 1 and Year 2, as opposed to a $200 note in Year 3. The rule as now drafted provides a seemingly arbitrary incentive for S to make debt distributions each year to the full extent of its E&P for the year, in order to take maximum advantage of the exception. Our proposed rule would allow for flexibility in such cases and removes this incentive, as long as S remains a member of the same EG. In addition, our rule would give recognition to the fact that, while a corporation's accumulated E&P may end up being at least approximately equal to its cash available for distribution over a longer period of time, in a particular year current E&P might be significantly different than cash available for distribution by corporation, for a variety of reasons.

As noted, the other exceptions currently provided in the Proposed Regulations are expected to have limited utility. The Current E&P Exception thus will play an important role providing relief to taxpayers from the far-reaching consequences of the Proposed Regulations, particularly if the forms of relief we have recommended in Part IX above are not adopted. Accordingly, we believe that making the Current E&P Exception more flexible is a worthwhile objective.

Our proposed rule is limited to an EG member's E&P derived in periods after the Proposed Regulations are finalized, because this provides the same overall result for an EG member if it makes note distributions periodically (not yearly) in the future, as if it opts to distribute a note every year in an amount equal to its current E&P (as permitted under the rules as currently drafted).[239] By comparison, a rule that allows the EG member to look to all of its accumulated E&P (including E&P derived in periods before the final regulations are issued) would result in very large distributions being permitted, in the case of a sizeable, long-established corporation with a history of being profitable. It is not clear that permitting such large distributions (for example, by a U.S. subsidiary of a foreign parent) would be consistent with the purposes of the Proposed Regulations.[240]

Our proposed rule is also limited to E&P derived while the EG member was part of the same EG.[241] This limitation is designed to prevent an acquirer (say, a foreign corporation) from buying its way into a situation where the target (say, a U.S. corporation) can immediately lever up by distributing a large note. This type of limitation is inherent in the present version of the Current E&P Exception as it looks to only a single year's E&P.[242]

[239] If an approach is adopted that looks to accumulated E&P, that may in fact end up being less generous in some cases than the current rules, because a corporation that has alternating years of profits and losses would have to take into account the losses in determining its accumulated E&P. An approach that directly tracked the present version of the Current E&P Exception, with the only change being to provide more flexibility as to the timing of debt distributions, would ignore a corporation's loss years.

[240] One might argue that distributions out of E&P from periods before the regulations are finalized should be permitted: under prior law there was no restriction (other than pursuant to conventional debt/equity factors) on the ability to pay a debt dividend; and, had the Proposed Regulations been applicable, distributions of such E&P on a year-by-year basis would have been allowed. On the other hand, it also might be argued that eventually, accumulated E&P from periods after the regulations are finalized could grow to be a very large amount and that allowing a large distribution at a single time, or a few large distributions, might prove problematic.

On balance, we believe the approach described in the text achieves a reasonable outcome within the overall scheme of the Per Se Stock Rules, and that neither of the arguments just described should prevail.

[241] *Compare* I.R.C. § 243(b)(1) (100% dividends received deduction is available only for distributions out of E&P derived while the distributing corporation and the holder were members of the same affiliated group); I.R.C. § 954(c)(3) (Subpart F look-through rule for dividends paid by a CFC applies only to E&P accumulated during the period when the CFC's shareholder directly or indirectly held the stock with respect to which the dividends are paid).

[242] Under our proposed rule, if, for example. a foreign-parented EG with a U.S. subsidiary is going to be bought by an unrelated foreign acquirer, the foreign parent of the existing EG would have an incentive to cause the U.S. subsidiary to distribute as large of a note as possible prior to the acquisition. In our view, such an incentive is not problematic. Distributions of the same total amount would have been permitted under the current version of the rules, had a distribution been promptly made each year. It seems reasona-

Under our proposed rule, it seems appropriate that the amount of accumulated E&P that is available for the E&P exception with respect to a distribution of a debt instrument (or a distribution of cash or property that is linked to a debt instrument under the Funding Rule), would be computed taking into account the aggregate amount of all previous distributions that the corporation had made, in periods following the finalization of the Proposed Regulations during which the distributing corporation was in the same EG as it is at the time of the distribution being tested. To reach a different conclusion would lead to the illogical result that a corporation could both make actual distributions of cash or property (other than its own debt instruments) to its shareholders over time, equal to the full amount of its E&P, and then make distributions of debt in a later period equal to full amount of its E&P, just as if none of that E&P had previously been distributed. [243]

On a separate point, under the Current E&P Exception as presently drafted, the aggregate amount of distributions and acquisitions that are described in the Per Se Stock Rules are reduced by the amount of current year E&P described in Section 316(a)(2), based on the order in which the distribution or acquisition occurs. Despite the literal language of the Current E&P Exception, we understand that Treasury and the IRS interpret the language of the Current E&P Exception to consider not only intragroup loans, but also distributions and acquisitions that are not yet associated with an intragroup loan under the Funding Rule. For example, suppose an EG member, S, with $50 of current E&P and no EGIs outstanding, makes two property distributions to its sole shareholder P in the same taxable year: first, S makes a cash distribution of $50; and second, S makes a note distribution of $50. It is our understanding that Treasury and the IRS believe that the note will be recharacterized as equity because the $50 cash distribution, which occurred first, would reduce the current E&P of S available for reducing the $50 note distribution.

As an initial matter, we do not believe this interpretation is consistent with the language of the Current E&P Exception, which states:

> For purposes of applying paragraphs (b)(2) [the General Per Se Rule] and (b)(3) [the Funding Rule] of this section to a member of an expanded group with respect to a taxable year, the aggregate amount of any distributions or acquisitions that are

ble to provide corporations with flexibility to make distributions at different times, rather than incentivize group members to pay annual debt dividends in order to qualify under an artificial annual cutoff.

243 In our view, a rule of this type is logical where the E&P that is relevant for the E&P exception can arises over multiple periods before the period in which the distribution being tested is made. By comparison, if the only E&P that is relevant is the current E&P for the year in which the distribution is made, it appears somewhat arbitrary to provide that the amount of current E&P available to protect a debt distribution, must be reduced by a distribution of cash or property (not linked to a debt instrument under the Funding Rule) that has occurred earlier in that same year—but not by the amount of such a distribution of cash or property made later during that year. This point is discussed immediately below in the text.

> described in paragraphs (b)(2) [the General Per Se Rule] or (b)(3)(ii) [the Funding Rule] of this section are reduced by an amount equal to the member's current year earnings and profits described in section 316(a)(2). This reduction is applied to the transactions described in paragraphs (b)(2) [the General Per Se Rule] and (b)(3)(ii) [the Funding Rule] of this section based on the order in which the distribution or acquisition occurs.[244]

Thus, it is clear that the Current E&P Exception reduces transactions within the scope of either the General Per Se Rule or the Funding Rule. In addition, the determination of current E&P under section 316(a)(2) is done without regard to distributions made during the tax year, such that S's current E&P is not reduced for the $50 cash distribution. Thus, in the above example, S has $50 of current E&P under section 316(a)(2), S has engaged in $50 of transactions described in the General Rule (the $50 note distribution), and S has engaged in $0 of transactions described in the Funding Rule because the $50 cash distribution is not otherwise a funded transaction in the year of the distribution. Thus, the Current E&P Exception should apply to reduce the $50 General Per Se Rule transaction to $0 as a result of S's current E&P of $50.

Nevertheless, under the government's potential alternative interpretation described above, the note will be recharacterized as equity regardless of whether the cash distribution is ever matched with an intragroup loan to the EG member under the Funding Rule.

Given the retroactive nature of the Per Se Stock Rules, the IRS and Treasury Department should clarify whether the Current E&P Exception, as drafted, would result in the $50 note distribution being recharacterized as equity under the General Per Se Rule.

Furthermore, if the Current E&P Exception is clarified consistent with the government's interpretation described above, the Current E&P Exception will place a premium on ordering that seems unnecessary and inappropriate. Thus, if the proposed rule described above is not adopted, we recommend that Treasury and the IRS clarify the Current E&P Exception to apply to protect intragroup notes that are issued during the year, without looking to distributions or acquisitions by the EG member that may never be relevant under the Per Se Stock Rules.

B. $50 Million Exception

Under the $50 Million Exception, in the event an EG has no more than $50 million of intragroup loans outstanding that otherwise would be recharacterized as equity under Prop. Treas. Reg. § 1.385-3, those loans are exempted from recharacterization. It appears the goal of this rule may be to provide medium-size groups with some relief. However, we note that the Proposed Regulations can provide a fairly severe result for a group of modest size: if the group even slightly exceeds the $50 million threshold, for even a brief period, all of its intragroup debt that would

[244] Prop. Treas. Reg. § 1.385-3(c)(1).

be recharacterized as equity but for the exception will be recast at the time the threshold is exceeded.

It may be that the rules have been designed in this manner in order to ensure that they do not benefit larger groups. A big group may simply not have the ability keep its aggregate intercompany loan balances low enough to ensure that not more than $50 million of debt would be recharacterized under the Per Se Stock Rules; thus, if the rules provided a $50 million exemption without any “clawback” if the threshold is exceeded, then a big group might have no real incentive to alter its behavior, but rather would just receive the benefit of a $50 million floor before the Per Se Stock Rules begin to apply to it.

To ameliorate the potentially harsh “cliff effect” of the rules, we recommend that if an EG exceeds the $50 million threshold, but can show reasonable cause for being unaware that it has done so, then: (1) the intragroup debt protected by the $50 Million Exception should continue to be covered by the exemption so long as the EG, within a relatively short time (say, 90 days) after becoming aware of exceeding the $50 million threshold, reduces to $50 million or less the amount of debt that would be subject to recharacterization under the Per Se Stock Rules; and (2) if the EG fails to reduce the amount of such debt to $50 million within the applicable time period, then the debt should be deemed to be converted to equity at time the EG became aware the threshold was exceeded (rather than the earlier time when the relevant distribution or acquisition occurred). We believe these changes would protect smaller groups against the potentially severe effects of inadvertently exceeding the $50 million threshold, while continuing to ensure that large corporate groups do not get an automatic $50 million floor for application of the Per Se Stock Rules.

C. Stock Acquisition Exception

The Stock Acquisition Exception carves out from the Funding Rule a case where an EG member (the “**acquiring corporation**”) subscribes for stock of another EG member (the “**issuing corporation**”) and ends up owning, for at least the next 3 years, directly or indirectly over 50% of the issuing corporation. In such a case, the issuing corporation becomes a successor to the acquiring corporation, such that distributions or acquisitions by the issuing corporation generally will result in recharacterization of intragroup debt that has been incurred by the acquiring corporation.

The rationale for this exception appears to be that the acquiring corporation continues to own, indirectly through a controlled subsidiary, a stake in the same assets as it owned directly prior to the transaction; it has just changed the form of its investment in the assets. For essentially the same reason, if the issuing corporation makes distributions (other than back to the acquiring corporation) or acquisitions, those ought to be attributed to the acquiring corporation, up to the amount of assets that the acquiring corporation has contributed to the issuing corporation.

We recommend that the Stock Acquisition Exception be broadened to cover other cases where an EG member's acquisition of stock can be seen as merely changing the form of its investment in the same assets. This would be the case, for example, where an EG member buys EG stock that it already indirectly owns, as determined by applying Section 304(c)(3) and 318(a)(2) indirect ownership principles.

> *Example 29*. P owns S1, which owns S2, which owns S3. S1 buys stock of S3 from S2 for a $100 note. Alternatively, S1 borrows $100 from P and uses the cash to buy stock of S3 from S2.

S1's acquisition of S3 stock in this Example is not covered by the Stock Acquisition Exception as currently drafted, and would trigger a recast of S1's note under the General Per Se Rule (in the first version of the fact pattern) or the Funding Rule (in the second version of the fact pattern). As another commentator has noted,[245] it is not clear this result makes sense, given the absence of any diminution in the assets or equity value of S1.

Similarly, if one EG member contributes assets to another EG member in exchange for an issuance of stock, even stock that represents a noncontrolling interest in the issuing corporation, the EG member making the contribution has acquired an asset of equal value (stock of the issuing corporation) in the transaction, and has continued to have an indirect ownership interest in the contributed assets.

> *Example 30*. P owns S1 and S2. S1 contributes its own $100 note to S2, in exchange for an issuance of stock representing (say) a 5% stake in S2. Alternatively, S1 borrows $100 from P and contributes the $100 to S2 in exchange for the same amount of S2 stock.

In these transactions, S1 has not reduced its net assets. Nor has it engaged in a transaction that has "distribution-like" tax consequences under Section 304 or 356. Moreover, although S1 itself has only a modest economic stake in and, probably, no ability to exercise control over S2, the significance of these facts should not be overstated, given that S2 is a member of S1's EG. There does not appear to be a strong reason here to recharacterize S1's note under the General Per Se Rule (in the first version of the fact pattern) or the Funding Rule (second version). However, the Stock Acquisition Exception as currently drafted does not apply.

[245] *See* James M. Peaslee, Letter to the IRS Re: IRS REG-108060-15 (Section 385 Proposed Regulations), May 18, 2016.

We believe it should be revised to cover these situations. In addition, in the above examples, it does not appear to be relevant whether S1 continues to hold for 3 years the EG stock it acquires. The 3-year requirement in the Stock Acquisition Exception should be eliminated.

The only exception to our proposal that appears to be warranted, is one in which an EG member acquires stock of a direct or indirect parent corporation in the EG that owns a controlling interest in the acquiring EG member. As discussed in Part VIII, such a transaction can be seen as resembling a distribution by the acquiring EG member, if the acquiring EG member does not expect to dispose of that stock and waives the right to receive dividends on it.

If the Stock Acquisition Exception is broadened in the manner suggested, then it is not clear that the special successor rule in Prop. Treas. Reg. § 1.385-3(f)(11)(ii) should continue to apply. However, if the rule is retained in the final regulations, then the manner in which it operates should be clarified. In particular, it is not clear whose current E&P (the acquiring corporation, or the issuing corporation) is relevant when determining whether the Current E&P Exception applies to a loan that would otherwise be recharacterized under this rule. It also is not clear when that current E&P would be measured, for purposes of applying the Current E&P Exception in the context of this successor rule. We believe the intended answers are that the current E&P of the issuing corporation is relevant (notwithstanding the construct that it is merely a successor to the acquiring corporation) and that current E&P is measured for the issuing corporation's taxable year in which the distribution or acquisition occurs. However, this should be confirmed in the final regulations, if the successor rule is retained.

XI. Consequences of Ownership and Disposition of Debt that Has Been Recharacterized as Equity under the Per Se Stock Rules

A. Consequences of Ownership and Sale of Recharacterized Debt

Where a debt instrument is recharacterized as stock under the Per Se Stock Rules, "it is treated as stock for all federal tax purposes."[246] The Preamble notes that the "type of stock" that the instrument will be characterized as will depend on the features of the instrument. Treasury and the IRS should provide express guidance in the regulations specifying a number of the potential key consequences of holding debt recast as equity under the Per Se Rules. The consequences should be those that would naturally follow under the tax law from holding stock with similar terms, except that rules and principles should not apply that are inconsistent with the basic premises of the Proposed Regulations. In this regard, a key proposition underlying the Per Se Stock Rules is that the closely related status between the borrower and the lender, coupled with the circumstances of issuance of the debt instrument, should be the determinative factors dictating treatment of an instrument as equity in the cases identified by the regulations; these fac-

[246] Prop. Treas. Reg. § 1.385-3(b)(1).

tors should outweigh more formal features of the instrument such as the existence of creditor's rights, or the absence of voting rights.[247] The specific recommendations made below reflect that basic proposition.

1. Recharacterization of Preferred Equity as Debt

Some cases stand for the principle that equity interests with debt-like economics and other terms will not be respected as equity.[248] The regulations should expressly provide that insofar as a debt instrument is recast as equity under the Per Se Stock Rules no further inquiry is to be conducted as to the status of the instrument for federal tax purposes.

2. Fast-Pay Stock Rules

Treas. Reg. § 1.7701(l)-3 generally defines "fast-pay" stock as stock structured so that dividends on the stock are economically, in whole or part, a return of the holder's investment (rather than on the holder's investment).[249] Stock issued at more than a *de minimis* premium to its redemption price is presumed to be fast-pay stock, unless clearly demonstrated otherwise. [250] The regulations provide that, if the issuer of the fast-pay stock is a RIC or REIT, or if the IRS determines that a principal purpose of the fast-pay arrangement is the avoidance of any U.S. federal tax, then the fast-pay stock should be recast as a "financing instrument" (often, debt) between the holders of the fast-pay stock, and the holders of the remaining stock of the corporation.[251] Under Notice 2000-15,[252] a transaction involving fast-pay stock is a listed transaction.

As discussed further in Part XI.B, in many cases under the Proposed Regulations, redemption of a debt instrument recharacterized as stock would be treated as a Section 301 distribution, rather than a sale or exchange. As a result, the stock might be viewed as fast-pay stock. In addition, as in Example 20 above, a debt instrument issued at more than a *de minimis* premium to its face amount and recharacterized as stock under the Proposed Regulations would

[247] *See* Preamble at 20917 ("although the holder of a debt instrument has different legal rights than the holder of stock, the distinction between those rights usually has limited significance when the parties are related").

[248] *See*, *e.g.*, Hewlett-Packard v. Comm'r, T.C. Memo. 2012-135 (put right against counterparty causes preferred stock to properly be characterized as debt); Comm'r v. Palmer, Stacy-Merrill, Inc., 111 F.2d 809 (9th Cir. 1940) (coupon payments on preferred stock issued by subsidiary, with a parent guarantee of coupon payments and redemption value, were not dividends for tax purposes); Northern Refrigerator Line v. Comm'r, 1 T.C. 824 (1943) (third-party guarantee does not result in recharacterizing preferred equity as indebtedness, because the arrangement with the third party did not include the borrower). *Cf.* TIFD III-E, Inc., 459 F.3d at 220.

[249] Treas. Reg. § 1.7701(l)-3(b)(2).

[250] Treas. Reg. § 1.7701(l)-3(b)(2)(i).

[251] Treas. Reg. § 1.7701(l)-3(c).

[252] 2000-12 I.R.B. 826.

be presumed to be fast-pay stock. Since the instrument is treated as stock, however, solely as the result of a recharacterization under the Proposed Regulations, it seems anomalous to then apply a separate rule, developed to deal with a different perceived abuse, to potentially further recharacterize that stock as debt. It would be self-defeating from the perspective of Section 385 to have debt issued by one EG member be treated, through a combination of recasts, as debt of a different EG member. We therefore recommend making clear that the debt that is recharacterized under the regulations will not be treated as fast-pay stock.

3. Sections 246, 901(k) and 1059

Revenue Ruling 94-28 holds that a corporate holder of stock that provides for payment of a fixed face amount on a fixed maturity date is denied a dividends received deduction ("**DRD**") pursuant to Section 246(c)(4)(A) where the holder has the rights of a creditor under local law to enforce payment of that amount. In the ruling, however, the IRS notes that "section 246(c)(4)(A) generally is interpreted as containing an exception for traditional mandatory redemption rights that are common in the terms of many preferred stocks." It notes this exception should be construed narrowly and, thus, not applied to the instrument that is the subject of the ruling. However, the ruling also states that it is not meant to address the availability of the DRD in the case of the "disqualified portion" of the interest on a high-yield debt obligation.

As indicated above, the Per Se Stock Rules appear to be based on the premise that, notwithstanding that a debt instrument provides for creditor's rights and has the other traditional terms of debt, those legal rights are relatively insignificant in deciding debt-versus-equity status; instead, the parties' closely related status and the nature of the transaction in which the debt was created within the EG should be the determinative factors for deciding the treatment of the instrument. It seems logically consistent with that premise not to attribute significance to the debt's possession of creditor's rights, when determining whether the DRD holding period requirements of Section 246 are met. Rather, consistent with paragraph 1 above, it seems appropriate to apply Section 246 without regard to such rights. The same should be true with respect to Section 901(k), which incorporates holding period requirements similar to those in Section 246 for purposes of being entitled to claim foreign tax credits with respect to dividends under Sections 901 and 902. [253]

If distributions on a recharacterized instrument to its holder are eligible for the DRD, then the redemption of the instrument or any other form of extraordinary dividend may be subject to

[253] For avoidance of doubt, we note we are not commenting here on the appropriateness of the results obtained under Revenue Ruling 94-28 outside the context of a debt instrument between EG members that has been recharacterized as equity under the Per Se Stock Rules. Rather, our comments are based only on what appears to us to be the overriding weight of the Per Se Stock Rules and the principles underlying them, in cases where those rules apply.

Section 1059, in which case the holder would be required to reduce its basis in the instrument to reflect the DRD. The final regulations should expressly reference Section 1059 on this point.

4. Section 902

Recharacterized debt instruments often will not by their terms provide for voting rights. If these instruments are treated as nonvoting stock for purposes of Section 902, then when a U.S. EG member holds recharacterized debt of a foreign corporation in the group, the U.S. EG member will not receive Section 902 credits with respect to dividends paid by the foreign corporation (unless the U.S. EG member otherwise directly owns sufficient voting stock).[254] In addition, it appears that even if the U.S. EG member is not entitled to claim Section 902 credits, dividend payments to the U.S. EG member have the effect of permanently removing Section 902 foreign taxes from the payor's foreign tax pool.[255] Thus, dividends paid to the U.S. EG member might have the follow-on effect of subjecting a different U.S. EG member that holds the foreign corporation's voting stock to U.S. tax on future dividends, without the benefit of Section 902 credits to which it otherwise would have been entitled.

These would be harsh results, which would not appear to further the goals, or address the concerns, expressed in the Preamble. Treasury and the IRS should therefore clarify that, for purposes of determining whether the 10% voting stock threshold in Section 902 is satisfied with respect to dividends from recharacterized debt, Section 304(c)(3) attribution rules should apply. Although Section 902 ordinarily does not take into account constructive ownership,[256] it is appropriate for constructive ownership rules to apply in this case. By comparison, even though the selling corporation in an intragroup Section 304 transaction may not directly own any voting stock of the acquiring corporation, the selling corporation has nevertheless been found by the IRS to be entitled to Section 902 credits with respect to the acquiring corporation's E&P, due to the close relationship between the corporations as identified by application of Section 304(c)(3).[257] We believe a similar approach is warranted here, given the importance placed by the Per Se Stock Rule on the closely related status of the borrower and lender and the relative insignificance of formal terms of the debt instrument between them. Other than with respect to the common parent, members of an EG must own 80% (by vote or value) of each other member. It is therefore very likely (although not necessarily a foregone conclusion) that a lender in an EG

[254] *See* First Chicago Corp. v. Comm'r, 96 T.C. 421 (1991).

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

[256] First Chicago Corp. v. Comm'r, 96 T.C. 421 (1991); Rev. Rul. 85-3.

[257] *See* Rev. Rul. 92-86, 1992-2 C.B. 199; Rev. Rul. 91-5, 1991-1 C.B. 114; STAFF OF THE JOINT COMM. ON TAX'N, GENERAL EXPLANATION OF TAX LEGISLATION ENACTED IN 1998 (JCS-6-98) ("The 1997 [Taxpayer Relief] Act amendments to section 304, including the modifications under this provision, are not intended to change the foreign tax credit results reached in Rev. Rul. 92-86 and 91-5."). As discussed earlier, Section 304(c)(3) provides the constructive ownership rules for determining membership in an EG.

would be treated as owning more than 10% of the voting stock of a borrower in an EG, if the constructive ownership rules of Section 304(c)(3) are applied.

If the U.S. EG member had simply invested in nonvoting preferred stock of the foreign EG member, the U.S. EG member would not be entitled to the same treatment. However, in that case the consequences would follow from the form the instrument chosen by the taxpayer. In contrast, where the Per Se Stock Rules apply, the Section 902 issue arises only because the form of the instrument (*i.e.*, as debt) is disregarded; and it may not be known that the instrument will be recast as stock, until some time after it has been issued.[258]

5. Section 909

The Proposed Regulations request comments on whether guidance is needed regarding the application of Section 909 to instruments treated as stock under the Per Se Stock Rules. Section 909 suspends the receipt of direct and indirect foreign tax credits in the case of a "foreign tax credit splitting event." A foreign tax credit splitting event occurs if a taxpayer receives income under an instrument that is equity for U.S. tax purposes and debt in the relevant non-U.S. jurisdiction, if the income and deductions associated with the debt instrument for non-U.S. tax purposes do not match the income inclusion on the equity instrument for U.S. tax purposes (an **"equity hybrid instrument**").[259]

Although a debt instrument treated as equity under the Per Se Stock Rules would often be treated as debt for foreign tax purposes, such an instrument in some cases may not be a U.S. equity hybrid instrument. Often, a recharacterized instrument would be preferred stock under Section 305 and in some cases Section 305(c) would require a taxpayer to include dividend yield on that stock in income as the yield accrues. However, in a case where Section 305(c) does not require these inclusions, there could be a mismatch between income inclusions for U.S. tax purposes and interest income and deductions on the instrument in the relevant non-U.S. jurisdiction(s), with the result that the instrument would be an equity hybrid instrument.

It seems to be somewhat unnecessary to apply Section 909 in such a case. First, taxpayers have a limited incentive to try to use the rules to plan their way into a splitter arrangement, given all the negative consequences that can accompany a recast under the Per Se Stock Rules. Second, given the basic debt-like economic terms of recharacterized instruments, dividends will ultimate-

[258] The lender and borrower within an EG, if mindful of this issue, might decide to amend a recharacterized debt instrument to provide for voting rights (or simply replace the debt instrument with voting preferred stock). Indeed, they might opt to plan for the issue up front, by providing for "springing" voting rights that apply only if the debt instrument is recharacterized as equity under the Per Se Stock Rules. However, in view of the de-emphasis of form that underlies the Per Se Stock Rules, it seems somewhat counterintuitive to induce taxpayers to engage in planning that places significant weight on formal characteristics. It also means that the Per Se Stock Rules will act as a trap for taxpayers with less sophistication.

[259] Treas. Reg. § 1.909-2(b)(3).

ly be paid on the instrument, generally in amounts equal to the interest that has been taken into account for foreign tax purposes, and not infrequently soon after the relevant yield has accrued. Because instruments recharacterized under the Per Se Stock Rules thus would not be natural vehicles in many cases for the type of planning Section 909 is designed to address, we recommend adopting a rule carving out these instruments from the Section 909 regulations.

6. Sections 305, 306, 351(g), 368(c), and 1504

It appears appropriate for an instrument treated as stock under the Per Se Stock Rules generally to be subject to the same tax treatment as actual stock that has comparable economic features. For example, a recharacterized instrument may be treated as preferred stock under Treas. Reg. § 1.305-5(a) and, thus, the holder may accrue distributions equal to any redemption premium on a constant-yield basis.[260] As suggested in the Preamble, if an instrument has the features of nonqualified preferred stock under Section 351(g), it should be treated as such for purposes of Section 351; and a similar conclusion holds with respect to Section 306.

As indicated above, recharacterized debt often will not expressly provide the holder with voting rights. Treatment of such debt as nonvoting stock will often have consequences when determining whether the requirements of Sections 368(c) or 1504 are met with respect to the EG member that has issued the debt. Although rules deeming recharacterized debt to be voting, rather than nonvoting, stock for purposes of these Code sections might be helpful to taxpayers in some cases in avoiding adverse collateral consequences from a recharacterization, this may not always be true; and, in some cases, the basic fact that the debt has been recast as stock, rather than the nature of that stock as voting or nonvoting, may be dispositive of the parties' tax treatment.[261]

As one commentator on the Proposed Regulations has noted, Section 351(g)(4) provides broad regulatory authority for Treasury and the IRS with respect to nonqualified preferred stock.[262] Treasury and the IRS should consider whether this authority should be used, for example, to treat this stock as not stock for purposes of the Section 368(c) control test and the Section 1504 stock ownership tests.

[260] *See* Treas. Reg. § 1.305-5(b).

[261] Although, as described above, there is precedent under Section 902 for treating a member of a corporate group as constructively holding voting stock of another member, there does not appear to be similar precedent for purposes of applying the Section 368(c) control test or the Section 1504 ownership requirements.

[262] James M. Peaslee, Letter to the IRS Re: IRS REG-108060-15 (Section 385 Proposed Regulations), May 18, 2016.

7. Application of Sections 954(c)(1)(D), 988 and 1221, and Treas. Reg. § 1.1275-6

A borrower or lender under a debt instrument that hedges interest rate or currency risk with respect to the debt in many cases is entitled to integrate the hedge with the debt.[263] By comparison, an issuer or holder of stock is not entitled to integrate those hedges with the stock. Further, while a U.S. shareholder of a CFC that hedges debt the CFC holds is generally able to net foreign currency gain or loss with respect to the debt and the hedge for purposes of computing Subpart F income, this netting is not available where the CFC hedges currency risk associated with stock.[264] In addition, while a person engaged in a lending business generally receives ordinary treatment for its gain or loss recognized with respect to loans made in that business, and can choose ordinary treatment for gains or losses under hedges of those loans, ordinary treatment is not available for gain or loss recognized with respect to stock.[265] These provisions, as applied to intragroup debt recast as equity under the Per Se Stock Rules, can exacerbate significantly what would already in many cases be adverse consequences for a holder of such debt. Nevertheless, they appear to follow directly from the recharacterization of the debt as equity. Treasury and the IRS should confirm whether these conclusions are correct.

8. Withholding Tax

Where the issuer of a recharacterized debt instrument is a U.S. corporation, dividend payments on the instrument to non-U.S. persons, in addition to being nondeductible, may result in U.S. withholding tax. To the extent a treaty applies, the rate will depend in part on whether the foreign EG member receiving the dividends owns sufficient voting stock of the U.S. corporation to qualify for the preferential rates applicable to non-portfolio investments. In general, it appears that only direct ownership of the requisite voting stock is taken into account under a number of U.S. tax treaties. Moreover, insofar as U.S. withholding taxes are deducted from the "dividends", the foreign EG member receiving the dividends may find it is not entitled to a credit for the withholding taxes in its home country. The repayment of the principal of the recharacterized debt could also be treated as a dividend with the same result of U.S. withholding tax and no credit in the recipient's home country. The final regulations should expressly confirm whether these consequences are intended.

[263] *See* Treas. Regs. §§ 1.988-5, 1.1275-6.

[264] *See* Section 954(c)(1)(D).

[265] *See* Code § 1221(a)(4); Burbank Liquidating Corp. v. Comm'r, 39 T.C. 999 (1963) , *aff'd in part and rev'd in part*, 335 F.2d 125 (9th Cir. 1964); Treas. Reg. § 1.1221-2.

9. Consequences Where Part (But Not All) of a Debt Instrument Is Recharacterized

Application of the Per Se Stock Rules could result in part, but not all, of a debt instrument being recharacterized. Treasury and the IRS should provide guidance on the consequences for the issuer and holder in these cases. The issues raised include:

a. *Determining which portion of the debt is recharacterized*. A simple approach (although not the only possible approach) would be to treat a pro rata portion of the entire debt instrument, based on the adjusted issue price of the instrument at the time of recharacterization, should be treated as equity.

b. *Allocating payments under the terms of, or in partial redemption of, the instrument between portions of the instrument treated as debt and equity*. Again, a straightforward approach would be to make the allocation based on relative adjusted issue price. This would have the somewhat unusual result of treating the debt and equity as *pari passu* in the issuer's capital structure; in theory, a more justifiable approach might be to attribute payments first to the debt portion of the instrument, and then to the equity portion, although in practice the computations required could be more burdensome than a pro rata allocation.

c. *Treatment of dispositions of part or all of the instrument*. It is unclear whether a disposition by the holder of part (but not all) of a partially recharacterized debt instrument should automatically be treated as a transfer of ratable portions of the debt and equity components of the instrument, or not (*e.g.*, whether the holder can choose to designate which component is being transferred). In addition, if the issuer is distressed, a question arises (somewhat similar to that described in the preceding paragraph) whether to allocate the amount realized pro rata between the debt and equity portions of the instrument, or first to the debt portion. If an allocation is made first to the debt portion, then presumably it would be possible to take a worthless stock deduction with respect to the equity component of the instrument in a case where no proceeds are allocated to that component.

A related question is the correct characterization of an assumption of obligations under the instrument from the issuer by another EG member. As noted in Example 21 in Part VIII.A above, the consequences for an assumption of the debt portion of the instrument are not entirely clear. In addition, tax and corporate law do not have any readily applicable construct for an assumption by one corporation of obligations under stock that has been issued by another corporation. One possibility, which may lead to a relatively simple analysis, would be to adopt the same basic characterization for an assumption of stock, as for an assumption of debt (*e.g.*, in both cases, the assuming corporation is deemed to issue a new debt or equity instrument to the original issuer, and the original issuer is then deemed to transfer the new instrument to the holder in satisfaction of the original issuer's obligations under the old instrument).

The same basic issues also exist under the Part-Stock Rule. One question for the government to address is whether the methodology for addressing these questions should be the same under both sets of rules.

B. Deemed and Actual Redemptions of Recharacterized Debt

If a debt instrument is recharacterized as stock under the Per Se Stock Rules, and the instrument subsequently ceases to be held within the EG (either because it is transferred to a third party or because the issuer or the holder leaves the EG), then the instrument ceases to be treated as stock immediately before it leaves the EG. More specifically, the stock is deemed to be exchanged for a new debt instrument at that time. We recommend that the Per Se Stock Rules be revised to expressly set forth the tax consequences of the deemed exchange of equity for debt, with unexpected consequences and costs (both for EG members, and for third parties) being avoided to the extent possible, as described further below.

Prop. Treas. Reg. § 1.385-1(c) sets forth the consequences of a deemed exchange of debt for equity when the debt is recharacterized under Prop. Treas. Reg. § 1.385-2 or Prop. Treas. Reg. § 1.385-3 effective as of a time after the debt's initial issuance. The consequences are designed to minimize the possibility for income recognition by the EG member that holds the instrument. We believe it would be appropriate to take a similar approach of minimizing collateral consequences when dealing with the converse case, in which an instrument that has been recharacterized as equity under the regulations ceases to be held within the group.

When the issuer or holder of a recharacterized debt instrument ceases to be a member of the EG, the deemed exchange of stock for debt that is contemplated by Prop. Treas. Reg. § 1.385-2(c)(2)(ii) and Prop. Treas. Reg. § 1.385-3(d)(2) should normally be treated as a redemption that is a sale or exchange under Section 302(a). In this regard, the issue price of the debt deemed issued at that time (which would determine the amount realized for the holder in the sale or exchange) logically should equal what the adjusted issue price of the original debt would have been had the debt remained outstanding since its original issue date and not been recharacterized as equity. In general, the holder's gain or loss in the redemption should be capital. In this regard, we believe it would be appropriate to specify that accrued but unpaid "dividends" (*i.e.*, stated interest that has accrued from the last interest payment date through the date of the sale or exchange) would not be taxed separately as ordinary income, but would form part of the redemption price.[266]

[266] *See* Rev. Rul. 69-191. We note that, for example, in the case of debt distributed by the issuer to the holder, which debt was recast as stock from initial issuance under the General Per Se Rule, the stock may be Sec-

Under the approach just described, one positive result would be that the issuer or holder, in periods after it has left the EG, should have the same consequences under the OID regime, as if the debt in question had never been recharacterized; this would presumably be the result that a third-party acquirer of the issuer or holder would normally expect.

Where a debt instrument that has been recharacterized is sold outside the group, but the original issuer and holder continue to be members of the group, it seems logical to provide results consistent with those just described. This will help ensure the rules apply in a predictable manner. We suggest that the EG member disposing of the instrument outside the group ought to be treated as having sold the deemed equity to the third-party acquirer in a Section 1001 transaction. The third-party acquirer of the instrument would be treated as having bought debt with the same issue price as described above; and any difference between that issue price and the actual consideration paid would be treated as market discount or as bond premium. This approach seems to lead to fair results for both parties, and to be consistent with the overall scheme of the Proposed Regulations.

We note that where a debt instrument that has been recharacterized as stock is actually redeemed, instead of remaining outstanding but ceasing to be held within the EG, the tax consequences may be different. For debt recast as equity under the Part-Stock Rule, the Documentation Rules, or the General Per Se Rule, it would seem reasonable to treat an actual redemption of the instrument as a Section 301 distribution, under Section 302(d); there does not appear to be grounds to treat such a redemption differently than redemptions of actual stock within a group.

However, different considerations would appear to apply, in the case of a redemption of stock that was deemed to be issued under the Funding Rule. Here, the recharacterized debt originally was issued with a view to funding payment of a Section 301 distribution by the issuer (or funding a "distribution-like" payment by the issuer with results similar to a Section 301 distribution, *e.g.*, under Sections 304 or 356). The subsequent redemption of that recharacterized debt *qua* stock results in an additional Section 301 distribution. This creates the possibility for two separate dividends from the issuer, where logically it seems there should only be one. In some cases, the initial distribution or distribution-like payment that causes the debt to be recharacterized may not be out of E&P; indeed, the fact that the distribution or payment might be made (by a CFC) at a time when the payor has no E&P is one of the core concerns that apparently motivated the Per Se Stock Rules. However, given the broad reach of the rules, they often may apply in a manner that results in two dividends.

tion 306 stock, with the result that a deemed redemption of the stock in exchange for debt may be subject to treatment as a Section 301 distribution pursuant to Section 306(a)(2).

This potential for a duplication of Section 301 distributions could have favorable results for the taxpayer (as in Example 12 in Part VII.C, to the extent the result there is permitted under the rule barring affirmative use of the Per Se Stock Rules), or adverse results (as in Example 15 in Part VIII.A), depending on the circumstances. In particular, such a Section 301 distribution, to the extent it is made out of E&P by a foreign corporation, might not be accompanied by Section 902 foreign tax credits if our recommendation above is not accepted (and, as noted above, may eliminate foreign taxes from the issuer's foreign tax pools). In addition, to the extent the distribution is made by a U.S. corporation to a foreign EG member, it may result in U.S. withholding tax, for which the foreign EG member may, or may not, be entitled to a credit in its home country.

It does not seem that treating a redemption of stock deemed issued under the Funding Rule as a Section 301 distribution (rather than a sale or exchange under Section 302(a)) furthers any of the policies that underlie the Per Se Stock Rules, at least where the initial distribution or acquisition that caused the Funding Rule to apply was a distribution out of E&P. If anything, treating these redemptions as Section 301 distributions may tend to be unfavorable to the government, because (subject to the prohibition on affirmative use of the Per Se Stock Rules) taxpayers who wish to achieve Section 301 treatment may be able to plan into redemptions and those who do not, may be able to avoid redemptions. Nevertheless, it may not be easy to amend the Proposed Regulations in a manner that eliminates this result. It could be asked whether the redemption, in these particular circumstances, ought to be viewed as not essentially equivalent to a dividend, under Section 302(b)(1), because the "stock" in question was issued only to fund an earlier Section 301 (or similar) distribution out of E&P and treating the redemption as a dividend would have the double-counting effect described above. However, it is not clear how strongly existing authorities under Section 302(b)(1) would support such an argument.

XII. TREATMENT OF PARTNERSHIP TRANSACTIONS IN THE PER SE STOCK RULES

A. Overview of the Partnership Rules

If an EG member makes a loan to a Controlled Partnership, the loan is treated for purposes of the Per Se Stock Rules as having been made to the EG members that are partners in the Controlled Partnership ("**EG Partners**") in proportion to their profits interest in the partnership. Thus, if an EG Partner acquires stock of an EG member or makes a distribution, then the portion of the loan attributed to that EG Partner is recharacterized as an equity interest in that EG Partner, to the same extent as would have been the case had the EG Partner borrowed its portion of the loan directly from the EG member that is the lender.[267] In other words, the regulations follow a two-step recasting. First, the actual loan is treated as having been made to the EG Partner or EG Partners in question, and second, the loan is recast as equity under the general Per Se Stock

[267] Prop. Treas. Reg. § 1.385-3(d)(5)(i), (ii).

Rules, if applicable. However, the rules do not appear to require that the relationship between the Controlled Partnership and the EG Partner that has been deemed to issue equity to the lending EG member be construed in any particular manner, merely stating that appropriate conforming adjustments be made. Little guidance is offered as to the meaning of "appropriate adjustments": the Proposed Regulations state that these adjustments must minimize the disparity between the partners' aggregate bases in their partnership interests and the partnership's aggregate basis in its assets, and the examples illustrate a series of adjustments that are considered "reasonable and appropriate" in two cases.[268] Thus, Prop. Treas. Reg. § 1.385-3(d)(5) raises a number of difficult interpretive questions and issues, some of which are discussed below.

The Preamble contains the following request for comments:

> [C]omments are requested on…the treatment of controlled partnerships in proposed §1.385-3 and the collateral consequences of the recharacterization and any corresponding adjustments, including the treatment of a partner's proportionate share of partnership assets or debt instruments, of treating a debt instrument issued by a controlled partnership as stock in its expanded group partners, including a situation in which a recharacterization results in a partnership owning stock of an expanded group partner. Specifically, the Treasury Department and the IRS request comments on how to apply proposed §1.385-3 when expanded group partners make distributions subject to the funding rule with respect to some, but not all, partnership debt instruments; when one or more, but not all, expanded group partners make a distribution subject to the funding rule with respect to part or all of their share of the partnership debt instrument; and how to address such distributions when a controlled partnership has one or more partners that are not expanded group members.[269]

We have the following comments and recommendations with respect to the application of the Per Se Stock Rules to Controlled Partnerships. While the application of these rules involves a number of difficult technical issues, the frequency with which such issues must be confronted will be reduced if, as we have strongly recommended above, the Funding Rule is scaled back (in particular, if the Funding Rule is applied only to cases where a loan is made as part of a series of steps, with a view to achieving the same economic result as if the borrower had made a distribution or acquisition described in the General Per Se Rule, as recommended in Part IX.B.2 above).

[268] Prop. Treas. Reg. § 1.385-3(d)(5)(ii); Prop. Treas. Reg. § 1.385-3(g), Ex. 14 and 15.

[269] Preamble, at 20929.

B. Proposed Treatment of a Loan by an EG Member to a Controlled Partnership

1. Recharacterization

As a preliminary matter, we note that while the Per Se Stock Rules specifically prescribe aggregate treatment for a Controlled Partnership, they are silent on the choice between entity and aggregate treatment for a partnership in which EG members own a less than 80% interest. Given the specificity and detail of the rules concerning aggregate treatment for an entity that meets the definition of Controlled Partnership, we presume that aggregate treatment was not intended for other partnerships, and that loans to those partnerships by EG members thus are not within the scope of the Per Se Stock Rules. However, it would be useful to have confirmation of that point.

In addition, it would be extremely helpful if the Proposed Regulations gave more explicit and detailed guidance with respect to the relationship between the Controlled Partnership and the EG Partners that have been deemed to issue equity to the lending EG member. Under the proposed regulations, this relationship is a "missing link" and, as noted above, an area where comments are specifically requested. The only guidance is found in two examples, Prop. Treas. Reg. § 1.385-3(g) Examples 14 and 15, that have very similar fact patterns but arguably take somewhat different approaches to the necessary conforming adjustments. In addition, it would be helpful if the regulations made clear that conforming adjustments are to be made (to the extent possible) in a manner that holds harmless partners that are non-EG members, both from an economic and tax perspective, and minimizes the distortion of allocations of partnership items of income, gain, loss, deduction and credit among all partners (including EG Partners as well as partners that are not EG members).

To illustrate some of the stakes, consider Prop. Treas. Reg. § 1.385-3(g) Example 14 ("**Proposed Example 14**"), which states:

> CFC and FS (a non-CFC) are equal partners in PRS and both are members of the FP EG. On Date A in Year 1, FP lends $200*x* to PRS in exchange for PRS Note. On Date B in Year 1, CFC distributes $100*x* to its U.S. parent, USSS1 (a subsidiary of FP and a member of the FP EG) and FS distributes $100*x* to FP.

The analysis of this example in the regulations is as follows:

> Under paragraph (d)(5)(i) of this section, solely for purposes of this section, CFC and FS are each treated as issuing $100*x* of PRS Note on Date A in Year 1, which represents their proportionate shares of PRS Note. CFC's and FS's shares of PRS Note are each issued to FP, a member of the same expanded group, during the 72-month periods determined with respect to the distributions by CFC and FS. Under paragraph (b)(3)(iv)(B)(1) of this section, PRS Note is treated as issued with a principal purpose of funding the distributions by CFC and FS. Accordingly, under

paragraphs (b)(3)(ii)(A) and (d)(1)(i) of this section, PRS Note is a principal purpose debt instrument that is treated as stock when it is issued on Date A in Year 1.

Under paragraph (d)(5)(ii) of this section, CFC and FS are each treated as issuing $100x of stock to FP. Appropriate conforming adjustments must be made to CFC's and FS's interests in PRS to reflect the deemed treatment of PRS Note as stock issued by CFC and FS, which must be done in a manner that avoids the creation of, or increase in, a disparity between PRS's aggregate basis in its assets and the aggregate bases of CFC's and FS's respective interests in PRS. For example, reasonable and appropriate adjustments may occur when the following steps are deemed to occur on Date A in Year 1:

1. CFC issues stock to FP in exchange for $100*x*;
2. FS issues stock to FP in exchange for $100*x*;
3. CFC contributes $100*x* to PRS in exchange for a partnership interest in PRS; and
4. FS contributes $100*x* to PRS in exchange for a partnership interest in PRS.

Pursuant to the timing rule of Prop. Treas. Reg. § 1.385-3(d)(1)(i), because the loan and distributions happened in the same taxable year, the deemed recharacterization occurs on the date the loan is made (Date A) rather than the distribution date later in the same year (Date B), and the loan by FP to PRS is, in essence, ignored. It is also clear that the deemed recast is that CFC and FS have both received an additional partnership interest in PRS, presumably with a new holding period for that additional interest.[270] However, it is not clear what the terms of those additional partnership interests are. It would be reasonable to infer that the terms are intended to be economically identical to the terms of the PRS Note which is being recast under the regulations.

If that is so, it would also seem logical that the resulting deemed partnership interests issued in steps 3 and 4 (above) should be treated as giving rise to guaranteed payments in respect of capital under Section 707(c) (or some other type of special allocation of income or items thereof) to the extent of the interest on the PRS Note that is being recast. The PRS Note still exists and, presumably, payments thereon are still being made. In order to assimilate those payments to the deemed distributions presumably made with respect to debt service on the stock deemed issued by CFC and FS, respectively, there must be terms imputed to the deemed partnership interests issued by PRS to CFC and FS (or some alternative explanation must be offered).[271]

[270] *See* Treas. Reg. § 1.1223-3.

[271] Under the general Per Se Stock Rule, although not explicitly stated, if an EG member had actually made a loan to an EG Partner, and the loan had been recast as equity of EG Partner, then presumably the actual debt service payments made by EG Partner to the lending EG member would be treated as distributions by EG Partner with respect to equity. In the partnership context however, the aggregate treatment applied to

If this inference is correct, it would be helpful to have clarification to that effect, and, if not, it would be helpful to know why and what the purported terms of the deemed partnership interests must be to comply with the regulations.

On the facts of Proposed Example 14, the manner in which this question is resolved may not make much difference because the partnership is a 50/50 partnership between two EG Partners, each of which is wholly owned by EG members. However, there may be cases in which there are minority members in the Controlled Partnership, minority members in the EG Partners, or non-pro rata allocations of items of income gain or loss, any of which could be affected by the nature of this deemed partnership interest.

In the discussion that follows, the recasting suggested by Proposed Example 14 will be referred to as the "**deemed issuance**" approach.

In Example 15 in the Per Se Stock Rules ("**Proposed Example 15**"), the facts are the same as for Proposed Example 14, except that FS and CFC make their respective distributions in the year following the loan, on date C of year 2. The analysis of this example in the regulations is as follows (in relevant part):

> For example, reasonable and appropriate adjustments may occur when the following steps are deemed to occur on Date C in Year 2:
>
> 1. CFC assumes liability with respect to $100*x* of PRS Note;
> 2. FS assumes liability with respect to $100*x* of PRS Note;
> 3. CFC issues stock to FP in satisfaction of the $100*x* of PRS Note assumed by CFC; and
> 4. FS issues stock to FP in satisfaction of the $100*x* of PRS Note assumed by FS.

In Proposed Example 15, because the loan and distributions do not occur in the same year, pursuant to the timing rule of Prop. Treas. Reg. § 1.385-3(d)(1)(ii), the recast occurs not on the date the PRS Note was made (Date A in Year 1), but on the date CFC and FS make distributions (Date C in Year 2). In addition, the "appropriate adjustment" does not expressly appear to involve the creation of a new partnership interest (as in Proposed Example 14), but rather, the assumption of an existing partnership liability.

the partnership debt is a pure tax fiction which exists only due to the operation of the regulations. Therefore, when PRS makes an actual payment to the EG member lender, there must be a mechanism to account for the deemed cash flow from PRS to EG Partner as well as the deemed cash flow from EG Partner to EG member, neither of which actually exists.

It is not clear, however, whether it would have also been an appropriate adjustment in this case to apply the deemed issuance approach above to deem a partnership interest to have been issued in exchange for the deemed assumption of indebtedness and if not, why not. Indeed, under Section 752, the liability assumptions by CFC and FS are treated as deemed equity investments of cash in PRS, so that it would appear there is not any significant difference between the assumption approach, and the deemed issuance approach of Proposed Example 14, at least in this regard. Presumably, all of the economic and tax results to the partners are intended to be the same in the two examples. However, it would be useful if the government could clarify this point.

Presumably the partnership agreement in Proposed Example 15 should create guaranteed payments (under Section 707(c)) or special income allocations from PRS to FS and CFC corresponding to payments of debt service made by PRS to FP, just as would presumably be the case in Proposed Example 14. Again, if this is the intended or permitted result, it would be useful to have that clarified. If not, it would be useful to know what is permitted or required in the way of these adjustments, other than that they be "reasonable" and "appropriate."

In the discussion that follows, the recasting suggested by Proposed Example 15 will be referred to as the "**deemed assumption**" approach.[272]

Under both the deemed issuance and deemed assumption approaches, (i) the deemed stock issued by the EG Partner must have payment terms identical to the PRS Note that is recharacterized or deemed repaid, in order to account for the payments actually made on that debt, and (ii) the partnership interest held by the EG Partners deemed to issue the stock must also have payment terms identical to the PRS Note recharacterized or repaid for the same reason. The Preamble rejected the approach of directly recasting the PRS Note to FP as a partnership interest, because such a recast would give rise to guaranteed payments or partnership income allocations that produce results similar if not identical to the results sought to be prevented by the Per Se Stock Rules. However, although not explicit, it appears that the same recasting the Preamble sought to preclude will in fact occur under Prop. Treas. Reg. § 1.385-3(d)(5). It will simply occur with respect to a different EG member: that is, instead of the EG member that is the lender to the partnership being deemed to acquire a (preferred) equity interest in the partnership, the EG member that is the lender will instead be deemed to acquire a (preferred) equity interest in one or more EG Partners who in turn will be deemed to have acquired or altered their interest in PRS, presumably on back-to-back terms. Thus, Prop. Treas. Reg. § 1.385-3(d)(5) is not just a rule for

[272] As pointed out in the text, in many if not all cases these two approaches should logically lead to similar if not identical results, leading to the question of whether they are really the same approach. The structure of the Proposed Regulations, however, seems to indicate that its drafters thought these differences were of some consequence, since they are the only fact patterns discussed in the Proposed Regulation. Accordingly, this Report treats the two examples as adopting different approaches to making conforming adjustments while requesting clarification of this and other matters.

recasting a debt instrument as equity; it is also a rule that alters the identity of the parties that issue and invest in that recharacterized instrument.

With that background, we are led to ask whether there is a reason why deeming CFC and FS to have made a loan to PRS (or, in Proposed Example 15, to have acquired from FP a preexisting loan to PRS), as the case may be, with the proceeds of the deemed equity interests issued to FP would not be "reasonable" or "appropriate." If this is a reasonable and appropriate conforming adjustment, confirmation of this point would be helpful, and if not, it would be useful to know why. Use of a deemed loan in lieu of a deemed partnership interest should alleviate many collateral consequences of the application of the Per Se Stock Rules to partnership transactions, including to non-EG member partners, as discussed further below. It might be argued that creating a deemed loan is not consistent with the overall thrust of the Per Se Stock Rules, which seek to distinguish debt from equity; in fact, however, as just noted above, Prop. Treas. Reg. § 1.385-3(d)(5) is at least as concerned with the issue of which corporation in an EG is advancing funds to a Controlled Partnership, as it is with the classification of an instrument issued by a Controlled Partnership as debt or equity under general principles of tax law. Accordingly, it seems reasonable in this regard to apply the Per Se Stock Rules to loans to Controlled Partnerships not by asking whether debt of a partnership should be recast as equity, but rather, by asking which EG member is most appropriately treated under the Per Se Stock Rules as having made the loan to the partnership.

> *Example 31*. Same facts as Proposed Example 14, except that FP makes a \$100*x* equity investment in each of CFC and FS, and each of those entities uses the proceeds of FP's equity investment to acquire 50% of the PRS Note.

Under these facts, if one uses an aggregate approach for purposes of Section 385 (as indicated in the regulations to be appropriate), then it appears the PRS Note should be analyzed as having been made 50% by FS to itself and 50% by CFC to itself. Thus, there should no longer be a loan to recharacterize here, under the Per Se Stock Rules. If this analysis is correct, it would be useful to have confirmation to that effect (or, if not, it would be useful to understand why).

Assuming the transaction in Example 31 does not raise issues under the Per Se Stock Rules, it would seem reasonable in Proposed Examples 14 and 15 to recast the transaction such that the deemed steps are the same as the actual transaction in Example 30. In the discussion that follows, the recasting suggested by Example 31 will be referred to as the "**deemed conduit**" approach.

The following discussion analyzes some common partnership fact patterns from the perspective of the deemed issuance, deemed assumption and deemed conduit approaches. We conclude that in general, the deemed conduit approach creates fewer potential problems regarding the application of Subchapter K and related rules to Controlled Partnerships, than do the other approaches. This is because at the Controlled Partnership level, the deemed conduit approach does not ask the question of how to characterize the loan to the partnership; instead, the deemed conduit approach asks the more straightforward question of which EG member(s) should properly be viewed as making the loan to the Controlled Partnership. The debt-equity recharacterization and related tax consequences then occur at the EG Partner level, where no Subchapter K issues are presented.[273]

2. Liquidation in Accordance with Capital Accounts

Many partnership agreements call for liquidation in accordance with capital accounts. Capital accounts, in turn, are typically maintained in accordance with the rules of Subchapter K.[274] Using this approach supports the allocation of items of income, gain or loss as having substantial economic effect, and, in fact, liquidating in accordance with capital accounts is the principal way of assuring that allocations are covered by the safe harbor under the substantial economic effect test.[275] In addition, liquidation in accordance with capital accounts is often used to comply with the "fractions rule" which allows partnerships between taxable and certain tax-exempt persons to hold leveraged real estate investments without giving rise to unrelated business taxable income.[276]

> *Example 32*. A and B are 20/80 partners in PRS and have capital accounts of $20 and $80, respectively. B is a member of the B EG; A is unrelated. PRS borrows $200 from BP, the parent of the B EG, to use in expanding PRS's business. Subsequently, B makes a $160 distribution to BP.

Under the deemed issuance approach and the deemed assumption approach, B's capital account is increased from $80 to $240 by reason of the deemed issuance of partnership interests or the deemed assumption of partnership debt. A's and B's capital accounts no longer stand in an 20/80 ratio. However, as pointed out above, it would make sense that under either approach, allocations of items should be made so as to put A and B in the same position they would have been in had Section 385 not applied, such that, after taking into account payments made on the PRS Note, A would get 20% of all proceeds on liquidation leaving B with 80%. In order to make this happen, actual payments on the loan must be treated as payments to B with respect to its partnership interest in such a manner that, over time, results in A (and B) receiving the proper amount of cash on an eventual liquidation. It should be possible to achieve this; but it could be cumbersome to do so, especially when taking into account the possibility that, over time, PRS

[273] Note that basis allocation could still shift in certain cases. See discussion at Part XII.B.6. below

[274] *See generally* Treas. Reg. § 1.704-1(b)(2)(iv).

[275] See Treas. Reg. § 1.704-1(b)(2)(ii)(b)(2).

[276] See Treas. Reg. § 1.514(c)-2(b)(1)(ii).

may become (and cease to be) a Controlled Partnership of the B EG multiple times.[277] In addition, it might be difficult to ensure that, in all events, the capital accounts will end up in the correct ratio, in view of the increased difficulty of complying with the Section 704(b) capital account maintenance rules where allocations are not pro rata.[278]

Under the deemed conduit approach, nothing has changed in relation to PRS by reason of the application of the Per Se Stock Rules, except that B's share of the PRS interest deduction is now offset to the extent of its interest inclusion. This leaves B without a net interest deduction, which is presumably the purpose of the regulations. Capital accounts remain the same and no correlative adjustments are required. The proposed regulations do not increase the risk (by reason of a foot fault or otherwise) of not giving A the "right" number on liquidation in accordance with capital accounts.

3. Fractions Rule Compliance

As pointed out above, fractions rule compliant partnerships often liquidate in accordance with capital accounts.[279] Compliance with the fractions rule also generally requires that allocations of losses to the taxable partners in a partnership not exceed a specified percentage of total losses, such that there is never a time when a disproportionately large share of losses is allocated to the taxable partners.[280]

> *Example 33*. Same facts as Example 32, except that A is a tax-exempt organization (which might include a title holding company, pension held REIT, etc.). It is intended that PRS be fractions rule compliant.

Under the deemed issuance and deemed assumption approaches, even assuming that liquidation is still in accordance with capital accounts, there is a layer of potential losses that must

[277] This point is discussed in detail in Part XII.C.1, below.

[278] Many partnerships do not liquidate in accordance with capital accounts, even though it means that their allocations of income, gain and loss may not be eligible for the safe harbor in the substantial economic effect rules, precisely because of the possibility that unanticipated results under the capital account adjustment rules in the Section 704(b) regulations could occur, thereby changing the business deal or creating the possibility of commercial disputes.

[279] Treas. Reg. § 1.514(c)-2(b)(1)(ii) (by reference to the substantial economic effect test).

[280] *See* Treas. Reg. § 1.514(c)-2(b)(1)(i).

be allocated solely to B.[281] To the extent this is so, PRS may not be able to satisfy the fractions rule under either the deemed issuance or deemed assumption approaches.[282]

Under the deemed conduit approach, no fractions rule compliance issues would be presented by reason of the recast, since capital accounts would be unchanged and (except perhaps in some cases) allocations of deductions attributable to the PRS debt would also appear to be unchanged.

4. Allocations of Credits and Other Noneconomic Items

Partnerships are supposed to allocate items of income, gain or loss in a manner that has substantial economic effect or which is in accordance with the partners' interests in the partnership.[283] However, certain partnership items cannot have economic effect. These include certain types of tax credits, recaptures of those credits and excess percentage depletion deductions.[284] These items are supposed to be allocated in accordance with the partners' interests in the partnership.[285] In certain cases, where the credit or deduction is generated by receipts, the item is explic-explicitly allocated based on the partners' shares of distributive gross income (for example, in the case of excess percentage depletion).[286]

> *Example 34*. Same facts as Example 32, except that PRS is engaged in a mining business and generates excess percentage depletion. The excess percentage depletion is intended to be allocated 20% to A and 80% to B. Alternatively, assume PRS was engaged in a wind power generation business that gave rise to production tax credits based on kilowatt hours generated.

The excess percentage depletion must be allocated in accordance with the partners' distributive share of PRS gross income.[287]

[281] After A's capital account has been reduced to zero, B would appear to still have a capital account balance, assuming losses have been allocated 20/80 and that the capital accounts were at $20/$240 by reason of the application of the deemed issuance or deemed assumption approaches.

[282] It may be possible to argue that any guarantee of PRS debt by A should be analogized to a deficit restoration obligation, which could have the result of permitting fractions rule compliance depending on how losses are allocated. However, this would appear to be a complex, and uncertain, analysis.

[283] *See* Treas. Reg. § 1.704-1(b)(2).

[284] *See, e.g.*, Treas. Reg. § 1.704-1(b)(4)(tax credits and recapture, excess percentage depletion); *see also* Treas. Reg. § 1.704-2(b)(1) (nonrecourse deductions).

[285] *Id*.

[286] Treas. Reg. § 1.704-1(b)(4)(iii).

[287] *Id*.

The production tax credits would appear to be allocable between A and B in accordance with their share of the receipts derived from the sale of electricity whose production gave rise to the credits (*i.e.*, gross income, or 20/80).[288]

Under the deemed issuance and deemed assumption approaches, some of the excess percentage depletion or production tax credits would shift from A to B (although it might be possible to mitigate that result, if some or all of the added items of income allocable to B by reason of the recharacterization were treated solely as guaranteed payments). No such shift would arise under the deemed conduit approach.

5. Allocations of Capitalizable Expenses

A partnership is often required to capitalize interest expense into the cost of a capital asset or Section 1231 asset, or into inventory, where it is added to cost of goods sold ("**COGS**").[289] Replacing interest expense with an allocation of bottom line net income or even with items of gross income will not necessarily replicate the results obtained by capitalizing interest expense.

> *Example 35*. Same facts as Example 32, except that PRS is engaged in a widget manufacturing business and some or all of the interest expense on the PRS debt is required to be capitalized into COGS. For ease of illustration, assume it is all capitalized.

Under the deemed issuance or deemed assumption approaches, $160 of the debt would be recast as equity. Accordingly, unless the payments of interest on the PRS debt are treated as capitalizable guaranteed payments to the relevant EG Partner, only 20% of the interest expense would be added to COGS—the other 80% would no longer be deductible, and PRS's income from sales of Section 1221(a)(1) property would increase accordingly. Assuming no special allocation of income from the widget selling business, A would get indirectly only 20% of this 20%, although economically it was bearing 100% of the 20%. This could perhaps be mitigated by special allocations of income, although even if such allocations are respected, it is not clear whether they would "work" in all cases.[290] Under the deemed conduit approach, by comparison, the amount of expense included in COGS (or any other capitalized asset) would not change by reason of the recharacterization that is imposed.

[288] *See* Treas. Reg. § 1.704-1(b)(4)(ii) (last sentence); PLR 200609001 (Mar. 3, 2006); PLR 200609002 (Mar. 3, 2006); PLR 200620004 (May 19, 2006).

[289] *See* Section 263A(f).

[290] For example, in a case in which the disallowance of interest expense turns PRS's net income from a net loss to a net gain, it is not clear how A would be allocated a net loss when there is no bottom line loss to allocate.

6. Basis Consequences under Section 752

Under Prop. Treas. Reg. § 1.385-3(d)(5), the portion of an EG member's loan to a Controlled Partnership which can be recast as equity of an EG Partner is effectively limited to an amount equal to the lesser of the EG Partner's share of that debt, or the EG Partner's distributions to other EG members.[291] For this purpose, the EG Partner's share of debt is based on its share of partnership profits.[292] Thus, these rules may work to allocate related party partnership debt in a manner very different from the manner in which tax basis resulting from that debt is allocated for purposes of Section 752. For example, under Section 752, debt basis may be allocated to an unrelated partner if that partner has guaranteed the debt.[293] Or, it may be allocated between related partners in a manner which does not correspond to the related partners' shares of profits.[294] This can lead to complexity and some apparently anomalous results.

> *Example 36*. PRS is owned 20% by A and 80% by unrelated B, each a U.S. corporation. P, the foreign parent of the B EG makes a loan of $100 to PRS, guaranteed by A. The proceeds of the loan are used to invest in PRS's business. Within 36 months, B distributes at least $80 to P.

Under Section 752, 100% of the debt is allocated to A for basis purposes.[295] However, the proposed regulations make clear that, once the distribution is paid, $80 of the $100 must be recharacterized as an equity investment in B by P.[296] The question is what the collateral consequences of this recharacterization are under the different approaches identified above.

[291] Although the Proposed Regulations do not expressly use the "lesser of" formulation, it inevitably results from the application of two separate rules. Under an "aggregate" approach, each EG Partner is only deemed to have issued its pro rata share of partnership debt based on its interest in partnership profits. This is the first limit. Second, this deemed EG Partner debt is then recast only to the extent the partner makes distributions (effectively, the same treatment as would have applied under the Per Se Stock Rules had the debt been incurred directly by the partner). This is the second limit. Prop. Treas. Reg. § 1.385-3(d)(5)(i); Prop. Treas. Reg. § 1.385-3(b)(3).

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

[293] Treas. Reg. § 1.752-2(c)(1).

[294] *See, e.g.*, Treas. Reg. § 1.752-4(b)(2); *see also* Prop. Treas. Reg. § 1.752-4(b)(3).

[295] Treas. Reg. § 1.752-2(b)(3)(i). Although the debt is issued by a party related to B, A bears economic risk of loss as a result of its guarantee.

[296] This is because EG member partners are treated as issuing their proportionate share of debt issued by the Controlled Partnership. For this purpose, a partner's proportionate share is determined based on the partner's share of partnership profits. Prop. Treas. Reg. § 1.385-3(d)(5)(i). See Part XII.C.2 for an additional discussion of partner-level consequences of the recast under Prop. Treas. Reg. § 1.385-3(d)(5).

Under the deemed issuance approach, B is deemed to acquire an additional partnership interest in PRS. Presumably, this recast applies for all purposes of the Code.[297] If so, then while A continues to guarantee $100 of liabilities, only $20 of liabilities now exists for Section 752 purposes. If the debt was deemed to have existed for some period of time, for example, as described in the facts under Proposed Example 15 above, then A has had a deemed distribution of $80 of cash.[298] If that deemed distribution exceeds A's basis in its PRS interest, A will recognize gain because unrelated B paid a dividend to P.[299]

In addition, there may be cases in which such a deemed distribution of cash causes A to recognize gain because a prior transaction is now recast as a disguised sale. This might arise, for example, in a case where a distribution by PRS to A would have been treated as a debt-financed distribution but now cannot be, due to the elimination of a portion of PRS's debt.[300] Whether or not there is a disguised sale in this context should not depend on whether or not B makes a distribution to a member of the B EG. Rather, it should depend on the substance of the transaction determined under normal Subchapter K rules.

Finally, allocation of certain items of income, gain or loss may change because the $80 of debt has disappeared. Certain deductions, for example, may be allocated to a partner which bears the economic risk of loss associated with those deductions. It may be the case that the manner in which A's continued guarantee of the nonexistent debt affects this allocation. Unfortunately, it is not entirely clear how to characterize the guarantee of the now non-existent indebtedness under the deemed issuance approach.[301]

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

[298] Section 752(b).

[299] Section 731(a)(1).

[300] *See* Treas. Reg. § 1.707-5(b).

[301] There are a number of possibilities. First, under the deemed issuance approach, one might treat the guarantee as a guarantee of the deemed preferred equity issued by PRS to B. As noted above in Part XI.A.1, in a few such cases, guaranteed equity has been viewed as debt of the issuer. *See* Hewlett-Packard Co., *et al.* v. Comm'r, T.C. Memo 2012-135, at 1072 (distinguishing between Northern Refrigerator Line, Inc. v. Comm'r, 1 T.C. 824 (1943) and Palmer, Stacy-Merrill, Inc., 111 F.2d at 809 based on whether the guarantee is an "integrated piece of the overall transaction"). It does not appear that such an approach would be consistent with the Per Se Stock Rules.

Alternatively, under the deemed issuance approach, it might be asked whether the remaining $20 of debt should be treated as equity, on the grounds that it is *pari passu* with the deemed issued equity. This does not seem satisfactory either, although it at least equates the treatment of the two instruments which are of equal priority from a commercial perspective.

Finally, one might take the position that A's guarantee should be bifurcated into a $20 guarantee of the remaining debt and a limited deficit restoration obligation. It is not clear whether treatment of the guaran-

The results under the deemed assumption approach are also unsatisfactory. First, one must grapple with the issue of how debt can be assumed by a person (B) who is not liable for it when another person (A) is liable and continues to be liable. It would seem that the proper treatment under an aggregate approach would be to allocate debt to the person who bears economic responsibility for that debt, which the Section 752 regulations attempt to do (albeit imperfectly), and which the Proposed Regulations do not. It may be that this simply means that the deemed assumption approach is not "reasonable" to the extent that the debt is deemed to have been assumed by a person who bears no economic responsibility for it. If so, it would be helpful to confirm this.

Assuming the deemed assumption approach does apply, it would seem to give rise to many of the same issues that the deemed issuance approach would give rise to: A would have a deemed distribution of cash which (depending on A's basis) could subject A to tax, A could (depending on the facts) possibly have a disguised sale issue; and A could have its allocation of certain items of income gain or loss changed.

By contrast, under the deemed conduit approach there do not appear to be any unusual issues presented regarding the application of the partnership tax provisions of the Code to PRS. Under this approach, all that would change is the identity of the lender. A's guarantee of PRS debt would survive as a guarantee of PRS debt. There should be no deemed distributions of cash, no disguised sale issues, and no changes in allocation of items of income, gain loss or deduction.[302]

Thus, it would appear that in this example (as well as the previous examples enumerated above), the deemed conduit rule is preferable to either of the other two approaches, because it minimizes the distortions in the application of Subchapter K and related provisions to a Controlled Partnership and its partners that would occur under the other approaches.

tee as a deficit restoration obligation would be consistent with the Section 704(b) regulations. The resolution conceivably might depend on the terms of the guarantee.

[302] Issues may arise in the case where the B EG differs from the group of persons who are related to B under Section 752, and that difference has an impact on the Section 752 treatment after application of the deemed conduit rule. It appears this would be a relatively unusual case, for example, where one member of PRS is an individual who is the owner of the parent of the EG. In addition, it appears that the result in such a case would be to alter the allocation of a liability under Section 752 among partners who are EG Partners, or are related under Section 752 to an EG Partner, and not the allocation to a truly unrelated partner in the Controlled Partnership. In this regard, we suggest that consideration be given, solely for purposes of debt allocation under Section 752, to allowing this deemed debt issued under the deemed conduit approach to be considered as having been held by the person holding the actual debt. This would minimize the need to make complex re-adjustments of debt allocation in those cases in which the normal Section 752 rules produced a different basis allocation than would be produced under a stricter version of the deemed conduit approach.

7. Allocation of Debt

We note that the deemed issuance, deemed assumption, and deemed conduit approaches each can produce results in which the recharacterization (or lack of recharacterization) of intragroup debt as equity in a particular fact pattern appears at odds with the purposes of the Per Se Stock Rules. Fundamentally, application of these approaches turns on an allocation among the partners in a Controlled Partnership of debt loaned to the partnership by an EG member; and, in a given case, the allocation that is produced under any of these approaches can appear "wrong." On balance, we believe this issue will be no more pronounced if the deemed conduit approach is adopted, than if the other approaches are used, as explained below.

As noted, Prop. Treas. Reg. § 1.385-3(d)(5) as currently drafted uses profit shares to allocate debt among the partners in a Controlled Partnership. This choice appears to produce surprising results in certain cases.

> *Example 37*. PRS is owned 20% by A, and the remaining 80% is owned by two U.S. members of the B EG, B1 (1%) and B2 (79%). P, the foreign parent of the B EG makes a loan of $100 to PRS, guaranteed by B1. All of the proceeds of the loan are distributed to B1, which in turn distributes the proceeds to P.

Under the Section 752 regulations, 100% of the $100 debt may be allocated to B1, since it bears the risk of loss.[303] Accordingly, B1 should not recognize income or gain on receipt of the cash due to its basis increase in respect of the liability.[304] However, on these facts, it appears that only $1 of the debt would be recharacterized as equity in B1, because the proposed regulations recharacterize an amount of debt equal to the lesser of the EG Partner's distributions to other EG members ($100) or the EG Partner's share of that debt, based on the EG Partner's share of PRS profits, which is only 1% ($1).[305]

In Example 37, the relevant issue is not how the deemed $1 of "missing" debt is recast and accounted for at the PRS level, as discussed above, but whether it is appropriate to recharacterize only $1 of debt. The end result in Example 37 seems very similar to the base case the Per Se Stock Rules were designed to prevent, namely the creation of interest deductions for a U.S. taxpayer in a case in which there was no net investment in the United States. The end result in this example can be seen as the product of two factors. First, the borrowing proceeds are distributed by PRS to B1. Second, the use of profit shares limits the recharacterization in a seemingly inappropriate way, because it does not correspond to the manner in which the same debt is allocated for purposes of Section 752.

[303] Treas. Reg. § 1.752-2(a), (c)(1).

[304] Section 752(a).

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

With respect to the partnership's use of the borrowing proceeds, we note that if (contrary to our recommendation above) the 72-Month Per Se Rule is retained, then logically it should be irrelevant how the Controlled Partnership uses the proceeds within the period covered by the rule. By comparison, if the rule is removed, then the partnership's use of the proceeds would be a relevant factor, and arguably is appropriate in Example 37.

In this connection, reliance on Section 752 to allocate debt among partners may fit better with the adoption of "a principal purpose" approach under the Funding Rule, than reliance on of profit shares. Often, an allocation of a recourse liability under Section 752 will be made to a partner that (as in Example 37) receives a distribution of the borrowing proceeds; the traditional rationale for allocation of a nonrecourse liability under Section 752 is that, by generally following profit allocations, it identifies the partners who have received the benefit of the borrowed funds.

The Proposed Regulations reflect a presumably conscious choice to make the allocation of partnership debt different than the method used for Section 752 purposes. A possible reason for this choice is illustrated by the following example.

> *Example 38*. Same facts as Example 37, except that B2, rather than B1, pays the dividend.

In this case, there is still the same extraction of cash from the United States and the same aggregate amount of interest deductions in the B EG U.S. tax base, as in Example 36. However, if Prop. Treas. Reg. § 1.385-3(d)(5) allocated PRS debt in the same manner that Section 752 allocates basis attributable to PRS debt, the Per Se Stock Rules would not apply to any extent if the P loan was guaranteed by B1 and the distribution was made by B2, since again the identity of the distributee differs from that of the person to whom the debt was allocated. It is not clear if this potential result was the reason that the Proposed Regulations do not follow the Section 752 regulations.

Furthermore, these allocation issues are not limited to guaranteed debt.

> *Example 39*. Same facts as Example 37, except that neither B1 nor B2 guarantees the debt.

In this case, under the current Section 752 regulations, the debt is wholly allocated to whichever of B1 or B2 is more closely related (to any extent) to P.[306] If both are equally related,

[306] Treas. Reg. § 1.752-2(c)(1); Treas. Reg. 1.752-4(b)(2)(i). Prop. Treas. Reg. § 1.752-4(b)(3) would alter this rule and provide that the debt is shared equally among partners related to the lender without regard to which entity is more closely related.

then the debt is allocated equally to B1 and B2.[307] Either result could lead to the possibility of mismatches similar to those described in Examples 37 and 38, to some greater or lesser extent.

We note that in Examples 38 and 39, if B1 and B2 are members of a consolidated group, then allocation of liabilities under the Proposed Regulations in accordance with Section 752 may raise fewer concerns for the government. In such a case, B1 and B2 will be treated for purposes of the Proposed Regulations as a single corporation.[308] Thus, if a Section 752 approach is used, their Section 752 shares presumably would be added together; if the parent of the consolidated group in which B1 and B2 are members makes a $100 distribution to P, 100% of P's loan to PRS would be recharacterized.

Thus, on balance, we believe that an approach under Prop. Treas. Reg. § 1.385-3(d)(5) that is based on allocation of debt among partners using Section 752 principles, and that uses the deemed conduit approach described above, produces results that fit at least as well with the apparent goals of the Proposed Regulations as the current approach taken in the Proposed Regulations, without producing the collateral consequences described above.[309]

8. Shifting Income of a Controlled Partnership from U.S. EG Members to Foreign EG Members

As suggested in the Preamble's request for comments noted above, it appears that the underlying issues that Prop. Treas. Reg. § 1.385-3(d)(5) is meant to address extend beyond the reach of Section 385 and rules recharacterizing debt loaned by EG members to a Controlled Partnership as equity. The basic terms of the Subchapter K regime allow for income to be allocated to foreign EG Partners in a Controlled Partnership, including in a non-pro rata manner that results in a reduced allocable share for U.S. EG Partners.

> *Example 40*. Same facts as Example 37, except PRS is not engaged in a U.S. trade or business, B1 is not a U.S. corporation and B2 is.

Assume Prop. Treas. Reg. § 1.385-3(d)(5) is applied (whether under a deemed conduit approach, or under another approach) in a manner that recharacterizes at least part of P's loan to PRS as an equity investment by P in B1. This would seem to be the logical first step in preventing earnings stripping in Example 40. The question then presented, however, is how B1's investment in PRS will be characterized.

[307] Treas. Reg. § 1.752-4(b)(2)(i).

[308] Prop. Treas. Reg. § 1.385-1(e) (discussed below in Part XIII).

[309] Prop. Treas. Reg. § 1.385-3(d)(6) applies rules to intragroup debt issued by a disregarded entity owned by an EG member that are similar to the rules in Prop. Treas. Reg. § 1.385-3(d)(5). We believe that these rules are consistent with the deemed conduit approach that we have suggested above, with the result that these rules should not need to be modified if the deemed conduit approach is adopted.

Under the deemed issuance approach, B1 would now have a new partnership interest in PRS with economics presumably identical to those of the missing PRS debt. The coupon on this new partnership interest could presumably be treated as a guaranteed payment since, like the debt it replaced, it is payable without regard to the profits of PRS. Depending on how the deduction from the guaranteed payment is allocated, PRS could be in exactly the same place as it was before the recast prescribed by the proposed regulations. On the recipient side, although not entirely clear, the guaranteed payment might either be non-U.S. source, and therefore not subject to U.S. withholding tax, or exempt under the "other income" article of a treaty (if B1 is a treaty-based holder). Alternatively, the payment could be viewed as not giving rise to a guaranteed payment, in which case presumably net income would be allocated to B1 in an amount equal to the deemed Section 731 distribution of coupon from PRS to B1. This would in most cases lead to the same end result.

Under the deemed assumption approach, B1 would be deemed to have assumed the debt. Again, it is not entirely clear how this recast should be applied (and how it differs from the deemed issuance approach) but presumably at the end of the day, the results would be the same as in the deemed issuance approach.

That result also is obtained under the deemed conduit approach. B1 would be deemed to have acquired debt of PRS. Thus, B1 would have non-U.S. source interest income, not subject to U.S. tax on either a gross or a net basis, and PRS would have a net deduction of the same amount, which would be allocated among A, B1 and B2 in the same manner it had been allocated prior to application of the Proposed Regulations.

Note that in each of these three approaches, it does not matter whether one applies the approach of the Proposed Regulations (in which case $1 of PRS debt is recharacterized) or the Section 752 approach discussed above (in which case all $100 of the PRS debt may be recharacterized). In either case, the "bottom line" result to PRS and B2 may well be unchanged.

It may be argued that this outcome should not be permitted, because the participants in PRS were trying to "game" the system. However, we believe the key point is that application of the Proposed Regulations in a case like Example 40 does not change the results that would be obtained if the Proposed Regulations did not apply and P's loan to PRS was respected. Rather, application of the Proposed Regulations only appears to replicate those results.

The Preamble seems to recognize this basic point:

> *If a debt instrument issued by a controlled partnership were to be recharacterized as equity in the controlled partnership, the resulting equity could give rise to guaranteed payments that may be deductible or gross income allocations to partners that would reduce the taxable income of the other partners that did not receive such allocations.* Therefore, under the authority of section 7701(l) to recharacterize multi-

> ple-party financing transactions, proposed §1.385-3(d)(5)(ii) provides that, when a debt instrument issued by a partnership is recharacterized, in whole or in part, under proposed §1.385-3, the holder of the recharacterized debt instrument is treated as holding stock in the expanded group partner or partners rather than as holding a partnership interest in the controlled partnership. The partnership and its partners must make appropriate conforming adjustments to reflect the expanded group partner's treatment under the proposed regulations. Any such adjustments must be consistent with the purposes of these proposed regulations…[310]

However, the Proposed Regulations do not eliminate this issue. Rather, they change the fact patterns that raise the issue to cases where (for instance) a foreign EG member is an EG Partner as in Example 40, as opposed to an EG lender. We believe the basic issue of whether to permit guaranteed payments, preferred income allocations, and other disproportionate income allocations among EG Partners in a cross-border partnership goes beyond the scope of the Proposed Regulations, and is more closely related to the operation of Sections 704 and 707 than to the debt-equity distinctions on which Section 385 is based. It appears to us that the Proposed Regulations, as modified to adopt the deemed conduit approach described above, would at least partially address these issues, while minimizing to the extent possible collateral effects under Subchapter K, in particular for partners in Controlled Partnerships that are not EG members.

In the context of cross-border partnerships, application of the deemed conduit approach could, in theory, lead to results different from those of the other two approaches in terms of base erosion in certain limited cases. To analyze this potential impact, it is necessary to consider three different cases involving cross border partnerships. In the first case, suppose in Example 40 that PRS is engaged in a U.S. trade or business and the EG Partner making the distribution is a U.S. corporation. Here the deemed conduit approach causes the PRS Note to be acquired (or deemed reissued) by that U.S. corporation. In all events, the U.S. corporation would have additional interest inclusions that offset its allocable share of PRS' interest deductions to the same extent as would have been the case had, for example, the deemed issuance approach been adopted and the resulting preferred partnership interest was treated as giving rise to guaranteed payments. Thus, in the case in which the distribution triggering application of the Per Se Stock rules erodes the tax base of a U.S. corporation (the usual case), the three approaches all appear to operate consistently. Second, as illustrated above in this Part XII.B.8, to the extent that PRS is not engaged in a U.S. trade or business, the rules would also appear to operate consistently. Third, in the case in which PRS is engaged in a U.S. trade or business but the distributing EG Partner is a foreign corporation, rather than a U.S. corporation, again the different approaches would operate consistently if and to the extent that the interest income on the recharacterized debt or guaranteed payments deemed received by the distributing foreign EG member are both treated either as ef-

[310] Preamble, at 20927 (emphasis added).

fectively connected income or not. However, if the guaranteed payments would have been treated as effectively connected while the interest income would not have been, a discrepancy could arise between the results under the deemed conduit approach and the other approaches. While there is no definitive authority on point, commentators appear to believe the guaranteed payments should not be treated as effectively connected.[311] Assuming these commentators are correct, no issue arises. However, if there is concern about this case, we think the best approach would be to provide uniform and clear rules which treat guaranteed payments received by a foreign partner either as effectively connected or not when the underlying partnership is engaged in a U.S. trade or business. To the extent they were so treated, and there was concern that interest payments under a deemed conduit approach would not be so treated, consideration could be given to providing that interest income received by an EG member by reason of application of the Per Se Stock rule where such member was, through PRS, engaged in a U.S. trade or business be treated as effectively connected to the extent the deductions arising with respect thereto were properly allocable to the conduct of the U.S. trade or business, applying the rules of Section 884(f) or rules similar thereto to determine the allocation. But, we think the problems here are of long standing and far from the core concerns of Section 385. The discussion highlights one of the main shortcomings of the deemed issuance and deemed assumption approaches: these approaches tend to create guaranteed payments for the use of capital, and the tax treatment of guaranteed payments for the use of capital tends to be uncertain in many respects.[312]

Thus, on balance, we believe that the Per Se Stock Rules' provisions concerning Controlled Partnerships, as modified to incorporate the deemed conduit concept, represent a reasonable approach to addressing cross-border partnership transactions in the context of the Proposed Regulations. As noted, we are not suggesting that the Proposed Regulations be altered to include rules that address broader, more fundamental issues of whether to allow guaranteed payments, preferred income allocations, and other disproportionate allocations among EG Partners in a cross-border partnership.

In coming to the foregoing conclusion, we considered and rejected a number of alternative approaches. For example, we considered an approach under which the Controlled Partnership debt would be recharacterized as equity of the Controlled Partnership, payments with

[311] *See* Sloan & Sullivan, *Deceptive Simplicity: Continuing and Current Issues with Guaranteed Payments*, Practising Law Institute: Corporate Tax Practice Series (2015) (concluding that the relevant authorities indicate that "… guaranteed payments should not be considered to be distributive share of ECI, regardless of the character of the partnership's underlying income"); Kreisberg, *Guaranteed Payments for Capital: Interest or Distributive Share?*, 2011 TNT 129-2 (Jul. 6, 2011) ("better view" although not conclusive).

[312] *See, e.g.*, Sloan & Sullivan, *Deceptive Simplicity: Continuing and Current Issues with Guaranteed Payments*, Practising Law Institute: Corporate Tax Practice Series (2015); Kreisberg, *Guaranteed Payments for Capital: Interest or Distributive Share?*, 2011 TNT 129-2 (Jul. 6, 2011); Banoff, *Guaranteed Payments for the Use of Capital: Schizophrenia In Subchapter K*, 70 Taxes 12 (1992).

respect to which gave rise to guaranteed payments and the deductions with respect to which would be disallowed (presumably to the same extent as under the Proposed Regulations), but only if the income with respect to such guaranteed payments was not subject to tax in the hands of the recipient. This approach presents a number of serious problems which, in our view, preclude its utilization.

First, this approach is fundamentally an earnings stripping approach, not a characterization approach. As discussed in Part I.A, we believe that the purpose of Section 385 is to determine whether or not to treat debt as debt for tax purposes, not merely to disallow the interest deductions arising from such debt. This approach simply adds an "extra step" of first recasting the debt as equity before disallowing the deduction. We do not think grafting such an alien purpose onto an initial recasting which then serves only as a springboard for the subsequent disallowance would be appropriate.

Second, since the deductions for such guaranteed payments arise under Section 162, rather than as deductions for interest under Section 163, it is hard to understand how such deductions could be disallowed under Section 385, even if the purposes of that statute are seen to be consistent with promulgation of rules to disallow otherwise deductible interest expense, as opposed to being limited to recharacterization of debt as equity. Even if it is possible to treat certain guaranteed payments involving EG members as giving rise to interest expense to the partnership for this purpose, that would seem to raise the question of why the related debt was recharacterized as equity in the first place. As noted above, the treatment of guaranteed payments for the use of capital has been mired in uncertainty for many years. Guidance concerning the proper treatment of guaranteed payments in cross border partnerships is one such area. But, any such guidance should be issued as part of a general effort to reform the treatment of these instruments, which is inherently a Subchapter K regulatory project.

Third, even if the other two obstacles are surmounted, it is not clear what is achieved once the income inclusion carve out is added. If income inclusion in a foreign treaty jurisdiction suffices to meet the test for deductibility, for example, then presumably nothing has been gained since interest is generally so treated in any event. If income inclusion in the foreign jurisdiction does not suffice, then it is difficult to see what the criterion should be and why it would be an appropriate burden to impose on EG members which are treaty-based holders.

Fourth, if only debt which has been recharacterized as equity is subject to the deduction disallowance rule, EG members that are indifferent to the receipt of guaranteed payments (presumably the target for this type of disallowance) would simply order their affairs so that they financed a Controlled Partnership by means of capital contributions giving rise to guaranteed payments from the outset. This simply reinforces the point made above that change in this area needs to be broad based, not rifle shot.

Alternatively, we considered adopting a variant of the deemed conduit approach under which the deemed loan would be acquired not by the EG member which made the distribution, but the one which (under general Subchapter K principles) would be allocated the deduction. This approach also raised a number of serious issues. The entire thrust of the Per Se Stock Rules is that they focus on financing transactions in which the borrower has only a transitory increase in its gross asset base because the investment represented by the borrowing is negated by one or more distributions. This is an asset focused test, not a deduction focused test, which is appropriate because the rule is a characterization rule, not an earnings stripping rule. The Proposed Regulations carry over this concept consistently in the partnership context because the recharacterization is tied to the person whose asset base is eroded by distributions. But this asset focus is inconsistent with an approach that allocates the deemed debt to the person who bore the economic effect of the deduction but did not shrink its asset base by distributions. A deduction focused approach raises the question of what role distributions have in the analysis, which is troubling considering that the Per Se Stock rules apply only to those debt instruments which would, but for the distribution in question, be treated as debt.

But even allowing for this arbitrary standard, the rule would still not have its intended effect. For example, in Example 40, whether or not B1 makes a foreign-to-foreign distribution is unrelated to the purposes of the Per Se Stock Rules. B1 may use the proceeds in its own business to repay debt or for other purposes. However, without such a distribution, there would be no triggering event to precipitate application of the Per Se Stock Rules. It is hard to see how the Per Se Stock Rules in their current form could be applied to such a partnership absent some sort of distribution by the partners and some sort of linkage between the distribution and the recasting. Thus, in cases where the EG had foreign partners which had no need to make distributions, the rule could be easily circumvented, and in cases in which it did not, application of the rule could result in arbitrarily denying deductions to corporations which were not eroding their asset base. We therefore concluded this approach also created a great deal of increased complexity with little or no ultimate benefit. Instead, we think results such as those identified in the text above, if determined to be in conflict with general tax principles, should be attacked directly under those principles.

C. Scope of the Controlled Partnership Rules

1. Definition of "Controlled Partnership": Measuring Percentage Shares

Partnerships are intended to be flexible vehicles. As such, they frequently have shifting profit shares. For example, the IRS has approved "flips" of profit allocations as high as 5%/95% to 95%/5% in partnerships in which tax attributes are being allocated among the partners.[313] In

[313] See Rev. Proc. 2007-65, 2007-2 C.B. 967 (Oct. 19, 2007).

addition, because capital accounts can and should be periodically revalued to reflect changes in the value of partnership property, and because priorities as to return of capital may differ or shift, it is also possible that partners' relative capital accounts would shift over time in multiple directions, including in transitory or immaterial ways.

Conceptually, there are two ways to look at these items (capital or profits) to determine whether a partnership is a Controlled Partnership in cases of partnerships with shifting allocations. One way to measure the partners' shares of capital and profits is to take continual "snapshots" of each item and treat the partnership as a Controlled Partnership of one or more partner EGs at various different times. This method would be quite complex to track and could result in multiple assumptions and deemed issuances of debt. It may also be open to manipulation because it may allow taxpayers to postpone EG membership until after distributions have been extracted.

The other method is to look at profits or capital on a cumulative basis. The problem with this method is that, especially in relation to capital accounts, it may be difficult if not impossible to determine how the method applies.

We therefore recommend that consideration be given to the use of a reasonable estimate of aggregate profit shares, in order to prevent frequent "flips" in and out of an EG or even from one EG to another. In order to avail itself of such a rule of reason, the partnership would have to demonstrate that there was a reasonable expectation that the chosen profit split was commensurate with the expectations of the parties.

> *Example 41*. A and B are unrelated members of different expanded groups. They form a partnership in which A is the general partner and operator of the partnership's business and B is the limited partner. A puts up 5% of the capital and B puts up 95% of the capital. Profits are allocated to "target" capital accounts, which means in essence they follow the distribution waterfall. Cash flow is allocated as follows: first, proportionate to capital contributions until a hurdle rate of return has been achieved and capital has been returned; second, 100% to A until A has received 20% of the cumulative profits allocated to B in step 1; third, 20% to A, and 80% divided between A and B in proportion to their capital contributions.[314] The parties are entering into the partnership in the expectation that profits will exceed the hurdle rate of return with the result that cumulative profits are expected to be shared 24%/76%. The tiered arrangement described here is intended to protect B against the possibility of a sub-optimal result, considering that it has a

[314] Alternatively, it could be stated that A is entitled to 5% plus 20% of B's 95% as a carried interest (5% + (20% x 95%)) = 24%.

disproportionately large share of the capital and a disproportionately small amount of control over the operation of the partnership.

Using the snapshot approach as applied to profits, the partnership commences its life as a Controlled Partnership of the B EG until the hurdle rate is reached. Thereafter, it becomes a Controlled Partnership of the A EG group until the catch up has been achieved; thereafter it is not a member of either EG, based on profits. Overall, there are three different periods with three different results as to Controlled Partnership status.

Using the snapshot approach as applied to capital accounts, the partnership also commences life as a Controlled Partnership of the B EG, at least until capital has been returned. Once capital has been returned, the partnership would not appear to be a member of either EG based on capital until there has been a book up or a further contribution.[315] Assume that is correct and that A subsequently makes a small contribution, for example, to make good on a cost overrun, guarantee or indemnity to the partnership or a creditor, such that A's capital account is $1 and B's is zero. At this point, it would seem that on a literal reading, the partnership now becomes a Controlled Partnership of the A EG based on capital, at least until A's capital account balance is reversed by the subsequent allocation of a deduction or capital accounts are booked up. Overall, there are at least three different periods with three different results as to Controlled Partnership status based on capital, which may or may not correspond to the periods based on profits. Thus, over its life, the partnership could be a member of the A EG, the B EG, both EGs, or neither.

On the other hand, the cumulative approach would appear to be relatively straightforward to apply to profits. In the instant example, the partnership should be able to treat itself as having a residual 24%/76% profit split to A and B, respectively, and therefore would not be treated as a member of either EG at any time based on profits. Note that in other cases, the result might be the opposite: it might be that a partner whose ultimate profit share was expected to be more than 80% could get out of the rule under the "snap shot" method by "staging" the profit split so that it exceeded 80% only after the relevant distribution had been made.

However, the cumulative approach does not easily lend itself to clarity in the case of capital accounts. Thus, it is likely that there would, in many cases, be multiple shifts in Controlled Partnership status based on capital, including shifts attributable to transitory or immaterial allocations. This complicates the partnership rules even further without furthering the goal of minimizing earnings stripping in any material way.

[315] Alternatively, the partnership might be considered a Controlled Partnership of both EGs at that time, since in theory, 0/0 could technically be regarded as 100% as opposed to zero percent. We think this is not the correct position and it would be useful to have this point clarified. *See* PLR 201432002 (Aug. 8, 2014) (impliedly taking the position for purposes of Section 7874 that an ownership fraction of 0/0 is zero percent, not 100%).

The aleatory nature of these rules may be illustrated by the following example.

> *Example 42.* The facts are the same as Example 41, except that in order to better protect itself, B demands that A subordinate its capital and carry to some portion of B's capital. A agrees, provided that it can reverse that subordination by "buying out" the senior capital B is providing. In order to effectuate this business deal, the parties determine that (i) B will loan A 19% of the total partnership capital, secured by A's entire interest in the partnership, (ii) the loan will bear a reasonable rate of interest approximately equal to the hurdle rate and is anticipated to be paid off over time and (iii) A will invest 24% of total partnership capital and forgo its carry.

This example is very similar to Example 41 economically, except that now A has 24% of capital and profits at all times, and the partnership is never a Controlled Partnership of either the A EG or the B EG. There does not appear to be any abuse potential in this example other than the potential inherent in any transaction which is 76%/24% as opposed to 80%/20%. Assuming 76%/24% transactions are permitted, Example 42 would not appear to call for any special anti-abuse rule. This then demonstrates that the multiple "flips" as to both capital and profits in Example 41 are in many cases "noise" rather than "signal" in terms of abuse potential, and therefore it would be reasonable to implement rules designed to minimize the effect of these flips. In these cases, consideration should be given to allowing the use of another metric focused solely on cumulative shares of profit. Failing adoption of such a rule, consideration should be given to allowing taxpayers leeway to ignore small or transitory shifts in capital that result in one or another partner exceeding 80% of total capital accounts. Finally, note that adoption of the deemed conduit approach is also very helpful in this respect, since it minimizes the impact of the flips that do occur.

2. Definition of "Partnership

Since the principal purpose of Prop. Treas. Reg. § 1.385-3(d)(5) is to apply aggregate treatment rather than entity treatment to partnership level debt, we recommend that the rule have no application to cases where there is no entity which is subject to Subchapter K.

> *Example 43*. A and B are unrelated members of different EGs, both engaged in the business of power generation. A and B form a 50/50 unincorporated joint venture to build and operate a power plant, whose output will be dispatched to A and B pro rata. A and B make a valid election under Section 761 to elect out of Subchapter K. Under the relevant case law, the AB joint venture would appear to be a

"partnership" under Section 7701 of the Code even though it is not a partnership for purposes of Subchapter K.[316]

In such a case, or any case in which the entity (regardless of what it is called) is not a partnership for Subchapter K purposes, we do not think the partnership rule should apply. Instead, we think that any financing furnished to the JV by members of the respective A and B EGs should simply be subject to the general Per Se Stock Rules (if otherwise applicable), rather than to the partnership rule. This recommendation that the general rules apply, rather than the partnership rule, is intended to be a neutral rule of general application. In the above example, it expands the scope of the earnings stripping rules: since neither A nor B owns 80% of JV, the partnership would not be a Controlled Partnership if it were respected for this purpose. On the other hand, if A held an 80% interest in the JV and B held a 20% interest, the partnership rule would still not apply if this recommendation is adopted (but the general Per Se Stock Rules would still apply separately to the A and B EGs).

XIII. ADDITIONAL PROPOSED CLARIFICATIONS AND CORRECTIONS TO THE PER SE STOCK RULES

A. Predecessor/Successor Rules

1. Overview of the Rules

A predecessor or successor of the funded member is treated as the funded member for purposes of determining whether a distribution or acquisition that triggers the Funding Rule has occurred (the "**predecessor/successor rules**").[317] The definition of a predecessor *includes* the target corporation and the definition of a successor *includes* the acquiring corporation in a transaction described in Section 381(a) in which the funded member is the distributor or transferor. In addition, if a distributing corporation transfers assets to a controlled corporation prior to the distribution of controlled corporation stock pursuant to Section 355 (a "**D/355 transaction**"), the distributing corporation is a predecessor of the controlled corporation and the controlled corporation is a successor to the distributing corporation.[318] Further, if the Stock Acquisition Exception applies, the transferor corporation is treated as a predecessor and the corporation whose stock is acquired is treated as the successor to the funded member, but only to the extent of the amount contributed to either such corporation by the funded member, and only with respect to any debt instrument (not otherwise treated as equity under the Per Se Stock Rules) issued by the funded

[316] Madison Gas & Electric Co., 72 T.C. 521 (1979), *aff'd*, 633 F.2d 512 (7th Cir. 1980).

[317] The single exception is that a distribution by a target entity treated as a successor of a funding entity under the Stock Acquisition Exception to that funding entity is not treated as a transaction that triggers the Funding Rule. Prop. Treas. Reg. § 1.385-3(b)(3)(v).

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

member within 36 months before or after the acquisition of such corporation's stock.[319] The use of the word "includes" in the definitions results in ambiguity regarding the universe of potential predecessors and successors.

2. Recommended Changes to the Scope of the Rules

The breadth of the Funding Rule is exacerbated by the scope of the predecessor/successor rules. While we appreciate the need for a predecessor/successor rule to insure that the Funding Rule will operate if a distribution or acquisition is made by an EG member other than the funded member when the two members are combined, the predecessor/successor rules apply well beyond the intended purpose of the rules. Because predecessors and successors are created under the Proposed Regulations in common transactions undertaken for legal entity rationalization and other business operations reasons, the predecessor/successor rules will result in complex recordkeeping for compliance and unanticipated recharacterizations of intragroup debt.

There are no time limitations on the definitions of predecessor and successor, resulting in an extension of the Funding Rule well beyond the 72-Month Per Se Rule. Because the predecessor/successor rules should operate consistently with the scope of the Funding Rule, they should be limited and consistent with the Funding Rule provided in the final regulations. If our recommendation to eliminate the 72-Month Per Se Rule is accepted, then the determination of whether a member is a predecessor or successor would be determined by looking at whether there is a principal purpose to avoid the Per Se Stock Rules. If our recommendation is not adopted, then the predecessor/successor rules should be limited consistent with the timeframe chosen for the 72-Month Per Se Rule.

> *Example 44.* Parent owns Sub 1 and Sub 2. Sub 1 borrows money from an EG member in Year 1; Sub 2 makes a distribution to Parent in Year 2. Sub 1 merges into Sub 2 in Year 6 in a Section 368(a)(1)(A) reorganization. Pursuant to the predecessor/successor rules as drafted in the Proposed Regulations, Sub 2 is a successor to the funded member, Sub 1, and the note issued by Sub 1 is recharacterized as equity—a result that is inconsistent with the Funding Rule parameters.

The predecessor/successor rules are also flawed in their application to D/355 transactions. Under the Proposed Regulations as drafted, a distributing corporation would be a predecessor of a controlled corporation and the controlled corporation would be a successor to the distributing corporation, even when the corporations are no longer part of the same EG. When a predecessor and successor are no longer related to each other, the Funding Rule should cease to be relevant (just as, outside the spin-off context, the Funding Rule appears to cease to be relevant with re-

[319] Prop. Treas. Reg. § 1.385-3(f)(11)(ii)

spect to a corporation that is a member of an EG, beginning when that member leaves the group (see Part XIII.D)). The predecessor/successor rules should be modified accordingly.

> *Example 45*. Parent owns Distributing. Distributing forms Controlled, transfers Business A to Controlled, and distributes the stock of Controlled to Parent. Distributing is a predecessor of Controlled and Controlled is a successor to Distributing under the Proposed Regulations. Parent contributes Controlled to External Spinco and distributes the stock of External Spinco to its public shareholders. A year later, Controlled distributes cash to External Spinco and Distributing borrows money from an EG member. Under the predecessor/successor rules, Distributing, the funded member, is treating as having made a distribution to External Spinco, a corporation that has no relationship to Distributing. Under the Funding Rule, Distributing's note would be recharacterized as equity.

More generally, we suggest that the government give further consideration to whether all D/355 transactions, including those in which distributing and controlled both remain within the EG, should be carved out from the predecessor/successor rules. As noted, we understand the need for these rules in certain cases in order to prevent easy avoidance of the Funding Rule. However, D/355 transactions are subject to numerous statutory, judicial, and regulatory rules, including that the D/355 transaction achieve a significant non-tax business purpose and not be undertaken as a device for the distribution of E&P. Further, a key component in many D/355 transactions is determining the appropriate capital structure for the distributing and controlled businesses following the separation in a manner that appropriately balances numerous business, legal, regulatory, and non-US tax considerations. These tax-law and practical constraints may obviate the need for complicated predecessor/successor rules. At the same time, we recognize that, in an internal D/355 transaction within an EG can accomplish some of the results that the Per Se Stock Rules are seeking to restrict. For example, assuming a taxpayer could satisfy the other requirements for a valid D/355 transaction, the distributing corporation could borrow and contribute cash to the controlled corporation, which then after the spin-off could use the cash for a distribution or acquisition. The government should therefore consider whether the benefits of simpler predecessor/successor rules outweigh the risk that a taxpayer could successfully accomplish a D/355 transaction (taking into account the various hurdles discussed above) with a principal purpose of avoiding the application of the Funding Rule.

B. "Chain Reaction" Per Se Fundings

We recommend that the Per Se Stock Rules be revised to eliminate the possibility that multiple loans will be recharacterized as equity on account of the same distribution or acquisition. More specifically, when a debt is recharacterized as equity under the Per Se Stock Rules, the deemed issuance of that equity, a transfer of that deemed equity within the EG, or an actual or deemed redemption of that equity should not be treated as a distribution or acquisition to which the Per Se Stock Rules can apply.

> *Example 46*. FP owns FS, which owns USS. In 2017, FP lends $1 million to USS in 2017, and USS distributes $1 to FS. By the end of that year, USS repays the entire $1 million loan to FP.

USS's $1 distribution to FS triggers application of the Funding Rule to FP's $1 million loan, resulting in a recharacterization of $1 of the loan as equity as of the date of the loan's issuance.[320] When USS repays the loan, it is treated as redeeming that $1 of equity, in a transaction that constitutes a Section 301 distribution. That distribution, in turn, is a transaction that, under the Funding Rule, causes an additional $1 of FP's $1 million loan to USS to be recast as equity; and the repayment of that additional $1, in turn, is an additional Section 301 distribution, triggering application of the Funding Rule to a further $1 of the $1 million loan; and the process continues, until the full $1 million loan is recharacterized as equity on account of the $1 distribution by USS to FS. It is unclear this result was intended, although it does follow from a literal application of the rules.[321]

Similarly, Example 10 in the cash pooling discussion in Part VII.C provides a more complicated, but conceptually similar, illustration of the same basic consequence of the cascading operation of the Proposed Regulations, both in multiplying recasts of different debt instruments issued by the same issuer, and in multiplying recasts of debt instruments of different issuers within the EG. Again, it is unclear whether results like those in the example were intended. The automatic operation of the 72-Month Per Se Rule compels taxpayers to address this technical issue, whereas the proposed "a principal purpose" standard in the Funding Rule should provide more scope for managing the problem.

In cases like these examples, the result of the cascading recharacterizations of intragroup debt is to multiply the tax consequences of EG members' ownership and redemption of such re-

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

[321] In Example 46, if USS repays the FP note in 2018, rather than 2017, it may be easier to argue that the Funding Rule does not apply in the circular manner described in the text. However, the rules are not entirely clear. Under Prop. Treas. Reg. § 1.385-3(d)(1)(ii), a recast of more than $1 of the note would occur only in 2018, at the time the note is repaid. If it is the case that, for purposes of applying the regulation, the $1 portion of the note treated as equity should be viewed as being redeemed, before the remaining $999,999 of the note is repaid, then the result will be the same as when the note is repaid in 2017. By comparison, assuming it can be argued that the repayment of the entire $1 million ought to be viewed as occurring simultaneously in a single transaction, then although the redemption of the $1 of equity is a distribution for purposes of the Funding Rule, the remaining $999,999 is no longer outstanding following the transaction and, thus, cannot be recharacterized as equity; instead, some other debt instrument issued within the applicable 72-month period could be recharacterized.

characterized debt described in Part XI above. Thus, there is the potential for multiple inclusions of essentially the same income by EG members, during the period when the recharacterized debt instruments remain outstanding and coupon payments are made on those instruments.

> *Example 47*. Parent owns Sub 1, Sub 2 and Sub 3, each of which has accumulated E&P but not current E&P. Within a 3-year period, Parent lends $1,000 to USS1; USS1 lends $1,000 to Sub 2; Sub 2 lends $1,000 to Sub 3; and Sub 3 makes a distribution or acquisition. Under the regulations, Sub 2's loan to Sub 3 is treated as equity; and this, in turn, causes Sub 1's loan to Sub 2 to be treated as equity (Sub 2 is deemed to have acquired $1,000 of shares of Sub 3), which in turn causes Parent's loan to Sub 1 to be treated as equity (Sub 1 has acquired $1,000 shares of Sub 2).

Where Subs 1, 2 and 3 are U.S. corporations not in a consolidated group, the effect is of several inclusions of the same income: each of them is denied interest deductions for coupon payments on the $1,000 instrument it has issued and, in the case of Subs 1 and 2, they both will include the coupon payments they receive as income (subject to any available dividends received deduction). By comparison, where Subs 1, 2 and 3 are CFCs and Parent is a U.S. corporation, the effect is the same, with the added consequence that each time a coupon payment is made by one sibling CFC to another, the Section 902 foreign taxes associated with the coupon payment are withdrawn from the payor's foreign tax pool, resulting in elimination of taxes of each of Sub 2 and Sub 3 that otherwise would have generated Section 902 credits when those subsidiaries paid dividends to Parent. Again, in effect, there will be multiple income inclusions subject to U.S. tax, due to a single distribution or acquisition by Sub 3 that is subject to Prop. Treas. Reg. § 1.385-3.

Similarly, when the recharacterized instruments are redeemed, to the extent each redemption is treated as a dividend under Section 302(d), each redemption will have the consequences just described.

It would appear there is no policy reason why Prop. Treas. Reg. § 1.385-3 needs to function in this manner. It should be possible to eliminate the issues described above if the Per Se Stock Rules are revised to state that, when an intragroup debt instrument is recast as equity, the deemed issuance of that equity, and any transfer or (actual or deemed) redemption of that equity, will not be treated as a distribution or acquisition for purposes of the Per Se Stock Rules.

Along somewhat similar lines, Prop. Treas. Reg. **§** 1.385-3(d)(2) provides that when a debt instrument recharacterized as equity under Per Se Stock Rules ceases to be held within the EG, other intragroup loans that have been made to the issuer of that instrument must be re-tested, to determine whether any of those loans should now be treated as equity by reason of having been made within 3 years of the distribution or acquisition that had previously caused the original instrument to be recharacterized. Under this rule, there is a matching-up of duplicative amounts of multiple loans with the same distribution or acquisition, potentially resulting in tax costs with respect to each of those loans. The idea that a single distribution or acquisition could have been funded several times, by multiple loans, appears in tension with the basic logic adopted by the Funding Rule of matching such a distribution or acquisition with a particular loan. In addition, as with the "chain reaction" cases described above, there does not appear to be a need for these consequences in order for Prop. Treas. Reg. **§** 1.385-3 to accomplish its intended objectives. We recommend this rule in Prop. Treas. Reg. **§** 1.385-3(d)(2) be eliminated.

C. Time for Determining Whether a Corporation is a Member of an EG

We recommend that the government clarify when a corporation's status as a member of an EG will be tested for purposes of the Per Se Stock Rules. In the case of a corporation that, as part of a transaction or series of related transactions, becomes a member of an EG, we believe it should normally be treated as a member of that EG, for purposes of testing whether its transactions with members of the EG are subject to recharacterization under the Per Se Stock Rules.

> *Example 48*. FP owns a minority equity interest in US Corp, with the remainder of US Corp's stock being owned by Unrelated Party. In a year when US Corp has no current E&P, FP redeems the stock it owns in US Corp for a note. Shortly afterward, as part of a plan, Unrelated Party sells the remaining stock of US Corp to FP for cash.

In a case like Example 48, it seems fairly clear that US Corp's distribution of a note to FP should be subject to the Per Se Stock Rules, even though at the time the note was distributed, FP was not a member of an EG that included US Corp. The Funding Rule should apply in a similar manner.

Conversely, a corporation should normally be treated as a member of an EG for purposes of analyzing a transaction between it and another group member under the Per Se Stock Rules even if, as part of a plan, it will shortly be leaving the group.

> *Example 49*. FP owns USS1 and USS2, with USS2 owning Corp X. FP lends to USS1, which uses the borrowing proceeds to buy Corp X from USS2. Shortly afterward, as part of a plan, Unrelated Party buys USS2 from FP.

The substance of Example 49 appears unaffected by the fact that USS2 leaves the EG after the cross-chain sale of Corp X. Even though the transaction ought to be treated as a redemption rather than a dividend under Section 304,[322] for purposes of the Per Se Stock Rules the key fact is that the EG has used the transaction to lever up USS1. The same would be true, if USS2 sells Corp X to USS1 for a note, and then distributes the note to FP before the sale.

[322] *See* Merrill Lynch & Co., Inc. v. Comm'r, 120 T.C. 12 (2003), *aff'd*, 386 F.3d 464 (2d Cir. 2004).

We note that the approach suggested above is consistent as a conceptual matter with the exceptions to the Per Se Stock Rules that we have recommended in Part IX.C.1 above, concerning positioning EG members as part of a post-acquisition, or pre-disposition, restructuring. The effect of those exceptions would be to treat transactions in which intragroup restructuring occurs shortly after an acquisition (or shortly before a disposition) the same, for purposes of the Per Se Stock Rules as comparable transactions occurring shortly before the acquired corporations become members of the EG (or shortly after the disposed corporations have left the EG). These exceptions thus remove pressure from formalistic differences that appear not to be significant for purposes of the goals of the Per Se Stock Rules. The approach proposed above to identifying the members of an EG for purposes of the Per Se Stock Rules similarly seeks to de-emphasize the importance of the sequencing of steps, where the precise sequencing logically ought not to have an impact on whether the rules apply.

In addition, Treasury and the IRS should clarify that in order for the Per Se Stock Rules to apply, a corporation's issuance of a debt instrument and a distribution or acquisition must both occur while the corporation is a member of the same EG (or is treated under the rules described above as being a member of that EG).

> *Example 50*. FP1 owns USS1. In Year 1, USS1 makes a distribution to FP1. In year 2, FP1 sells USS1 to FP2, the unrelated parent of a different EG. In year 3, FP2 lends to USS1.

Under the 72-Month Per Se Rule, the Funding Rule appears literally to apply to the debt between FP2 and USS1, because the debt was issued to a member of USS1's EG and, with 72 months, a distribution was made by USS1 to a member of USS1's (other) EG. However, these scenarios were clearly not intended to be covered by the Per Se Stock Rules, since there was no flow of cash between members of the same EG.

If the regulations are revised to provide that a corporation's debt issuance must occur in the same EG as a distribution or acquisition by it, they should address a case where multiple corporations move from one EG to another, with an issuance of debt occurring among those corporations when they are all members of one of the EGs and a distribution or acquisition occurs when they are all members of the other EG.

> *Example 51*. FP1 owns USS1. In 2017, USS1 makes a distribution to FP1. In 2018, FP1's owners sell FP1 to FP2, the unrelated parent of a different EG. In 2019, FP1 lends to USS1.

In a case like Example 51, even though USS1's distribution to FP1 occurs when they are members of a different EG, than at the time FP1 lends to USS1, it nevertheless appears the Funding Rule should apply, to the same extent it would if FP1 and USS1 had remained members of the same EG throughout.

We believe that a similar approach to the issues discussed above would be appropriate when determining whether a corporation is a member of an EG (or MEG) for purposes of the Part-Stock Rule and the Documentation Rules.

D. Corrections to Example 12 of Prop. Treas. Reg. § 1.385-3(g)(3)

We recommend that Treasury and the IRS clarify Prop. Treas. Reg. § 1.385-3(g)(3), Example 12. In the example, FS lends $100 to USS1 in exchange for a USS1 Note. USS1 then transfers $20 to CFC for CFC stock (in a subsidiary contribution that is not treated as an acquisition of affiliate stock under the Per Se Stock Rules by virtue of Prop. Treas. Reg. § 1.385-3(c)(3)). CFC later acquires stock of FS from FP in exchange for $50. Under the successor rules of Prop. Treas. Reg. § 1.385-3(f)(11)(ii), CFC's acquisition of FS stock is held to be a transaction described in the Funding Rule, to the extent of the value of the EG stock acquired by USS1 from CFC in the funding transaction—here, $20. The example concludes (in paragraph (ii)(D)) that CFC's purchase of FS stock from FP causes the USS1 Note to become a principal purpose debt instrument that is deemed exchanged for stock pursuant to the Funding Rule.

However, it seems that only $20 of the USS1 Note (not the entire $50) should be converted to equity: the example should be corrected or clarified on this point. In addition, the example refers to the USS1 Note as being described in Prop. Treas. Reg. § 1.385-3(b)(3)(ii)(A) as a result of CFC's acquisition of FS stock (*i.e.*, a loan used to fund a distribution). It appears the cross-reference should be to Prop. Treas. Reg. § 1.385-3(b)(3)(ii)(B) (a loan used to fund an acquisition of EG member stock, *i.e.*, the FS stock).

E. Additional Issues

While the discussion in Parts VIII – XIV of this report reflect a number of the issues raised by the Per Se Stock Rules in their current form, we note the discussion is not exhaustive. We understand additional issues have been, and expect additional issues will continue to be, raised, as taxpayers and practitioners have a fuller opportunity to consider this extremely complex set of rules and analyze how they are likely to apply in practice. Absence of a discussion of a particular issue in this report is not intended to convey a conclusion about the existence or degree of difficulty of the issue, or about whether the Per Se Stock Rules provide an appropriate resolution.

XIV. CLARIFICATION OF THE RULE TREATING A CONSOLIDATED GROUP AS A SINGLE CORPORATION

As noted above, all the members of a consolidated group are treated as a single corporation for purpose of applying the rules in the Proposed Regulations.[323] The Preamble elaborates

[323] Prop. Treas. Reg. § 1.385-1(e).

that "many of the concerns regarding related-party indebtedness are not present in the case of indebtedness between members of a consolidated group. Accordingly, the proposed regulations under section 385 do not apply to interests between members of a consolidated group, although general federal tax principles continue to apply. Proposed §1.385-1(e) achieves this result by treating a consolidated group as one corporation."[324]

We recommend that the government clarify the manner in which Prop. Treas. Reg. §1.385-1(e) interacts with other Code provisions and regulations, when analyzing a transaction between one or more members of a consolidated group, and corporations in the EG that are outside the consolidated group. Specifically, we recommend that the government expressly confirm that the appropriate order of operations is first, to apply provisions of the Code and regulations other than the Proposed Regulations, treating the members of the consolidated group as separate entities for purposes of applying those rules; and then, to apply the Proposed Regulations to the transaction as it is characterized under those other provisions of the Code and regulations, treating the members of the consolidated group as a single corporation for purposes of applying the Proposed Regulations and determining whether to recast an intragroup debt instrument as equity. We believe this approach respects the single-entity concept of a consolidated group adopted in the Proposed Regulations, while not applying that concept more broadly than is warranted by the rule's purposes.

> *Example 52*. USP is the common parent of a consolidated group that includes USS1 and USSS2. USP owns CFC X; USS1 owns CFC1; and USS2 owns CFC2. USS1 sells the stock of CFC1 to CFC X for a $100 note, and USS2 sells the stock of CFC2 to CFC X for $100 of cash.

Under our recommended approach, USS1 and USS2 would be treated as separate corporations that have sold CFC1 and CFC2 in two separate transactions. Section 304 would apply to USS2's sale of CFC2 for cash. When analyzing the consequences of USS1's sale of CFC1, USS1 and USS2 would be treated as a single corporation, which has sold CFC1 and CFC2 in 2 separate transactions, with Section 304 applying to the CFC2 sale; and the deemed single corporation would be treated as selling CFC1 in exchange for debt of CFC X recast as stock under the

[324] Preamble, at 20921; *see id* at 20914 ("While these proposed regulations are motivated in part by the enhanced incentives for related parties to engage in transactions that result in excessive indebtedness in the cross-border context, federal income tax liability can also be reduced or eliminated with excessive indebtedness between domestic related parties. Thus, the proposed rules apply to purported indebtedness issued to certain related parties, without regard to whether the parties are domestic or foreign. Nonetheless, the Treasury Department and the IRS also have determined that the proposed regulations should not apply to issuances of interests and related transactions among members of a consolidated group because the concerns addressed in the proposed regulations generally are not present when the issuer's deduction for interest expense and the holder's corresponding interest income offset on the group's consolidated federal income tax return.").

General Per Se Rule. One could imagine an alternative approach in which the first step would be to deem USS1 and USS2 to be a single corporation, and that single corporation then would be treated as selling the stock of each CFC in exchange for $50 of cash and a $50 note (recast as stock). However, in view of the rationale for Prop. Treas. Reg. §1.385-1(e) in the Preamble, there appears not to be any compelling policy reason to apply the provision broadly, so that it alters the tax consequences of a transaction (USS2's sale of CFC2) to which, if USS1 and USS2 were not consolidated, the Per Se Stock Rules would not apply.

> *Example 53*. FP owns USP1 and USP2, each of which is the common parent of a different consolidated group. USP1, which owns USS1 and several other subsidiaries, sells USS1 to USP2 for a note.

We believe the correct result here is that, first, USP1 should be treated as transferring the stock of USS1 to USP2 in exchange for consideration. Next, the Per Se Stock Rules should be applied to that transaction, with the result that USP2's note is recast as equity. By comparison, under an alternative approach which first deems members of a consolidated group to be a single corporation, it would appear that USS1 would be treated as a branch of USP1 and USP1, in turn, might be treated as selling that branch to USP2 for a note. The USP2 note would not be recast, because the General Per Se Rule does not apply to an asset transfer that is not a reorganization. Again, given the purpose of Prop. Treas. Reg. §1.385-1(e) as a means of preventing application of the Proposed Regulations to transactions between members of the same consolidated group, there does not appear to be any compelling rationale for applying the single entity concept broadly to treat the sale of USS1 as an asset sale.

Logically, this same approach would dictate which corporations in an EG are treated as members of a consolidated group, for purposes of applying the single-entity rule.

> *Example 54.* USS1 and USS2, members of the same consolidated group, own 100% of PRS, which owns USS3.

Under general tax principles, USS3 would not be a member of the consolidated group that includes USS1 and USS2. In our view, USS1 and USS2 should be treated for purposes of the Proposed Regulations as a single corporation, which is deemed to own 100% of a non-consolidated subsidiary, USS3. If the first step in the analysis of Example 53 were to treat USS1 and USS2 as a single corporation, the result might be different. However, that approach seems to be at odds with the Preamble's concern that even debt between domestic related parties can lead to inappropriate earnings stripping or other results.

More complex fact patterns may arise that present the question of whether an EG member should be treated as a member of a consolidated group:

> *Example 55*. FP owns FS, USX, and USP. USP is the parent of a consolidated group that includes USP's subsidiary, USS. The fair market value of USS's stock

> is $300. USS borrows $900 from USP and $100 from FS, under debt instruments that are pari passu. The debt provides a face amount substantially higher than $1,000. USS then buys the assets of USX from it for $1,000 in cash. USX liquidates immediately following the asset sale.

USS's acquisition of assets from USX for cash, followed by USX's liquidation, is a cash D reorganization. As such, it is an acquisition that causes USS's $100 debt to FS to be recharacterized as equity; and, if the equity does not qualify as plain vanilla preferred stock under Section 1504(a)(4) (*e.g.*, due to its high redemption premium), then the result will potentially be that USS ceases to be a member of USP's consolidated group, because the stock held by USS would represent 25% by value of the equity of USS. However, if USS were to cease to be a member of the consolidated group, this would have an impact on the $900 of debt owed by USS to USP; that debt would be an "exempt consolidated group instrument" as defined in Prop. Treas. Reg. §1.385-4(b)(1)(i) and, thus, would be deemed to be exchanged for equity of USS immediately after USS has left the consolidated group. Such equity would be pari passu with the $100 of deemed stock held by FS. The result would seem to be that USS should now be viewed as over 90% owned by value by USP and, thus, should once again become a member of USP's consolidated group. However, before USS enters the group, the $900 instrument held by USP would be deemed to be converted back to debt, pursuant to Prop. Treas. Reg. §1.385-4(c); and such conversion would once again seem to cause USS to cease to be a consolidated group member. We believe this type of circular result cannot have been intended. On balance, we believe the most logical approach in Example 55 is to treat USS as continuing to be a member of the consolidated group: this reflects the economic reality that USP owns over 80% by value and by vote of the interests in USS; and it also reflects the fact that the rules cannot be construed here as providing for a deconsolidation that does not immediately have consequences requiring that USS be reconsolidated.

We also note that if an EG member lends to a Controlled Partnership wholly owned by EG members that are members of the same consolidated group, the effect under the Per Se Stock Rules is the same as if the loan had been directly made to members of the consolidated group. If the lender is also a member of that consolidated group, the loan is disregarded entirely, pursuant to the combined effect of Prop. Treas. Regs. §§1.385-1(e) and 1.385-3(d)(5). We believe this result is appropriate, and recommend that it be extended so that it applies for purposes of the Part-Stock Rule and the Documentation Rules as well. A loan between members of a consolidated group would be disregarded for purposes of those rules; however, a loan between a member of the consolidated group to a Controlled Partnership wholly owned by members of the same consolidated group would be subject to these rules. There is no obvious rationale for this distinction; and we believe it could lead to unintended consequences for consolidated groups that own such a partnership.

As a final point, if a debt instrument is issued between two members of the consolidated group, which debt instrument would have been treated as stock if the Per Se Stock Rules applied within a consolidated group, and the issuer or holder later leaves the consolidated group but remains in the EG, then the debt instrument is treated as exchanged for stock immediately following the exit by the issuer or holder from the consolidated group. This rule undercuts the benefit of the exception from the Per Se Stock Rules for members of a consolidated group, because taxpayers must track debt between consolidated group members under the Per Se Stock Rule even if those rules do not currently apply, in case an entity leaves the consolidated group in the future. When the issuer or holder of group debt does leave the consolidated group, the treatment of the debt instrument depends on transactions that occurred when the debt was issued, potentially many years earlier. This retroactive analysis seems unduly burdensome and inconsistent with the general treatment in the Proposed Regulations of members of a consolidated group as a single corporation. We therefore recommend that this analysis be mandated only in the event the corporation leaving the consolidated group does so as part of a plan that included the issuance of the debt instrument.[325] In other cases, debt issued or held by a departing member of a consolidated group should be treated as reissued immediately after the member leaves the group, similar to the treatment of a debt instrument directly transferred out of a group.[326]

XV. TREATMENT UNDER THE PROPOSED REGULATIONS OF FOREIGN EG MEMBERS THAT ARE OUTSIDE THE U.S. TAX SYSTEM

The Proposed Regulations by their terms apply to all members of an EG or MEG, including foreign corporations that are not CFCs, are not subject to U.S. net income tax or required to file a U.S. income tax return, and do not transact with members of the EG that are U.S. corporations or are otherwise within the U.S. tax system. In the Preamble, Treasury and the IRS have requested comments on the application of the Proposed Regulations to an entity with respect to a year in which the entity is not a U.S. person, is not required to file a U.S. tax return, and is not a CFC or a controlled foreign partnership, but in a later year becomes one of the foregoing.[327]

We recommend that the Proposed Regulations not apply to debt issued, or distributions or acquisitions completed, by a foreign corporation at a time when it is not required to file a U.S. tax return and is not a CFC, in cases where these transactions are entered into with an EG member that is also not at the time a U.S. corporation, a CFC, or a foreign corporation required to file a U.S. tax return and are not otherwise entered into with a view to reducing U.S. tax liability by avoiding application of the Proposed Regulations. In this regard, we anticipate that many foreign

[325] Treasury and the IRS could consider including a presumption that a plan exists if deconsolidation occurs within, say, one or two years after the debt instrument has been issued.

[326] *See* Prop. Treas. Reg. § 1.385-4(b)(2).

[327] Preamble, at 20929.

corporations that are not subject to U.S. tax return filing obligations and are not CFCs may well be unaware of the Proposed Regulations and, even if aware of them, would have no reason to monitor compliance with the rules if they do not anticipate becoming, or transacting with an EG member that is, subject to U.S. tax. As a result, if such a foreign corporation does eventually enter the U.S. tax system or transact with a U.S. EG member, it may be quite difficult to reconstruct a history of the corporation's borrowing, lending, distributions and acquisitions and analyze those transactions under the Proposed Regulations. Apart from these practical considerations, it appears as a policy matter that loans and other transactions entered into by a foreign EG member with other foreign EG members, before any of them entered the U.S. tax system, present (almost by definition) little or no opportunity for the types of inappropriate planning that the Proposed Regulations are meant to curtail.

Our proposal to address these cases would have the following specific features. A foreign EG member should not be subject to the Part-Stock Rule or the Documentation Rules for debt issued to another foreign EG member, at a time when both of them were not CFCs and were not required to file U.S. tax returns. This would be similar to the approach taken, for example, in the Section 362(e) regulations dealing with loss importation.[328] As in those regulations, we suggest that an exception be provided to cover a case where the original transaction between the foreign EG members, and a later transaction whereby one or both of those corporations becomes a U.S. corporation, CFC, or subject to U.S. tax return filing obligations, occur with a view to avoiding the Proposed Regulations.[329]

As discussed in Part IX.A.1, we believe a broader exception is warranted in the case of the Per Se Stock Rules, such that loans, distributions, and acquisitions between all foreign EG members (other than those with large U.S. branches) would be excluded from the scope of those rules, for policy and practical reasons specific to those rules.

For purposes of the various rules recommended above, we propose to treat a foreign corporation that is not a CFC, and that files only a protective U.S. income tax return on which it does not report effectively connected income (or, in the case of a foreign corporation eligible for

[328] *See* Treas. Reg. § 1.362-4(c)(2).

[329] In the Section 362(e) regulations, this anti-abuse exception is backstopped by a rule whereby, if either the transferor or transferee corporation enters the U.S. tax system within 2 years after the transaction at issue, the regulations apply to the transaction. We do not recommend adopting such a rule under Section 385. It seems harsh to apply the Proposed Regulations, if the facts show the parties clearly did not anticipate entering the U.S. tax system at the time they completed a transaction. In addition, application of the Proposed Regulations would often require an additional U.S. tax analysis significantly more extensive than that which would be required to apply Treas. Reg. § 1.362-4, since the stock basis, E&P, and transactional history of multiple corporations in the group would potentially be needed in order to apply the Proposed Regulations.

treaty benefits, reports only income not connected with a U.S. permanent establishment) the same as a corporation not required to file a U.S. tax return. In view of the large number of foreign corporations that file returns purely as a precaution as contemplated by the government's Section 882 regulations, despite the absence of any actual taxable nexus to the United States, we believe it is appropriate to give such corporations the benefit of the same relief as applies to foreign corporations not filing a U.S. tax return.[330] If it is later determined that the protective returns were required to show effectively connected income, the Per Se Stock Rules would apply to the foreign corporation going forward; but for ease of administration, we propose that the rules not apply on a retroactive basis, provided that the original return was filed in good faith.

XVI. TREATMENT OF FUNDS' BLOCKER CORPORATIONS

The Preamble requests comments on "whether certain indebtedness commonly used by investment partnerships, including indebtedness issued by certain 'blocker' entities, implicate similar policy concerns as those motivating the Proposed Regulations, such that the scope of the Proposed Regulations should be broadened."[331]

If a private equity fund or hedge fund is treated as a partnership for tax purposes, it will not be a member of an EG. In addition, unless members of an EG have at least an 80% stake in the fund, it also will not be a Controlled Partnership. In that case, when the fund invests in a portfolio company through a leveraged blocker corporation, the loan from the fund to the blocker will not be subject to the Per Se Stock Rules. However, assuming the recommendations described in Part IV above are accepted, all the portfolio companies that are at least 80%-owned by the fund will be members of the same EG; thus, if any loans are made between portfolio companies, those loans would be subject to the Per Se Stock Rules.

We believe it is appropriate that the Per Se Stock Rules not apply to a fund's loan to a portfolio company, where the fund is not a Controlled Partnership. As discussed above, the paradigmatic case that appears to motivate the Per Se Stock Rules involves a distribution of a debt instrument by a corporation to its 80% or greater corporate parent. Often, although not always, such a distribution will be eligible for favorable U.S. tax treatment, under rules that are intended to prevent double taxation of the subsidiary corporation's profits: the 100% dividends received deduction, in a case where the parent and subsidiary are U.S. non-consolidated corporations; or the 0% withholding tax rate applicable under several treaties, where the parent is a foreign corporation and the subsidiary is a U.S. corporation. The Per Se Stock Rules appear to reflect a decision that corporate groups should not be allowed to exploit these favorable rules, by using

330 *See* Treas. Reg. § 1.882-4(a)(3)(i), 1.6012-2(g)(1); Swallows Holding Ltd. v. Comm'r, 515 F.3d 162 (3rd Cir. 2008).

331 Preamble, at 20929.

these rules to avoid incurring a tax cost when a subsidiary distributes a debt instrument to a parent in order to facilitate earnings stripping or other planning strategies that erode the corporate tax base.

By comparison, an investment by a private equity fund or hedge fund in a leveraged portfolio company would often involve facts quite different from the ones just described. First, when a private equity fund or hedge fund invests through a leveraged blocker corporation that it owns, the corporation usually uses the cash borrowed from the fund to acquire real assets from unrelated parties, rather than to make a distribution to the fund or investors in the fund. Second, since the fund is treated as a partnership for U.S. tax purposes, it would not, itself, be able to use the same favorable rules as an 80% corporate owner would to minimize U.S. tax on a leveraged distribution from a portfolio company the fund owns. The same would normally be true for the investors that own partnership interests in the fund. Indeed, even an EG member that owns an 80% or greater interest in the fund may well not be entitled to utilize favorable rules with respect to its share of a distribution made by the corporation to the fund, notwithstanding that the favorable rules would have been applicable if the distribution was made on an 80% shareholding owned by that EG member directly.

We believe that a fund's investment in debt of a blocker corporation is much more closely analogous to an investment in debt of a corporation by a group of unrelated shareholders of the corporation, than it is to the type of situations that have motivated the Per Se Stock Rules. Each investor in the fund has separate economic and tax consequences from their investment. It is true that the fund has a general partner or manager to direct the fund's actions, subject to whatever consent or opt-out rights limited partners have; but a group of unrelated shareholders that directly own stock of a corporation, similarly, may have a shareholders' agreement or other arrangements to coordinate their actions. On balance, it appears to us to be appropriate to view a fund as a proxy for a group of separate investors and, just as the rules do not apply in the latter case, to not apply them in the case of a fund, either.[332] Any notion that the Per Se Stock Rules, or the Proposed Regulations more generally, ought to apply to situations beyond debt issued within a closely related corporate group – particularly debt issued to shareholders none of which are closely related to the issuing corporation – would involve policy considerations significantly different from the ones described above.

We believe the same basic logic holds true for the Documentation Rules as well (*i.e.*, loans issued within a corporate group create especially significant opportunities for inappropriate tax planning and, thus, need to be policed more carefully than does other debt, including other

[332] *See* Treas. Reg. § 1.871-14(g)(3) (portfolio interest exemption from U.S. withholding tax on interest paid by a portfolio company to a partnership is determined at the partner level, rather than at the partner level).

Although a fund often will hold the shareholder debt issued by a leveraged portfolio company, in a number of cases the debt may be held individually by the different partners that have invested in the fund.

related-party debt). Also, in our experience, the legal documentation of a fund's investment in a portfolio company frequently tends to be more comprehensive, and more closely akin to that used in a third-party transaction, than described in the Preamble with respect to transactions between EG members. One reason is that the agreements documenting the fund's relationship with the portfolio company tend to be under greater scrutiny by third parties (including the sellers of the business or asset that the fund will hold through the portfolio company, as well as the management team for the business or asset, and third-party financing sources) than may be the case for a number of internal transactions within an EG. In view of these considerations, it is not clear that special requirements like those in the Documentation Rules would prove as suitable or useful with respect to debt owed by a portfolio company to a fund, as they are expected to be with respect to debt between EG members.

The Part-Stock Rule as currently drafted would, in a number of cases, apply to debt issued by a corporation to a fund, because an entity that owns 50% of a MEG member is itself treated as an MEG member (as described in Part V). If our recommendation to incorporate the Part-Stock Rule into the Documentation Rules is accepted, however, this will change. As noted above, we believe it is reasonable for the Part-Stock Rule's scope to be co-extensive with the Documentation Rules; and we do not see a reason why the Part-Stock Rule would need to apply more broadly in the context of fund investments than in other cases.

Thus, we recommend that the Proposed Regulations not be broadened to cover transactions that funds enter into with portfolio companies, beyond the coverage already provided by the rules as currently drafted (with our revisions in Part V).