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Baker & McKenzie

Alternative C:
U.S. Developments
(including Section 385)

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Agenda

- Overview
- Exclusion of Part Debt / Part Stock Rule
- Documentation Rules and Requirements
- Debt Issued in Distributions and Acquisitions; Funding Rules
- Effective Dates and Transition Rules
- Potential Challenges to the Regulations

Exclusion of Part Debt / Part Stock Rule

Exclusion of Part Debt / Part Stock Rule

- Treasury did not provide a general bifurcation rule in the final regulations, but did retain a bifurcation rule in Treas. Reg. § 1.385-3
- Treasury and the IRS will "continue to study comments received" on a general bifurcation rule, including:
  - When to bifurcate an instrument; and
  - How payments will be treated for tax purposes
- Nothing prevents the IRS from asserting partial bifurcation during an audit, and we expect more guidance from the LB&I campaign on debt issues

Exclusion of Part Debt / Part Stock Rule

- Treas. Reg. § 1.385-3
  - When a taxpayer can, and cannot, designate the repayment between debt and equity
  - Pro rata if no designation

Documentation Rules and Requirements

Documentation Rules and Requirements

- Implementation Date: Instruments issued on or after January 1, 2018
- Purpose: Provide IRS with documentation / information necessary to properly exam / audit debt instruments
- Scope:
  - EGIs issued by certain "large" Expanded Groups (publicly-traded group, $100M in assets, or $50M in revenues)
  - Covered members (domestic)

Documentation Rules and Requirements

– Excluded Instruments Include:
  - Intra-consolidated group instruments
  - Certain instruments issued by regulated entities
  - Rev. Proc. 99-32 receivables
  - Receivables deemed created under Code / regulations
  - Timing for documentation – filing of tax return for "relevant date"

Documentation Rules and Requirements

– Four Key Requirements (Indebtedness Factors):

1. Obligation to repay
2. Creditor's rights
   - Default rights, seniority to equity, non-recourse remedies
   - May instead reference governing law
   - Market safe harbor (also applies to obligation to repay)
3. Evidence of ability to repay
   - Must be prepared annually (unless "material event" occurs)
   - In-house vs. third-party analysis
   - Same documentation can be used for multiple EGIs

Documentation Rules and Requirements

– Four Key Requirements (Indebtedness Factors):
  - Disregarded entities

4. On-going evidence of debtor-creditor relationship (maintenance)
    - Form – wire / bank statements, journal entries
    - Actions in response to failure to pay

Documentation Rules and Requirements

– Operating Rules
  - Exceptions for non-compliance
    1. Highly compliant – rebuttable presumption
       - Average issue price test
       - Average number of non-compliant EGIs
    2. Reasonable cause exception
    3. Ministerial / non-material failures
  - Weighting – indebtedness factors "significant"; rest "lesser"

Documentation Rules and Requirements

– Operating Rules

- Cashpooling / Revolving Facilities
  - Notional arrangements subject to rules
  - Material documentation (enabling documents)

Documentation Rules and Requirements

– Practical Considerations
  - Must consider whether, in practice, creditor will be able to adhere to and enforce loan terms (requirement 4)
    - In this regard, it may be prudent to exercise restraint with respect to requirement 2
  - Taxpayers should develop internal policies and practices to ensure required documentation is prepared and maintained
    - Checklists for debt issuances and payments
    - Central repository for documentation materials
    - Internal policies relating to exercise of creditor's rights

Documentation Rules and Requirements

- Taxpayers may also wish to identify "higher" risk borrowers
- Coordination with Treasury and Legal will be critical

General Rule and Funding Rule

Overview – Per Se Stock Rules

- Rules treat certain debt instrument as stock without regard to terms or substance of instrument
- Two sets of rules:
  1. General Rule
  2. Funding Rule

Overview – Per Se Stock Rules

- Exceptions:
  - Threshold Exception ($50M)
  - Expanded Group Earnings Account
  - Qualified Contribution
  - Qualified Short-Term Debt Instruments
  - Expanded Group Stock Issuance Exception
  - Ordinary course

General Rule

– Debt issued in the following circumstances is treated as stock:

1. Distributions of debt (whether or not treated as a dividend)
2. Debt used to acquire stock of Expanded Group members (other than exempt exchange)
   - Exempt Exchange – acquisition of Expanded Group stock in an asset reorganization, and either:
     - Section 361(a) or (b) applies to the transferor of the stock and the stock is not issued as part of the asset reorganization, or

General Rule

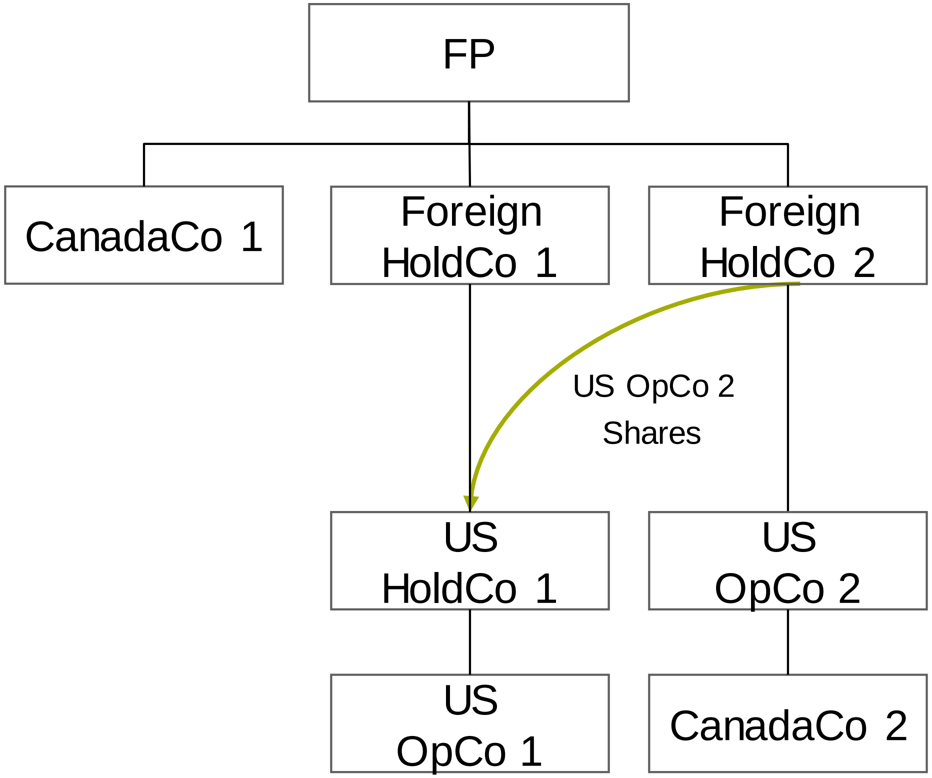
- Section 1032 applies to the transferor of the stock and the stock is distributed by the transferee pursuant to a plan of reorganization

3. Debt issued as "boot" in certain asset reorganizations

Funding Rule

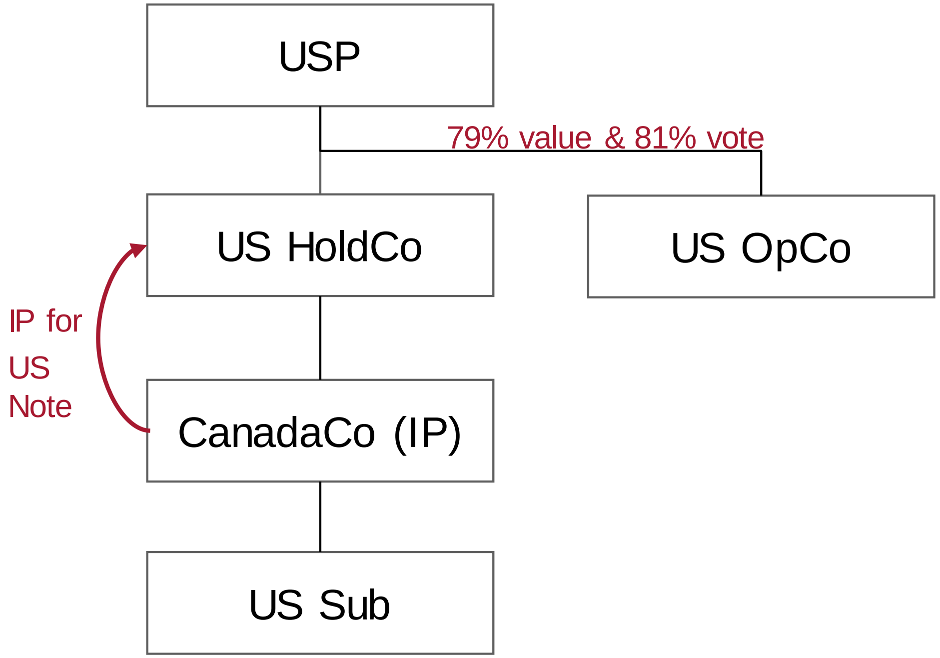
- "Principal purpose debt instruments" (PPDI) treated as stock
  - A debt instrument issued with a principal purpose of funding (a General Rule transaction):
    - Distribution
    - Acquisition of Expanded Group member stock
    - Distribution of boot in an asset reorganization

Impact on Post-Acquisition Integrations



- Assume FP recently acquired Foreign HoldCo 2 and wishes to form a single US consolidated group and integrate the business operations of US OpCo 1 and US OpCo 2
- Impact of general rule of Treas. Reg. § 1.385-3(b)(2) or the funding rule of Treas. Reg. § 1.385-3(b)(3) on various integration scenarios
  - If US HoldCo 1 (or US OpCo 1) borrows cash from a third party and uses the cash to purchase the shares of US OpCo 2 from Foreign HoldCo 2, nether the general rule nor the funding rule applies
  - If US HoldCo 1 (or US OpCo 1) issues a note (Note 1) to Foreign HoldCo 2 for the shares of US OpCo 2, the general rule dictates that Note 1 be treated as stock and payments of interest and principal be treated as distributions on that stock
  - If US HoldCo 1 (or US OpCo 1) borrows cash from Foreign HoldCo 1 in exchange for a note (Note 1) and uses the cash to purchase the shares of US OpCo 2 from Foreign Holdco 2, the funding rule dictates that Note 1 be treated as stock and payments of interest and principal be treated as distributions on that stock
  - Impact of general rule of Treas. Reg. § 1.385-3(b)(2) and the funding rule of Treas. Reg. § 1.385-3(b)(3) on various integration scenarios is the same even if US OpCo 2 converts to a DRE or merges with US OpCo 1 after the sale
- What other integration scenarios could be pursued?

US HoldCo Issues US Note to CanadaCo in Exchange for IP



- US Note is a covered instrument
- Section 956 issue arises whether the note is recast or not
- US Note is not yet deemed equity, but US HoldCo is funded
- Assume US HoldCo purchases the stock of US Sub or the assets of US Sub and US Sub liquidates into CanadaCo
  - The stock sale fits within the subsidiary exception in Treas. Reg. § 1.385-3(c)(2)
  - The asset purchase and liquidation of US Sub is not a D reorg because the transaction fails the control requirement
- Alternatively, assume US OpCo purchases the stock of US Sub or the assets of US Sub in an all-cash D reorg
  - US Note is recast as equity because the subsidiary exception does not apply
    - The subsidiary exception requires 50% direct or indirect control, but not attribution under § 318
  - Partial payment of the debt is a dividend subject to US withholding tax
  - A lump sum payment (or a series of related payments) cannot qualify as a complete termination of interest due to attribution under § 318
    - US dividend withholding tax still applies

Consolidated Groups

Consolidated Groups

- "One Corporation" Approach – Consolidated group (CG) generally treated as a single corporation for purposes of -3 and -3T
  - Consolidated group debt instruments (CGDI) generally disregarded
    - One member can issue debt to another member to "fund" a distribution or acquisition without triggering recast under -3 and -3T
  - Expanded group earnings account calculated at CG level
  - Qualified contributions determined at CG level

Consolidated Groups

- CG instruments treated as "issued" immediately after it leaves CG
  - Deemed reissuance under § 1.1502-13(g) generally treated as transaction separate / independent from recasts under -3 and -3T
- Two Step Analysis
  - (1) General U.S. tax treatment of transaction determined
  - (2) -3 and -3T are applied, applying one corporation principle
    - CG instruments recast as equity not treated as "stock" under § 1504(a)(4)

Effective Dates

Effective Dates and Transition Rules

- Documentation
  - Debt issued on or after January 1, 2018 and must be prepared by the time the return is filed in 2019 (with extensions)

Effective Dates and Transition Rules

– Per Se and Funding Rules
  - General rule: Effective for taxable years ending on or after 90 days after publication in the Federal Register
  - Transition rule for covered debt instruments that would be treated as stock in taxable years ending on or after 90 days after publication
  - Transition rule for certain covered debt instruments treated as stock
  - Transition funding rule

Validity – Potential Challenges to the Regulations

Potential Challenges to the Regulations

- Litigation under the Administrative Procedure Act
  - Pre-enforcement review of agency regulations
  - Court must set aside regulations that are:
    - (1) Contrary to statute;
    - (2) Arbitrary or capricious; or
    - (3) Procedurally defective.
  - The administrative record is the focal point for review
- Two procedural obstacles:
  - Standing; and
  - The Anti-Injunction Act
- Specific challenges to the Final Regulations

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