BAKER & MCKENZIE

Client Alert

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Proposed Regulations Under Code Section 385

The U.S. Department of Treasury ("Treasury") and the IRS recently issued proposed regulations under Code Section 385 (the "Proposed Regulations," and the related guidance and commentary, the "Preamble"). In parallel with, and on the same day as, the release of the Proposed Regulations, Treasury and the IRS also issued new final and temporary regulations under section 7874 (the "Inversion Regulations"). The Inversion Regulations represent a culmination of the guidance that Treasury and the IRS have released on inversions and post-inversion "out-from-under" planning over the previous two years. See Notice 2014-52 and Notice 2015-79; Baker & McKenzie Client Alert: *Treasury Takes Another Shot at Stopping Inversion Transactions,* distributed on November 23, 2015 and available under publications at www.bakermckenzie.com/tax. In light of the coordinated release of these two sets of guidance, many taxpayers and tax practitioners had initially assumed that the Proposed Regulations were targeted at earnings-stripping transactions arising in the context of inversions. That assumption was only partly correct. While the Proposed Regulations will certainly impact inverted companies and out-from-under planning, they apply equally to non-inverted foreign-based multinationals and US multinational companies as well.

If finalized in their current form, the Proposed Regulations would dramatically change the manner in which debt instruments are characterized for US federal income tax purposes by adding new reporting and documentation requirements and *per se* rules that would recharacterize debt (respected as such under general tax principles and compliant with the new documentation and reporting requirements) as stock in certain circumstances. As we note at the end of this alert, the radical nature of the Proposed Regulations' departure from the traditional common law principles considered by Congress when it enacted section 385 make the regulations vulnerable to a validity challenge.

In broad strokes, the Proposed Regulations:

1. impose extensive documentation and reporting requirements in connection with the issuance of certain intercompany debt instruments which, if not satisfied, result in the instrument being characterized as stock for US tax purposes (the "Documentation Requirements");

2. allow the IRS to treat a portion of a debt instrument as stock, rather than as either entirely debt or entirely equity (the "Part Stock Rules"); and

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3. automatically treat certain intercompany debt instruments as stock if issued in connection with certain intercompany distributions, stock acquisitions, and asset reorganizations (the "General Rule"), or with a principal purpose of funding such a distribution, acquisition or reorganization (the "Funding Rule").

Significantly, the Documentation Requirements and the Funding Rule have the potential to recharacterize debt as stock based on facts and circumstances occurring long after the instrument was first issued and which have no bearing on the treatment and character of the instrument under general tax principles.

The proposed effective dates only further complicate these already complex rules. The Part Stock Rules and the Documentation Requirements only apply prospectively to debt instruments issued (or deemed issued) after the regulations become final. The General Rule and the Funding Rule, on the other hand, apply to any debt instrument issued (or deemed issued as a result of a significant modification) on or after April 4, 2016. Affected instruments, however, will not be recharacterized as stock under the General Rule or Funding Rule until 90 days after the date final regulations are issued. The Preamble notes that Treasury "intends to move swiftly" to finalize the Proposed Regulations.

It is important to note at the outset that the Proposed Regulations principally target and apply to intercompany debt instruments. The Proposed Regulations not only create uncertainties for garden variety intercompany financing transactions, but also impose substantial administrative and compliance burdens on taxpayers. For most US-based multinationals, the Proposed Regulations will make planning more difficult but will not necessarily shut down the transactions that the IRS cites disapprovingly in the Preamble because virtually every one of these transactions can be accomplished using third-party debt. Although this may increase the cost of certain planning transactions, and may be problematic for groups not wishing to burden their balance sheets with third-party liabilities, it will not necessarily prevent them. What will likely trouble US-based multinationals more is the Documentation Requirements simply because the rules are so burdensome and the consequences of failing to comply can be stark, as we note below.

Foreign-based multinationals are even more severely impacted by these rules. The Proposed Regulations may increase the effective tax rate of those multinationals doing business in the United States. This is most likely to occur where a US subsidiary has significant interest-bearing debt owing to its foreign parent which is subject to recast as stock under the Proposed Regulations, and the foreign parent has no corresponding third-party debt of its own which can be pushed down to the US subsidiary or group. In these circumstances, the loss of US interest expense deductions will likely create a significant and unexpected US tax cost for the group. Importantly, this treatment would apply to inverted and non-inverted foreign-based multinationals alike.

Interestingly, private companies controlled by individuals and private equity funds will largely be exempt from these rules. Although the Part Stock Rules could potentially apply, loans from individuals and widely held partnerships to corporations they control are (for the moment) exempt from the reach of the Documentation Requirements, the General Rule, and the Funding Rule.

Documentation Requirements

Whether intentional or unintentional, the Documentation Requirements send a strong message to taxpayers: the days of flexible intercompany lending arrangements are nearing their end. Treasury and the IRS now expect taxpayers to treat intercompany loans with the same "discipline" that they do third-party obligations and, to that end, have created a set of new administrative documentation and reporting requirements for taxpayers that use intercompany debt to finance internal operations. If a taxpayer fails to prepare and maintain the required documentation for each affected intercompany loan, the loan is recharacterized as stock (subject only to a limited reasonable cause exception). Fortunately, because a consolidated group is treated as a single corporation for purposes of these rules, they do not apply to intercompany loans and other liabilities exclusively between members of the same consolidated group. Thus, neither the Documentation Requirements nor the other provisions of the Proposed Regulations apply to intercompany obligations between members of the same consolidated group during the period such obligations remain within the consolidated group.

Of the three sets of rules issued in the Proposed Regulations, the Documentation Requirements have perhaps the narrowest application. They only apply to "large" expanded groups, namely, those in which: (i) the stock of any member of which is traded on an established financial market; (ii) the group's assets exceed $100 million; or (iii) the group's annual total revenue exceeds $50 million. If, however, one of these threshold requirements is met, the Documentation Requirements apply broadly to *all* applicable instruments[1] issued between members of the expanded group ("Expanded Group Instruments" or "EGIs") and, therefore, could impact everything from basic intercompany notes and receivables to revolving-credit and cash-pooling arrangements. An “expanded group,” largely derives from section 1504(a) principles, and generally includes corporations (foreign and domestic) related by at least 80% (vote or value) direct or indirect common parent ownership.

The Documentation Requirements require affected expanded groups to prepare and maintain four categories of documentation that substantiate the "essential" characteristics of indebtedness for each EGI: (i) the issuer's binding obligation to repay the instrument; (ii) the holder's right to enforce the terms of the instrument; (iii) evidence, as of the date of issuance, of the issuer's financial position and the parties' reasonable expectations that the instrument will be repaid in accordance with its terms; and (iv) the existence of a genuine on-going creditor-debtor relationship. Evidence of the first three characteristics must be documented within 30 days of date on which the debt is issued.[2] This very short period is particularly burdensome because there is no exception for small or de minimis advances.

The Documentation Requirements are expected to result in significant compliance costs and burdens for affected expanded groups. Such groups will need to implement new internal procedures to prepare the requisite documentation each time a new intercompany loan is issued (or modified or amended), and will need to diligently monitor the instrument over the life of the loan, including documenting actions evidencing an ongoing and genuine debtor-creditor relationship. Of the various documentation requirements, the requirement to prepare financial

[1] For this purpose, an applicable instrument is a loan or indebtedness issued in the "form" of a loan. Thus, sale-repurchase transactions that are, in substance, loans may not be considered applicable indebtedness. The government reserves on the documentation for these types of loans.

[2] Interestingly, and by contrast, in the cost sharing context, Treasury has defined “contemporaneous” to mean that the documentation must be prepared within 60 days of the effective date.

analyses supporting an issuer's ability to repay intercompany indebtedness may prove to be the most complex, time-consuming, and expensive.[3] Such analyses would not only involve a review of future cash flows of the issuer and its on-going capital structure, but may also necessitate more in depth valuations to determine the fair market value of the equity of the borrower.

The fourth category of documentation—evidence of a genuine on-going creditor-debtor relationship—has the potential to be equally burdensome. The Proposed Regulations require affected expanded groups to prepare documentation showing or otherwise memorializing *each* payment of interest and / or principal with respect to an EGI, within 120 days of the relevant payment. Perhaps even more concerning, if the issuer fails to make a scheduled payment or otherwise defaults on the relevant instrument, the expanded group must prepare documentation memorializing the steps taken by the holder to exercise its rights as a creditor, including efforts to seek settlement of or legal judgment with respect to the instrument. In the event that the holder decides not to pursue action against the issuer (which very often will likely be the case), the expanded group must prepare documentation detailing the reasons for the holder's decision.

Similarly, if a debt instrument undergoes a significant modification (within the meaning of Treas. Reg. § 1.1001-3—*e.g.*, a meaningful change in interest rate or maturity date), the change must be documented and the issuer's expanded group must prepare a new (or, at the very least, updated) financial analysis which demonstrates the issuer's continued ability to repay the modified instrument in accordance with its terms.

The Proposed Regulations acknowledge that requiring strict adherence to the Documentation Requirements may be impractical in the context of revolving credit and cash pooling arrangements. The proposed rules therefore impose more relaxed standards in these circumstances, requiring parties to maintain "material documentation" governing such arrangements. In the case of revolving credit arrangements, this might include directors' resolutions, credit agreements, omnibus agreements, security agreements, as well as any documentation showing initial and on-going principal balances. In the case of cash pooling arrangements, this would include the cash pooling agreement, as well as any side agreements between expanded group members and non-expanded group members. The Proposed Regulations do not distinguish between physical pooling arrangements (where an expanded group member acts as the bank) and a notional pooling arrangement (where an intervening third-party bank is interposed between depositing and borrowing members of the expanded group). Therefore, it is unclear whether the government intended that the Documentation Requirements apply to notional pooling through a third-party bank.

The required documentation must be prepared and maintained for each EGI for all years that the EGI is outstanding and until the relevant statute of limitations period expires. If the taxpayer fails to satisfy these requirements, the EGI is treated as stock. There could be dramatic consequences from such a recast. As will be discussed below, if a loan is made from one expanded group member to a disregarded entity owned by another expanded group member, and the Documentation Requirements are not satisfied, the disregarded entity is deemed to issue equity to the purported lender. This could cause the disregarded entity to spring into existence as a partnership, along with any intercompany loans that

[3] The Preamble estimates that the Proposed Regulations will create an additional 735,000 hours of annual compliance burden for taxpayers. One wonders whether this is a gross underestimate in light of the fact that the Documentation Requirements in many respects are more burdensome than contractual requirements imposed by third-party lenders.

disregarded entity owed its parent. This, in turn, could trigger sizable taxable sales and events that the taxpayer might not even become aware of until an audit is resolved. To alleviate the harsh effects of this rule, however, the Proposed Regulations provide a reasonable cause exception (which has yet to be fully defined).

Observations

The Documentation Requirements will likely be a trap for the watchful and unwary alike. With the exception of a narrow reasonable cause defense, the contours of which have yet to be defined, the Proposed Regulations do not appear to offer any relief for failure to comply with the Documentation Requirements: affected intercompany debt instruments will be treated as stock for US tax purposes. In light of the purported purpose of the Documentation Requirements—facilitating and improving administration of debt-equity issues—this is an incredibly harsh and punitive result. One would hope that Treasury and the IRS would relax these rules in final regulations, particularly in circumstances where taxpayers are able to correct any inadvertent foot faults and provide the IRS with the information necessary to properly analyze and assess the character and substance of an affected debt instrument.

The on-going maintenance and monitoring requirements also raise thorny issues, particularly with respect to IRS audits. At a minimum, expanded groups will need to exercise extra diligence in crafting and, more importantly, maintaining their loan arrangements. As discussed above, the consequences of failing to make an interest or principal payment may be dire. Hence, groups may opt for loan terms that make on-going compliance simpler and easier (*e.g.*, annual interest payments instead of quarterly interest, bullet loans instead of amortizing loans, etc.). Expanded groups will also need to carefully consider how to document any non-payments and departures from the terms of an EGI and, in particular, balance compliance with the Documentation Requirements against the risk of creating statements against the interests of the expanded group in a subsequent audit.

The Part Stock Rules

Historically, courts and the IRS have either respected the form of a debt instrument in its entirety, or recast the instrument entirely as stock (subject to a handful of exceptions). The Part Stock Rules depart from this historic treatment and allow the IRS to recharacterize a debt instrument between members of a modified expanded group as in part stock and in part debt. The definition of "modified expanded group," which is critical to understanding and appreciating the broad reach of the Part Stock Rules, largely derives from section 1504(a) principles, with several modifications and adjustments, most notably: (i) members must be related by at least 50% (vote or value) direct or indirect common parent ownership (rather than the 80% threshold required under section 1504(a)); and (ii) a modified expanded group may include not only domestic corporations, but also foreign corporations, RICs, REITs, S corporations, and certain non-corporate entities, such as partnerships, trusts, estates, and individuals which own at least 50% of the stock or interests in a modified expanded group member. This second point is particularly important, as it brings loans from a private equity fund to a domestic corporation that it controls within the scope of the Part Stock Rules.

The Part Stock Rules appear to contemplate a two-step analysis. The first step requires an assessment of the relevant debt instrument and whether a portion of it may be recharacterized as stock for US tax purposes. The Proposed Regulations

and Preamble indicate that this initial assessment is based on "general tax principles"(*i.e.*, common law debt-equity principles). If the facts and circumstances warrant treating some or all of the instrument as stock, the second question then becomes—what portion of the instrument should be recharacterized as equity? The Proposed Regulations offer little guidance in this regard, other than to note that the issuer's intent and ability to repay the instrument in accordance with its terms may be a relevant consideration. "General tax principles"—the starting point for the initial assessment—are equally unhelpful in this regard. Courts and the IRS have not substantively or meaningfully addressed how an instrument should be bifurcated into debt and equity, largely because they have not had the need to. As discussed above, debt instruments have historically been characterized generally as either *entirely* debt or *entirely* stock. The absence of guidance on this latter point is concerning given that there are few limitations on the IRS's ability to recharacterize a debt instrument under the Part Stock Rules. The Proposed Regulations merely require that "the Commissioner's analysis *supports a reasonable expectation*" that the debt instrument should be partly recharacterized as stock.

If a debt instrument is recharacterized as in part stock, that treatment applies to both the holder and the issuer of the instrument, as of the date of issuance (or deemed issuance). The Preamble notes that, for other purposes of the Code (*e.g.*, for purposes of determining whether the instrument is common or preferred stock, non-qualified preferred stock under section 351, stock described in section 306, etc.), the deemed stock interest will be characterized in accordance with the terms and conditions of the underlying legal instrument.

Observations

Among the various provisions introduced in the Proposed Regulations, the Part Stock Rules potentially have the broadest reach. The remaining two sets of rules—the Documentation Requirements and the General and Funding Rules—generally apply only to debt instruments issued between members of an "expanded group," which largely parallels the definition of a modified expanded group, but requires a higher 80% threshold of relatedness. In most cases, a modified expanded group will therefore be broader than the corresponding expanded group and, as a result, the Part Stock Rules will, in practice, potentially capture a broader range of intercompany debt instruments than the Documentation Requirements and the General and Funding Rules.

If a recast occurs under the Part Stock Rule, it is unclear how the issue price of the bifurcated instrument would be allocated between the debt and equity components (*e.g.*, would the bifurcated instrument be treated as an "investment unit" requiring allocation of the issue price between the two components based on their relative fair market values?) and how subsequent payments are allocated. Presumably the form of the instrument should dictate whether the payments are interest, dividends, return of principal or redemption proceeds. If so, a practice may develop whereby taxpayers explicitly state in the underlying instrument itself how payments are to be allocated in the event the instrument is recast. We would also expect intercompany loans to be made in tranches to enhance the possibility that only the junior tranches would be recast as stock, and the senior tranches respected as debt.

Another open question is whether these rules will meaningfully advance the goals the Proposed Regulations purport to achieve, in particular, improved and more effective administration of debt-equity classification issues. The Preamble notes that, under existing debt-equity case law, "courts apply inconsistent sets of factors

to determine if an interest should be treated as stock or indebtedness… [t]he result has been a body of case law that perpetuates the 'uncertainties and difficulties which the distinction between debt and equity has produced'." The Part-Stock Rules, however, continue to rely on these very same common-law principles for purposes of determining whether a debt instrument should be characterized as in part stock (*i.e.*, the initial assessment). In this regard, the Part-Stock Rules do nothing to eliminate the "uncertainties and difficulties" that exist under current law. If anything, the Part Stock Rules perpetuate and further compound the uncertainties in this area by introducing a new potential source of controversy between taxpayers and the IRS: disputes concerning the portion of or extent to which a debt instrument is characterized as in part stock.

Even if final regulations include more concrete guidance on the points above, taxpayers should expect to face more protracted controversies with the IRS involving debt-equity characterization. The Part Stock Rules most likely portend a more aggressive approach by the government to recast intercompany debt instruments.

The General Rule and the Funding Rule

In addition to the Part Stock Rules and the Documentation Requirements—both of which have the potential to (but do not necessarily) cause a debt instrument to be recharacterized as stock for US tax purposes, the Proposed Regulations introduce two new rules which would automatically recharacterize certain intercompany debt instruments between expanded group members as stock for US tax purposes: (i) the General Rule and (ii) the Funding Rule.

The most remarkable aspect of these rules is that they assume that the instrument in question constitutes debt under traditional debt-equity principles and apply to recast such instruments as equity. In contrast, the Part-Stock Rules and the Documentation Requirements generally respect an instrument as debt if it would be treated as such under general tax principles. That is, an instrument structured as debt, with respect to which the issuer has both the intent and capacity to repay in accordance with its terms, may nevertheless be treated as stock under the Proposed Regulations. As discussed further below, it is not entirely clear whether the legislative grant of authority under section 385(a) allows Treasury and the IRS to promulgate such broad and sweeping rules and regulations which completely ignore common law debt-equity principles.

The General Rule treats a debt instrument as stock if the instrument is issued:

1. as a distribution to an expanded group member (*e.g.*, a section 301 distribution);

2. in exchange for stock of an expanded group member (*e.g.*, a section 304 transaction), other than an "exempt exchange";[4] and

3. in an asset reorganization, but only to the extent that a shareholder, who is a member of the issuer's expanded group prior to the reorganization, ultimately receives the purported debt instrument pursuant to the plan of reorganization.

[4] An “exempt exchange” is an acquisition of expanded group stock in which the transferor and transferee are parties to an asset reorganization, and either (i) 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 (ii) section 1032 applies to the transferor of the stock and the stock is distributed by the transferee pursuant to a plan of reorganization.

In the Preamble, Treasury and the IRS express their belief that debt instruments issued in these circumstances often "lack substantial non-tax business purpose" and frequently have "minimal or non-existent non-tax effects." In their view, such instruments allow "related parties to obtain significant federal tax benefits at little or no cost."

The General Rule is intended to be a bright-line rule, with only two apparent exceptions: (i) the Threshold Exception and (ii) the Current E&P Exception. The Threshold Exception provides that a debt instrument will not be recharacterized under the General Rule if, immediately after the instrument is issued, the aggregate adjusted issue price of all instruments held by members of the issuer's expanded group does not exceed $50 million. Once the $50 million threshold is crossed, however, all debt instruments (including the first $50 million) are subject to automatic recharacterization under the General Rule (unless the Current E&P Exception provides for a different outcome).

The Current E&P Exception essentially allows an issuer to issue instruments to expanded group members without the threat of recharacterization under the General Rule up to its current E&P balance for the taxable year. This exemption applies to instruments (otherwise subject to the General Rule) in the order in which they are issued. As discussed below, these exceptions are also available when analyzing an instrument under the Funding Rule. Note that this exception will undoubtedly motivate the US parent of a consolidated group, the stock of which is owned by a foreign corporation, to distribute notes to its foreign shareholder to the extent of its current E&P rather than distributing cash. Thus, we would expect the Current E&P Exception to alter the dividend policies of foreign-based multinational groups.

Apparently concerned that the General Rule, standing alone, might leave open opportunities for taxpayers to continue to achieve the outcomes described above (obtaining federal tax benefits with little or no cost), Treasury and the IRS also introduced the Funding Rule, which is intended to function as a backstop to the General Rule. The Funding Rule provides that a principal purpose debt instrument ("PPDI") will be treated as stock for US tax purposes. A PPDI is an instrument issued with a principal purpose of funding a transaction described under the General Rule. A PPDI would therefore include an instrument the proceeds from which are used by the issuer (the "funded member") to fund:

1. a distribution of property by the funded member to an expanded group member (other than a distribution of stock in an asset reorganization governed by section 354(a)(1) or governed by section 355(a)(1));

2. an acquisition of stock of an expanded group member by the funded member, other than an exempt exchange (discussed above); or

3. the funded member's acquisition of an expanded group member's assets in an asset reorganization, but only to the extent that a shareholder, who is a member of the issuer's expanded group before the reorganization, receives other property or money (within the meaning of section 356) with respect to its stock in the transferor.

Whether the requisite "principal purpose" exists is determined based on all facts and circumstances. This general rule, however, is largely supplanted by a non-rebuttable presumption that any instrument issued by the funded member during the 72-month period beginning 36-months before and ending 36-months after a disposition or acquisition described above was made with a principal purpose of

funding the disposition or acquisition. Similar to the approach taken in its recent inversion guidance, Treasury is creating a "purpose" test that ultimately ignores a taxpayer's actual purpose for engaging in a particular transactions or arrangement. The Proposed Regulations include only one exception to this presumption—an instrument issued by the funded member in the ordinary course of its business, in exchange for property or services that are currently deductible or treated as costs of goods sold, will not be presumed to be made with a principal purpose of funding a disposition or acquisition, provided the obligation at no time exceeds an amount necessary to carry on the funded member's trade or business. The Preamble notes that the ordinary and necessary exception does not extend to treasury functions or cash pooling arrangements. Based on the plain language of the Proposed Regulations, it also appears that ordinary and necessary exception would not extend to rents or royalties that arise in the ordinary course of business, even if such expenses were currently deductible. Given the apparent purpose of the exception (to exclude amounts arising in the ordinary course of business), it is unclear why these should be treated any differently than payments for services or the purchase of goods.

As discussed above, even if an instrument is treated as stock under the Funding Rule, the Threshold Exception and the Current E&P Exception may offer relief.

Although the Funding Rule is drafted quite broadly, its reach is largely limited to the funding instrument itself. The Funding Rule does not alter the character or treatment of the funded distribution or acquisition. For example, if a funded member issued a debt instrument to an expanded group member in exchange for cash and subsequently distributes the borrowed funds to another expanded group member, the debt instrument may be recast as stock under the Funding Rule but the subsequent distribution is respected as such. That does not mean that the Funding Rule recast cannot alter the tax treatment of the subsequent disposition or acquisition, however. For example, suppose that the recast causes the shareholder of the funded member to no longer own 80 percent of the value of the funded member under sections 1504 and 243(b). In that case, a dividend that would have otherwise qualified for a 100 percent dividends received deduction will only qualify for a partial dividends received deduction.

As a final backstop, the Proposed Regulations include an anti-abuse rule, which provides that a debt instrument may be treated as stock if issued with a principal purpose of avoiding the application of the Proposed Regulations (the "Anti-Abuse Rule"). Perhaps in anticipation of potential taxpayer responses to the Proposed Regulations, the Anti-Abuse Rule also allows the IRS to treat instruments not denominated as debt (*e.g.*, section 483 contracts and non-periodic swap payments) as stock if issued with a principal purpose of avoiding the Proposed Regulations. The reference to non-periodic payments is particularly curious, given that the notional principal contract regulations already include a provision that seeks to recast significant non-periodic payments as loans. Hence, it is not clear why the drafters felt the need to go beyond that rule and target any non-periodic payment made during the life of a notional principal contract. The Proposed Regulations provide little guidance or explanation on the circumstances in which an issuer will be considered to have the requisite avoidance principal purpose and instead merely identify several transactions which could potentially trigger the Anti-Abuse Rule:

- Debt issued to a person that is not an expanded group member but later becomes an member of the issuer's expanded group or sells the debt to an expanded group member;

- Debt issued to an entity that is not taxable as a corporation for US federal income tax purposes; and
- The substitution or addition of a member of the issuer's expanded group as a new obligor or a co-obligation to an existing debt instrument.

The lack of guidance as to how the Anti-Abuse Rule will be applied creates additional risks to, and uncertainties for, taxpayers and very well may have been intended as a catch-all deterrent to taxpayers engaging in related party debt transactions that otherwise would not be within the purview of the Proposed Regulations. For example, is the Anti-Abuse Rule focused on the intent for incurring the debt / funding, or is doing something in a different manner from what would have otherwise been done enough to put a taxpayer in the cross-hairs of this rule?

In addition to the Anti-Abuse Rule, the Proposed Regulations provide that taxpayers may not affirmatively use or invoke the Proposed Regulations for "a principal purpose of reducing the federal tax liability of any member of the expanded group that includes the issuer and holder of the debt instrument by disregarding the treatment of the debt instrument that would occur without regard to [the Proposed Regulations]."[5] We sometimes refer to this below as the Anti-Affirmative Use Rule.

Observations

The Preamble indicates the Treasury and the IRS intend for the General Rule and the Funding Rule to curtail various planning strategies in which taxpayers affirmatively rely upon Code provisions to create debt without paying tax on a commensurate amount of income, such as section 304, the boot-within-gain limitation of section 356, the section 368(a)(1)(D) reorganization rules, and the return of capital provisions in section 301(c)(2). The problem, of course, is that virtually any of these planning techniques can also be achieved by borrowing from third-parties (which does not appear to be covered by the Proposed Regulations) and using the proceeds to purchase stock of an expanded group member or make tax-free boot distributions in a reorganization. Although the General Rule and the Funding Rule may make those techniques somewhat costlier and more difficult to implement, they do not shut them down.

It may also be possible to preserve the historic treatment (*i.e.¸* pre-Proposed Regulations) of these transactions by funding the issuer with debt from an another expanded group member (the "funding member") in the circumstances above. In other words, the issuer would borrow from an expanded group member and use the proceeds to acquire stock or assets (as the case may be) in the transactions above. In such case, the Funding Rule would presumably treat the instrument issued by the issuer to the funding member as stock of the issuer, but would leave the issuer's subsequent acquisition untouched. However, taxpayers

[5] In effect, the IRS has drafted the General Rule and the Funding Rule such that they can apply to recast debt as equity if the application results in additional federal income tax, but prevents the application of the rules when doing so produces a federal income tax benefit. One might wonder whether this kind of result-oriented exercise of discretion (heads I win, tails you lose) is an unconstitutional encroachment on the role of the federal judiciary. At a bare minimum, the Anti-Affirmative Use Rule is a glaring admission by Treasury and the IRS that neither the General Rule nor the Funding Rule is based on any analysis of whether the subject EGI qualifies as debt or equity under general tax principles, and rather is merely a means of attacking transactions they believe are abusive. As discussed below, there is no indication in the legislative history of section 385 that Congress intended the statute to serve such a role.

contemplating such an approach would be well advised to fully consider the potential impact of the Anti-Abuse Rule and the Anti-Affirmative Use Rule.

It may also be possible to mitigate the impact of the Proposed Regulations by carefully structuring the terms and conditions of debt instruments in anticipation of an eventual recast under either the General Rule or the Funding Rule (or the Part Stock Rules or the Documentation Requirements). As mentioned, the Preamble notes that debt instruments subject to the General Rule and the Funding Rule will be treated as stock for all purposes of the Code and that the deemed stock interests will be characterized consistent with the terms and conditions of the underlying legal instrument. With this in mind, debt could, for instance, conceivably be structured so that the recast instrument constitutes nonqualified preferred stock (within the meaning of section 351(g)), which in many cases will produce consequences and outcomes similar to indebtedness. Although the impact of the Anti-Abuse Rule and the Anti-Affirmative Use Rule would need to be considered, such an approach may preserve the historic treatment of at least some of the transactions above.

The bottom line is that the General Rule and Funding Rule are not likely to shut down affirmative planning engaged in by US-based multinationals. Instead, they will likely create significant potential for inadvertent foot faults for garden variety intragroup debt instruments and arrangements which are not created for any particular US tax purpose, but which taxpayers simply do not sufficiently monitor.[6]

The rules will likely have a greater effective tax rate impact for foreign-based multinationals. Some foreign multinationals, which borrow from third-parties and on-loan to their US subsidiaries, may be fortunate enough to be in a position where their US subsidiaries are able to begin borrowing directly from third-parties. Such third-party borrowing would not be subject to the General Rule or the Funding Rule (unless the Anti-Abuse Rule or Anti-Affirmative Use Rule required a different result). If the foreign parent guarantees the third-party debt, the US subsidiary might even be able to pay deductible guarantee fees to the foreign parent.[7] Such an arrangement will not be available to all foreign multinationals, however. In these cases, and as we noted at the outset, the recharacterization of debt owing from US subsidiaries as equity, and the corresponding loss of US interest expense deductions, could significantly increase the effective tax rate of the foreign multinational group, particularly where the US subsidiary debt exceeds the foreign multinational's own third-party debt. We can expect affected foreign multinationals to heavily rely upon the Current E&P Exception to manage their effective tax rates. The entire US consolidated group's E&P should be available for this purpose given that the entire group is treated as a single corporation for purposes of applying the rules (discussed below).[8]

Consolidated Groups

As noted above, the Proposed Regulations provide that, for purposes of the section 385 regulations, all members of a US consolidated group are treated as a single corporation. Consequently, neither the Documentation Requirements nor the other provisions of the Proposed Regulations (such as the General Rule, the Part Stock Rule, an the Funding Rule) apply to obligations running exclusively

[6] For example, it would be shocking if the Funding Rule applied to ordinary course deposits in a cash pooling arrangement. How many multinationals are going to be able to monitor how the deposited cash is used and whether the withdrawing pool participants makes any distributions or stock acquisitions within the 72-month window period?

[7] The group would be well-advised to consult the other income provisions of the relevant U.S. tax treaty, however, to ensure that the guarantee payment is not subject to gross-basis withholding.

[8] In addition, subsidiary E&P bubbles up to the parent anyway under Treas. Reg. §1.1502-33.

between members of a consolidated group (including "intercompany obligations" within the meaning of Treas. Reg. §1.1502-13(g)(2)(ii)). Moreover, other intercompany transactions are disregarded for purposes of applying the Funding Rule. So, for example, if a foreign parent loans money to a US subsidiary member of a consolidated group, the distribution by that subsidiary member to its consolidated group parent is not considered a tainted transaction that triggers the application of the Funding Rule. However, if another member of the consolidated group makes a distribution outside the group to a member of the expanded group (*e.g.*, a foreign subsidiary of the foreign parent that made the loan), treating the consolidated group as a single corporation violates the Funding Rule. Also, "[i]f an applicable instrument ceases to be an intercompany obligation and, as a result, becomes an EGI, the applicable instrument is treated as becoming an EGI immediately after it ceases to be an intercompany obligation."

In addition to the foregoing, Prop. Treas. Reg. §1.385-4 contains the following rules regarding consolidated groups:

- If a member leaves a consolidated group but continues to be a member of the expanded group, any debt instrument issued or held by the departing member is treated as exchanged for stock immediately after the member's departure where the only reason the instrument was not previously treated as stock under Prop. Treas. Reg. §1.385-3 (the General Rule and the Funding Rule) was due to the characterization of members of a consolidated group as a single corporation under Prop. Treas. Reg. §1.385-1(e). Such instruments are called "exempt consolidated group debt instruments."

- Any other obligation (a "non-exempt consolidated group debt instrument") issued or held by such a departing member is treated as stock if and when the instrument becomes a PPDI due to a "distribution or acquisition" occurring after the member's departure.

- If a member holding a consolidated group debt instrument transfers the instrument to an expanded group member that is not a member of the consolidated group, the instrument is treated as issued by a single corporation (that includes the transferor and issuer of the instrument) to the expanded group transferee member, and if the instrument is treated as stock under Prop. Treas. Reg. § 1.385-3 (the General Rule and the Funding Rule), then it is treated as exchanged for stock immediately after the transfer.

- Finally, if a debt instrument treated as stock becomes a consolidated group debt instrument, the expanded group transferor is deemed to exchange the stock for debt immediately before the transfer in a transaction that is disregarded for purposes of Prop. Treas. Reg. §1.385-3(b).

The foregoing rules apply in addition to the consolidated intercompany transaction regulations addressing the consequences of obligations that become, or cease to be, "intercompany obligations" within the meaning of Treas. Reg. §1.1502-13(g)(3)(i)(A)(2). Under the consolidated return rules, an obligation that becomes or ceases to be an intercompany obligation generally is treated as being satisfied and reissued (a "DSR") immediately after it becomes, or immediately before it ceases to be, an intercompany obligation. Significant questions arise as to how the Proposed Regulations interact with the consolidated return rules requiring a DSR with respect to such intercompany obligations. For example, Treas. Reg.

§1.1503-13(g)(5) generally treats a non-intercompany obligation that becomes an intercompany obligation as subject to a DSR immediately after it becomes an intercompany obligation. Suppose a non-consolidated member of an expanded group transfers an EGI issued by a consolidated member of the expanded group, recast as stock under the General Rule or Funding Rule (but respected as debt under general tax principles), to another expanded group member that is also a member of the EGI issuer's consolidated group. In such a case the Proposed Regulations treat the EGI as converted into true debt immediately before the transaction in order to permit the occurrence of a DSR with respect to the obligation immediately after it becomes an intercompany obligation. Does this mean that neither the General Rule nor the Funding Rule can apply to any debt instrument issued by the consolidated group member acquiring the EGI because the EGI is no longer viewed as stock?

Partnerships and Disregarded Entities

The Proposed Regulations are arbitrary in how they address disregarded entities and partnerships. Specifically, the Documentation Requirements adopt an entity approach and provide that, if a disregarded entity or a partnership issues an EGI that fails to comply with the Documentation Requirements or satisfies those requirements but is recast (in whole or in part) as equity under general tax principles, the disregarded entity or partnership will be deemed to issue equity to the holder. This could have some rather profoundly negative consequences. In the case of a disregarded entity it could mean that any transactions between the disregarded entity and its owner "spring" into existence when the disregarded entity converts into a partnership. This conversion could in turn produce deemed sale or liability assumption transactions the taxpayer did not anticipate. In the case of a pre-existing partnership, the deemed issuance of equity could have consequences under section 108(e)(8) (if the loan is originally respected and only subsequently recharacterized) or section 752 (if the entry of a new partner causes liabilities to shift).

The General Rule and the Funding Rule, on the other hand, take an opposite and "aggregate" approach for both partnerships and disregarded entities. If the General Rule or the Funding Rule applies to recast debt issued by a disregarded entity as stock, the owner of the disregarded entity is deemed to issue the relevant instrument and the corresponding equity interest, thereby preserving the disregarded entity's disregarded status. Similarly, if a partnership issues debt that is recharacterized under the General Rule or the Funding Rule, the partners (rather the partnership) are treated as issuing the equity in proportion to their profits and capital interests in the partnership, thereby avoiding the creation of a new interest and partner in the partnership.

Surprisingly, the Part Stock Rules do not specify what happens when a disregarded entity or partnership issues debt that is only partially recast.

Validity

The Proposed Regulations would exercise the grant of authority provided under section 385. Section 385(a) authorizes Treasury and the IRS "to prescribe such regulations as may be necessary or appropriate to determine whether an interest in a corporation is to be treated for purposes of this title as stock or indebtedness (or as in part stock and in part indebtedness)." This seemingly broad rulemaking authority is subject to one very important limitation found in section 385(b): regulations promulgated under section 385 must set forth factors for purposes of analyzing and determining whether an instrument is to be characterized as debt

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or equity for US tax purposes. This requirement is clear on the face of the statute; indeed, section 385(b) offers several factors which Treasury and the IRS may consider (but need not necessarily include) in promulgating regulations. Thus, the clear implication from the form and language of the statute and its legislative history is that Congress intended that the government should promulgate regulations generally applicable to all interests in corporations that provide uniform standards for determining whether, or the extent to which, such interests are properly viewed as debt or equity for federal income tax purposes, and there is no indication in the statute or its legislative history that the statute was intended to provide the government with a weapon to combat transactions the government finds "abusive." Interestingly, the Preamble to the Proposed Regulations affirmatively cites some of the cases where courts have used different factors and / or reached seemingly inconsistent results as support for the need to provide guidance in this area.

Despite the apparent purpose of the statute and the Preamble, the Proposed Regulations do not consider any of the factors enumerated in section 385(b) and, importantly, *do not set forth any factors at all*. Instead, in addition to the Documentation Requirements (which contain no standards for characterizing an instrument as debt or equity), they simply create *per se* rules establishing situations in which purported debt instruments will be treated as stock, irrespective of how the instruments would have been treated under common law and irrespective of whether the instrument would be characterized as debt had it been issued in a transaction not described in the General Rule or Funding Rule. Moreover, the Funding Rule may recast an instrument as equity without any regard for how the instrument would be characterized under general principles due to Treasury's discomfort with another transaction that may be completely separate and occur up to 36 months before or after the intercompany debt is issued. In addition, the Anti-Affirmative Use Rule both allows the IRS to avoid applying the *per se* rules when doing so provides a federal income tax benefit and clearly demonstrates that the *per se* rules are result-oriented proscriptions having absolutely nothing to do with whether the instrument recast under the rules would qualify as debt under a rational debt characterization system. As a result, the Proposed Regulations are vulnerable to challenge as having exceeded their statutory authority under section 385.

Perhaps anticipating such a challenge, the Preamble cites to legislative history explaining that the regulations need not rely on the factors listed in section 385(b), as if such language justifies a regulation presenting no factors at all (one might call this, at best, a “leap of logic”). *Ipso facto*, Treasury and the IRS conclude that section 385 supplies the requisite authority and discretion "to establish specific rules for determining whether an interest is treated as stock or indebtedness for federal tax purposes in a particular factual situation," apparently without the need for any factors. The Preamble explains that the transactions subject to the rules "raise significant policy concerns" and warrant recharacterizing the debt instrument as equity in such cases on the basis that the instrument "lacks meaningful non-tax significance." Such a position is not supported by the plain meaning of the statute, the legislative history, or even the IRS's own prior guidance.

Section 385(b) and the legislative history cited in the Preamble unequivocally require that the regulations "set forth factors," not *per se* rules. Had Congress intended for section 385 to dispense with a multi-factor analysis on the basis of "significant policy concerns" alone, it would have simply drafted the concurrent section 279 to deny the interest deduction for *all* debt used in corporate acquisitions or distributions. Interpreting section 385 as requiring a multi-factor

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analysis is not merely a pro-taxpayer view – it is a view once held by Treasury and the IRS in 1980 when they first proposed regulations under section 385. In the preamble to those proposed regulations, Treasury and the IRS explained that "the legislation requires the Secretary to set forth factors" and delimited the scope of their task between two "opposite extremes": (1) "list the relevant factors," or (2) "have a specific set of rules (based on the relevant factors)." In fact, Treasury and the IRS rejected calls from some commentators to adopt "purely mechanical formulas" devoid of the relevant debt-equity factors, which, in the view of Treasury and the IRS, would necessarily result in "oversimplification." Thus, Treasury and the IRS did not view their authorization as including—even at the "extreme"—the ability to prescribe blanket rules without considering debt-equity factors.

Finally, it is also no response for Treasury and the IRS to argue that the lack of "meaningful non-tax significance" for an instrument that otherwise meets the classic requirements for debt is a "factor." First, "non-tax significance" has not generally been an element of any debt-equity analysis under common law and is in fact contrary to the position of Congress that taxpayers—even related taxpayers—are free to choose whether to use debt or equity to finance their business, even if the choice is driven in part by the deductibility of the attendant interest expense. *Cf.* H.R. Rep. No. 111-443, at 296 (2010) (section 7701(o) not intended to alter the tax treatment of "certain basic business transactions . . . merely because the choice between meaningful economic alternatives is largely or entirely based on comparative tax advantages, including "the choice between capitalizing a business enterprise with debt or equity."). Moreover, even if "non-tax significance" was a relevant "factor," the proposed rules are not keyed off of the presence or absence of such significance as would be the case if it were actually a factor. Instead, ignoring basic section 482 principles, Treasury and the IRS simply assumed that certain related-party debt issuances *always* lack such significance, without allowing taxpayers to disprove this assumption in a particular case.

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