International Tax Watch

Treasury Releases Game Changing Code Sec. 385 Regulations

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I. Introduction

As long as the United States has had an income tax, there has been a difference between the way debt and equity issued by a corporation has been treated.[1] Equity and debt are just two different types of financial instruments that reside on either side of a continuum. Thus, it is not always easy to discern whether a particular legal document creates "equity" or "debt" in substance. In the early years of the corporate income tax, Congress made attempts to curtail the amount of debt a corporation could incur.[2] Yet, Congress did not define what the term "debt" meant.

Prior to 1969, it was solely up to the courts to distinguish between debt and equity. The last time the Supreme Court holistically[3] addressed whether an instrument should be classified as debt or equity was in *John Kelley Co.*[4] In *Kelley*, the Court reviewed an appeal of two different cases, *Kelley* and *Talbot Mills*, where the Tax Court was required to conclude that an instrument was either debt or equity. The cases reached the Supreme Court because each had similar facts, but the Tax Court and lower courts arrived at different conclusions in each. The Supreme Court affirmed the Tax Court's conclusion that the instruments at issue in *Kelley* were debt based on the fact that there was a promise to pay an annual amount, a priority for the instruments over common stock and a definite maturity date in the reasonably foreseeable future. The Supreme Court also affirmed the Tax Court's conclusion that the instruments in *Talbot Mills* were equity, highlighting the fact that the instruments possessed floating interest rates, and the fact that notes were only issued to shareholders in exchange for stock.[5] Unfortunately, the Supreme Court's decision did not contain a significant amount of analysis. As a result, the Courts of Appeal in a number of different circuits have each developed their own list of "factors" which they have relied on to distinguish debt from equity. The Ninth Circuit Court of Appeals, for example, has identified 11 factors to consider.[6] The Fifth Circuit has enumerated 13 factors,[7] and the Third Circuit has set forth 16 different factors that it considers relevant.[8] Although there is a significant amount of overlap, there are some important differences between the ways the various circuits approach a debt versus equity determination.[9]

In 1969, Congress enacted Code Sec. 385 to try to provide some guidance on the debt versus equity distinction. Code Sec. 385(a) authorizes the IRS to prescribe regulations to determine whether an interest in a corporation is to be treated as stock or indebtedness either in whole or in part. Explaining the need for guidance, the legislative history provides:

The Proposed regulations are truly sweeping in their breadth.

> The committee agrees with the House that in many cases the characteristics of an obligation issued in connection with a corporate acquisition make the interest in the corporation which it represents more nearly like a stockholders interest than a creditor's interest, even though the obligation is labeled as debt. In view of the increasing use of debt for corporate acquisition purposes and the fact that the substitution of debt for equity is most easily accomplished in this situation the committee also agrees with the House that it is appropriate to take action in this bill to provide rules for resolving, in a limited context, the **ambiguities and uncertainties** which have long existed in our tax law in distinguishing between a debt interest and then equity interest in a corporation.[10]

Code Sec. 385(b) provides that "the regulations proscribed under this section **shall** set forth factors which *are* to be taken into account" to distinguish debt from equity and then lists certain factors that the regulations should take into account in determining whether an advance constitutes debt or equity. Code Sec. 385(c) imposes a consistency requirement on the issuer and holder of an instrument. Specifically, if the issuer characterizes the instrument as debt then that classification is binding on the holder unless the holder notifies the issuer of the inconsistent treatment. Importantly, the consistency requirement only applies to the U.S. tax treatment. There is no prohibition on treating an instrument as equity for U.S. purposes and debt for another country's purposes (or *vice versa*).[11]

Since 1983, there have been no regulations implementing Code Sec. 385.[12] Instead, the IRS has issued guidance in the form of notices and revenue rulings, *etc*.[13]

On April 4, 2016, the government published new proposed regulations ("Proposed Regulations") that would, under certain conditions, recast debt as equity (either in whole or in part). Contrary to congressional intent, the Proposed Regulations do not seek to resolve the disagreements among the Courts of Appeal or provide a single methodology for distinguishing debt and equity. The regulations radically depart from the guidance the Congress directed the Treasury to issue and upend well-settled law. Consistent with Code Sec. 385(b), which provides that "the regulations shall set forth factors" to distinguish debt from equity, the legislative history provides that the regulations "are to set forth factors." [14] The statute in Code Sec. 385(b) then goes on to list examples of factors based on common law existing as of 1969. The Proposed Regulations do not even attempt to rationalize the various multi-factor tests created by the various Circuit Courts of Appeal. Instead, the Proposed Regulations explicitly acknowledge that taxpayers have to continue to make a debt-equity determination based on the conflicting case law that currently exists. In addition, taxpayers have to overlay the Proposed Regulations on top of the traditional debt-equity analysis they have always had to undertake using bright-line tests that have never been part of the case law. For this reason, certain aspects of the Proposed Regulations may be subject to an invalidity challenge. Depending on the recast, the regulations may also be subject to challenge under applicable treaties which prohibit withholding of tax on "interest" under the theory that terms in a treaty should have their ordinary and customary meanings.

The Proposed Regulations are truly sweeping in their breadth. As a brief example of the breadth of these rules, these regulations can even apply to short-term noninterest bearing debt[15] for which earnings stripping cannot possibly be a concern. Although issued primarily in response to political pressure to do "something" about the debt issued by domestic corporations as part of, or after, an inversion, the Proposed Regulations are not limited to inverted companies. This presumably reflects the government's concern that the U.S. treaty network is not working as it should and that debt, especially cross-border debt, is being treated too favorably relative to equity. Specifically, most of our treaties allow interest to be paid free of withholding tax. This concession is made on the assumption that the holder is paying full tax in their country. The United States is concerned that that assumption is not accurate in many cases, which is why they proposed modifications to the U.S. model treaty.[16] Negotiating and implementing those treaty modifications in all of the relevant jurisdictions may take decades, and the IRS apparently is unwilling to take the time to go through the long-standing and well-established procedures to make those changes. Hence, the Proposed Regulations attack the same problem but in a different way. Rather than imposing withholding tax, the

Proposed Regulations seek to recast the debt as equity.

Moreover, the Proposed Regulations are not limited to foreign-based multinationals lending money to the U.S. subsidiaries. They apply across the board to a wide range of plain vanilla nonabusive transactions that no one would have ever expected to be caught by inversion-related guidance. We can only assume that the Treasury and the IRS felt compelled to cast a wide net to avoid the impression that they were selectively targeting foreign multinationals. This may belie some concern on the part of the government that they are vulnerable to challenges under the nondiscrimination provisions of U.S. tax treaties.

The Proposed Regulations will likely prove to be game-changing for foreign-based multinationals (whether they inverted or not). For U.S.-based multinationals, unless the Proposed Regulations are substantially narrowed, they will impose significant compliance burdens on garden variety every day transactions that are not intended to generate material U.S. tax benefits. As we will illustrate with examples, some planning transactions will be curtailed or require the use of third-party debt and cash instead of intra-group notes.

Moreover, the rules will create significant uncertainty for all companies. This uncertainty arises because the Proposed Regulations have not fully addressed the knock-on effects of potential recasts that the regulations create. For example, the transfer pricing implications of converting a debt instrument into equity in a variety of ordinary course transactions have not been explained. Will the government not only recast the instrument but also insist that the yield be increased to reflect the fact that it is now equity instead of debt and so safe-harbors like the applicable federal rate no longer apply? Similarly, as will be noted below, the knock-on effects of recasting partnership debt as equity have also not been fully sorted.

At a high level, the Proposed Regulations impose a new documentation requirement ("Documentation Rule"), a partial recast rule ("Partial Recast Rule") and a set of *per se* recast rules ("*Per Se* Recast Rules"). In brief, if the Documentation Rules are not satisfied, an otherwise valid debt instrument will be considered equity. The documentation requirements only apply to a financial instrument issued on or after the date the Proposed Regulations are published as final in the Federal Register.[17] Thus, the Documentation Rules of the regulations are truly prospective.[18]

Even if the Documentation Rules are satisfied, however, the Partial Recast Rule makes it clear that the IRS has the ability to recast a single advance "in part" as equity and leave the remaining instrument regarded as debt. Importantly, the Proposed Regulations do not address the correlative effects of the recast. Stated differently, they do not address what happens when a partially recast debt is subsequently repaid, or how cash payments should be allocated between the debt and equity pieces. The Partial Recast Rule also is truly prospective, like the Documentation Rule, in that it applies to instruments issued after the Proposed Regulations are finalized.

The *Per Se* Recast Rules, on the other hand, represent a significant and radical departure from existing law. The *Per Se* Recast Rules recast instruments that would otherwise be considered debt under common law into equity in certain situations based on the reason the debt was issued, without any regard to how these instruments would be characterized under the traditional common law factors. Despite the fact that the *Per Se* Recast Rules represent the most significant departure from existing law, the *Per Se* Recast Rules are not entirely prospective. Instead, the *Per Se* Recast Rules apply to any financial instrument issued on or after April 4, 2016.[19] This appears to include instruments that were issued *before* April 4, 2016, but significantly modified (or deemed to be issued due to a check the box election) within the meaning of Reg. §1.1001-3 on or after April 4, 2016.[20] Thus, for example, an instrument issued before April 4, 2016, but significantly modified after April 4, 2016, would likely escape the application of the General Rule (described below) but could nevertheless still be caught by the Funding Rule (which we also describe below). In the event the *Per Se* Recast Rules would apply to treat those instruments as equity, the instruments can continue to be treated as debt from the date they are issued until 90 days after the date the Proposed Regulations are finalized.[21] At that point, if they have not been repaid, they are recast. Hence, it is very important for taxpayers to consider the implications of these regulations on their existing debt *now*.

In this column, we hope to provide an overview of the regulations and outline planning options that taxpayers should begin thinking about.

II. Overview of the Proposed Regulations

This section provides a broad overview of the Proposed Regulations. We (i) review the scope of the regulations; (ii) address the *Per Se* Recast Rules; (iii) address the Documentation Rules; and (iv) address what happens when an instrument becomes or ceases to be subject to the Proposed Regulations.

A. The Scope of the Proposed Regulations

The Proposed Regulations only apply to related party debt instruments. Curiously, the Documentation Rules, Partial

Recast Rules and the *Per Se* Recast Rules use somewhat different nomenclature to reach that conclusion. Thus, it is important address each set of rules separately, as each has a different scope.

1. The Expanded Group

The Documentation Rule and the *Per Se* Recast Rules rely on the term "Expanded Group" to define the parties within the related group. The Expanded Group is defined broadly by reference to the rules for determining members of an affiliated group under Code Sec. 1504, but with some key modifications.[22] For example, the entities that are typically excluded from joining in a consolidated return filing such as S corporations, tax-exempt corporations or foreign corporations are included for this purpose.[23] Moreover, the ownership threshold is revised downward to include ownership of 80 percent of voting power *or* value (not voting power *and* value).[24] Indirect ownership counts in determining whether the 80-percent chain of ownership test is satisfied.[25] The constructive ownership rules of Code Sec. 304(c)(3) apply in determining indirect ownership, which means a shareholder of a corporation is considered to own stock owned by that subsidiary even if the shareholder only owns five percent or more of that subsidiary.[26] By cross-referencing the Code Sec. 1504 rules, the Expanded Group definition appears, at first blush, to be limited to corporations. But the regulations expand it to include partnerships. A Controlled Partnership is considered a member of an Expanded Group.[27] The term "Controlled Partnership" means a partnership where at least 80 percent of the capital or profits are owned, directly or indirectly by one or more members of an Expanded Group.[28]

> **Example 1**. FP directly owns 79 percent of the equity interests in USP and directly owns 79 percent of the equity interests in USS1. FP is a foreign corporation. USP is a domestic partnership. USS1 is a domestic corporation. FP also owns a five-percent interest in FS, another foreign corporation. The remainder of FS is owned by the public. FS owns 20 percent of the equity interests in each of USP and USS1. Each of FP, USP and USS1 would be considered constituent members of an Expanded Group.

Importantly, the Expanded Group definition does not include individuals. It also does not include widely owned partnerships that own U.S. corporations. Thus, typical related party loans from private equity and hedge funds to U.S. companies they own and control will likely be exempted from the Documentation and *Per Se* Recast Rules, but not the Partial Recast Rule described below.

Nevertheless, all three sets of rules can potentially apply to recast debt issued by partnerships. To the extent they do, the rules would appear to fall far outside of the congressional mandate. After all, Code Sec. 385(a) states that the, "Secretary is authorized to prescribe such regulations as may be necessary or appropriate to determine whether an interest *in a corporation* is to be treated for purposes of this title as stock or indebtedness."[29] Thus, the Code's plain language would appear to preclude the application of the section 385 regulations to partnerships. Time will tell if this will be a successful ground for challenge.

2. Scope of the Documentation Rule

The Documentation Rules, at present, only apply to "Applicable Instruments" that are "Expanded Group Instruments" or EGIs. An "Applicable Instrument" is any instrument issued in the "form" of a debt instrument.[30] The regulations reserve on other types of instruments. The regulations do not specify what they mean by the "form" of a debt instrument. The preamble says, "The documentation and other rules in proposed §1.385-2(b) are tailored to arrangements that in form are traditional debt instruments and do not address other arrangements that may be treated as indebtedness under general federal tax principles."[31] Presumably, a sale of property followed by a lease-back of the same property for the property's useful life, although considered debt that generates an interest deduction for U.S. tax purposes, would not be considered to be debt "in form." Similarly, a contingent earn-out payment that could give rise to interest deductions under Code Sec. 483 would be excluded. As such, the instrument would not be an Applicable Instrument and would thus not subject to the Documentation Rules.

The Documentation Rules do not apply to all Applicable Instruments. Instead, the rules only apply to an Applicable Instrument that is an EGI. An EGI is any Applicable Instrument where the issuer and holder are members of an Expanded Group and therefore have a sufficient degree of relatedness to one another.[32]

The regulations exempt certain smaller companies from the application of the Documentation Rules. Specifically, documentation will only be required if one of three tests is satisfied:

(i) the stock of any member of the Expanded Group is traded on (or subject to the rules of) an established financial market within the meaning of Reg. §1.1092(d)-1(b);
(ii) on the date the purported debt instrument first becomes an EGI, total assets reflected on a financial

statement ("Applicable Financial Statement") exceed $100 million; or

(iii) on the date the purported debt instrument first becomes an EGI, total revenue on any Applicable Financial Statement exceeds $50 million.[33]

For this purpose, the term Applicable Financial Statement includes (i) a financial statement filed with the Securities and Exchange Commission; (ii) an audited financial statement; or (iii) a financial statement (other than a tax return) required to be provided to a federal, state or foreign government, if it shows any assets or revenue of any member of the Expanded Group and is filed within three years prior to the Applicable Instrument first becoming an EGI.[34]

Companies that issue debt or equity securities on a U.S. or foreign exchange would be caught by the statements referred to in (i) and (ii). Private companies can also be caught. An obvious trap for nonpublicly traded companies would be statutory filings that companies have to submit to foreign authorities with respect to their non-U.S. subsidiaries. Furthermore, private companies that create audited financials for lenders would appear to be within the scope of the rules.

What is unclear from the regulation, however, is whether the IRS can "add" up the separate statutory financial statements filed with respect to each subsidiary or, instead, whether the rule requires that "a" single Applicable Financial Statement reflect $100 million of assets or $50 million of revenue. Assume, for example, a U.S. corporation owns no assets other than stock of 10 foreign subsidiaries in 10 different foreign countries and each has $10 million of assets on their individual statutory balance sheets. If the former interpretation prevails, then the group will be subject to the Documentation Rule. Otherwise, they would be exempt.

Notwithstanding the foregoing, Applicable Instruments that are between two consolidated group members and, thus, intercompany obligations within the meaning of Reg. §1.1502-13(g)(2)(ii) are "treated as not outstanding" for purposes of the Documentation Rules as a consolidated group is generally treated as a single corporation for purposes of these rules.[35]

3. Scope of the Partial Recast Rule

As a preliminary matter, the IRS exercised the regulatory authority granted to them in Code Sec. 385(a) to provide that an EGI may be recast in whole or in part as equity. As Congress noted when it modified Code Sec. 385(a), "there has been a tendency by the courts to characterize an instrument entirely as debt or entirely as equity."[36] Typically, when courts have recast advances as equity in part, they have done so on a temporal basis. For example, when there were multiple advances over a period of time, they have treated earlier advances as debt and later advances as equity if made while the borrower's financial condition deteriorated.[37] Nevertheless, the courts have been reluctant to partially recast a single advance, at least in situations in which the instrument received by the creditor does not provide the creditor with an unlimited participation in the stock of, or one or more assets owned by, the debtor.[38] The IRS indicated in the preamble that, "This all-or-nothing approach is particularly problematic in cases where the facts and circumstances surrounding a purported debt instrument provide only slightly more support for characterization of the entire interest as indebtedness than for equity characterization, a situation that is increasingly common in the related-party context."[39] One troubling aspect of this Partial Recast Rule is that the IRS has not provided any guidelines for determining when and how it will apply this rule.

They apply across the board to a wide range of plain vanilla nonabusive transactions that no one would have ever expected to be caught by inversion-related guidance.

The Partial Recast Rule only applies to Applicable Instruments issued between related parties,[40] but the Proposed Regulations define related party more broadly in this context. Instead of limiting the rule to Applicable Instruments issued between members of the Expanded Group, the Partial Recast Rules apply to Applicable Instruments issued between members of the Modified Expanded Group.[41] The Proposed Regulations define the Modified Expanded Group by reference to the Expanded Group definition but with some very important changes. For example, the 80-percent ownership threshold is reduced to 50 percent. [42] In addition, individuals and other "persons" referred to in Code Sec. 7701(a) are included.[43] Moreover, the Modified Expanded Group includes Modified Controlled Partnerships.[44] A Modified Controlled Partnership is defined as any partnership where one or more members of the Modified Expanded Group own 50 percent or more of the capital or profits interests in the partnership.[45]

Example 2. Joe, a U.S. individual, owns 50 percent of the stock of USCO, a U.S. corporation. Joe makes a loan to USCO at a time when USCO's cash flow is declining, USCO is already overleveraged and USCO cannot obtain any additional loans from the bank and there are serious doubts that USCO will be able to repay more than half of the loan from Joe. The loan is an Applicable Instrument. Joe is a member of USCO's Modified Expanded Group. As such, the IRS can choose to assert that the loan is entirely equity or, alternatively, assert that half of the loan is equity under the Partial Recast Rule.

The key point here is that Joe, an individual, is part of the Modified Expanded Group.[46] The broader reach of the Modified Expanded Group definition will likely mean that the Partial Recast Rule will be applicable to many hedge funds and private equity funds even if they are organized as partnerships.

Example 3. PE Fund, a U.S. partnership owned by hundreds of individuals and funds, owns 50 percent of the stock of USCO, a U.S. corporation. PE Fund makes a loan to USCO at a time when USCO's cash flow is declining, USCO is already overleveraged. USCO cannot obtain any additional loans from the bank and there are serious doubts that USCO will be able to repay more than half of the loan from PE Fund. The loan is an Applicable Instrument. PE Fund is a member of USCO's Modified Expanded Group. As such, the IRS can choose to assert that the loan is entirely equity or, alternatively, assert that half of the loan is equity under the Partial Recast Rule.

4. Scope of the Per Se Recast Rules

Like the Documentation Rule, the *Per Se* Recast Rules only apply to instruments between Expanded Group members. The *Per Se* Recast Rules do not use the Applicable Instrument and EGI nomenclature, however. Instead, the *Per Se* Recast Rules apply to any instrument executed between Expanded Group members that would, but for the Proposed Regulations, be considered a debt instrument under Section 1275(a) of the Code.[47] Reg. §1.1275-1(d) defines a "debt instrument" as "any instrument or contractual arrangement that constitutes indebtedness under general principles of Federal income tax law (including, for example, a certificate of deposit or a loan)." The *Per Se* Recast Rules thus cast a wider net than the Documentation Rules. A sale-leaseback arrangement entered into on or after April 4, 2016, that is considered a loan in substance would presumably not be within the scope of the current version of the Documentation Regulations but would nevertheless be subject to the *Per Se* Recast Rules.

This does not mean that every transaction that generates interest deductions would be subject to the rule. For example, it is common in private acquisitions for the buyer to pay the seller an "earn-out" over and above a fixed purchase price. The earn-out is typically contingent on the performance of the acquired asset for a period of years post-closing. A portion of those payments may be considered "interest" and deductible to the purchaser under Section 483 of the Code even though the earn-out is not otherwise considered "indebtedness." Although these arrangements are not, as a general matter, within the scope of the *Per Se* Recast Rules, they can, however, be swept in under the Anti-Abuse Rule (described below) if they arise between two Expanded Group members.

The preamble refers to the instruments subject to the *Per Se* Recast Rules as Expanded Group Debt Instruments (or EGDIs).[48] As noted above, the *Per Se* Recast Rules also are not truly prospective (like the Documentation and Partial Recast Rules). They can apply to instruments issued (or deemed issued due to a significant modification) on or after April 4, 2016. Thus, an instrument the parties entered into long before April 4, 2016, that is deemed issued due to a check the box election or significant modification in interest rates would be subject to these rules.

B. The Documentation Rules

The Documentation Rules represent one of the more bizarre, and frankly unreasonable, requirements imposed by the Proposed Regulations. The stated rationale for this rule is that, not surprisingly, related parties do not undergo the same types of financial analysis when lending to each other that occurs between unrelated parties. This stems from the fact that the lender already has the requisite information about the lender to make an informed decision. Yet, according to the IRS:

> The absence of reasonable diligence by related-party lenders can have the effect of limiting the factual record that is available for additional scrutiny and thorough examination. Nonetheless, courts do not always require related parties to engage in reasonable financial analysis and legal documentation similar to that which business exigencies would incent third-parties in connection with lending to unrelated borrowers … .

> The lack of such guidance, combined with the sheer volume of financial records taxpayers produce in the ordinary course of business, makes it difficult to identify the documents that will ultimately be required to support such a characterization, particularly with respect to whether a reasonable expectation of repayment is present at the time an interest is issued.[49]

The IRS specifically cites to lack of information about the ability to repay. This justification is just odd. Once the IRS asserts a deficiency, the burden of proof is on taxpayers. Debt-equity cases are no different. One would think that if taxpayers could not prove that the borrower has the ability to repay indebtedness to a related party at the time the loan was advanced then it would be quite easy for the IRS to successfully challenge the taxpayer's treatment of the advance as debt. If anything, establishing a documentation standard is only likely to help taxpayers by establishing what will likely become viewed as a checklist that, once completed, demonstrates they acted like an independent creditor.

Importantly, the documentation requirement is a threshold requirement for debt characterization and does not establish a safe-harbor.[50] The preamble states:

> Satisfaction of the requirements of the proposed regulations does not establish that a related-party instrument is indebtedness. Rather, satisfaction of the proposed regulations acts as a threshold test for allowing the possibility of indebtedness treatment after the determination of an instrument's character is made under federal tax principles developed under applicable case law. If the requirements of the proposed regulations are not satisfied, the purported indebtedness would be recharacterized as stock.[51]

The sheer breadth of these rules renders them unreasonable. They apply, for example, even to noninterest bearing debt for which there could not possibly be an abuse. Presumably even accounts payable for the acquisition of goods or services in the ordinary course of business are subject to this rule. We fail to see how these types of transactions present any possible abuse. This will likely be one factor asserted by taxpayers in asserting that the regulations are arbitrary, capricious and unreasonable. Interestingly, the Proposed Regulations do contain an exception from the 72-month Window Period (described below) for ordinary course trade payables, but the Documentation Rules do not contain a similar exception.

The regulations require four types of documentation.[52] We describe each type below.

1. Taxpayer Must Document the Unconditional Obligation to Pay a Sum Certain

The regulations require a written agreement[53] prepared within 30 days of the date that a member of the Expanded Group becomes an issuer of an EGI.[54] If an Applicable Instrument is issued and then becomes an EGI on a subsequent date, the 30-day period begins when the Applicable Instrument becomes an EGI. The written agreement must document the borrower's unconditional obligation to pay a sum certain to the lender at a date (or dates) certain. Importantly, the 30-day period ignores any subsequent deemed issuance under the material modification rules in Reg. §1.1001-3. The 30-day period is out of step with other recent guidance such as the cost-sharing rules, which allow a 60-day time period for providing contemporaneous documentation.[55] But it is unclear why the government needs this information any time prior to the filing of a tax return.

> **Example 4.** FP, a foreign corporation, owns all of the stock of USCO, a U.S. corporation. FP loans $100 million to USCO on January 1, 2018. FP and USCO must have a written agreement evidencing USCO's obligation to pay a sum certain by January 31, 2018. If there is a significant modification (*i.e.*, a change in obligor) of the obligation on June 30, 2018, there is no new obligation to revise the written agreement, however.[56]

The regulations provide a special rule for revolving credit agreements and open account indebtedness.[57] For these types of arrangements, the credit agreement or the board of directors resolutions will suffice as documentation.[58] The documentation must be prepared within 30 days of the execution of the documents or any amendment to those documents permitting an increase in the maximum amount of principal.[59]

The regulations also provide a special rule for cash pooling arrangements.[60] In this case, the Documentation standard will be satisfied if the documents governing the operation of the cash pool are obtained within 30 days of their execution or amendment. The regulations do not distinguish between physical and notional pools, but there is a big difference between these two types of common cash pooling arrangements. In a notional pooling arrangement, there is a third-party bank interposed between the depositing members and the withdrawing members. The bank typically absorbs and hedges all foreign currency risks associated with the different deposits

and withdrawals, not an Expanded Group member. It is not abundantly clear from the regulations that they were intended to target notional pooling structures as well. Subsequent statements by Treasury personnel indicate that they really do not understand what cash-pooling entails.[61] For reasons we discuss more below, the *Per Se* Recast Rules, unless they are substantially changed, will likely substantially reduce the ability of taxpayers to engage in cross-border cash pooling structures. This is unfortunate, especially since cash-pooling structures are not driven by tax departments. They are driven by the Treasury groups within large multinationals to centralize foreign currency risk, have one entity enter into hedges of that risk with banks and invest the aggregated cash in one or possibly two currencies at higher yields than would normally be available if every company invested by itself.

This rule will likely prove very daunting for many multinationals who extend credit to one another without any specific loan agreement, credit facility or even board resolution. In other words, it is often the case that intercompany accounts between related companies can be created under the authority of a corporate officer without resort to a board resolution. Again, it is important to stress that even routine, noninterest bearing intercompany accounts can be caught by this rule.

2. Taxpayer Must Document Creditor's Rights

The written agreement must establish that the creditor has rights to enforce the obligation.[62] The Proposed Regulations do not mandate a list of creditor's rights. Instead, the regulations simply provide that the creditor must be superior to equity holders in the case of liquidation. They cannot rank *pari passu* with shareholders. The regulations suggest (but do not mandate) that the creditor have the right to trigger an event of default or acceleration upon the nonpayment of interest or principal when due.[63]

Taxpayers, however, should not automatically assume that infusing a debt instrument with myriad creditor's rights will be beneficial. The Proposed Regulations do not alter case law in this regard. Whatever creditor's rights were acceptable before ought to be acceptable now. They just need to be contained within the four corners of the written loan document.

Instead, taxpayers need to consider the ongoing documentation requirements described below. If a taxpayer drafts various credit protections in the instrument at issuance but then subsequently fails to adhere to the terms, the instrument may be subject to recast at a later date. Indeed, we would generally advise taxpayers to avoid inserting provisions within their own agreements that create footfaults that could cause substantial trouble later under the on-going documentation requirements described below.

3. Taxpayer Must Document the Reasonable Expectation to Repay the EGI

The taxpayer must also prepare documentation evidencing the issuer's ability to repay the obligation as of the date of issuance.[64] Again, the Proposed Regulations do not mandate what that documentation includes but instead suggests that it could include cash flow projections, forecasts, appraisals, debt-to-equity ratios and other ratios as compared to industry averages.[65]

The regulations do insist that, "If any member of an expanded group relied on any report or analysis prepared by a third party in analyzing whether the issuer would be able to meet its obligations pursuant to the terms of the EGI, the documentation must include the report or analysis."[66] The regulations provide that if the taxpayer asserts that the documentation is privileged, then the contents of the report cannot be taken into account in satisfying the documentation requirement.[67]

Taxpayers must prepare this documentation within 30 days of the date the debt is issued if the instrument is an EGI on that date.[68] If an Applicable Instrument is not an EGI on the date of issuance, then the 30-day clock starts to tick when a member of the Expanded Group becomes an issuer of the EGI.[69]

Moreover, unlike the previously described documentation requirements, a new 30-day clock starts whenever there is a material modification triggering a deemed reissuance under Reg. §1.1001-3.[70]

> **Example 5.** FP, a foreign corporation, owns USS1, a domestic corporation. On January 1, 2017, FP loans money to USS1 at the applicable federal interest rate for five years pursuant to a documented loan. USS1 prepares all of the documentation required under the Documentation Rule. On January 1, 2020, FP and USS1 agree to extend the term for three years. The modification represents a significant modification within the meaning of Reg. §1.1001-3. As such, USS1 must prepare documentation evidencing why FP should have a reasonable expectation that USS1 will repay the loan.

4. Taxpayer Must Document Ongoing Debtor-Creditor Relationship

Lastly, the taxpayer must prepare documentation evidencing a debtor-creditor relationship.[71] The regulations indicate that this documentation should, at a minimum, include documents evidencing payment of interest or principal, which support the taxpayer's treatment. This

evidence could include wire transfers or bank statements.[72] Presumably, it could also include book entries if the loan is not paid in cash but instead *via* offset against other amounts owed to the debtor. Unfortunately, this conclusion is not certain. Without further guidance, some taxpayers in an abundance of caution may very reasonably choose to incur the costs of moving actual cash merely to document that the debtor is making is payments as they come due. Importantly, this documentation must be prepared and maintained within 120 days of the date the interest or principal *is due*, not 120 days from when it is paid.[73]

As noted above, it is not entirely clear why the IRS felt the need to reiterate that taxpayers need to keep records evidencing payment, given that the burden of proof is on the taxpayers in the first instance. The IRS presumably wants taxpayers and reviewing courts to continuously revisit the debt versus equity characterization of their instruments during their term. Yet, the rule recasting instruments as equity based on facts that arise long after the parties entered into the debt instrument is one of the many sharp departures from existing law. Under the case law, although courts sometimes use subsequent events to determine the original intent of the parties, the courts typically characterize an instrument as debt or equity based on the facts that existed at the time the parties entered into the instrument.[74]

Moreover, the regulations go further and actually require the taxpayer to ensure that the lender and borrower are engaging in the types of activities that an unrelated lender and borrower would engage in. Specifically, the regulations provide that if there is a failure to pay interest or principal or "any other event of default or similar event" there must be written documentation evidencing the holder's "reasonable exercise of the diligence and judgment of a creditor."[75] Again, the regulations do not provide a mandatory list, but instead provide illustrative examples such as evidence of the holder's efforts to renegotiate the EGI or to mitigate the breach of an obligation under the EGI, and evidence documenting the reason the lender refrained from actions to enforce payment.[76] The Documentation must be prepared within 120 days of each date on which an event of default, acceleration event or similar event occurs under the terms of the EGI.[77]

The important thing to keep in mind that the rule applies if there is a violation of the underlying agreement. Hence, it will behoove taxpayers to be careful when drafting their agreement to ensure that the interest and principal payment terms are crafted consistently with the taxpayer's anticipated conduct. If the taxpayer thinks it will more likely violate a quarterly interest payment rule than an annual payment rule, then the loan should not contain a quarterly interest payment requirement, *etc*. If the taxpayer believes it is more likely to violate an EBITDA ratio than a debt to equity ratio, the taxpayer should avoid drafting an EBITDA ratio. Accordingly, we would suggest that once the agreement satisfies the minimum standards for documentation, that the age-old proverb of "less is more" will be a good rule of thumb to follow.

5. Reasonable Cause Defense

If the taxpayer fails to comply with the Documentation requirements, the regulations contemplate that the taxpayer may be able to claim a reasonable cause defense.[78] The regulations specifically point to the standard established in Reg. §301.6724-1. The Preamble does not explain its reason for cross-referencing the reasonable cause standard established in Reg. §301.6724-1.[79] Other regulatory "reasonable cause" provisions do not make this cross reference[80] and Reg. §301.6724-1 itself limits its own application to a narrow set of circumstances.[81] The reasonable cause provisions of Reg. §301.6724-1 are longer and more complex than those provide in other regulations and perhaps that is the reason the choice was made to cross reference them.

6. Treatment of Disregarded Entities and Partnerships

If the Documentation Rule is flunked, the recast that applies to debt issued by partnerships and disregarded entities is different from the recast that applies under the *Per Se* Recast Rules. The reason for this distinction is not readily apparent. What is clear, however, is that the recast can have very serious knock-on effects.

As noted above, Controlled Partnerships are partnerships controlled by one or more members of the Expanded Group. If a Controlled Partnership issues an EGI and fails to satisfy the Documentation Rule, the EGI is treated as an equity interest in the Controlled Partnership.[82] This recast is very different from the recast that the Proposed Regulations impose when the *Per Se* Recast Rules apply (described below). Moreover, this recast could have potentially serious knock-on effects. For example, nonrecourse partnership liabilities can be inadvertently shifted from one partner to another under Code Sec. 752 creating Code Sec. 731 or Code Sec. 707 issues to the partners who have liabilities shifted away from them, if the EGI is initially viewed as a debt instrument and is subsequently recast. This could easily happen if the partnership initially complies with the Documentation Rule but there is a late payment in a subsequent year, and the partnership fails to create documentation evidencing a debtor-creditor relationship

as required by the Documentation Rule. Similarly, the deemed issuance of new equity to a new partner could wreak havoc with respect to existing partnership income and loss allocations.

The Documentation Rule's potential recast to debt issued by a disregarded entity under the Documentation Rule can be even more dire. The Documentation Rule provides that if a disregarded entity issues an Applicable Instrument, the Applicable Instrument is an EGI and the EGI is characterized as equity under the Proposed Regulations (*i.e.*, because there is a failure to adequately document the loan), the regulations treat the EGI as equity issued by the disregarded entity.[83] As a result, the disregarded entity will become a partnership for U.S. tax purposes. Such an unexpected change in the classification of the entity can have dramatic and profound consequences for the parties. In this regard, taxpayers need to consider Rev. Rul. 99-5.[84]

> **Example 6.** FP, a foreign corporation, owns all of the outstanding shares of USS1. USS1 is a domestic corporation that, in turn, owns all of the outstanding membership interests of LLC, a domestic limited liability company whose default classification is a disregarded entity. LLC owns one appreciated asset (Asset A) with a basis of $0 and a value of $1 billion. LLC owes $100 million to FP pursuant to a loan bearing adequate stated interest. LLC also has an outstanding payable to USS1 of $500 million. LLC's payable to USS1 would normally be disregarded under general tax principles. If USS1 and LLC fail to adequately document the FP loan, however, the FP loan will be considered equity issued by LLC, causing LLC to spring into existence as a partnership. This has further unfavorable knock-on effects. As a preliminary matter, FP would be a partner in the LLC partnership and likely have to file a *U.S. income tax return* on 1120-F.[85] If FP fails to file the return, the statute of limitations will not start to run, and the IRS would be able to impose tax on allocable profits on a gross basis.[86] More damaging would be the fact that the LLC partnership would be deemed to issue a $500 million note to USS1 in exchange for Asset A which would likely trigger sizable gain.[87]

The foregoing example illustrates how the Documentation Rules can cause a partnership to suddenly spring into existence when the taxpayer never intended. This can have very bad consequences.

Importantly, the regulations also provide that if the shareholder of the disregarded entity has limited liability then only the disregarded entity's assets and liabilities are counted in determining its ability to repay the EGI.[88] Thus, in the foregoing example, only Asset A and the income it generates can be considered in determining whether there is a reasonable expectation of repayment of the payable owed to FP.

C. The *Per Se* Recast Rules

As noted above, the *Per Se* Recast Rules are broader than the Documentation Rule and apply to any "indebtedness" within the Expanded Group even if that indebtedness may not qualify as an Applicable Instrument. The Proposed Regulations refer to this as an Expanded Group Debt Instrument or EGDI.

The game-changing feature of the *Per Se* Recast Rules is that they seek to convert debt into equity based solely on the rationale for which the debt was created. Stated differently, even if a purported debt instrument has *all* of the indicia of debt that one could possibly want under common law, the Proposed Regulations nevertheless recast the debt as equity if it was created for what the IRS deemed to be an invalid purpose.

As will be demonstrated below, these recasts appear to "right" some of the "wrongs" the government perceives (correctly or incorrectly) in our present system of taxation. In doing so, the government is effectively using regulations to trump the results that are clearly mandated under case law and other Code provisions. Moreover, the *Per Se* Recast Rules convert debt to equity based on facts that have never been relevant to the courts in determining the true character of an instrument. As explained below, the Funding Rule goes even farther and potentially recasts debt as equity even if it is clearly debt under the common law indicia based on a factually unrelated transaction occurring up to 36 months before or after the parties entered into the debt instrument. Accordingly, there are serious unresolved questions about the validity of these rules. We note that the legislative history to Code Sec. 385 provides:

> Under our tax structure, an interest deduction is properly disallowed only if the underlying obligation constitutes equity rather than debt we therefore consider the first section of H.R. 7489 pending before you does not adequately address itself to this basic question. The Treasury is presently seeking to develop rules or regulation that will aid in distinguishing debt from equity and disallow the interest deduction where the interest payments represent, *in substance*, a return on equity.[89]

Put another way, Congress directed the IRS in Code Sec. 385 to set forth factors to determine the underlying substance of an instrument so that there would be some uniformity in how the courts and the IRS address debt equity issues. It is not readily apparent how this grant of authority allows the IRS to set forth rules that fail to set forth any factors and disregard the underlying substance of the instrument.

There are three distinct sub-rules that create a recast: (i) the General Rule; (ii) the Funding Rule; and (iii) the Anti-Abuse Rule. We sometimes refer to these rules collectively as the "*Per Se* Recast Rules" and we address each individually below.

1. The General Rule

The General Rule applies to recast an EGDI in three scenarios. The three scenarios involve situations where the debt is created pursuant to (i) a distribution; (ii) an acquisition of stock of an Expanded Group member; or (iii) in exchange for any property[90] pursuant to an asset reorganization if the shareholder of the target that receives the debt instrument is a member of the issuer's Expanded Group *before* the transaction occurs.[91] We address each possibility below.

a. Distribution of Debt Instrument. The Preamble to the Proposed Regulations makes clear that the IRS wished to overrule the result reached by the Second Circuit Court of Appeal in *Kraft Foods Co.* In this case, a subsidiary issued its own notes to its shareholder-parent.[92] The subsidiary was profitable and the parent had losses. The notes were issued during a brief period when the tax laws did not permit the filing of consolidated returns. Thus, the note was apparently issued to reduce the tax burden on the subsidiary and synthetically achieve some of the benefits of consolidation even though the law did not allow consolidation at that time. The IRS sought to challenge the issuance of the notes citing the tax-avoidance motive and the lack of a nontax rationale. The IRS lost, and taxpayers have since relied on the holding to argue that a corporation can create a related party debt instrument by issuing a note to its shareholder and that a business purpose is not required to issue a debt instrument. The IRS does not like this holding and thus seeks to reverse it in the Proposed Regulations. The IRS went so far in the preamble to quote from the dissenting opinion in this 1956 decision.[93]

> **Example 7.** FP is a public company organized under the laws of the United Kingdom. FP wholly owns USS1, a domestic corporation. USS1 has capacity to borrow additional monies from FP under Section 163(j) of the Code but has no need for additional cash to expand its business. So, USS1 issues an interest bearing note to FP. USS1 claims deductions on the note at the U.S. rate and FP recognizes the interest income at its rate which is almost 20 percent points lower.

Historically, the interest-bearing note could be considered debt. But now, the debt instrument is considered equity issued by USS1 to FP under the Proposed Regulations because it was created as a result of a distribution.

At the shareholder level, the distribution should be tax-free under Code Sec. 305(a) unless one of the exceptions in Code Sec. 305(b) were to apply. Importantly, the fact that the distributed debt instrument is considered equity means that it cannot be considered a distribution of "property." It is not a distribution of property because Code Sec. 317 provides that when a corporation issues its own stock that stock cannot be property to it. That also means that any other loans made to USS1 should not run afoul of the Funding Rule (described below), provided the only tainted transaction engaged in is the distribution of the corporation's own note.

> **Example 8.**[94] FP owns all of the stock of FS and USS1. FP and FS are foreign corporations. USS1 is a domestic corporation. On Date A in Year 1, FS lends $100x to USS1 in exchange for a note—"USS1 Note A." On Date B in Year 2, USS1 issues another note "USS1 Note B," which has a value of $100x, to FP in a distribution. USS1 Note B is a debt instrument that is issued by USS1 to FP, a member of USS1's Expanded Group, in a distribution. Accordingly, USS1 Note B is treated as stock under the General Rule form the date it is issued on Date B in Year 2. Accordingly, USS1 is treated as distributing USS1 stock to its shareholder FP in a distribution that is subject to Code Sec. 305.

It is relevant to point out that the USS1 Note B is not treated as "property" because the note is considered equity under the General Rule. USS1's "equity" is not "property" to USS1 under Code Sec. 317. Thus, even though USS1 Note A was issued within a year of the distribution, the distribution was not a distribution of "property" and so USS1 Note A should not be recast under the Funding Rule and 72-month Window Period which we describe below.

The rule is not limited to foreign multinationals with U.S. operations, however. The preamble to the Proposed Regulations makes clear that the government also wanted to target certain repatriation transactions U.S. multinationals execute under current law.[95] Specifically, the government apparently wanted to attack certain transactions that rely on *M. Falkoff*.[96] *Falkoff* is another case

the government is not particularly fond of. In that case, a domestic partnership owned a domestic corporation which had no earnings and profits. The domestic corporation owned a domestic subsidiary that did have earnings and profits. The domestic corporation borrowed money from a bank and distributed the borrowed proceeds to its partnership/shareholder near the end of the year. The shareholder did not recognize any income, however, as the partnership had sufficient basis in the corporation to treat the distribution as a tax-deferred return of basis transaction under Code Sec. 301(c)(2). The corporation subsequently received dividends from its subsidiary in a later year, which it used to repay the bank. The IRS argued that the partnership/shareholder should be taxed as if it had received the proceeds in the following year when the corporation had received its subsidiary's earnings. The Seventh Circuit Court of Appeals refused to defer the transaction and held that the partnership had indeed received the distribution when the cash was distributed.

Due to the effective date provisions of the Per Se *Recast Rules and the government's intention to finalize the regulations this year, taxpayers need to pay attention to these rules immediately.*

The court in *Falkoff* correctly noted that there is nothing untoward about being able to receive a tax-free return of basis stating:

> The situation here is an unusual one—a corporation without accrued or current earnings and profits but with substantial assets against which it can borrow to make a cash distribution to its shareholders. Yet, even here the effect is only to delay, not escape, taxation. A distribution reduces a shareholder's basis in his shares and thereby increases taxable gain upon disposition of the stock. The Corporation's future earnings and profits will be taxed as dividends when distributed.[97]

Nevertheless, the government is hostile to this ruling because it allows taxpayers to effectively obtain a tax-free return of basis before having exhausted every dollar of earnings and profits (E & P) in their structures. One would not normally consider using a tax attribute (*i.e.*, basis) as abusive, but apparently the IRS does.

The *Per Se* Recast Rules would make this planning more difficult going forward, but certainly not impossible.

> **Example 9.** USS1 is a domestic corporation that owns all of the stock of CFC1. CFC1 owns all of the stock of CFC2. CFC1 and CFC2 are both controlled foreign corporations. CFC1 has no E & P. CFC2 has significant E & P. USS1 has a $1 billion of stock basis in CFC1. CFC1 distributes its own $1 billion note to USS1. Due to the absence of CFC1's E & P, USS1 would normally report the distribution as a tax-free return of capital. In the following year, CFC2 could distribute a dividend to CFC1, and CFC1 could use the cash to repay the note owing to USS1. Under the General Rule, however, CFC1's distribution of its own note would be considered a distribution of its own equity and cause USS1 to receive a tax-free stock dividend under Code Sec. 305. If CFC2 distributes a dividend in the following year, CFC1 would not have any way to remit that cash to USS1 without causing USS1 to pay tax.

Importantly, the rules do not preclude taxpayers from engaging in an economically identical transaction. They just make it harder. Specifically, nothing would prevent CFC1 from borrowing from a bank, distributing cash to USS1, allowing USS1 to repay third-party debt that it has, wait until a new tax year begins, and have CFC2 distribute a dividend to CFC1 in the following year so CFC1 can repay its loan. This alternative transaction accomplishes the same result but avoids the use of an EGDI. Hence, it is not subject to the Proposed Regulations.[98]

The rules provide that a distribution by an Expanded Group member of a loan receivable owing from another Expanded Group member is not considered a distribution of property that would trigger application of the General Rule, however.

> **Example 10.**[99] FP owns all of the stock of FS and USS1. USS1 owns all of the stock of CFC. FP, FS and CFC are foreign corporations, and CFC is a controlled foreign corporation. USS1 is a domestic corporation. On Date A in Year 1, CFC lends $100x to FS in exchange for FS Note. On Date B in Year 2, CFC distributes FS Note to USS1. Although CFC distributes FS Note, which is a debt instrument, to USS1, another member of CFC's expanded group, the General Rule does not apply because CFC is not the issuer of the FS Note.

That does not necessarily mean that CFC's distribution would not be problematic under the Funding Rule,

however, which we discuss below. On the contrary, in many cases, the note would be recast as equity under the Funding Rule solely because FS issued the note to USS1 too close in time to the property distribution, which is one of the "tainted transactions" described in the Funding Rule.

b. EGI Issued for Stock of an Expanded Group Member. The IRS has long lamented their distaste for the fact that foreign-based multinationals can sell affiliates to U.S. companies in taxable transactions or in tax-free reorganizations in ways that increase the debt burden of U.S. companies while avoiding applicable U.S. withholding tax.[100]

Example 11. FP, a U.K. publicly traded company, owns all of the shares of USS1 and USS2, both of which are U.S. corporate subsidiaries. FP sells the shares of USS1 to USS2 for a note. The transaction is treated as a Code Sec. 304 transaction, and each of USS1 and USS2 are deemed to have distributed dividends to FP as a result. No dividend withholding tax applies under the U.S.-U.K. income tax treaty, however. USS2 enjoys increased interest deductions going forward, subject to common law, Code Secs. 163(j) and 267(a)(3) limitations.

Alternatively, when the applicable treaty does not call off the dividend withholding tax, taxpayers were able to structure the transaction as an all-cash Code Sec. 368(a)(1)(D) reorganization to infuse debt without triggering withholding tax.

Example 12. FP, a Spanish publicly traded company, owns all of the shares of USCO1 and USCO2, both of which are U.S. corporate subsidiaries. FP recently acquired USCO1 and so has a basis equal to the value of the shares. FP knows that if it sells USCO1 to USCO2 for a note, Code Sec. 304 will apply, a deemed dividend will result, and withholding tax will apply. So, to avoid withholding tax, FP sells USCO1 to USCO2 for a note and then causes USCO1 to merge upstream into USCO2. The transaction is viewed as a Code Sec. 368(a)(1)(D) reorganization. No dividend withholding tax applies because FP realizes no gain and so has no "dividend" under the boot-within-gain limitation rule in Code Sec. 356. USCO2 enjoys increased interest deductions going forward, subject to common law, Code Sec. 163(j), and Code Sec. 267(a)(3) limitations.

The General Rule would shut down both transactions by treating the debt issued in each transaction as equity.[101]

The regulations also cover transactions where shares are not acquired in form. Quite often, stock is not actually issued or transferred in intercompany property transfers because issuing stock would be a meaningless gesture. For example, when a corporation owns all of the outstanding stock of a subsidiary, the contribution of property by the corporation to the subsidiary can be a Code Sec. 351 transaction without regard to whether the subsidiary issues any stock. The regulations clarify that in those cases, the General Rule can still apply.

Example 13.[102] FP, a foreign corporation, owns all of the stock of USS1 and USS2, both domestic corporations. USS2 owns 100 percent of the stock of DS2, a domestic corporation. On Date B in Year 1, FP issues FP stock and an FP Note to USS1 as a contribution to capital. USS1 does not formally issue additional USS1 stock to FP in exchange for the FP stock and FP Note. Immediately afterward, USS1 transfers the FP stock and FP Note to DS2 in exchange for all of DS2's assets, and DS2 distributes the FP stock and FP Note to USS2 with respect to USS2's DS2 stock in a liquidating distribution.

Although USS1 does not actually issue shares for the FP Note, the FP Note is deemed issued by FP to USS1 in exchange for stock of USS1, a member of the Expanded Group. Thus, the General Rule treats the FP Note as stock beginning on Date B in Year 1.

The regulations also have the effect of shutting down the technique used to create intercompany debt in most inversion transactions.

Example 14.[103] FP, a foreign corporation, owns all of the stock of USS1, a domestic corporation. UST is a publicly traded domestic corporation unrelated to FP and USS1. On Date A in Year 1, USS1 issues a note (the "USS1 Note") to FP in exchange for FP stock. On Date B of Year 1, USS1 transfers the FP stock to UST's shareholders, which are not members of the FP expanded group, in exchange for all of the stock of UST. Because USS1 and FP are both members of the FP expanded group, USS1 Note is treated as stock when it is issued by USS1 to FP in exchange for FP stock on Date A in Year 1 under the General Rule. Moreover, because USS1 Note is treated as stock for federal tax purposes when it is issued by USS1, Reg. §1.367(b)-10(a) (governing the use of debt in triangular reorganizations involving a foreign corporation) does not apply.

Nothing prohibits USS1 from borrowing from a third party, but generally that is only going to provide an acceptable economic answer if there is debt at the foreign parent level that can be repaid. In many cases that is what the result of the proposed regulations will be. Instead of borrowing at the FP level and pushing debt down to the U.S. group, foreign based multinationals will be incentivized to have their U.S. groups borrow locally with a foreign parent guarantee.

c. EGI Issued in Exchange for Property in an Asset Reorganization Described in Section 368 of the Code. If a corporation issues a debt instrument pursuant to an "asset reorganization" and any one of the shareholders of the target corporation is a member of the issuer's Expanded Group *before* the reorganization and receives the EGI in exchange for the shareholder's stock in the target, then the EGI is considered equity.[104] For this purpose, an "asset reorganization" is defined as any reorganization described in Code Sec. 368(a)(1)(A), (C), (D), (F) or (G).[105] One should assume this picks up triangular asset reorganizations under Code Sec. 368(a)(2)(D) even though it is not separately identified because that transaction is also described in Code Sec. 368(a)(1)(A). Although less clear, for the same reason, presumably this rule applies to a reorganization under Code Sec. 368(a)(2)(E), even though it is effectively a stock acquisition. The fact that the relationship of the issuer to the shareholder is tested *before* the reorganization occurs is important.

Example 15. USCO issues its stock and debt to USS1 in exchange for all of USS1's assets. USS1 distributes the USCO stock and debt to its sole shareholder, FP. The transaction is viewed as a Code Sec. 368 reorganization. Prior to the transaction, FP did not own any USCO shares. After the transaction, FP owns 80 percent of USCO's outstanding stock. USCO's issuance of its debt is not caught by the General Rule because FP was not a member of USCO's Expanded Group *before* the reorganization took place.

The preamble clarifies that the General Rule only applies debt issued in an asset reorganization if the debt is distributed to shareholders of the target corporation for their stock. It does not apply to debt instruments exchanged for securities or other debt instruments.[106] So, in the prior example, if FP was related to USCO but received the USCO note in exchange for debt issued by USS1, the General Rule would not apply.

The rules described in b. and c. will also profoundly impact many nonabusive routing structuring transactions. It is exceedingly common as part of a joint venture structuring exercise or a sale or spin-off for companies to sell one company to another company to "package" the business in a single structure which can then be dropped into a joint venture or sold or spun-off to the public shareholders. The objective is not typically to infuse debt. The objective is simply to get the assets where they need to be in the quickest and most efficient manner possible. If that sale occurs while the seller and buyer are members of the Expanded Group, however, the debt will be caught by this rule. The fact that the buyer will cease to be a member of the Expanded Group within a month does not change that fact.

As a result of this rule, taxpayers will be incentivized to ensure these pre-packaging transactions are structured as asset (not stock) acquisitions that do not otherwise qualify as tax-free asset reorganizations. So long as the note is issued for assets other than Expanded Group member stock and the transaction does not otherwise qualify as a section 368 reorganization, the transaction should escape the application of the General Rule as it is currently crafted. It will still, of course, have to run the gauntlet of the Funding Rule, described below.

2. The Funding Rule

Even if an EGDI is issued for cash or other property that is not covered by the General Rule, and it would clearly be respected as debt under the common law factors, the EGDI may still be recast as equity under the "Funding Rule." The Funding Rule applies to "principal purpose debt instruments." A debt instrument is considered a principal purpose debt instrument and thereby recast under the "Funding Rule" if the debt instrument is issued by a corporation (*a.k.a.*, the "Funded Member")[107] to a member of the Funded Member's Expanded Group with "a" principal purpose of funding one of three tainted transactions that correspond to the three transactions described under the General Rule.[108] If the Funding Rule applies to a principal purpose debt instrument, the debt instrument is recast but the underlying tainted transaction is not recast.[109]

Importantly, the standard is "a" principal purpose and not "the" principal purpose, which would be a higher standard. The regulations provide that the principal purpose determination is made based on all of the facts and circumstances.[110] The regulations also clarify that it does not matter whether the funding occurs before or after one of the tainted transactions described below.

What is particularly troubling is that a debt instrument will *automatically* be treated as issued with a principal purpose of engaging in one of the tainted transactions if the debt is issued within the 72-month period beginning

36 months before and ending 36 months after the tainted transaction (the "72-month Window Period").[111]

Example 16.[112] FP, a foreign corporation, owns all of the outstanding stock of USS1, a domestic corporation. USS1 owns all of the outstanding shares of a controlled foreign corporation, CFC. On Date A in Year 1, FP lends $200x to CFC in exchange for CFC Note A. On Date B in Year 1, CFC distributes $400x of cash to USS1 in a distribution. The Funding Rule applies to cause CFC Note A to be treated as a "Principal Purpose Debt Instrument" because CFC Note A is issued to a member of its Expanded Group during the 72-month period beginning 36 months before CFC made its distribution. As a result, CFC Note A is treated as stock when it is issued by CFC to FP on Date A in Year 1.

This rule is simply bad policy for a number of reasons. First, it is a *per se* rule and not merely a presumption akin to the presumption in the Code Sec. 707 disguised sale rules or the 355(e) anti-*Morris Trust* provisions. It cannot be rebutted. If a funding occurs within this period, it will *automatically* be deemed to have a principal purpose and thus be considered an equity instrument. The only way a taxpayer can get out of the rule is to establish that the loan arose in the ordinary course of business in connection with the acquisition of property or services in amounts that can be deducted under Code Sec. 162 as ordinary business expenses or added to cost of goods sold or inventory and, even then, only "provided that the amount of the obligation outstanding at no time exceeds the amount that would be ordinary or necessary to carry on the trade or business of the issuer if it was unrelated to the lender."[113] This exception is far too narrow and would not for example, encompass payables for rent or royalties, even if they are not interest-bearing and present no possible avenue for earnings stripping. Second, the rule is underdeveloped, failing to establish what happens if, for example, at some point the outstanding obligation does exceed the business needs of the issuer. Is a loan safe from the presumption once it satisfies the ordinary course exception, or may subsequent events undo the exception. More importantly, this is an absurdly lengthy window period, and longer than other comparable provisions.[114] There are longer certification periods in the gain recognition agreement[115] or dual consolidated loss rules,[116] for example, but in those cases the taxpayer is availing itself of a known benefit (*i.e.*, tax-deferral under Code Sec. 367(a) or loss utilization under Code Sec. 1503(d)). Those rules do not "deem" two unrelated transactions to be part of the same plan, like the 72-month Window Period does.[117]

The Funding Rule only applies, however, if there is a tainted transaction. We describe each of the three tainted transactions that a Funded Member may engage in below. To the extent the Funded Member engages in an activity that could be described in more than one category of tainted transactions, the rules provide that the activity will only be described in one of those categories.[118]

a. First Tainted Transaction: Funding a Distribution of Property. The first tainted transaction is a distribution of property by the Funded Member to a member of the Funded Member's Expanded Group.[119]

Example 17. FP, a foreign corporation, owns all of the outstanding shares of USS1 and FS. USS1 is a domestic corporation. FS is a foreign subsidiary of FP and serves as the global treasury center for the group. USS1 routinely deposits its excess cash with FS. FS, occasionally, makes dividend distributions to FP. To the extent the deposits occur 36 months before or after the dividend distributions, USS1 can be considered to have an equity investment in FS, a foreign corporation.

The consequences of this recast can be profound. As a preliminary matter, when USS1 withdraws its deposit it will be deemed to have a section 302(d) redemption distribution which is fully taxable, not a tax-free return of principal. To add insult to injury, given that USS1 does not have any voting rights in FS, USS1 will not be able to offset the U.S. tax with any FS foreign tax credits under Code Sec. 902.

If USS1 is deemed to have more than 50 percent of the value of FS's stock, FS will all of a sudden become a CFC. USS1 will then have to navigate the section 951 regulations and try and ascertain how much subpart F income USS1 should have recognized each year that it owned FS. If USS1 is deemed to own less than 50 percent of the value of FS the consequences can actually be worse. This is because FS may conceivably be considered passive foreign investment company (PFIC). There is an exception in Code Sec. 1297(b)(2)(C) which may help FS reduce its "passive" income and avoid PFIC status, but that exception only helps with dividends, interest, rents and royalties. It does not preclude "gains" from being "passive".

The foregoing example illustrates one reason why the *Per Se* Recast Rules will likely have a profoundly negative impact on cash-pooling arrangements generally. It will simply not be possible for most companies to have adequate controls to ensure that a deposit by a U.S. company will not be recast due to some transaction occurring within the 72-month Window Period. For this reason, companies

will have to consider having their U.S. subsidiaries and CFCs of those U.S. subsidiaries withdraw from cash pools.

Another planning possibility would be to ensure that all entities above the U.S. group but below FP elect to be disregarded. This is because the "distribution" of property in the foregoing example is only tainted because FS made a distribution to another Expanded Group member, FP. Distributions by FP to its public shareholders (or shareholders who are not members of its Expanded Group) are not tainted. Hence, by electing to treat FS and other FP foreign subsidiaries as disregarded, USS1 may make it less likely that its deposits will run afoul of the Funding Rule.

Interestingly, although the regulations would appear to stymie one form of *Falkoff* planning described above in Example 9, they appear to leave open alternative forms of *Falkoff* planning.

Example 18. USS1 owns all of the outstanding stock of CFC1, and CFC1 owns all of the outstanding stock of CFC2. USS1 has a $1 billion tax basis in the stock of CFC1. CFC1 has no earnings and profits. CFC2 has significant earnings and profits. CFC2 loans $1 billion to CFC1 and CFC1 distributes the cash as a return of capital to USS1. CFC2 waits a year and then either distributes its loan receivable to CFC1 or distributes cash to CFC1 which then enables CFC1 to repay the loan to CFC2. Under the Funding Rule, CFC2's loan to CFC1 is considered equity issued by CFC1. The recast presumably does not alter the return of capital transaction made by CFC1 to USS1. After all, CFC2's transfer of cash to CFC1 for equity would not flood CFC1 with E & P. It may, however, make unwind somewhat more complicated, as CFC2 would now own "hook stock" in CFC1.

The regulations exempt distributions of stock that the Funded Member may distribute to its shareholders, provided the shareholders can receive the stock without recognizing gain under Code Sec. 354, 355 or 356.[120]

Example 19.[121] FP, a foreign corporation, owns all of the stock of USS1 and USS2, both U.S. corporations. FP also owns FS, a foreign corporation. On Date A in Year 1, FS lends $100x to USS2 in exchange for the USS2 Note. On Date B in Year 2, in a transaction that qualifies as a reorganization within the meaning of Code Sec. 368(a)(1)(D), USS2 transfers all of its assets to USS1 in exchange for stock of USS1 and the assumption by USS1 of all of the liabilities of USS2, and USS2 distributes to FP, with respect to FP's USS2 stock, all of the USS1 stock that USS2 received. FP does not recognize gain under Code Sec. 354(a)(1). USS1 is a successor with respect to USS2. Thus, the Funding Rule treats USS2 and its successor, USS1, as Funded Members with respect to the USS2 Note. Although USS2, a funded member, distributes property (USS1 stock) to its shareholder, FP, pursuant to the reorganization, the distribution of USS1 stock is not a tainted transaction because the property is permitted to be received without the recognition of gain under Code Sec. 354(a)(1). The distribution of USS1 stock is also not a tainted transaction because FP does not receive the USS1 stock as "other property" within the meaning of Code Sec. 356. USS2's exchange of assets for USS1 stock is not a tainted transaction because USS2's acquisition of USS1 stock is an "exempt exchange." USS2's acquisition of USS1 stock is an exempt exchange because USS1 and USS2 are both parties to a reorganization, Code Sec. 1032 applies to USS1, the transferor of the expanded group stock, and the USS1 stock is distributed by USS2, the transferee, pursuant to the plan of reorganization. Thus, because neither USS1 nor USS2 has made a distribution or acquisition that is a tainted transaction, the USS2 Note is not a principal purpose debt instrument recast as equity under the Funding Rule.

b. Second Tainted Transaction: Funding an Acquisition of Another Expanded Group Member's Stock. The second tainted transaction arises when the Funded Member acquires the stock of another member of the Expanded Group to which the Funded Member belongs.[122] Again, the breadth of this rule is staggering. It is not uncommon for U.S. subsidiaries of foreign-based multinationals to deposit excess cash in the foreign cash pools managed by their foreign parent or other foreign affiliates. Those U.S. subsidiaries often have no idea what that cash is then used for. Historically, they have not had to. Now, they will. If they deposit cash in a foreign cash pool, and the money is used to acquire stock of another foreign affiliate, the U.S. subsidiary could be deemed to own equity in a foreign treasury center.

c. Third Tainted Transaction: Funding an Acquisition of Property in an Asset Reorganization. The third and final tainted transaction arises when the Funded Member acquires property in an asset reorganization, at least one shareholder of the target is part of the Funded Member's Expanded Group before the acquisition, and that shareholder receives "other property" under Section 356 of the Code.[123]

d. Coordination Rules. Money is fungible, and so the sheer breadth of the Funding Rule makes it highly

probable that multiple debt instruments could be treated as funding multiple tainted transactions. This then necessitates a series of coordination rules.

The Proposed Regulations provide that if two or more debt instruments could be viewed as funding the same tainted transaction, then the first issued debt instrument is recast before subsequently issued debt is recast.[124]

Example 20.[125] FP, a foreign corporation, owns all of the outstanding stock of USS1, a domestic corporation. USS1 owns all of the outstanding shares of a controlled foreign corporation, CFC. On Date A in Year 1, FP lends $200x to CFC in exchange for CFC Note A. On Date B in Year 1, CFC distributes $400x of cash to USS1 in a distribution. Then, on Date C in Year 2, FP lends an additional $300x to CFC in exchange for CFC Note B. Because CFC Note A was issued within the 72-month period beginning 36 months before CFC made its property distribution, it is deemed to be a principal purpose debt instrument and thus recast as equity. The distribution of $400 exceeds the loan of $200, however. Hence, CFC Note B, which was also issued within the 72-month period, is similarly recast. Only a portion of CFC Note B is recast, however, to account for the fact that $200 of CFC's distribution has already been accounted for with CFC Note A. Accordingly, $200x of CFC Note B is recast under the Funding Rule. The remaining $100x of CFC Note B continues to be treated as indebtedness.

One interesting point to note about the foregoing example is the timing of the recast. Since CFC Note A was issued in the same year as the distribution, it was recast from inception.[126] Had the distribution been made in a subsequent year, the recast would have occurred in that later year.[127]

An oddity created by the 72-month Window Period is that loans that have no factual relationship to a tainted transaction may be recast while other loans borrowed specifically to fund a tainted transaction are not recast. For example, if an Expanded Group member loans $100 to another member in year 1 and in year 2 loans another $100 to the same member for the express purpose of funding a distribution by that borrower member, it is the first loan which is recast, not the second loan.

Alternatively, if a debt instrument may be treated as funding more than one tainted transaction, the tainted transaction occurring first in time is associated with the debt instrument.[128]

Moreover, if a Funded Member issues or distributes a debt instrument that is considered equity under the General Rule pursuant to an asset reorganization, that distribution will not be considered a distribution that causes a loan to that Funded Member to be a principal purpose debt instrument that is then recast as equity.[129] This is admittedly convoluted, so we try and explain with an example from the regulations.

Example 21.[130] FP, a foreign corporation, owns all of the stock of USS2, a domestic corporation. On Date A in Year 1, FP lends $200x to USS2 in exchange for USS2 Note. In a transaction that is treated as independent from the transaction on Date A in Year 1, on Date B in Year 2, USS2 transfers a portion of its assets to DS2, a newly formed domestic corporation, in exchange for all of the stock of DS2 and DS2 Note. Immediately afterward, USS2 distributes all of the DS2 stock and the DS2 Note to FP with respect to FP's USS2 stock in a transaction that qualifies under Code Sec. 355. USS2's transfer of a portion of its assets qualifies as a reorganization within the meaning of Code Sec. 368(a)(1)(D). The DS2 stock has a value of $150x, and DS2 Note has a value of $50x. The DS2 stock is not nonqualified preferred stock as defined in Code Sec. 351(g)(2). Under the General Rule, the DS2 Note is treated as stock when it is issued by DS2 to USS2 on Date B in Year 2 pursuant to the General Rule. This is because the note was issued pursuant to an asset reorganization and distributed to a shareholder (FP) that was part of US2's Expanded Group before the reorganization occurred. That is not the end of the analysis, however. FP's loan of $200 to USS2 also has to be addressed. This could be caught under the Funding Rule if USS2 is considered to have engaged in a tainted transaction. In this regard, USS2 did a number of activities, and each of them has to be analyzed. First, USS2 distributed DS2 stock. The DS2 stock is "property" to USS2 within the meaning of Code Sec. 317. Nevertheless, that should not be considered a tainted transaction because FP received the stock tax-free under Code Sec. 355(a)(1). Second, USS2 distributed the DS2 Note. We know the DS2 Note is considered "equity." The question is whether the stock is nonqualified preferred stock or not. Provided the DS2 Note is not considered nonqualified preferred stock then its distribution should be treated the same as the distribution of the DS2 common stock. If the DS2 Note is treated as nonqualified preferred stock, FP would be considered to receive "other property" under Code Sec. 356(e) and FP's loan to USS2 could conceivably be caught by the Funding Rule. Yet,

because the DS2 Note is treated as stock under the General Rule, USS2's distribution of DS2 Note is not also treated as a tainted transaction described in the Funding Rule. Finally, USS2's transfer of assets to DS2 in exchange for DS2 stock is not a tainted transaction because USS2's acquisition of DS2 stock is an exempt exchange. USS2's acquisition of DS2 stock is an exempt exchange described in Proposed Reg. §1.385-3(f)(5)(ii) because USS2 and DS2 are both parties to a reorganization that is an asset reorganization, Code Sec. 1032 applies to DS2, the transferor of the expanded group stock, and the DS2 stock is distributed by USS2, the transferee, pursuant to the plan of reorganization. Thus, in the end, the USS2 Note is not a principal purpose debt instrument that is recast into equity under the Funding Rule.

The FP loan to USS2 was not recast because the Funded Member did not distribute any property other than stock. The answer would have been different if USS2 distributed cash or other property. It would also have been different if a predecessor or successor distributed cash or property. The regulations generally define a "predecessor" or "successor" by reference to the transferor and acquirer defined in Code Sec. 381 (which applies to section 368 reorganizations and 332 liquidations).[131] There is a tweak, however. Divisive reorganizations, even though considered 368 reorganization, are not covered by Code Sec. 381. Yet, the regulations say that in a divisive reorganization, like the foregoing example, the controlled company can be a successor. This can create some interesting results as illustrated in the following example.

Example 22.[132] The facts are the same as the previous example, except that on Date C in Year 3, DS2 distributes $200x of cash to FP and, subsequently, on Date D in Year 3, USS2 distributes $100x of cash to FP. DS2 is a "successor" with respect to USS2 and USS2 is a "predecessor" with respect to DS2. Thus, a distribution by DS2 is treated as a distribution by USS2. Under the Funding Rule, the USS2 Note is treated as issued with a principal purpose of funding the distribution by DS2 to FP because the USS2 Note was issued during the 72-month period determined with respect to DS2's $200x cash distribution. Accordingly, the USS2 Note is a Principal Purpose Debt Instrument that is deemed to be exchanged for stock on Date C in Year 3. Because the entire amount of USS2 Note is treated as funding DS2's $200x distribution to FP, the USS2 Note is not treated as funding the subsequent distribution by USS2 on Date D in Year 3.

What is interesting about the foregoing example is that a single loan resulted in two Funded Members. What is even more confounding is that there is no requirement in the regulations that the cash proceeds from the loan from FP to USS2 find their way into DS2 to actually fund the tainted transaction. There is absolutely no requirement that there be any factual linkage between the loan and the distribution even though the loan goes to one company and the distribution emanates from a different company.

3. The Anti-Abuse Rule

Even if a debt instrument is not caught by the General Rule or Funding Rule, it can still be recast if it is issued with "a" principal purpose of avoiding the application of the Proposed Regulations.[133] Moreover, even transactions that are not considered debt can be recast as equity if entered into with a principal purpose of avoiding the Proposed Regulations. The regulations identify transactions governed by Code Sec. 483 and nonperiodic swap payments as examples of transactions the government is concerned about. Notwithstanding the government's concern, it is unclear why the IRS felt it was necessary to target nonperiodic swap payments when the swap rules already recast significant nonperiodic payments as loans if they are economically equivalent to loans.[134]

Example 23.[135] FP is a foreign corporation which owns all of the stock of USS1. On Date A in Year 1, USS1 issues USS1 Note A, which has a value of $100x, to FP in a distribution. On Date B in Year 1, with a principal purpose of avoiding the application of this section, FP sells USS1 Note A to Bank for $100x of cash and lends $100x to USS1 in exchange for USS1 Note B. USS1 Note A is a debt instrument that is issued by USS1 to FP, a member of USS1's expanded group, in a distribution. Accordingly, under paragraphs (b)(2)(i) and (d)(1)(i) of this section, USS1 Note A is treated as stock when it is issued by USS1 to FP on Date A in Year 1. Accordingly, USS1 is treated as distributing USS1 stock to its shareholder FP. Because USS1 Note A is treated as stock of USS1, USS1 Note A is not property as specified in Code Sec. 317(a) on Date A in Year 1. Under paragraph (d)(2) of this section, USS1 Note A ceases to be treated as stock when FP sells USS1 Note A to Bank on Date B in Year 1. Immediately before FP sells USS1 Note A to Bank, USS1 is deemed to issue a debt instrument to FP in exchange for USS1 Note A in a transaction that is disregarded for purposes of the General Rule and Funding Rule. USS1 Note B is not treated as stock under the Funding Rule because the Funded Member, USS1, has not made a distribution

of property. Yet, because the transactions occurring on Date B of Year 1 were undertaken with a principal purpose of avoiding the purposes of the regulations, USS1 Note B is treated as stock on Date B of Year 1 under the Anti-Abuse Rule.

One obvious response to these regulations will be to push third-party debt into the United States. Yet, foreign multinationals will likely be incentivized to pledge as many assets outside of the United States as they can to support the borrowing and thereby lower the interest rate.

Example 24. FP, a foreign corporation, owns all of the stock of USS1, a domestic corporation. FP would normally borrow money at the FP level and on-loan to USS1. Due to the Proposed Regulations, FP causes USS1 to borrow directly from a third-party bank. In order to achieve a better interest rate, however, FP pledges certain cash it has on deposit with that bank to secure the loan.

The question raised by the foregoing example is whether and to what extent the foregoing arrangement would be caught under the Anti-Abuse Rule. One would certainly hope that it would not be.

4. Exceptions

The Proposed Regulations provide a number of exceptions to the General Rule and the Funding Rule. The three exceptions are the (i) Threshold Exception; (ii) Current Year E & P Exception; and (iii) Exception for Funded Acquisitions of Subsidiary Stock by Issuance. Of these, the most useful will likely prove to be the Current Year E & P Exception.

a. Threshold Exception. In an attempt to restrict the application of the Proposed Regulations,[136] the regulations exempt debt from the ambit of the rules when the aggregate adjusted issue price of all debt instruments held by members of the Expanded Group that would otherwise be recast as equity under the General Rule, Funding Rule or Anti-Abuse Rule does not exceed $50 million at the time the debt in question was issued.[137] A couple of important points are worth noting. First, the threshold exception does not have anything to do with the size of the Expanded Group or the members in that group. The largest companies in the world can avail themselves of this exception. In this sense, the threshold exception serves the same function as, for example, the exception for *de minimis* subpart F income generated by a CFC. It does not matter how large the CFC is. It only matters how much tainted income the CFC generates. Second, the exception does not restrict the aggregate amount of EGIs an Expanded Group can have. An Expanded Group could issue a billion dollars of EGIs and still avail itself of this exception provided the EGIs that could be recast are $50 million or less. Third, the exception is not permanent. If the $50 million threshold is exceeded at any time, then debt that was previously exempted but remains outstanding can be subject to recast.

The Proposed Regulations will likely prove to impose extremely costly compliance burdens on all multinationals. It will also severely restrict common cash pooling practices of multinationals.

b. Current Year E & P Exception. The Proposed Regulations provide that the amount of any distributions or acquisitions made by the borrower (under the General Rule) or the Funded Member (in the Funding Rule) is reduced by the borrower or Funded Member's current year earnings and profits (E & P).[138] This begs the question as to what year is used to measure the "current year" E & P is measured. The regulation is somewhat cryptic but suggests that the current year E & P is the E & P in the year in which the distribution or acquisition occurs. Thus, a planning possibility for taxpayers is to stretch out distributions or acquisitions across multiple years to try and gain access to multiple years' worth of "current" year E & P. Another strategy is to issue notes in years in which the issuer has current E & P and distribute cash in years in which it does not.

It also begs the question whether the E & P of consolidated group members that "bubbles up" to the consolidated group parent every year under Reg. §1.1502-33 would all be considered "current" E & P. If so, this could significantly reduce the impact of the rules for foreign-based multinationals. Presumably, because the regulations treat all members of a consolidated group as "one" corporation for purposes of the regulation, all of the constituent members' E & P should be considered.

If all E & P of a consolidated group is considered, then this exception will likely prove useful for U.S. subsidiaries of foreign companies that will be able to distribute their own notes to their foreign parent entities each year up to the amount of their current E & P.

c. Exception for Funded Acquisitions of Subsidiary Stock by Issuance. The third exception is limited to the Funding

Rule.[139] The exception is somewhat convoluted but applies when the Funded Member transfers cash or other property to another member of the Expanded Group in exchange for newly issued stock of that member, provided that, for the following 36 months, the Funded Member owns, directly or indirectly,[140] more than 50 percent of the total voting power and value of the member's stock. This exception is severely limited by the fact that the shareholder must own the stock of the subsidiary directly or indirectly, and not constructively. If the ownership requirement is satisfied for the entire 36 months, the debt issued by the Funded Member is forever exempted. If the ownership requirement ceases to be satisfied during the 36-month period, then the debt issued by the Funded Member is recast at that time, not the date the debt was originally issued.

Example 25.[141] FP owns all of the outstanding shares of FS and USS1. USS1 owns all of the stock of CFC. FP, FS and CFC are foreign corporations, but CFC is a controlled foreign corporation. USS1 is a domestic corporation. On Date A in Year 1, FS lends $100x to USS1 in exchange for USS1 Note. On Date B in Year 1, USS1 transfers property that has a value of $20x to CFC in exchange for additional CFC stock that has a value of $20x. On Date C in Year 2, CFC distributes $20 cash to USS1. On Date D in Year 3, CFC acquires stock of FS from FP in exchange for $50x cash. Normally, the issuance of the USS1 Note would be considered a principal purpose debt instrument under the Funding Rule because it would be deemed to have funded an acquisition of Expanded Group stock, which is a tainted transaction. However, because USS1's acquisition of CFC stock results from a transfer of property from USS1 to CFC in exchange for CFC stock and immediately after the transaction USS1 holds 100 percent of the stock of CFC, the exception applies. Accordingly, USS1's acquisition of CFC stock on Date B in Year 1 is not treated as a tainted transaction under the Funding Rule.

Unfortunately, that is not the end of the example. The Proposed Regulations contain a convoluted modification to its definition of what constitutes a predecessor or successor whenever this exception applies. As noted above, a successor has its usual meaning under Code Sec. 381 (*i.e.*, the acquirer of assets in an asset reorganization or liquidation), but it is expanded to include controlled entities that are distributed as part of a divisive Code Sec. 368(a)(1)(D) reorganization.

When the foregoing exception applies, however, the regulations create a special rule defining the transferee-subsidiary as a successor to the transferor even though Code Sec. 381 does not apply. The subsidiary is only treated as a successor to the extent of the value of the expanded group stock acquired in the transaction.[142] The same rule also exempts distributions of cash or property by the subsidiary to its shareholder from the application of the Funding Rule.[143] Thus, in the foregoing example, CFC is viewed, but only in part, as a "successor" to USS1. CFC's $20x cash distribution to USS1 on Date C in Year 2 is not taken into account for purposes of applying the Funding Rule to the USS1 Note. On Date D in Year 3, CFC continues to be a successor to USS1 and its acquisition of FS stock does run afoul of the Funding Rule. Accordingly, the USS1 Note becomes a principal purpose debt instrument at that time and is deemed to be exchanged for stock on Date D in Year 3.[144]

5. Treatment of Partnerships and Disregarded Entities

As noted above, the Documentation Rule and *Per Se* Recast Rules apply differently to partnerships and disregarded entities. The Documentation Rule treats them like entities whereas the *Per Se* Recast Rules use an aggregate approach. It is not clear why the drafters made this distinction.

The *Per Se* Recast Rules treat a Controlled Partnership as the aggregate of its partners.[145] Thus, a corporate partner's share of loan receivables and loan payables held (or owed) by the partnership is deemed to be held (or owed) by the corporate partner.[146] A partner's "share" is determined by reference to the partner's interest in partnership profits.[147] Importantly, this is different than the way that subchapter K allocates liabilities.[148]

Example 26.[149] FP owns all of the outstanding shares of FS and USS1. USS1 owns all of the outstanding shares of CFC. FP, FS and CFC are foreign corporations, and CFC is a controlled foreign corporation. USS1 is a domestic corporation. CFC and FS are equal partners in PRS, a domestic partnership. PRS owns 100 percent of the stock of X Corp, a domestic corporation. On Date A in Year 1, X Corp issues X Note to PRS in a distribution. PRS is treated as an aggregate in determining whether X Corp is a member of the Expanded Group[150] and so CFC and FS are each treated as holding 50 percent of the X Corp stock held by PRS. Accordingly, X Corp is a member of the FP expanded group. PRS is a Controlled Partnership because at least 80 percent of its capital and profits interests are held by members of the same Expanded

Group.[151] For purposes of applying the General Rule, Funding Rule and Anti-Abuse Rule, when X Corp issues X Note to PRS, proportionate shares of X Note are treated as issued to CFC and FS. Accordingly in Year 1, 50 percent of X Note is treated as issued to CFC in a distribution and the other 50 percent of X Note is treated as issued to FS in a distribution. Therefore, X Note is treated as stock beginning on Date A in Year 1. For all federal tax purposes (other than the Proposed Regulations), X Note is treated as stock in X Corp that is held by PRS, and X Corp is treated as distributing its stock to its shareholder in a distribution that is subject to Code Sec. 305.

If a partnership issues a debt instrument that is recast as equity under the General Rule, the Funding Rule or the Anti-Abuse Rule, then the corporate partners (not the partnership) are treated as having issued equity to the holders of the debt instrument.[152]

Example 27.[153] FP owns all of the outstanding shares of FS and USS1. USS1 owns all of the outstanding shares of CFC. FP, FS and CFC are foreign corporations, and CFC is a controlled foreign corporation. USS1 is a domestic corporation. CFC and FS are equal partners in PRS, a domestic partnership. PRS owns 100 percent of the stock of X Corp, a domestic corporation. PRS is treated as an aggregate in determining whether X Corp is a member of the Expanded Group[154] and so CFC and FS are each treated as holding 50 percent of the X Corp stock held by PRS. On Date A in Year 1, FP lends $200x to PRS in exchange for the PRS Note. On Date B in Year 1, CFC distributes $100x to USS1 and FS distributes $100x to FP. Solely for purposes of applying the General Rule, Funding Rule and Anti-Abuse Rule, CFC and FS are each treated as issuing $100x 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 the Funding Rule, the PRS Note is treated as a principal purpose debt Instrument treated as stock when it is issued on Date A in Year 1. As such, CFC and FS are each treated as issuing $100x of stock to FP.

It is important to note that the Funding Rule applies even though the example does not suggest that PRS ever distributed any cash to the two partners. Thus, it is not even clear that the loan to PRS enabled the CFC and FS distributions that trigger the application of the Funding Rule. Nevertheless, the Funding Rule applies to this example. The regulations provide that 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. The regulations provide that, for example, reasonable and appropriate adjustments may occur when the following steps are deemed to occur on Date A in Year 1: (i) CFC issues stock to FP in exchange for $100x; (ii) FS issues stock to FP in exchange for $100x; (iii) CFC contributes $100x to PRS in exchange for a partnership interest in PRS; and (iv) FS contributes $100x to PRS in exchange for a partnership interest in PRS.

Example 28.[155] The facts are the same as in the previous example, except that CFC and FS do not make distributions on Date B of Year 1; instead, CFC distributes $100x to USS1 and FS distributes $100x to FP on Date C of Year 2. 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. The Funding Rule treats the PRS Note as a Principal Purpose Debt Instrument that is treated as stock on Date C in Year 2. CFC and FS are each treated as issuing $100x of stock to FP.

Again, the regulations provide that 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. For example, reasonable and appropriate adjustments may occur when the following steps are deemed to occur on Date C in Year 2: (i) CFC assumes liability with respect to $100x of PRS Note; (ii) FS assumes liability with respect to $100x of PRS Note; (iii) CFC issues stock to FP in satisfaction of the $100x of PRS Note assumed by CFC; and (iv) FS issues stock to FP in satisfaction of the $100x of PRS Note assumed by FS.

In all events, the Proposed Regulations fail to adequately explain the corollary effects of this recast. After all, the liabilities that are allocated to each partner under the Proposed Regulations are not necessarily the same liabilities allocated to them under Code Sec. 752. Hence, it is not clear how the liabilities allocated to the partners under Code Sec. 752 should be adjusted when repayment occurs.

Specifically, in Examples 27 and 28, how should repayments be treated? Should they be considered deemed distributions of cash by PRS to each partner followed by payments to the creditors? Can a taxpayer partner

be deemed to receive two different cash amounts? The amount required by the section 385 regulations and a different amount reflecting what they are deemed to receive when liabilities are paid down under Code Sec. 752? What happens if a partner ceases to be a partner but remains an Expanded Group member?

Alternatively, how are loans to the partnership treated? Assume Partner 1 and Partner 2 are Expanded Group members and own a partnership 50/50, and Partner 1 makes a $100 loan to the partnership. Should the loan be ignored because the partnership is an aggregate of its partners? Or should Partner 1 be considered to have made a $50 loan to Partner 2?

In contrast, if a disregarded entity issues a debt instrument and that debt instrument is recast under the *Per Se* Recast Rules, then the debt instrument is treated as an equity interest in the entity's owner.[156] Again, the regulations do not address correlative effects. So, for example, it is not clear what would happen if the disregarded entity suddenly gains a new owner or ceases to be owned by the original owner altogether.

D. Consequences of the Recast Under the Documentation Rule, Partial Recast Rule or *Per Se* Recast Rules

If the recast applies from date the instrument in question is issued, then the instrument will simply be viewed as stock from the date it was issued. This is the case under both the Documentation Rule and the *Per Se* Recast Rules.[157]

There are numerous instances, however, where an instrument could begin life outside of the scope of the rules, and then be brought into the scope of the rules. Or, alternatively, the instrument could begin within the rules and then fall outside of the rules.

Once inside the rules, the instrument could begin its life as debt and be converted to equity. Or, alternatively, the instrument could begin its life as equity and become debt. There are a number of permutations here, so we have attempted to break them down in a logical order.

1. Becoming or Ceasing to Be Within the Expanded Group

An instrument could initially be created between persons who are not members of the same Expanded Group, and that could subsequently change.

a. An Applicable Instrument or Debt Instrument Moves Into the Expanded Group. The Documentation Rule uses the term "Applicable Instrument" whereas the *Per Se* Recast Rules use the term "indebtedness." Both use the term Expanded Group.

If an Applicable Instrument (or indebtedness) is created outside of the Expanded Group and subsequently moves within the Expanded Group, then there are rules governing what happens. If the instrument would normally be considered debt under common law, and the Documentation Rule is satisfied with respect to the instrument, it retains its character as debt.

If the instrument does *not* satisfy the Documentation Rule, then the instrument is equity from the date it becomes an EGI.[158] Specifically, the instrument is deemed exchanged for equity immediately *after* the instrument becomes an EGI.[159] Alternatively, it is possible that the Applicable Instrument could become an EGI, initially satisfy the Documentation Rule and then subsequently flunk the Documentation Rule. In that latter case, the instrument would be deemed exchange for stock at the time the facts and circumstances warrant the recast.[160]

The exact mechanics of the exchange are set forth in Proposed Reg. §1.385-1(c). We refer to these mechanics collectively as the "Exchange Mechanics." The rules provide that the holder of the EGI is deemed to surrender the EGI in exchange for "equity" having the same terms as the EGI.[161] The holder is deemed to receive an amount equal to the holder's adjusted basis in the debt (or the portion of the debt) that is recast excluding any amounts attributable to accrued but unpaid qualified stated interest (QSI). But for currency gain or loss, this should prevent the holder from having any gain or loss on the deemed satisfaction of the EGI.[162] The holder must recognize the currency exchange gain or loss associated with the EGI under Code Sec. 988 however.[163] The holder then takes a basis in the "equity" equal to the adjusted basis that the holder formerly had in the debt instrument. The holder does not recognize any gain or loss with respect to the accrued but unpaid QSI.[164] The issuer will be deemed to satisfy the amounts outstanding with shares equal in value to the adjusted issue price of the debt. The issuer similarly recognizes no gain or loss with respect to the accrued but unpaid qualified stated interest.[165]

The rules governing timing in the event the *Per Se* Recast Rules apply are more complicated. As a preliminary matter, the *Per Se* Recast Rules implicitly assume that the General Rule will only apply from the date that the instrument is issued, as there is no special timing rule for debt instruments recast under the General Rule.[166] The Funding Rule, however, can cause a loan to be recast many years after it is first issued. In that case, the recast occurs when the Funded Member engages in one of the tainted transactions mentioned above.[167] At that time, the Exchange Mechanics described above apply.

The Partial Recast Rule uses the Modified Expanded Group concept. The Proposed Regulations do not provide special rules for an instrument moving into (or out of) the Modified Expanded Group, but they presumably track the rules mentioned above for the Documentation Rules.

b. An Applicable Instrument or Debt Instrument Moves Outside of the Expanded Group. The Documentation Rule uses the EGI terminology whereas the *Per Se* Recast Rules use the EGDI terminology. If an EGI or EGDI ceases to be within the Expanded Group, there are a number of possibilities. If the EGI or EGDI was treated as debt before departing, it will presumably remain debt after departing and so no special rule is required. The common law continues to apply to the instrument.

Alternatively, if the EGI or EGDI was considered equity before departing, the taxpayer has to ask why it was treated as equity. If it was treated as equity under common law principles, then it should remain equity when it leaves the group.

If, instead, it was an EGI treated as stock solely because it failed to satisfy the Documentation Rule, then the instrument is characterized under general tax principles immediately before it ceases to be an EGI.[168] If the Applicable Instrument would be considered a debt instrument under common law, then the Applicable Instrument (which is treated as equity) is deemed to be redeemed in exchange for the issuance of a debt instrument immediately **before** the Applicable Instrument ceases to be an EGI.[169] This would presumably then be subject to Code Sec. 302(a) (capital gain redemption rules) or Code Sec. 302(d) (dividend-equivalent redemption rules) and/or Section 306 of the Code.

Similarly, if an EGDI that is recast as equity under the General Rule, Funding Rule or Anti-Abuse Rule, and subsequently ceases to be between members of the same Expanded Group, the regulations deem the issuer to issue a new debt instrument to the holder in redemption of the "equity" immediately **before** the debt ceases to be between Expanded Group members.[170] Again, Code Sec. 302 would presumably apply to determine the consequences.

Given that money is fungible and multiple debt instruments could potentially be caught and recast under the rules, when a recast debt instrument leaves the Expanded Group, all of the debt issued by the issuer that issued the debt which left the group and which has not yet been recast has to be **retested**.

Example 29.[171] FP, a foreign corporation, owns all of the stock of USS1, a domestic corporation. On Date A in Year 1, FP lends $300x to USS1 in exchange for USS1 Note A. On Date B in Year 2, USS1 distributes $300x of cash to FP. On Date C in Year 3, FP lends another $300x to USS1 in exchange for USS1 Note B. On Date D in Year 4, FP sells USS1 Note A to Bank. USS1 Note A is the first loan issued and so it is recast as equity from Date B in Year 2. But USS1 Note A subsequently ceases to be treated as stock when FP sells USS1 Note A to Bank on Date D in Year 4. Thus, the regulations require the other debt instruments created within the 72-month period beginning 36 months before the distribution to be retested. USS1 Note B was issued following USS1 Note A, and so under the first in time rule, USS1 Note B is considered a principal purpose debt instrument and recast as equity on Date D in Year 4, the re-testing date.

Interestingly, the re-test rules only apply when an EGDI ceases to be within the Expanded Group due to a transfer of the receivable, an assumption of the liability or a departure of the borrower or lender from the group.[172] Hence, it should not apply to simple repayments. Thus, had USS1 Note A simply been repaid instead of leaving the group, the re-test rule presumably would not apply.

Again, it is important to note that the Partial Recast Rule uses the Modified Expanded Group concept. The Proposed Regulations do not provide special rules for an instrument moving into or out of the Modified Expanded Group, but they presumably track the rules mentioned above for the Documentation Rules.

2. Becoming or Ceasing to Be an Intercompany Obligation

As previously noted, the Proposed Regulations do not apply to intercompany obligations between members of a consolidated group. If an instrument created outside of the Expanded Group becomes an intercompany obligation, no special rules are required. Instead, the taxpayer should simply consult the Reg. §1.1502-13(g) rules. Similarly, if the intercompany obligation ceases to be an intercompany obligation, then a determination has to be made whether the instrument is suddenly an EGI or EGDI. If it is not, no special rules are necessary. The taxpayer should simply consult the deemed satisfaction and reissuance rules in Reg. §1.1502-13(g). This could happen if, for example, a consolidated group member is sold to an unrelated party and, for whatever reason, the member continues to owe the consolidated group some money. It could also happen if a consolidated group member sold the receivable from an intercompany obligation to an unrelated party.

Life is more complicated, however, if an EGI or EGDI moves into the consolidated group or, alternatively, an

intercompany obligation leaves the consolidated group but remains within the Expanded Group.

a. An EGI or EGDI Becomes an Intercompany Obligation. If an EGI is considered equity, and becomes an intercompany obligation, then the issuer of the EGI is deemed to issue a new debt instrument in redemption of its equity immediately before the EGI becomes an intercompany obligation.[173] This redemption may or may not be considered a capital gains redemption under Section 302 of the Code. The redemption is ignored for purposes of applying the *Per Se* Recast Rules, however. In other words, the hypothetical redemption will not cause the General Rule or Funding Rule to apply.[174]

b. An Intercompany Obligation Ceases to be an Intercompany Obligation but Remains within the Expanded Group. As noted previously, loans between members of a consolidated group are treated as not outstanding for purposes of the Proposed Regulations.[175] If an intercompany obligation ceases to be an intercompany obligation but remains in the Expanded Group (*i.e.*, if the borrower or lender ceases to be in the same consolidated return, but continues to be related with the other), then the Documentation Rule can apply if the former intercompany obligation is an EGI and the *Per Se* Recast Rules can potentially apply if it is an EGDI. Either way, the regulations provide that Reg. §1.1502-13(g) rules and the deemed satisfaction and reissuance that they hypothesize occur first.[176] If an Applicable Instrument becomes an EGI upon ceasing to be between members of a consolidated group, the 30-day documentation period begins from the date the instrument ceases to be an intercompany obligation and becomes an EGI.[177]

If the issuer or holder leaves the consolidated group, but remains in the Expanded Group and the instrument would otherwise be considered equity but for the exemption for intercompany obligations, the issuer is deemed to satisfy the obligation with its equity immediately after the departing member leaves the group.[178] The Deemed Exchange Mechanics (described above) apply for this purpose.

Importantly, when determining whether the instrument would otherwise be considered equity, the fact that the loan was between consolidated group members is not considered. But consolidated group members do continue to be treated as one corporation. The importance of this rule is illustrated in the following example.

Example 30.[179] FP owns all of the stock of USS1 and FS. USS1 owns all of the stock of DS1, and DS1 owns all of the stock of DS2. FP and FS are foreign corporations whereas USS1, DS1 and DS2 are domestic entities and are members of a consolidated group. On Date A in Year 1, DS2 lends $100x to DS1 in exchange for DS1 Note. On Date B in Year 1, DS1 distributes $100x of cash to USS1. On Date C in Year 1, FP purchases 25 percent of DS2's stock from DS1, resulting in DS2 ceasing to be a member of the USS1 consolidated group. After DS2 ceases to be a member of the USS1 consolidated group, DS1 and USS1 continue to be treated as one corporation, such that DS1's distribution of cash to USS1 on Date B in Year 1 continues to be disregarded for purposes of applying the *Per Se* Recast Rules. Accordingly, the DS1 Note, which is issued in exchange for cash, would not be treated as stock even absent the exception for intercompany obligations, because, the DS1 Note does not fund any tainted transaction. The distribution of cash to USS1 does not count because DS1 and USS1 are treated as one corporation for this purpose. Accordingly, the DS1 Note is not treated as stock when it ceases to be a consolidated group debt instrument, provided there are no distributions or acquisitions described in the Funding Rule by DS1 that occur later in Year 1 (after Date C).

The conclusion in the foregoing example would presumably hold even if DS1 and USS1 ceased to be in a consolidated group with one another in a later year. Stated differently, the intra-consolidated group debt that was ignored on Date B would remain ignored.

If, instead, the issuer or holder leaves the consolidated group, but remains in the Expanded Group and the instrument would not otherwise be considered equity, then the loan remains a loan unless or until it is subsequently recast under the Documentation Rule or *Per Se* Recast Rules.[180]

Example 31.[181] FP owns all of the stock of USS1 and FS. USS1 owns all of the stock of DS1. FP and FS are foreign corporations whereas USS1 and DS1 are domestic entities and are members of a consolidated group. On Date A in Year 1, DS1 issues DS1 Note A to USS1 in a distribution. On Date B in Year 2, USS1 lends $100x to DS1 in exchange for DS1 Note B. On Date C in Year 4, FP purchases 25 percent of DS1's stock from USS1, resulting in DS1 ceasing to be a member of the USS1 consolidated group. USS1 and DS1 are considered one corporation until Date C in Year 4. Accordingly, when DS1 issues the DS1 Note to USS1 in a distribution on Date A in Year 1, DS1 is not treated as issuing a debt instrument to a member of DS1's Expanded Group in a distribution for purposes of the General Rule, and the DS1 Note A is not treated as stock on Date A in Year 1. The only reason that is the case is because DS1 and USS1

(as consolidated group members) are considered one corporation under the Proposed Regulations. Hence, immediately after DS1 leaves the USS1 consolidated group, the DS1 Note A is deemed to be satisfied with stock issued by DS1. The DS1 Note B is not similarly recast. This is because the DS1 Note B, which is issued in exchange for cash, would not be treated as stock even absent the intercompany obligations exception. This is because DS1, as the Funded Member, has not engaged in any tainted transactions that would cause the debt to be converted to equity under the Funding Rules. Accordingly, the DS1 Note B is not treated as stock when DS1 ceases to be a member of the USS1 consolidated group, provided there are no distributions or acquisitions subject to the Funding Rule by DS1 that occur later in Year 4 (after Date C).

If the holder and issuer remain within the consolidated group, but the instrument is transferred to, or assumed by, a nonconsolidated group member within the Expanded Group, then a debt instrument is treated as having been issued to that nonconsolidated group member for property. It either then retains its character as debt or is considered to be satisfied with equity using the Deemed Exchange Mechanics.[182]

Example 32.[183] FP owns all of the stock of USS1. USS1 owns all of the stock of DS1. FP is a foreign corporation whereas USS1 and DS1 are domestic entities and are members of a consolidated group. On Date A in Year 1, DS1 issues a DS1 Note to USS1 in a distribution. On Date B in Year 2, USS1 distributes that DS1 Note to FP. The USS1 consolidated group is treated as one corporation for purposes of the Proposed Regulations. Accordingly, when DS1 issues DS1 Note to USS1 in a distribution, DS1 is not treated as issuing a debt instrument to another member of DS1's Expanded Group, and the DS1 Note is not treated as stock under the Proposed Regulations. When USS1 distributes the DS1 Note to FP, the USS1 consolidated group is treated as issuing a debt instrument to FP in a distribution. Accordingly, the DS1 Note is treated as stock of DS1 under the General Rule. For this purpose, DS1 Note is deemed to be exchanged for stock immediately *after* DS1 Note is transferred outside of the USS1 consolidated group.

It is important to note how profound the consequences of the recast can be. In the foregoing example, if the DS1 Note is not considered "plain vanilla preferred stock" within the meaning of Code Sec. 1504(a)(4) upon its recast, it can cause USS1 and DS1 to cease to be in a consolidated group relationship. This can then trigger any deferred intercompany gains, *etc*.

For purposes of applying the Proposed Regulations, the loan is considered to be issued immediately *after* the departing member leaves the group.[184]

Example 33.[185] FP owns all of the stock of USS1 and FS. USS1 owns all of the stock of DS1. FP and FS are foreign corporations whereas USS1 and DS1 are domestic entities and are members of a consolidated group. On Date A in Year 1, DS1 lends $200x to USS1 in exchange for USS1 Note. On Date B in Year 2, USS1 distributes $200x to FP. On Date C in Year 2, DS1 sells USS1 Note to FS for $200x. The USS1 consolidated group is treated as one corporation. Accordingly, when USS1 issues the USS1 Note to DS1 on Date A in Year 1, USS1 is not treated as a Funded Member, and when USS1 distributes $200x to FP on Date B in Year 2, the Funding Rule does not apply. When DS1 sells USS1 Note to FS, the USS1 consolidated group is treated as issuing the USS1 Note to FS in exchange for $200x on Date C in Year 2. Because USS1 Note was issued by the USS1 consolidated group to FS within 36 months of the distribution by the USS1 consolidated group to FP, the Funding Rule can apply to treat the USS1 Note as issued with a principal purpose of funding that distribution. Accordingly, the USS1 Note is a principal purpose debt instrument and treated as USS1 stock. Thus, immediately after USS1 Note is transferred outside of the USS1 consolidated group, the USS1 Note is deemed to be exchanged for stock.

Notwithstanding the foregoing, for purposes of applying the 72-month Window Period, the debt in the foregoing example is treated as having been issued when it was first considered an intercompany obligation.[186] Normally, this will assist taxpayers in running out the clock under the *per se* rule.

Example 34.[187] FP owns all of the stock of USS1 and FS. USS1 owns all of the stock of DS1. FP and FS are foreign corporations whereas USS1 and DS1 are domestic entities and are members of a consolidated group. On Date A in Year 1, DS1 issues DS1 Note A to USS1 in a distribution. On Date B in Year 2, USS1 lends $100x to DS1 in exchange for DS1 Note B. On Date C in Year 4, FP purchases 25 percent of DS1's stock from USS1, resulting in DS1 ceasing to be a member of the USS1 consolidated group. On

Date D in Year 6, DS1 distributes $100x pro rata to its shareholders ($75x to USS1 and $25x to FP). The 72-month Window Period does not apply to the DS1 Note B and the distribution on Date D in Year 6 because the DS1 Note B is treated as issued on Date B in Year 2, which is more than 36 months before Date D in Year 6.

Yet, even with the earlier start date, the instrument can still be caught by the *per se* rule.

Example 35.[188] FP owns all of the stock of USS1 and FS. USS1 owns all of the stock of DS1. FP and FS are foreign corporations whereas USS1 and DS1 are domestic entities and are members of a consolidated group. On Date A in Year 1, DS1 lends $200x to USS1 in exchange for USS1 Note. On Date B in Year 2, USS1 distributes $200x to FP. On Date C in Year 2, DS1 sells USS1 Note to FS for $200x. The USS1 consolidated group is treated as one corporation. Accordingly, when USS1 issues the USS1 Note to DS1 on Date A in Year 1, USS1 is not treated as a Funded Member, and when USS1 distributes $200x to FP on Date B in Year 2, the Funding Rule does not apply. When DS1 sells USS1 Note to FS, the USS1 consolidated group is treated as issuing USS1 Note to FS in exchange for $200x on Date C in Year 2. Because USS1 Note was issued by the USS1 consolidated group to FS within 36 months of the distribution by the USS1 consolidated group to FP, the Funding Rule can apply to treat the USS1 Note as issued with a principal purpose of funding that distribution. Accordingly, the USS1 Note is a principal purpose debt instrument and treated as USS1 stock. Thus, immediately after USS1 Note is transferred outside of the USS1 consolidated group, the USS1 Note is deemed to be exchanged for stock.

III. Planning Techniques

The regulations do not apply to debt issued to third-parties (*i.e.*, parties that are not a member of the issuer's Expanded Group). This is true, even if the debt happens to be guaranteed by another member of the Expanded Group. It is very typical for foreign-based multinationals to borrow at the parent level because that is typically the cheapest location in the structure for them to borrow. They then on-loan those funds to their subsidiaries, including but not limited to, subsidiaries in the United States. Under the Proposed Regulations, and the 72-month Window Period, it is entirely probable that those loans to the United States would be caught by the Funding Rule. One planning technique that foreign-based multinationals should consider going forward is causing their U.S. subsidiaries to borrow from third-party banks directly. If left unguaranteed, the debt will likely be more expensive. Yet, the Proposed Regulations do not address unrelated debt guaranteed by a related party.[189] The U.S. subsidiary should also be able to pay a deductible guarantee fee to the related foreign parent. The U.S. subsidiary will need to be wary of case law, like *Plantation Patterns*,[190] which can deem the foreign parent to be the true borrower. The guarantee fee would have a U.S. source, and so the taxpayer would need to consider nature of the payment and check the provisions of any applicable treaty to verify the withholding tax consequences of the payment.[191]

Foreign-based multinationals should also seek to maximize their interest deductions now, before the Proposed Regulations are finalized. Although the *Per Se* Recast Rules apply to new debt issued on or after April 4, 2016, the regulations do not impact net operating losses or suspended interest deductions a taxpayer may generate under Code Sec. 163(j) prior to the date that is 90 days after the regulations are finalized. This planning may have limited utility if, as the IRS has promised, the government finalizes the regulations this year.

Once finalized, taxpayers should make aggressive use of the current year E & P exception. A consolidated group parent can effectively distribute its own note to its foreign parent in an amount equal to the current year E & P of its consolidated group each year, subject to general debt equity considerations under the common law and Code Sec. 163(j).

Another planning technique is to use third-party debt and cash payments wherever intercompany notes were previously used. As we illustrated in the examples above, many common planning transactions can still be accomplished. It will just require the taxpayer to borrow from a bank in order to effect the transaction.

In another twist, the Proposed Regulations may make it exceedingly easy to create cross-border hybrid instruments. Whereas, historically, a U.S. multinational would have to use hybrid entities or complex hybrid instruments to create instruments that generated interest deductions abroad and dividends at home, the Proposed Regulations recast instruments that are "in form" debt instruments into equity. There are rules ostensibly prohibiting the affirmative use of the Proposed Regulations. For example, Proposed Reg. §1.385-2(d) provides that if taxpayers issue an EGI with "a" principal purpose of reducing the federal tax liability of any member of the issuer's Expanded Group, then the Proposed Regulations do not apply. Proposed

Reg. §1.385-3(e) provides that the *Per Se* Recast Rules do not apply if a person enters into a transaction with "a" principal purpose of reducing the federal tax liability of any member of the Expanded Group that includes the issuer and the holder. The problem with these rules is that the rules are so broad that they will apply to a number of business motivated transactions. One can easily imagine a U.S. company explaining that it receives dividends from its foreign subsidiary every year as part of its normal dividend planning, but it also loaned money to a foreign subsidiary to fund a plant expansion. If the loan occurs within 36 months of any of the dividends, all or part of the loan is now equity and, hence, a hybrid instrument. The sheer breadth of the rules will make it difficult for the IRS to argue on audit that "a" principal purpose for receiving dividends and making loans for capital expansion (something that occurs every day) is to avoid the Proposed Regulations. Hence, despite the IRS's attempt to draft heads-I-win-tails-you-lose rules, they will almost certainly result in the growth of the cross-border hybrid instruments that the OECD BEPS initiative was designed to curtail.

V. Conclusion

The Proposed Regulations are sweeping in their breadth. Due to the effective date provisions of the *Per Se* Recast Rules and the government's intention to finalize the regulations this year, taxpayers need to pay attention to these rules immediately. The Proposed Regulations will likely prove to impose extremely costly compliance burdens on all multinationals. It will also severely restrict common cash pooling practices of multinationals. For foreign-based multinationals, however, the *Per Se* Recast Rules are truly game-changing and will likely cause some foreign-based multinationals to rethink the after-tax return on investment of investing in the United States.

ENDNOTES

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1 Congress enacted an income tax in the Act of Aug. 5, 1861. Act Secs. 49–51 of the Act of Aug. 5, 1861, ch. 45, 12 Stat. 309. Despite being enacted, Secretary of the Treasury, Salmon B. Chase made no effort to actually collect the tax. Edwin R. A. Seligman, The Income Tax: A Study of the History, Theory and Practice of Income Taxation at Home and Abroad, at 435–436 (1911). There was, at the time, a debate over whether the tax should be imposed on "net" income, which implied that various deductions could be claimed, or whether the word "income" was sufficiently clear to allow for deductions from gross receipts. Cong. Globe, 37th Cong., 1st Sess. 315 (1861). As one author has noted, this distinction was the precursor of the United States' current debt-equity distinction because interest on "debt" was deductible in computing "net" income whereas dividends paid on equity were not. *See* Camden Hutchinson, The Historical Origins of the Debt-Equity Distinction, at 7 and 10 available on the Social Science Research Network.

2 Mortimer Caplin, *The Caloric Count of a Thin Incorporation*, 43 Marquette L. Rev. 31, 62–63 (1959) (noting how Congress enacted legislation in 1909, 1913, 1916 and 1919 impacting the amount of debt that could be incurred).

3 The Supreme Court addressed the issue indirectly in a continuity of interest case in *H.T. Paulsen*, SCt, 85-1 ustc ¶9116, 469 US 131, 105 SCt 627.

4 *John Kelley Co.,* SCt, 46-1 ustc ¶9133, 326 US 521, 66 SCt 299 (1946).

5 *Id*., at 526.

6 *P.E. Bauer*, CA-9, 84-2 ustc ¶9996, 748 F2d 1365, 1368; *R.A. Hardman,* CA-9, 87-2 ustc ¶9523, 827 F2d 1409, 1411; and *In re Duffy*, BC-DC-CA, 95-1 ustc ¶50,110.

7 *T. Mixon, Jr. Est.*, CA-5, 72-2 ustc ¶9537, 464 F2d 394, 402.

8 *Fin Hay Realty Co.*, CA-3, 68-2 ustc ¶9438, 398 F2d 694, 696.

9 For example, the Third, Fifth and Ninth circuits all consider whether or not the obligor could obtain debt from a third party as a factor to determine whether a shareholder loan should be considered debt. The Third Circuit, however, applies this test by asking whether or not a third party would lend to the obligor on the *same terms* that were used in the borrowing at issue. *See Scriptomatic, Inc.*, CA-3, 555 F2d 364 (1977) (phrasing the test as "whether the transaction would have taken the same form had it been between the corporation and an outside lender … ."); *Segel*, 89 TC 816, 827 (1987) (also applied the test strictly because the case could be appealed to the Third Circuit). The Fifth Circuit phrases the test quite differently, suggesting that the independent creditor factor will be satisfied if the borrower can demonstrate that they could borrow the same amount pursuant to *any terms*. *See Montclair, Inc.*, CA-5, 63-1 ustc ¶9489, 318 F2d 38, 40; *Tomlinson v. 1661 Corp.*, CA-5, 67-1 ustc ¶9438, 377 F2d 291. The Ninth Circuit is less clear.

10 S. Rep. No. 91-552, pt. 2, at 137–138 (1969).

11 H.R. Rep. No. 716, 102d Cong., 2d Sess. 3 ("It has come to the attention of the committee that certain issuers and holders may be taking inconsistent positions with respect to the characterization of a corporate instrument as debt or equity. For example, a corporate issuer may designate an instrument as debt and deduct as interest the amounts paid on the instrument, while a corporate holder may treat the instrument as equity and claim a dividends received deduction with respect to the amounts paid on the instruments. The committee believes that the fisc should be protected from this whipsaw potential of inconsistent debt-equity classifications."); 138 Cong. Rec. H7165-66 (daily ed. Aug. 3, 1992) (statement of Rep. McGrath) ("[Code Sec. 385(c)] will help prevent an illegal tax avoidance scheme known among practitioners as the debt-equity whipsaw. Issuers of stocks or bonds and the holders of those interest classify their interests differently to maximize tax advantages.") *See also* Philip R. West, *Foreign Law in U.S. International Taxation: The Search for Standards*, reprinted in 96 Tax Notes International 161-13 at fn. 119 (Aug. 16, 1996) ("In the domestic context, inconsistent treatment of hybrid instruments is severely limited by section 385(c), enacted in 1992 (Pub. L. No. 102-486, section 1936(a), 106 Stat. 2776, 3032), which provides that the issuer's characterization, at the time of issuance, of an instrument as stock or debt is binding on the issuer and on all holders except holders who disclose on their tax returns that they are treating the instrument in a manner inconsistent with the issuer's characterization. Although section 385(c) generally mandates consistent treatment for U.S. income tax purposes, it has no effect on the treatment of an instrument under foreign law. Consequently, it does not limit the inconsistent treatment of a hybrid instrument under the laws of the United States and a foreign jurisdiction.").

12 Proposed regulations under Code Sec. 385(a) were issued on March 24, 1980. Final

regulations were issued in December 1980 (with a delayed effective date). The final regulations were withdrawn in 1983. T.D. 7920, 1983-2 CB 69.

[13] Notice 94-47, 1994-1 CB 357. *See also* Rev. Rul. 83-98, 1983-2 CB 40 and Rev. Rul. 85-119, 1985-2 CB 60.

[14] S. Rep. No. 91-552, pt. 2, at 138 (1969); Joint Comm. on Internal Revenue Taxation, 91st Cong., General Explanation of the Tax Reform Act of 1969, at 124 (1970).

[15] *See, e.g.*, Reg. §1.482-2(a)(1)(iii)(B). There is an exception to the Funding Rule (described below) for "ordinary course" trade receivables and payables incurred to pay deductible expenses or for inventory but this exception only applies to the Funding Rule. It does not apply to the Documentation Rule or the Anti-Abuse Rule.

[16] Marie Sapire, *News Analysis: Model Treaty Highlights Treasury's New International Policies*, 151 Tax Notes 148 (Apr. 11, 2016).

[17] Proposed Reg. §1.385-2(f).

[18] There is one exception for debt that springs into existence before the Documentation Rules are finalized due to an entity classification election filed after the date the Documentation Rules are finalized. Proposed Reg. §1.385-2(f).

[19] Proposed Reg. §1.385-3(h)(1). Proposed Reg. §1.385-1(f), which contains certain definitions and describes the consequences of a deemed exchange when a debt is recast as equity after it is issued, is generally applicable after it is finalized but can also apply to any debt issued after April 4, 2016, and any debt that springs into existence before April 4, 2016, as a result of an entity classification election filed after April 4, 2016.

[20] Interestingly, the Proposed Regulations do not explicitly say that, but they imply that conclusion by referring in the Documentation Rules to "deemed issuances" under Reg. §1.1001-3. *See* Proposed Reg. §1.385-2(b)(3)(ii)(B).

[21] Proposed Reg. §1.385-3(h)(3).

[22] Proposed Reg. §1.385-1(b)(3).

[23] Proposed Reg. §1.385-1(b)(3)(i)(A).

[24] Proposed Reg. §1.385-1(b)(3)(i)(C).

[25] Proposed Reg. §1.358-1(b)(3)(i)(B) and (ii).

[26] Proposed Reg. §1.358-1(b)(3)(ii).

[27] Proposed Reg. §1.358-2(c)(6)(i).

[28] Proposed Reg. §1.385-1(b)(1).

[29] (Emphasis added).

[30] Proposed Reg. §1.358-2(a)(4)(i).

[31] 81 FR 20911, 20920 (Apr. 4, 2016).

[32] Proposed Reg. §1.358-2(a)(4)(ii).

[33] Proposed Reg. §1.385-2(a)(2)(i)(A)-(C). In the event the Applicable Financial Statement is denominated in a non-U.S. dollar currency, the statement has to be translated into U.S. dollars at the spot exchange rate on the date of the Applicable Financial Instrument. Proposed Reg. §1.385-2(a)(2)(ii).

[34] Proposed Reg. §1.385-2(a)(4)(iv)(A)-(C).

[35] Proposed Reg. §§1.385-1(e) and 1.385-2(c)(4)(i).

[36] H.R. Rep. No. 101-386, at 562 (1989) (Conf. Rep.).

[37] *C.M. Gooch Lumber Sales*, 49 TC 649, Dec. 28,883 (1968) (concluding that advances made to corporation before June 30, 1960, were debt, whereas advances after that point were not); *Chester I. Johnson*, 36 TCM 1780, Dec. 34,806(M), TC Memo 1977-436 (concluding that advances made to corporation in 1971 were debt, whereas advances in 1972 were contributions to capital).

[38] In amending Code Sec. 385 as part of the 1989 Act, Congress contemplated the possibility of bifurcating an instrument into separate debt and equity components. *See* H.R. Rep. No. 386, 101st Cong., 1st Sess. (1989) ("The committee believes that the Treasury Department should be accorded the opportunity to separately characterize different portions of such instruments as debt or equity."). In fact, prior to this amendment to Code Sec. 385, at least two courts reached the conclusion that, based on the facts of the particular case, the instrument in issue should be bifurcated into an equity component and a debt component for federal income tax purposes. *See Richmond Fredericksburg & Potomac R.R. Co.*, CA-4, 76-1 USTC ¶9101, 528 F2d 917; *Farley Realty Corp.*, CA-2, 60-2 USTC ¶9525, 279 F2d 701 (1960). *See also* Rev. Rul. 88-31, 1988-1 CB 302; Rev. Rul. 78-142, 1978-1 CB 111; Rev. Rul. 75-33, 1975-1 CB 115 (rulings treating separately tradable equity interests as severable from the accompanying debt instrument). Despite these decisions and the congressional intent underlying the 1989 amendment to Code Sec. 385, it appears that both the IRS and the courts have generally been unwilling to apply a bifurcation approach to debt/equity classification issues. Instead, an instrument's debt characteristics have been weighed against its equity characteristics and the instrument characterized according to its predominant factors (*i.e.,* an "all or nothing" approach). *See, e.g., Monon Railroad*, 55 TC 345, 356, Dec. 30,438 (1970) (*acq.*); *C.E. Curry*, 43 TC 667, 686, Dec. 27,251 (1965) (*acq.*); Rev. Rul. 83-51, 1983-1 CB 48; Rev. Rul. 76-413, 1976-2 CB 213; TAM 8735008 (May 22, 1987). In *Farley Realty*, the court bifurcated a $70,000 loan into a debt instrument and a 50-percent interest in underlying real estate. The creditor was entitled to interest at a rate of up to 15 percent on the principal, plus 50 percent of any appreciation in the property if it were sold to a third party. This conclusion should be compared to the conclusion reached by the IRS in Rev. Rul. 83-51, 1983-1 CB 48, to the effect that a payment of 40 percent of any appreciation in real estate collateralizing a mortgage loan during the term of the mortgage was interest. A significant factor considered in reaching this conclusion was that, unlike *Farley Realty*, the contingent payment right (or shared appreciation component of the mortgage) was extinguished if and when the total fixed principal and interest owed on the mortgage was paid, including prepayments, prior to disposition of the real estate. Also, in GCM 36702 (Apr. 12, 1976), the IRS observes that bifurcation generally would necessitate the allocation of a single principal amount between severable debt and equity interests. The IRS notes the "serious computational problems" that such allocation would entail. "Such an allocation might require computing the amount allocable to the loan as a portion of the contribution sufficient to establish the fixed interest as a true, arm's-length return and then allocating the remaining portion to equity." The *Farley Realty* court did not address this issue in its analysis.

[39] 81 FR 20911, 20914 (Apr. 4, 2016).

[40] Proposed Reg. §1.385-1(d)(1).

[41] Proposed Reg. §1.385-1(d)(2).

[42] Proposed Reg. §1.385-1(b)(5).

[43] *Id.*

[44] Proposed Reg. §1.385-1(b)(5).

[45] Proposed Reg. §1.385-1(b)(4).

[46] Proposed Reg. §1.385-1(b)(5) ("In addition, if a person (as defined in section 7701(a)(1)) is treated, under the rules of section 318, as owning at least 50 percent of the value of the stock of a modified expanded group member, the person is treated as a member of the modified expanded group.")

[47] Proposed Reg. §1.385-3(f)(3).

[48] 81 FR 20911, 20922 (Apr. 4, 2016).

[49] 81 FR 20911, 20915 (Apr. 4, 2016).

[50] Proposed Reg. §1.385-2(b)(1)(i) ("If the requirements of this section are satisfied, general federal tax principles apply to determine whether, or the extent to which, the EGI is treated as indebtedness for federal tax purposes.")

[51] 81 FR 20911, 20920 (Apr. 4, 2016).

[52] A fifth item of documentation, relating to an instrument that is not in form indebtedness is reserved. Proposed Reg. §1.385-2(b)(2)(v).

[53] Proposed Reg. §1.385-2(b)(2)(i).

[54] Proposed Reg. §1.385-2(b)(3)(ii)(A).

[55] Reg. §1.482-7(k)(1)(iii).

[56] Proposed Reg. §1.385-2(b)(3)(ii)(A).

[57] Proposed Reg. §1.385-2(b)(3)(iii)(A).

[58] Proposed Reg. §1.385-2(b)(3)(iii)(A).

[59] Proposed Reg. §1.385-2(b)(3)(i) and (Proposed Reg. §(iii)iii).

[60] Proposed Reg. §1.385-2(b)(3)(iii)(B).

[61] Andrew Velarde, Cash-Pooling Viability Debated Following U.S. Related Party Debt Regulations, 2016 WTD 81-7 (citing Kevin Nichols, "when I think about 'cash pools' I view that term as just a label and I need to understand more of what is behind it.").

[62] Proposed Reg. §1.385-2(b)(2)(ii).

[63] Proposed Reg. §1.385-2(b)(2)(ii).

[64] Proposed Reg. §1.385-2(b)(2)(iii).

[65] *Id.*

[66] *Id.*

[67] *Id.*

[68] Proposed Reg. §1.385-3(b)(3)(B).

[69] *Id.*

[70] *Id.*

[71] Proposed Reg. §1.385-3(b)(2)(iv).

[72] Proposed Reg. §1.385-3(b)(2)(iv)(A).

[73] Proposed Reg. §1.385-3(b)(3)(ii)(C).

[74] *Pepsico Puerto Rico, Inc. et al.*, 104 TCM 322, Dec. 59,199(M), TC Memo. 2012-269; *Fin Hay Realty Co.*, CA-3, 68-2 USTC ¶9438, 398 F2d 694, 697 [22 AFTR 2d 5004]; *Litton Bus. Sys., Inc.*, 61 TC 367, 377, Dec. 32,263 (1973); *A.R. Lantz Co.*, CA-9, 70-1 USTC ¶9308, 424 F2d 1330, 1333 [25 AFTR 2d 70-917].

[75] Proposed Reg. §1.385-3(b)(2)(iv)(B).

[76] Proposed Reg. §1.385-3(b)(2)(iv)(B).

[77] Proposed Reg. §1.385-3(b)(2)(iv)(C).

[78] Proposed Reg. §1.385-2(c)(1).

[79] 81 FR 20911, 20921–20922 (Apr. 4, 2016).

[80] *See, e.g.*, Reg. §1.6038-2(k)(3) (relating to failure to file Form 5471 for a controlled foreign corporations); Reg. §1.6038-3(k)(4) (relating to failure to file Form 8865 for a controlled foreign partnership); Reg. §1.6664-4 (relating to relief from accuracy related penalties); Reg. §1.1503(d)-1(c)(2) (relating to make certain filings and elections with respect to dual-consolidated losses); Reg. §1.367(a)-8(p) (relating to failure to file a gain recognition agreement).

[81] *See* Reg. §301.6724-1(j).

[82] Proposed Reg. §1.358-2(c)(6)(ii).

[83] Proposed Reg. §1.385-2(c)(5).

[84] Rev. Rul. 99-5, 1999-1 CB 434.

[85] Code Secs. 875 and 6031.

[86] *See* Code Sec. 882 and *Swallows Holding Co.*, CA-3, 2008-1 USTC ¶50,188, 515 F3d 162.

[87] The taxpayer may conceivably have an argument under case law that treats springing debt differently, however. Specifically, in *Wham Construction Co.*, a corporation ("A") transferred all of the assets of its asphalt division (the transferred division) into a newly created corporation ("B") in exchange for stock. *Wham Construction Co.,* CA-4, 79-2 USTC ¶9471, 600 F2d 1052. In addition, B assumed as a liability a pre-existing intracompany accounts receivable held by A's remaining division and previously owed by the newly transferred division. After the incorporation of B, one such receivable was due from the transferred division to the transferor corporation. Although the court noted that the indebtedness, appropriately, was not reflected on the books of the transferor corporation (because the corporation could not be indebted to itself), the court recognized the existence of the loan. The court determined that in fact the transactions should be regarded as two separate and distinct steps: (i) a loan in the amount of the intracompany account receivable and (ii) a Code Sec. 351 incorporation, as opposed to an integrated transaction where Code Sec. 351(b) applies. In some situations, an obligation to a shareholder has been held not to exist, and as a result the determination of whether a note is boot issued or part of a nontaxable loan transaction is never reached. *See R. Shisler Farms, Inc.*, 33 TCM 635, Dec. 32,618(M), TC Memo. 1974-141 (1974). The court noted that the new subsidiary, instead of setting up an intracompany account with the taxpayer, could have borrowed money from a bank or, a few days after its organization, borrowed on a short-term basis from the taxpayer. In either case, according to the court, no boot would have been transferred. Moreover, the deemed transfer of money in exchange for the receivable was only temporary, as demonstrated by the receivables' repayment within a year after the organization with assets transferred by the taxpayer to the subsidiary at the time of the organization. The court explained its rationale as follows:

> [I]t is readily apparent that what it [the taxpayer] got it already owned. What the brothers did was to wrap the asphalt business [the transferred division] … into a new corporate housing. There was no substantive change … . The purpose of Section 351 is to insure that no tax consequence will be recognized when one or more persons transfer property to a corporation solely in exchange for stock or securities in such corporation when the transferor or transferors immediately after the exchange are in control of the corporation. When there has been only a change in form and the transferor has not received anything which, in an economic sense, he did not possess before, he should not suffer the imposition of income tax liability … . The exchange here, however, cannot be regarded as a partial sale, for the … receivable was the same old receivable that had been on the construction division books after adjustment for asphalt division trucks and equipment not transferred. And since its retention necessitated the transfer of quick assets to provide the asphalt corporation with a healthy beginning, it was a giving with one hand what the other hand retained. In short, there was no economic change of substance effected by the exchange, and the construction company received in the exchange no "other property" within the meaning of Sections 351(b) or 361(b) … We look to the substance of the transactions of the brothers, and not the mere form of their dealings.

Wham Construction, 600 F.2d at 1054. What seems to have principally motivated the court's decision was the understanding of the parties prior to the transactions that the receivable that sprang into existence upon the incorporation of the subsidiary was to be repaid within a short period with funds provided by the transferor itself. On this view, by getting the receivable, the transferor did not realize any gain from its transferred assets. The Wham court implicitly appeared to be concluding that the transferor taxpayer transferred a net amount (fair market value property subject to a payable).

[88] Proposed Reg. §1.385-2(b)(2)(iii).

[89] *Tax Reform Act of 1969: Hearings on Tax Reform Before the H. Comm. on Ways and Means*, 91st Cong. 5493 (1969) (statement of Edwin S. Cohen, Assistant Secretary of the Treasury for Tax Policy).

[90] For this purpose, the term "property" is defined by reference to Code Sec. 317 and so excludes stock of the issuing corporation. Proposed Reg. §1.385-3(f)(10).

[91] Proposed Reg. §1.385-3(b)(2).

[92] *Kraft Foods Co.,* CA-2, 56-1 USTC ¶9428, 232 F2d 118.

[93] 81 FR 20911, 20917 (Apr. 4, 2016).

[94] Proposed Reg. §1.385-3(g)(3), Example 1.

[95] 81 FR 20911, 20917 (Apr. 4, 2016). ("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. An example of the latter type of transaction could involve the distribution of a note from a first-tier CFC to its United States shareholder in a taxable year when the distributing CFC has no earnings and profits (although lower-tier CFCs may) and the United States shareholder has basis in the CFC stock. In a later taxable year, when the distributing CFC had untaxed earnings and profits (such as by reason of intervening distributions from lower-tier CFCs), the CFC could use cash attributable to the earnings and profits to repay the note owed to its United States shareholder.")

[96] *M. Falkoff*, CA-7, 79-2 USTC ¶9569, 604 F2d 1045, 1046–1047.

[97] *Id.*, at 1051.

[98] There may be significant nontax issues that make this alternative unpalatable such as showing large third party creditors on the balance sheet, borrowing costs, *etc*.

[99] Proposed Reg. §1.385-3(g)(3), Example 16.

[100] Michael L. Schler, *Rebooting Section 356: Part 1—The Statute*, Tax Notes (July 19, 2010), at 288–293; Department of the Treasury, General Explanations of the Administration's Fiscal Year 2016 Revenue Proposals (February 2015), at 119–121; 81 FR 20911, 20918 (Apr. 4, 2016) ("Internal asset reorganizations can operate in a similar manner to section 304 transactions as a device to convert what otherwise would be a distribution in to a sale or exchange transaction without having any meaningful non-tax effect … . Consider the following example: A foreign parent corporation (Parent) owns all of the stock of two U.S. subsidiaries, S1 and S2. In a transaction qualifying as a reorganization described in section 368(a)(1)(D), Parent transfers its stock in S1 to S2 in exchange for a note issued by S2, and S1 converts to a limited liability company. For federal tax purposes, S1 is treated as selling all of its assets to S2 in exchange for a debt instrument, and under section 356, Parent is treated as receiving the S2 debt instrument from S1 in a liquidating distribution with respect to Parent's S1 stock. This transaction has a similar effect (and tax treatment) as a section 304 transaction in which S2 issues a

debt instrument to Parent in exchange for S1 stock, with the only difference being that S2 acquired the assets of S1 instead of the S1 stock and that Parent received the debt instrument as a result of the liquidation of S1. This transaction introduces no new capital into the P group, and does not affect the ultimate ownership of the assets held by S1 or S2. Furthermore, S1 generally would not be required to recognize any built-in gain on the transfer of its assets to S2. Although this transaction entails a transfer of assets from S1 to S2, the tax costs (if any) and the non-tax consequences that result from this type of transaction among related parties are typically insignificant relative to the federal tax benefits obtained through the introduction of a related-party debt instrument. Accordingly, the proposed regulations treat a debt instrument issued by an acquiring corporation as consideration in an exchange pursuant to an internal asset reorganization as stock, consistent with the treatment of a debt instrument issued in a distribution or in exchange for affiliate stock. This transaction introduces no new capital into the P group, and does not affect the ultimate ownership of the assets held by S1 or S2. Furthermore, S1 generally would not be required to recognize any built-in gain on the transfer of its assets to S2. Although this transaction entails a transfer of assets from S1 to S2, the tax costs (if any) and the non-tax consequences that result from this type of transaction among related parties are typically insignificant relative to the federal tax benefits obtained through the introduction of a related-party debt instrument. Accordingly, the proposed regulations treat a debt instrument issued by an acquiring corporation as consideration in an exchange pursuant to an internal asset reorganization as stock, consistent with the treatment of a debt instrument issued in a distribution or in exchange for affiliate stock.").

[101] *See, e.g.*, Proposed Reg. §1.385-3(g)(3), Example 3, for an example of a recast involving what would otherwise have been a Code Sec. 304 transaction.

[102] Proposed Reg. §1.385-3(g)(3), Example 11.

[103] Proposed Reg. §1.385-3(g)(3), Example 2.

[104] Proposed Reg. §1.385-3(b)(2)(iii).

[105] Proposed Reg. §1.358-3(f)(1).

[106] 81 FR 20911, 20923 (Apr. 4, 2016). ("The third prong of the general rule is limited to debt instruments distributed to shareholders pursuant to the reorganization, and does not apply to debt instruments exchanged for securities or other debt interests because, in that latter case, the newly issued debt instrument is exchanged for existing debt interests and thus no additional debt is incurred by the parties to the reorganization.")

[107] References to the Funded Member include references to predecessors or successors of the Funded Member. Proposed Reg. §1.385-3(b)(3)(v). For this purpose, the term "predecessor" is defined to mean the person transferring or distributing assets to the corporation at issue in a transaction described in Code Sec. 381(a) of the Code, including a divisive reorganization under Code Sec. 368(a)(1)(D). Proposed Reg. §1.385-3(f)(9). A "successor" refers to a corporation that acquires assets from the corporation at issue. Proposed Reg. §1.385-3(f)(11).

[108] Proposed Reg. §1.385-3(b)(3)(i) and (ii).

[109] Proposed Reg. §1.385-3(b)(3)(vi).

[110] Proposed Reg. §1.385-3(b)(3)(iv)(A).

[111] Proposed Reg. §1.385-3(b)(3)(iv)(B)(1).

[112] Proposed Reg. §1.385-3(g)(3), Example 4.

[113] Proposed Reg. §1.385-3(b)(3)(iv)(B)(2).

[114] Typically, rules that presume transactions to be part of the same plan use, at most, a two-year window. *See, e.g.*, Code Sec. 355(e)(2)(B) (acquisition of stock representing a 50-percent or greater interest in a distributing corporation or controlled corporation in a Code Sec. 355 distribution with two years before or after the Code Sec. 355 distribution presumed to be part of a plan); Code Sec. 269(b)(1) (tax benefits of liquidation of target within two years after a qualified stock purchase denied if principal purposes was avoidance of US federal income tax); Code Sec. 1031(e)(2) (taxable disposition by a related party within two years after a taxpayer's tax-free like-kind exchange treated as a disposition by the taxpayer); Code Sec. 382(c)(1) (new loss corporation is not treated as continuing its business if business is ceased within two years after ownership change); Code Sec. 382(l)(1)(B) (capital contributions made within two years prior to ownership changes deemed to be part of a plan to increase loss carryforward limitation); Reg. §1.707-3(c) (contribution and distribution within a two year period generally deemed to constitute a sale to a partnership); Reg. §1.381(c)(22)-1(b)(13)(iii) (acquiring corporation's transfer of an insurance or annuity contract it received in the liquidation or reorganization to another person within two years deemed to be pursuant to a plan in existence at the time of the liquidation or reorganization).

[115] To avoid recognition of gain on certain outbound stock transfers, taxpayers must file an agreement with the IRS, where that taxpayer agrees to recognize gain on a subsequent disposition made within five years of the original transfer. *See* Reg. §1.367(a)-3; Reg. §1.367(a)-8.

[116] Taxpayers who make a domestic use election, allowing them to use dual-consolidated losses to offset U.S. taxable income, must certify that there has been and will not be a foreign use of such losses within five years of the time the agreement was entered. *See* Reg. §1.1503(d)-6(d)(1); Reg. §1.1503(d)-1(b)(20).

[117] There are additional examples of statutory periods, where otherwise separate actions or circumstances impact one another based on their temporal proximity. *See, e.g.*, Code Sec. 302(c)(2)(A) (a distribute in a stock redemption is not treated as not terminating its interests in a distributing corporation when the distribute acquires an interest in the distributing corporation within 10 years after the terminating distribution); Code Sec. 897(c)(1)(A) (a U.S. corporation continues to be treated as a United States real property holding corporation for five years after it no longer holds the requisite amount of U.S. real property); Code Sec. 735 (gain from a partner's sale of property received in a distribution from a partnership, where the property was held as inventory by the partnership, is treated as ordinary income, when the property is sold within five years from the distribution; Code Sec. 382(i) (the testing period to determine whether there has been a change in ownership triggering a 382 limitation is generally three years); Reg. §1.884-2T(a)(2)(i) (the "complete termination of a U.S. trade or business" exception from the branch profits tax does not apply if the foreign taxpayer or a related party operated a U.S. trade or business within three years after the complete termination). Yet, none of these examples operates by deeming two transactions as being part of the same plan.

[118] Proposed Reg. §1.385-3(b)(3)(iii).

[119] Proposed Reg. §1.385-3(b)(3)(ii)(A).

[120] Proposed Reg. §1.385-3(b)(3)(ii)(A).

[121] Proposed Reg. §1.385-3(g)(3), Example 10.

[122] Proposed Reg. §1.385-3(b)(3)(ii)(B).

[123] Proposed Reg. §1.385-3(b)(3)(ii)(C).

[124] Proposed Reg. §1.385-3(b)(3)(iv)(B)(3).

[125] Proposed Reg. §1.385-3(g)(3), Example 5.

[126] Proposed Reg. §1.385-3(d)(1)(i).

[127] Proposed Reg. §1.385-3(d)(1)(ii). *See also* Proposed Reg. §1.385-3(g)(3), Example 6.

[128] Proposed Reg. §1.385-3(b)(3)(iv)(B)(4).

[129] Proposed Reg. §1.385-3(b)(5).

[130] Proposed Reg. §1.385-3(g)(3), Example 8.

[131] Proposed Reg. §§1.385-3(f)(9) and (11).

[132] Proposed Reg. §1.385-3(g)(3), Example 9.

[133] Proposed Reg. §1.385-3(b)(4).

[134] Reg. §1.446-3(f)(2).

[135] Proposed Reg. §1.385-3(g)(3), Example 17.

[136] Proposed Reg. §1.385-3(c)(2).

[137] Proposed Reg. §1.385-3(c)(2). If the debt is denominated in a non-U.S. dollar currency, it must be translated at the spot rate on the date the instrument is issued.

[138] Proposed Reg. §1.385-3(c)(1).

[139] Proposed Reg. §1.385-3(c)(3).

[140] For this purpose, "indirect" ownership is determined using the rules in Code Sec. 958(a) without regard to whether the intervening corporations are domestic or foreign. Proposed Reg. §1.385-3(c)(3).

[141] Proposed Reg. §1.385-3(g)(3), Example 12.

[142] Proposed Reg. §1.385-3(f)(11)(ii) .

[143] *Id.*

[144] Proposed Reg. §1.385-3(d)(1)(ii).

[145] Proposed Reg. §1.385-3(d)(5)(i).

[146] Proposed Reg. §1.385-3(d)(5)(i).

[147] *Id.*

[148] *See generally* Reg. §1.752-2 and Reg. §1.752-3.

[149] Proposed Reg. §1.385-3(g)(3), Example 13.

[150] Proposed Reg. §1.385-1(b)(3).

[151] Proposed Reg. §1.385-1(b)(1).

[152] Proposed Reg. §1.385-3(d)(5)(i).

[153] Proposed Reg. §1.385-3(g)(3).

[154] Proposed Reg. §1.385-1(b)(3).
[155] Proposed Reg. §1.385-3(g)(3), Example 15.
[156] Proposed Reg. §1.385-3(d)(6).
[157] Proposed Reg. §1.385-2(c)(3)(i) (addressing an Applicable Instrument for which the Documentation requirements are not satisfied upon inception); and Proposed Reg. §1.385-3(d)(1)(i) (governing a debt instrument that is recast as equity under the General Rule, Funding Rule or Anti-Abuse Rule from inception).
[158] Proposed Reg. §1.385-2(c)(3)(i). Because members of a consolidated group are treated as a single corporation, a transfer of an obligation held by an outside creditor and issued by a member of a consolidated group to another member of the same consolidated group results in the deemed extinguishment of the obligation under Proposed Reg. §1.385-2(c)(4)(i) for purposes of the proposed Code Sec. 385 regulations. Presumably, this does not prevent the application of Reg. §§1.1502-13(g)(5) and \§(6) to such an inbound transaction. *See* Proposed Reg. §1.385-2(c)(4)(ii) (noting that "[t]his paragraph (c)(4)(i) [sic] does not affect the application of the rules under §1.1502-13(g)").
[159] Proposed Reg. §1.385-2(c)(2)(i) and(3)(i).
[160] Proposed Reg. §1.385-2(c)(3)(ii).
[161] Proposed Reg. §1.385-1(c).
[162] *See generally* Code Sec. 1271 (governing gain or loss to holder on satisfaction of a debt instrument).
[163] Proposed Reg. §1.385-1(c) and Reg. §1.988-2(b)(13). Given that currency gain or loss is limited to the economic gain or loss on the entire instrument, the proposed regulations deem the entire economic gain or loss on the instrument to be equal to the currency gain or loss. This will prevent taxpayers from arguing, for example, that their economic gain is less than the currency gain and, thus, less gain needs to be recognized.
[164] Proposed Reg. §1.385-1(c).
[165] Proposed Reg. §1.385-1(c).
[166] Proposed Reg. §1.385-3(d)(1)(i).
[167] Proposed Reg. §1.385-3(d)(1)(ii).
[168] Proposed Reg. §1.385-2(c)(2)(ii). The regulations are silent on what happens if the Applicable Instrument retains its stock classification, but presumably the answer is "nothing." There is no special treatment under the Proposed Regulations.
[169] *Id*.
[170] Proposed Reg. §1.385-3(d)(2).
[171] Proposed Reg. §1.385-3(g)(3), Example 7.
[172] Proposed Reg. §1.385-3(d)(2).
[173] Proposed Reg. §1.385-4(c). For example, if the common parent of a consolidated group (USP) issues a USP note to its sole foreign shareholder (FP) in Year 1, and in Year 2 another member of the USP consolidated group (USS) issues a USS note to FP in exchange for the USP note, it would appear that neither the General Rule nor the Funding Rule applies to the USS note. However, one might expect in such instances that the IRS would apply the Anti-Abuse Rule to recast the USS note issued to FP as stock.
[174] *Id*.
[175] Proposed Reg. §1.385-2(c)(4)(i).
[176] Proposed Reg. §1.385-2(c)(4)(ii).
[177] Proposed Reg. §1.385-2(b)(3)(ii)(A).
[178] Proposed Reg. §1.385-4(b)(1)(i).
[179] Proposed Reg. §1.385-4(d)(3), Example 5.
[180] Proposed Reg. §1.385-4(b)(1)(ii).
[181] Proposed Reg. §1.385-4(d)(3), Example 3.
[182] Proposed Reg. §1.385-4(b)(2).
[183] Proposed Reg. §1.385-4(d)(3), Example 1.
[184] Proposed Reg. §1.385-4(b)(1)(ii)(B).
[185] Proposed Reg. §1.385-4(d)(3), Example 2.
[186] Proposed Reg. §1.385-4(b)(1)(ii)(B).
[187] Proposed Reg. §1.385-4(d)(3), Example 4.
[188] Proposed Reg. §1.385-4(d)(3), Example 2.
[189] 81 FR 20911, 20915 (Apr. 4, 2016). ("The Treasury Department and the IRS recognize that authorizing the Commissioner to treat purported debt instruments issued among unrelated parties as indebtedness in part and stock in part could result in unnecessary uncertainty in the capital markets in the absence of detailed standards for the exercise of that authority.") The preamble addressed the application of guarantees to the Documentation Rules specifically. 81 FR 20911, 20920 (Apr. 4, 2016). ("A person can be an issuer if that person is expected to satisfy a material obligation under an EGI, even if that person is not the primary obligor. A guarantor, however, is not an issuer unless the guarantor is treated as the primary obligor under federal tax principles. *See e.g.*, *Plantation Patterns, Inc. v. Commissioner*, 462 F.2d 712 (5th Cir. 1972).").
[190] *Plantation Patterns*, CA-5, 72-2 USTC ¶9494, 462 F2d 712, *cert. denied*, SCt, 409 US 1076, 93 SCt 683 (1972) (corporate debentures treated as loan to shareholder/guarantor followed by equity contribution to corporation because corporation too thin to have borrowed the funds without the principal shareholder's guarantee; thus, corporation's repayment of the debentures constituted a taxable dividend to the shareholder/guarantor); *Casco Bank & Trust Co.*, CA-1, 76-2 USTC ¶9722, 544 F2d 528, *cert. denied*, SCt, 430 US 907, 97 SCt 1176 (1977) (same). *But see Murphy Logging Co.*, CA-9, 67-1 ustc ¶9461, 378 F2d 222 (corporation respected as true borrower where not thinly capitalized; guarantee of shareholder reduced the cost of funds but was not essential to the borrowing); *In re Lane*, CA-11, 84-2 USTC ¶9817, 742 F2d 1311 (guarantees used as "substitutes for infusion of more capital"); *J.P. Smyers*, 57 TC 189, Dec. 31,062 (1971) (fact that bank loan would not have been made to corporation without the shareholder guarantee does not *per se* make the bank loan a loan to the shareholder and equity issued by the corporation where the corporation is not thinly capitalized).
[191] Code Secs. 861(a)(9) and 862(a)(9).

