Baker & McKenzie

Client Alert

November 1, 2016

Treasury Issues Temporary and Final Code Section 385 Regulations

On April 4, 2016, the United States Treasury ("Treasury") and the Internal Revenue Service ("IRS") proposed regulations (hereinafter, "Proposed Regulations") under Code Section 385 of the Internal Revenue Code (the "Code"). The Proposed Regulations were truly sweeping in their breadth and represented perhaps the most significant regulatory change in tax policy since the entity classification (or "check-the-box") regulations were issued over 20 years ago. The Proposed Regulations contained three (3) distinct sets of rules.

The first rule was referred to as the "Part-Stock Rule" and permitted the IRS to recast a single advance as equity "in part." The Part-Stock Rule applied to instruments where the issuer and the holder were members of the same modified expanded group ("MEG"). Even foreign corporations could be issuers under the Part-Stock Rule. The Part-Stock Rule would only be effective on a prospective basis, after notice and comment.

The second rule was the "Documentation Rule," which required the taxpayer to create and maintain documentation associated with certain instruments upon issuance and over the life of the instrument. The time frames for compliance were drafted by reference to the date the loans were issued or amended, or after certain events occurred. Failure to comply with the Documentation Rule with respect to any given instrument resulted in automatic recast of that instrument as equity. The Documentation Rule only applied to "Applicable Interests" which were defined as debt issued in the "form" of a loan. Moreover, the rule only applied if the issuer and holder of the Applicable Interest are part of the same affiliated group of corporations ("Expanded Group"). An Applicable Interest held between related parties was referred to as an Expanded Group Instrument ("EGI"). Like the Part-Stock Rule, the Documentation Rule applied to foreign issuers, and would only be effective on a prospective basis, after notice and comment.

The third, and most sweeping, rule was the "Per Se Recast Rule," which, under certain circumstances, caused an instrument that would otherwise be considered "debt" under the common law and the Documentation Rule to nevertheless be considered "equity." Like the Documentation Rule, the Per Se Recast Rule applied where the issuer and holder were part of the same Expanded Group. The rules were complex, but, at a high level, the rule applied if the debt instrument arose pursuant to a "tainted" transaction (the "General Rule"), or arose 36 months before or after (the "72-month window period") the occurrence of a "tainted" transaction (the "Funding Rule"), or was issued with a principal purpose of avoiding the General Rule or Funding Rule (a principal purpose debt instrument or "PPDI"). In brief and subject to a narrow set of exceptions, "tainted" transactions

Baker & McKenzie
Global Services LLC
300 East Randolph Drive
Suite 5000
Chicago, Illinois 60601, USA
Tel: +1 312 861 8000
Fax: +1 312 861 2899

involved the borrower: (i) making a distribution of property; (ii) acquiring stock of an Expanded Group member from another member, or (iii) issuing a note or property other than stock to an Expanded Group member in an asset reorganization described in section 368 of the Code. Unlike the Part-Stock Rule and Documentation Rule, the Per Se Recast Rule had immediate effect. It applied to all instruments issued on or after April 4, 2016. Thus, the regulations were effective prior to the government giving any notice and before the government received any taxpayer comment.

The Proposed Regulations were harshly criticized. In brief, many questioned whether the government had the authority to issue the Per Se Recast Rule in the first instance. Moreover, even if the government did have the authority, many questioned whether the government could upend decades of common law with an immediately effective regulation and without notice and comment. Most commentators recommended the sheer scope of the Per Se Recast Rule, including its 72-month window period, be narrowed. In particular, many questioned why Treasury was drafting such extremely complicated rules to address what, in many cases, would be foreign-to-foreign loans likely having only a tangential and indirect impact on US tax collections.

Taxpayers also questioned the need for, and scope of, the Documentation Rule. They questioned the time frame for compliance and complained that the penalty for non-compliance (*i.e.*, equity treatment) was disproportionate to the omission.

The Part-Stock Rule, which Congress had authorized in 1989, was less controversial. Comments on the Part-Stock Rule focused primarily on when it would be invoked, and how it would apply in practice if invoked.

On October 13, 2016, Treasury issued final, temporary and proposed regulations under section 385 (hereinafter referred to collectively as the "Final Regulations") which sought to address some of the concerns raised during the comment period. As a preliminary matter, Treasury withdrew the Part-Stock Rule and, instead, states in the preamble that the government continues to study the issue. In contrast, the government chose to retain both the Documentation and Per Se Recast Rule with many of the same onerous features that were heavily criticized in the Proposed Regulations. For example, failure to comply with the Documentation Rule will still lead to an equity recast, and the Per Se Recast Rule continues to rely on the exceedingly lengthy 72-month window period. Nevertheless, the government did seek to make the regulations more palatable to taxpayers by ***significantly*** limiting their scope. Whereas the Proposed Regulations applied to any foreign-to-US, US-to-foreign, and foreign-to-foreign debt instrument between members of an Expanded Group, the Final Regulations restrict their application solely to instruments issued by certain types of domestic corporations.

Thus, in sum, the Final Regulations will apply to a much smaller subset of related party loans than the Proposed Regulations would have. To the extent the Final Regulations do apply, however, they retain many of the same onerous features of the Proposed Regulations, with certain modifications that make them more administrable.

We analyze the Final Regulations in more detail below. First, we address which types of taxpayers gained the most from the changes brought by the Final Regulations and which taxpayers will likely still want to challenge them. Second, we set forth a Quick Reference Guide to enable taxpayers to quickly highlight significant changes from the Proposed Regulations to the Final Regulations. Third, we address the Documentation Rule. Fourth, we address the Per Se Recast Rule. Lastly, we end with some concluding observations about the way forward for many multinationals.

Winners & Losers

In a sense, all taxpayers benefit from the changes made in the Final Regulations. The withdrawal (albeit perhaps temporary) of the Part-Stock Rule and the significantly narrowed scope of the Documentation and Per Se Recast Rule benefits all taxpayers. Yet, the changes from the Proposed Regulations to the Final Regulations benefits some taxpayers much more than others.

S Corporations

The Final Regulations represent a significant improvement for S corporations. S corporations, for example, benefit from the withdrawal of the Part-Stock Rule. An S corporation that issues debt need not (at present) worry that its debt could be recast as a second class of stock, thereby violating its S corporation status, due to the Part-Stock Rule. But S corporations also benefit significantly from the fact that they are no longer considered part of an Expanded Group. Thus, even debt issued by a wholly owned domestic C corporation to its S corporation shareholder-parent is no longer subject to these recast rules, as the S corporation is not considered part of the Expanded Group.

US-Based Multinationals

Publicly-traded (or widely held) US-based multinationals are also winners. The Final Regulations substantially narrow the scope of the rules such that US-based multinationals will only have to address the Documentation Rule in the context of loans from its foreign subsidiaries to US affiliates.

Due to the application of subpart F and Code Section 956, it is not common or a foreign subsidiary of a multinational to make long-term loans of money to its US affiliates unless the tax department is involved in the decision and approves the transaction. Instead, the more common types of loans that would typically exist and be owing from a US corporation to its foreign subsidiary are trade payables.

As we will discuss below, unfortunately, US multinationals ***will*** have to ensure those trade payables and section 956 loans (if any) comply with the Documentation Rule. Nevertheless, loans between consolidated group members, loans from the US group to foreign subsidiaries, and loans between foreign subsidiaries do not, at present, need to comply with the Documentation Rule.

One way to minimize the necessary work under the Documentation Rule even further is to minimize (to the extent possible) the “touchpoints” that Expanded Group members that are not Covered Members have with Covered Members. Stated differently, if a multinational has 12 different members of its domestic consolidated group engaging in transactions with foreign affiliates, it may want to determine whether it could route those transactions through 1 Covered Member who then interacts with the other 11. This would have the effect of dramatically minimizing the sheer number of Covered Members for which documentation needs to be assembled as the transactions between the 1 Covered Member and the 11 other Covered Members would be between consolidated group members and, thus, not Applicable Interests.

Moreover, although, technically, the Per Se Recast Rule could conceivably apply to these loans, the discussion below will illustrate that the possibility of recast under these rules will be reduced under the Final Regulations. Specifically, trade payables would typically be exempt from the application of the Funding Rule in the first instance. Section 956 loans or loans that foreign subsidiaries make between quarter ends would not be exempt from the Funding Rule. Nevertheless, the fact that the US consolidated group is treated as one corporation makes it less likely (although not impossible) that a "tainted transaction" will occur.

> EXAMPLE: USCO, a publicly traded corporation, owns USSUB. USSUB owns all of the stock of FC1 and FC2. FC2 owns all of the stock of FC3. USCO and USSUB are domestic corporations and members of a US consolidated group. FC1, FC2, and FC3 are all foreign subsidiaries and controlled foreign corporations ("CFCs") within the meaning of Code Section 957. FC1 loans money to USSUB for a four-year period. The loan is considered an investment in US property. USSUB makes numerous dividend distributions during these years and USCO also makes distributions to its shareholders.

As will be seen below, the Final Regulations would treat FC1's loan to USSUB as a Covered Debt Instrument or "CDI." As such, they could potentially be subject to the Funding Rule and Per Se Recast Rule.

However, USSUB's distributions are not "tainted" because the consolidated group is treated as one corporation. Moreover, USCO's distributions to its shareholders are not "tainted" because they are not made to Expanded Group members.

There are traps for the unwary, however. Specifically, should USCO or USSB acquire stock of FC3 from FC2, that acquisition of Expanded Group stock could potentially be viewed as a "tainted" transaction. That transaction could then trigger a recast of FC1's loan to USSUB. Even though there is absolutely no obvious abuse in this case, a US consolidated group could suffer a detrimental recast on these facts. For this reason, even US-based multinationals should review their existing structures for CDIs and tainted transactions. They should seek to repay any problematic CDIs before they are recast on January 19, 2017, and put structures in place to prevent future CDIs or tainted transactions from occurring.

Thus, the takeaway for US-based multinationals is that while their burden has been reduced substantially, they must still comply with the Documentation Rules and remain vigilant with respect to the Per Se Recast Rule.

Foreign-Based Multinationals

Foreign-based multinationals fared the worst under the Final Regulations. This is not too surprising, given that the Proposed and Final Regulations were billed as "earnings stripping" regulations. Specifically, the Final Regulations continue to apply to loans payable from a US corporation to its foreign parent or foreign sister entities or subsidiary entities. In addition, the Final Regulations apply to loans even between two separate consolidated groups that are part of the same Expanded Group. All of these loans remain subject to both the Documentation Rule and Per Se Recast Rule. Thus, foreign-based multinationals will presumably still want to challenge these rules, and we address the mechanisms for doing so below.

Quick-Reference Guide

We produce a quick-reference guide below comparing the Proposed and Final Regulations with respect to each of the Part-Stock Rule, the Documentation Rule, and the Per Se Recast Rule.

Part-Stock Rule		
Rule:	**Proposed Regulations**	**Final Regulations**
Part-Stock Rule	Applied prospectively and allowed the IRS to recast certain debt instruments between related parties as equity "in part." Rule was designed to make it easier for the IRS to assert equity recasts where some but not all of the debt could reasonably be repaid.	Withdrawn pending further study.

Documentation Rules		
Rule:	**Proposed Regulations**	**Final Regulations**
Effective Date	Applied to EGIs issued on or after the Proposed Regulations were finalized.	Only applies to "Applicable Interests" (defined below) issued on or after January 1, 2018.
	Also applied to EGIs issued ***before*** the Proposed Regulations were finalized if the EGI was significantly modified within the meaning of Treas. Reg. §1.1001-3.	The Final Regulations state that a significant modification does <u>not</u> trigger a new testing date for purposes of documenting under Treas. Reg. §1.385-2(c)(2)(i) (issuer's unconditional obligation to pay); and (c)(2)(ii) (establishment of creditor's rights) unless the actual written terms of the EGI are altered. It is unclear whether EGIs issued before January 1, 2018, that are significantly modified after January 1, 2018 will be subject to the rules. Presumably, they will be if the actual written terms of the EGI are altered.
Scope	Applied to any instruments that were issued "in form" as debt instruments, which it referred to as "Applicable Interests." The rules even applied to non-interest bearing payables, such as trade payables.	The Final Regulations retain the Applicable Interest definition, but clarify that certain transactions are not considered Applicable Interests. The rules still include non-interest bearing trade payables.
	Only applied where the issuer and holder were members of the same Expanded Group	Only apply if the issuer is a Covered Member, which dramatically restricts their application to instruments issued by domestic corporations or disregarded entities owned by domestic corporations to another Expanded Group member. The rules do not apply to instruments issued by partnerships.

Documentation Rules		
Rule:	**Proposed Regulations**	**Final Regulations**
	Only applied when the Expanded Group was sufficiently large. An Expanded Group was sufficiently large if any member had publicly traded stock on an established financial market, the group had more than $100 million of assets on any applicable financial statement, or the group more than $50 million of revenue on any financial statement.	The Final Regulations retain the size requirement of the Proposed Regulations but clarify how assets and revenues are to be measured.
Consequences of Non-Compliance		
Corporate Issuer	The instrument was automatically recast as equity unless a stringent reasonable cause exception applied.	The instrument is recast unless one of three exceptions applies. First, the taxpayer can prove that a stringent reasonable cause exception applies. Second, the taxpayer can prove that the non-compliance was not material and the taxpayer remedied it before the IRS discovered the error. Third, the entire Expanded Group can demonstrate a "high" degree of compliance with respect to EGIs issued by Covered Members. If the group can demonstrate a "high" degree of compliance, then the Final Regulations establish a rebuttable presumption that the instrument should be recast. The presumption may be overcome by reference to various debt-equity factors.
Disregarded Entity Issuer	The Documentation Rule applied to EGIs issued by disregarded entities owned by Expanded Group member. If an EGI was recast, the disregarded entity was deemed to issue stock in satisfaction, thereby causing the entity to "spring" to life potentially creating significant negative tax consequences. The deemed exchange rule did not conform to the Per Se Recast Rule.	Like the Proposed Regulations, the Final Regulations do apply to EGIs issued by a disregarded entity. However, unlike the Proposed Regulations, if there is a recast, the stock is deemed to be issued by the owner of the disregarded entity. The deemed exchange rule in Treas. Reg. §1.385-1(d)(1)(iv)(A) is conformed with, and applies equally to, the Per Se Recast Rule.
Controlled Partnership Issuer	The Documentation Rule applied to EGIs issued by Controlled Partnership. If EGI recast, Controlled Partnership was deemed to issue equity in satisfaction of debt instrument, thereby potentially triggering significant shifts of allocable liabilities under section 752. The rule did not conform to the Per Se Recast Rule.	The Documentation Rule does not apply to debt issued by a Controlled Partnership. The only exception is if the debt is issued by a partnership with a principal purpose of avoiding the Documentation Rule.

Documentation Rules		
Rule:	**Proposed Regulations**	**Final Regulations**
Contents of Documentation	Proposed Regulations contained vague references to four (4) basic types of information that it required such as: (i) the unconditional obligation to pay a sum certain at maturity; (ii) creditor's rights; (iii) reasonable expectation to repay the EGI; and (iv) the ongoing debtor-creditor relationship.	The Final Regulations retain the four (4) basic types of information. The Final Regulations also provide: (i) a market-based safe harbor where the taxpayer may prove a lesser standard is used in the marketplace; and (ii) a special rule for regulated financial entities which will be deemed to satisfy the Documentation Rule provided the instrument is issued to satisfy regulatory requirements.
Time for Compliance	The Proposed Regulations required documentation to be assembled within a specified number of days after certain events (*e.g.*, the issuance of an EGI or its modification etc…).	The Final Regulations permit the Covered Member to put the documentation in place on or before the due date (including extensions) of the Covered Member's tax return for the year in which the event occurred which triggered the documentation requirement. For most calendar year taxpayers, this will be September 15, 2019.

Per Se Recast Rule		
Rule:	**Proposed Regulations**	**Final & Temporary Regulations**
Effective Date	Applied to any debt instrument issued by one Expanded Group member to another on or after April 4, 2016. The regulations clarified that if the regulations would cause the instrument to be recast, no recast would actually occur until 90 days after publication of the final regulations.	Applies to debt instruments issued by Covered Members, disregarded entities owned by those Covered Members and Controlled Partnerships to another member of the Expanded Group on or after April 5, 2016. As promised in the Proposed Regulations, no recast will occur until January 19, 2017, which is 90 days after October 21, 2016, the date that the Final Regulations were published in the Federal Register.
Scope	The Proposed Regulations referred to "expanded group debt instruments" to distinguish the types of instruments to which the Per Se Recast Rule applied from Applicable Interests, to which the Documentation Rule applied.	The Final Regulations refer to "Covered Debt Instruments" to distinguish them from Applicable Interests.
	The Proposed Regulations did not exempt certain types of instruments from the rules.	In response to comments from the financial industry, the Final Regulations do not apply to "Qualified Dealer Debt Instruments" defined in Treas. Reg. §1.385-3(g)(3)(ii) and Excluded Statutory or Regulatory Debt Instruments defined in Treas. Reg. §1.385-3(g)(3)(iii).

Per Se Recast Rule		
Rule:	**Proposed Regulations**	**Final & Temporary Regulations**
	The Proposed Regulations applied to any debt instrument issued between members of an Expanded Group other than consolidated group members.	The Final Regulations only apply to Covered Debt Instruments issued by a "Covered Member." This restricts the application of the rules to domestic corporations that issue debt to another Expanded Group member that is not a member of the same consolidated group as the issuer and where the issuer is not: (i) an "Excepted Regulated Financial Company" defined in Treas. Reg. §1.385-4(g)(3)(iv); or (ii) a "Regulated Insurance Company" defined in Treas. Reg. §1.385-4(g)(3)(v).
Transactions Triggering Recast	The Proposed Regulations recast debt instruments that ran afoul of a General Rule, a Funding Rule, or were considered PPDIs.	The Final Regulations also recast debt instruments that run afoul of a General Rule, Funding Rule or if they are considered PPDIs.
	The General Rule applies if the Covered Debt Instrument is distributed, issued in exchange for stock of an Expanded Member or issued in an asset reorganization.	The Final Regulations mirror the Proposed Regulations' General Rule.
	The Funding Rule applies if a Covered Debt Instrument is issued any time 36 months before or within 36 months after a tainted transaction (a.k.a., "the 72-month window period"). The Funding Rule is not rebuttable. A narrow exception was provided for debts issued in the ordinary course of business for inventory or which give rise to deductions under Code Section 162.	The Final Regulations retain the 72-month window period from the Proposed Regulations despite numerous comments to the contrary. The Final Regulations refused to make the Funding Rule a rebuttable presumption despite numerous comments to the contrary. The Preamble to the Final Regulations clarifies that only loans for "property" (not the provision of services, license or lease rights) can trigger the Funding Rule. Moreover, the Final Regulations contain a broader exemption for Qualified Short-Term Debt Instruments (or "QSTDIs"). The QSTDI definition is a composite of four (4) different exemptions we describe below. If a loan is described in any of these categories, it cannot trigger the Funding Rule.
Exceptions to "Tainted Transactions" Under the General Rule and Funding Rule:	The Proposed Regulations excepted certain transactions from the list of "tainted" transactions that would otherwise trigger a recast under the General Rule or Funding Rule.	The Final Regulations retain and expand on the exceptions.

Per Se Recast Rule		
Rule:	**Proposed Regulations**	**Final & Temporary Regulations**
Subsidiary Stock Exception	The Proposed Regulations provided that certain acquisitions of controlled subsidiary stock were not "tainted" acquisitions of Expanded Group member stock that would trigger a recast. Control was defined as owning 50 percent of voting power <u>and</u> value.	The Final Regulations retain the exception for subsidiary stock and retain the 50 percent vote and value threshold for determining control.
Current Year Earnings Reduction	The Proposed Regulations provided that a corporation could make a distribution or acquire property in a transaction that would otherwise be tainted, without triggering a recast to the extent the corporation's current year earnings exceeded the value of the distribution or acquisition. Effectively, the amount of the "tainted transaction" was reduced.	Treas. Reg. §1.385-3(c)(3)(i) expands the exception and provides that both current <u>and</u> accumulated earnings accrued while a member of the Expanded Group and in taxable years ending after April 4, 2016 are counted. It is important for taxpayers to remember that prior year earnings (*i.e.*, 2015 and before) are not counted.
Qualified Contribution Reduction		Treas. Reg. §1.385-3(c)(3)(ii) creates a new exception and that allows "Qualified Contributions" of select types of property to the Covered Member within a prescribed time period to reduce the amount of the a "tainted" transaction.
Threshold Exception	Allowed up to $50 Million of EGIs to run afoul of General or Funding Rule and avoid recast, but once the threshold was crossed all EGIs were recast from dollar one (so-called "Cliff Effect").	Retains $50 Million threshold but eliminates the Cliff Effect. Only Covered Debt Instruments exceeding the $50 million threshold are recast.
Section 355 Distributions	If not part of a divisive section 368(a)(1)(D) reorganization, a corporation's distribution of stock described in section 355 could be considered a distribution of "property" and therefore a tainted transaction that triggers application of the Funding Rule (described below).	A corporation's distribution of subsidiary stock that is described in Code Section 355 is not considered a distribution of property to which the Funding Rule can apply regardless whether the distribution occurs as a stand-alone section 355 distribution or as a component part of a divisive reorganization described in sections 368(a)(1)(D) and (G).
Section 331 and Section 332 Liquidations	Unclear how the Proposed Regulations applied.	The Final Regulations provide that distributions in a complete liquidation (whether taxable or not) is considered an "exempt distribution" and so not a tainted transaction that triggers the application of the General Rule or Funding Rule.

Per Se Recast Rule		
Rule:	**Proposed Regulations**	**Final & Temporary Regulations**
Cash Pooling	No special rules. Unclear how the rules applied to notional pooling. Both deposits into a treasury center and borrowings from a treasury center could potentially invoke the Per Se Recast Rule.	Clarifies that the rules can apply to physical and notional pooling arrangements. Exempts deposits by an Expanded Group member with the pool from the rules. Creates an exception for "Qualified Short Term Debt Instruments" to address borrowings from the pool. The actual application of these rules to notional pooling arrangements is still unclear.
Prohibition on Affirmative Use	A taxpayer could not affirmatively trigger the application of the Per Se Recast Rule in order to gain a tax advantage. In that case, the government reserved the right to continue treating the instrument as debt.	The prohibition on affirmative use is now reserved in the Final Regulations.
Straddling Expanded Groups	If P1 owned 100 percent of S and received a dividend from S in Year 1, P1 sold S to unrelated P2 in Year 2, and P2 loaned money to S in Year 3, the distribution and loan could trigger application of the Per Se Recast Rule.	S's distribution to P1 is no longer combined with P2's loan to S under Per Se Recast Rule, but the loan could still conceivably be considered a PPDI and subject to recast based on taxpayer's subjective intent. Moreover, if P1 and S are both acquired by P2, Per Se Recast Rule would continue to apply.

Key Common Definitions

The Documentation Rule and Per Se Recast Rule each contain unique definitions. Nevertheless, there are some terms common to both sets of rules that drive the application of the Final Regulations. We describe these key definitions and the implications of them below.

The Expanded Group and Expanded Group Parent Definitions

The Expanded Group is the term used to identify when issuers and holders are in a sufficiently close relationship to one another that the rules should apply. In sum, the Expanded Group refers to chains of corporations linked by direct or indirect ownership of at least 80 percent of voting power or value and headed by a common parent ("Expanded Group Parent"). The term "indirect" ownership allows for upward attribution from a corporation or partnership to its shareholder or partner, provided that, in the case of corporations, the shareholder must own at least 5 percent or more of the value of the corporation.

The Expanded Group Parent concept is new. It did not appear in the Proposed Regulations. It is introduced to illustrate the point that a given Expanded Group may only have a single Expanded Group Parent, but a given corporation may be a member of more than one Expanded Group.

> EXAMPLE: Assume that X and Y are unrelated publicly traded corporations. X owns all of the Class A stock of P, a corporation, and Y owns all of the Class B stock of P. P, in turn, owns S1, another corporation. The Class A stock represents 85 percent of the voting

> power, but only 15 percent of the value of P, whereas the Class B stock represents 85 percent of the value, but only 15 percent of the voting power of P. X, P and S1 form an Expanded Group with X as the Expanded Group Parent. Y, P and S1 also form an Expanded Group with Y as the Expanded Group Parent.

The Final Regulations narrow the Expanded Group definition in a couple of ways.

First, they provide that the Expanded Group Parent cannot be a regulated investment company ("RIC"), a real estate investment trust ("REIT") or a subchapter S corporation. However, a RIC or a REIT can still be an Expanded Group member if it is controlled by an Expanded Group member. Thus, certain captive REIT structures may be subject to the Final Regulations.

Second, family attribution and downward attribution are not permitted, although the regulations reserve the right to invoke those attribution rules in the future to reach brother-sister groups with a non-corporate owner. The removal of the downward attribution rules mitigates the fear that the regulations could apply to corporations that were not, in fact, related to one another. For example, assume USP, a domestic publicly traded corporation, owned all of the stock of Sub1 and, at the same time, owned a 50 percent interest in a joint venture with FP, a foreign corporation. Assume further that FP wholly owned a foreign subsidiary F1. There was a concern that USP's ownership of S1 and FP's ownership of F1 would be imputed to the joint venture vehicle and then to each other, thereby making S1 and F1 part of the same Expanded Group.

Third, the regulations clarify that options should only be considered if they are "reasonably certain" to be exercised within the meaning of Treas. Reg. §1.1504-4(g). Similarly, the cross-reference to the "reasonably certain" language in Treas. Reg. §1.1504-4(g) alleviates the concern that many had that simple tag-along / drag-along rights, or rights of first refusal that are common in many joint ventures would be deemed exercised for attribution purposes.

Lastly, the MEG and "modified controlled partnership" definitions from the Proposed Regulations have been removed. This is because those definitions were only relevant for the Part-Stock Rule and the government has removed that rule pending further study.

The Controlled Partnership Definition

A controlled partnership ("Controlled Partnership") refers to a partnership with respect to which at least 80 percent of the interest in partnership capital or profits are owned, directly or indirectly, by one or more members of the Expanded Group. For this purpose, the term "indirect" ownership has the same meaning as noted above. Thus, upward attribution is permitted, but downward attribution is not. Below we sometimes refer to an Expanded Group member that is also a partner in the Controlled Partnership as an Expanded Group Partner or "EG Partner."

The New Covered Member Definition Narrows the Scope of the Final Regulations

The Final Regulations also introduce an entirely new term which is key to the government's efforts to narrow the scope of the regulations. Specifically, the Final Regulations contain the term "Covered Member." A Covered Member is a member of the Expanded Group that is domestic. As will be discussed in more detail below, the Documentation Rule and Per Se Recast Rule limit their application to instruments issued by Covered Members.

Documentation Rule

Effective Date

In response to comments received on the Proposed Regulations regarding the need for additional time to comply with the Documentation Rule, Treasury and the IRS extended the effective date of the Documentation Rule. Under the Final Regulations, the Documentation Rule applies to taxable years ending on or after January 19, 2017. The Documentation Rule, however, applies only with respect to Applicable Interests (as defined below) issued or deemed issued on or after January 1, 2018, including EGIs issued on or after such date but under a master agreement in place before January 1, 2018. The delayed effective date is welcome relief to taxpayers and represents a significant deferral from the Proposed Regulations. Thus, effectively, the regulations are only relevant for calendar year taxpayers beginning in 2018.

The preamble to the Final Regulations and the text of the regulations themselves clarify that if an Applicable Interest is issued before January 1, 2018, but is significantly modified within the meaning of Treas. Reg. § 1.1001-3, the Documentation Rule can apply if the modification involves an alteration of the terms of the written agreement comprising the EGI.

Scope

The Final Regulations limit the scope of the Documentation Rule both by type of instrument and by type of issuer.

First, the Documentation Rule applies only to Applicable Interests that are EGIs. An Applicable Interest is any instrument that is "in form" a debt instrument. The Final Regulations clarify that this includes instruments that are not subject to a written agreement, such as payables or receivables recorded solely in a ledger.

The Final Regulations reserve on the treatment of arrangements that are not "in form" debt instruments, such as sale-repurchase agreements, transactions to which section 483 applies and may impute interest, and sale-leasebacks. In response to comments, the Final Regulations further exclude any instrument or interest that is specifically treated as indebtedness for US federal income tax purposes under a provision of the Code or the regulations thereunder, including section 636 production payments, REMIC interests, and deemed instruments arising under Rev. Proc. 99-32, which permits taxpayers to establish a hypothetical receivable or payable after a transfer pricing adjustment. The Final Regulations did not similarly exempt the receivables/payables created from a hypothetical royalty imposed under section 367(d) and Treas. Reg. §1.367(d)-1T(g), but the preamble indicates that is because the scope of the Final Regulations are limited to US debt issuers and so a section 367(d) payable owing from a foreign corporation would not be subject to the rules in any event.

Disappointingly, Treasury and the IRS declined to exclude ordinary trade payables from the scope of the Documentation Rule despite the significant burden placed on taxpayers to document such recurring obligations, even if the obligations are non-interest bearing (although Treasury and the IRS did exclude certain ordinary course instruments and non-interest bearing obligations from the scope of the Funding Rule, as discussed below). Thus, in order to minimize the burden of documenting such trade payables, taxpayers may want to consider entering into a master instrument that every domestic and foreign affiliate in the Expanded Group signs that satisfies the requirements for such arrangements discussed below.

Second, loans between consolidated group members are not considered Applicable Interests. Hence, the Documentation Rules do not apply to such instruments.

Third, as alluded to above, the Documentation Rule only applies to instruments issued on or after January 1, 2018. Thus, a loan issued by a US corporation to a foreign member of its Expanded Group on March 1, 2017, would not require documentation under the Documentation Rule.

Fourth, the Documentation Rule applies only to certain types of issuers. In a major departure from the Proposed Regulations, an EGI is subject to the Documentation Rule only if it is issued by a Covered Member or by a disregarded entity that has a Covered Member as its regarded owner. This limitation substantially narrows the universe of instruments subject to the Documentation Rule. As a result, the Documentation Rule now only applies to a domestic issuer of debt to either a foreign affiliate or a non-consolidated domestic affiliate.

As a practical matter, this substantially reduces the burden of the Documentation Rule for US-based multinationals. The only debt instruments to which the Documentation Rule can apply are those owing from the US parent or its consolidated group members to a foreign subsidiary. Given that Code Section 956 imposes a significant penalty on most inbound loans, the reality is that mostly trade payables will likely be caught by the rules. Nevertheless intra-quarter loans made by a foreign subsidiary to its parent or loans designed to trigger section 956 inclusions could also be subject.

Foreign-based multinationals are not so lucky, however. They have to address the Documentation Rules in connection with trade payables owing from the US group to its foreign subsidiaries, just like a US-based multinational. However, they also have to apply the Documentation Rule to all loans owing to the foreign parent and the US group's foreign brother and sister affiliates. The only relief foreign-based multinationals received in the Final Regulations was that deposits that the US group or its foreign affiliates may have with an offshore cash pool maintained by the foreign parent will not be subject to the Documentation Rules.

The Final Regulations, like the Proposed Regulations, exempt smaller Expanded Groups from the application of the Documentation Rules. Specifically, an EGI is subject to the Documentation Rule only if on the date the applicable interest first becomes an EGI any of three following criteria are satisfied: (i) the stock of any Expanded Group member is publicly traded; (ii) total assets exceed $100 million on any "applicable financial statement" (certain financial statements independently prepared within the past three years, such as for an SEC filing), or (iii) annual total revenue exceeds $50 million on any applicable financial statement. In response to comments, the Final Regulations further exclude certain EGIs issued by financial institutions and insurance companies on the view that such issuers are already subject to significant regulatory oversight with respect to such instruments.

Perhaps the key take-away for taxpayers is that, despite ample commentary requesting relief, trade payables constitute Applicable Interests, even if the Expanded Group currently reflects them simply as journal entries. Thus, non-interest bearing trade payables owing from US corporations will have to be documented. Treas. Reg. §1.385-2(c)(1)(ii) of the Final Regulations provides that taxpayers can use transactions (including trade payables) with third parties to establish the requisite level of documentation. Yet, given the variability many companies have across different business units, and given the difficulty of creating new documentation for every affiliate sale or service transaction, taxpayers may want to consider executing a multi-lateral instrument that applies absent other, more specific, documentation. That would give the Expanded Group the flexibility to simply document the payable in journal entries, in which case the terms of the multilateral instrument would apply, or, alternatively, create more specific stylized documentation.

Similarly, despite commentary to the contrary, there is no general exception for cash-pooling. Having said that, the fact that only EGIs issued by Covered Members are subject to the rules, and most controlled foreign corporations do not participate in domestic cash-pools due to section 956, means that most cash-pools will not require documentation. A big exception would be deposits made by foreign parent corporations (or their foreign subsidiaries that are not controlled foreign corporations) with a cash pool maintained by a member of the US consolidated group. Another exception would be US consolidated group members withdrawing money from a foreign-managed cash pool.

A number of comments requested clarification as to how the rules may apply differently to physical vs. notional cash pools. The regulations do not provide this guidance. Instead, the preamble simply states that taxpayers should refer to Rul. 87-89, 1987-2 C.B. 195, for guidance as to whether a notional pooling arrangement (which involves deposits with and withdrawals from an intermediary bank) should be considered a direct loan between Expanded Group members. This ruling addressed the application of US withholding and section 956 rules to one-off back-to-back loan scenarios through an intermediary bank where there was an intention to avoid the withholding or section 956 rules. The only relevant guidance provided in the ruling is that if the borrowing from the bank would not have been made on the same terms absent the deposit, then the loan is considered as having been made directly between the parties. The ruling does not begin to address the numerous questions raised in the comments regarding how taxpayers are supposed to actually apply the rules when the deposits and withdrawals are in different currencies, and the identity of the borrowers cannot be determined due to multiple transactions occurring in the same day. It is somewhat shocking that the government would dismiss this issue out of hand by simply referring to Rev. Rul. 87-89, especially since the government declared the ruling obsolete over twenty years ago in Rev. Rul. 95-56, 1995-2 C.B. 322. The bottom line is that taxpayers should proceed on the assumption that US members withdrawing money from a physical or notional cash pool with foreign depositors need to assume that the borrowings are subject to the Documentation Rule.

Nevertheless, in response to comments from the financial industry, Treas. Reg. §1.385-2(c)(1)(iii) of the Final Regulations does include a new exception for instruments issued by "regulated financial corporations" and "insurance companies." Even this exception only applies if it is expected that the EGI will be paid in accordance with its terms.

Substantive Requirements

Unchanged from the Proposed Regulations, the Final Regulations specify that, for each EGI, a taxpayer must prepare and maintain documentation and information that establishes four "indebtedness factors" to be used in the determination of whether an instrument will be treated as indebtedness for US federal tax purposes: (i) an unconditional obligation to pay a sum certain; (ii) creditor's rights; (iii) a reasonable expectation of ability to repay the EGI; and (iv) actions evidencing a debtor-creditor relationship. These substantive requirements can be broken down into two categories. The first two factors are formalistic and simply establish basic standards for the documentation of a Covered Member EGI regardless of the borrower's ability to repay. The last two factors relate to proving that the borrower does in fact have an ability to repay.

Documentation Requirements

One of the stated purposes of the Proposed Regulations was to force taxpayers to reduce their debt instruments to writing, and better document their terms. The Final Regulations retain this emphasis.

The Final Regulations retain the requirement that the Applicable Interest document: (i) the unconditional obligation to pay a sum certain; and (ii) creditor's rights. We address the two documentation requirements in more detail below.

An Unconditional Obligation to Pay a Sum Certain. Drawing upon a factor historically viewed both by courts and the IRS as the *sine qua non* in determining that an instrument is indebtedness, the Documentation Rule requires that the taxpayer prepare written documentation establishing that the issuer has entered into an unconditional and legally binding obligation to pay a fixed or determinable sum certain on demand or at one or more fixed dates. *See, e.g.*, FSA 199940007 (Oct. 8, 1999) ("The presence of a sum certain payable at maturity is a sine qua non of debt treatment under the Code. ").

Creditor's Rights. The taxpayer must prepare written documentation establishing that the holder has the common rights of a creditor to enforce the obligation, such as the right to trigger an acceleration of the EGI or sue in the event of non-payment of interest or principal when due under the terms of the EGI. As a creditor, the holder must further have superior rights as compared to shareholders to receive any assets of the issuer in the case of dissolution. In response to comments, the Final Regulations clarify that the instrument need not specify creditor's rights if such rights are already provided for under local law and the instrument simply contains a reference to such provisions of local law.

Application to Revolving Credit Agreements and Cash Pools. If an EGI does not have a fixed principal amount because it is a revolving credit facility or a cash pooling arrangement, then there is a special set of rules in Treas. Reg. §1.385-(c)(3)(i)(A)(1). In this case, the regulations require the underlying legal agreement itself plus all "enabling" documents be maintained. This includes board resolutions and any documentation related to the establishment or increase of credit limits. As noted above, the government punted on whether deposits and withdrawals from notional cash pools are always treated the same as deposits and withdrawals from physical cash pools.

Requirements to Perform Financial Analysis

The Proposed Regulations and the Final Regulations both require more than mere written documentation, however. They also require the taxpayer to demonstrate that an analysis of the borrower's ability to repay has been performed. The Final Regulations do attempt to make this analysis somewhat less onerous than the Proposed Regulations, but given that the rules do apply to non-interest bearing trade payables owing from Covered Members, the rules will require extra effort that companies do not currently expend.

A Reasonable Expectation of Ability to Repay the EGI. The taxpayer must prepare written documentation establishing that, as of the date of issuance of the Applicable Interest, the issuer's financial position supported a reasonable expectation that the issuer intended to, and would be able to, meet its obligations under the terms of the Applicable Interest. The Documentation Rule (unlike the Per Se Recast Rule) respects the separate nature of each member of a consolidated group. Thus, if a Covered Member belongs to a consolidated group, it is only its assets and operations that are considered in determining the ability to repay.

In this regard, it is important to note that guarantees should not be taken into account. Specifically, the repayment analysis must demonstrate the "issuer's" ability to repay the EGI. The "issuer" for this purpose is defined in Treas. Reg. §1.385-2(d)(4) to exclude guarantors, unless the taxpayer acknowledges that the guarantor is the "primary obligor." This would likely prove problematic in many cases, because it could then allow the government to assert that a different entity deserves the interest deduction under the theory of *Plantation Patterns, Inc. v. Commissioner*, 462 F.2d 712 (1972), *aff'g* T.C.M. 1970-182. The repayment analysis must take into account all relevant circumstances at such time, including all other obligations incurred by the issuer as of the date of issuance of the Applicable Interest or reasonably anticipated to be incurred after the date of issuance of the Applicable Interest (which necessarily bear on the issuer's financial position).

The Final Regulations helpfully provide that a ***single*** written analysis can be developed to support multiple EGIs issued by a single Covered Member. Specifically, a taxpayer would generally only need to prepare such documentation on an annual basis, which would then cover any EGIs issued during the subsequent 12-month period beginning on the date of the analysis. Thus, for example, a calendar year taxpayer that performs a credit analysis "as of" January 1st of each year, would be free to have a Covered Member issue EGIs up to the level indicated in the financial analysis throughout the year.

If the issuer has a "material event" during the covered year, however, the taxpayer cannot rely on such documentation on or after the date of such event until updated documentation is prepared. A "material event" includes certain events that significantly impact the issuer's ability to pay, such as a bankruptcy or a sale of a substantial portion of the issuer's assets. In response to comments pointing out that taxpayers, even those on solid financial footing, often times intend to repay an indebtedness by refinancing, the Final Regulations generally treat such repayments from proceeds of another borrowing as satisfying the requirements of this factor, provided that the taxpayer can demonstrate that a third party would similarly be willing to extend credit.

The issue that taxpayers will likely find most challenging about these regulations is that they require the taxpayer to determine a dollar threshold associated with each and every domestic entity within the US consolidated group that issues EGIs on at least an annual basis. So, for example, assume that USP is the parent of the consolidated group, and USP owns 10 subsidiaries USS1 through USS10. It is entirely possible that one or more of the subsidiaries may not be financially healthy on a stand-alone basis. Nevertheless, every member of the group engages in sales and services transactions with foreign subsidiary members of the Expanded Group without anyone ever performing a credit analysis. Under the Final Regulations, this will no longer be sufficient. The taxpayer will have to determine a credit limit for ***each*** entity in the group (not the group as a whole) and monitor the payables of that subsidiary to ensure it does not exceed that limit.

To limit the effort required, taxpayers should consider a couple of strategies. First, consider making it a policy (if possible) to route all transactions with Expanded Group members that are not members of the consolidated group with a single member of the consolidated group. This will limit the number of entities that have to be analyzed every year. Second, ensure that that single entity is capitalized with sufficient equity to ensure that it has the ability to repay any EGIs and any other debt obligations that may be incurred during the year. If possible, attempt to limit the amount of third party debt this entity is primarily or secondarily liable for.

Even this process will undoubtedly prove to be a time-consuming and burdensome effort for multinationals. For those multinationals willing to engage in the effort, however, Treas. Reg. §1.385-2(c)(2)(iii)(F) provides that a commitment letter (or other written evidence) from a bank indicating that it would lend money on the same or substantially similar terms as the EGI will constitute evidence of ability to repay. Importantly, the regulations use the word "may" and not "must." Thus, the regulations do not require the taxpayer demonstrate that an unrelated party would have loaned the same amount on similar terms. Taxpayers should consult the common law in their appellate circuit, however, as some circuits have insisted on a demonstration that a third party would have loaned the same amount on the same terms. *See e.g.*, *Scriptomatic Inc. v. Commissioner*, 555 F.2d 364 (3rd Cir. 1977) (requiring evidence that third party would have loaned same amount on same terms).

Actions Evidencing a Debtor-Creditor Relationship. The taxpayer must prepare written documentation evidencing either: (i) timely payments of interest and/or principal; or (ii) if such payments were not timely made or not made at all, or other events of default or similar event have occurred, the holder's "reasonable exercise of the diligence and judgment of a creditor." With respect to timely payments of interest and/or principal, the Final Regulations expand upon the examples in the Proposed Regulations of wire transfer records and bank statements to also include journal entries. With respect to events of default, the required evidence may include evidence of the holder's assertion of its rights under the terms of the EGI, including the parties' efforts to renegotiate the EGI or to mitigate the breach of an obligation under the EGI. If a holder does not enforce its rights with respect to the payment of interest and/or principal (as would most likely be the case with related parties), the Documentation Rule further requires documentation that supports the holder's decision to refrain from doing so as nevertheless being reasonable, *e.g.*, the holder reasonably believes that the issuer's business or cash flow will improve and therefore extends the time for payment. What this likely means in practice is that if a borrower encounters financial difficulties, the Expanded Group will have to ensure that additional equity is contributed to the borrowing member to shore up its balance sheet.

In the case of EGIs issued pursuant to a master agreement such as a revolving credit agreement or cash pooling arrangement, certain additional evidentiary requirements must be satisfied with respect to the aforementioned "indebtedness factors." All of the "material documentation" with respect to such arrangements must be prepared and maintained, namely the relevant enabling documents such as board of directors' resolutions, omnibus agreements, cash pooling agreements, and security agreements. As discussed above in the context of a single annual credit analysis, the taxpayer may similarly rely on such an analysis provided no material event has occurred during the covered period.

Revolving Credit Agreements and Cash Pools. Treas. Reg. §1.385-(c)(3)(i)(A)(3) contains special rules for revolving credit agreements and cash pools. Effectively, instead of a credit analysis demonstrating the ability to repay a fixed loan amount, the analysis needs to demonstrate that the ability to repay the maximum amount that could be borrowed under the revolving credit agreement or cash pooling facility. In addition, the regulations impose an additional requirement on cash pools in that any agreements with third-party banks also have to be assembled and maintained with the prescribed time period. As noted above, the government punted on whether deposits and withdrawals from notional cash pools are treated the same as deposits and withdrawals from physical cash pools, and instead refers taxpayers to an obsolete revenue ruling for guidance.

Due Date for Compliance

Under the Proposed Regulations, taxpayers generally would have been required to prepare documentation evidencing the first three factors within 30 days after the EGI's issuance date, and 120 days after the date a payment is due or an event of default occurs. Commentators severely criticized these unrealistic timeframes, especially in light of the fact that the IRS would not even need such documentation until—at the earliest—any subsequent audit of such instrument.

In response to such comments, the Final Regulations provide that a taxpayer must prepare the required documentation with respect to a "relevant date" is no later than the time for filing the issuer's US federal income tax return (taking into account any applicable extensions) generally for the taxable year in which the "relevant date" occurs. A "relevant date" for this purpose is the issuance of the EGI payments on the EGI or a default of the issuer. Thus, if an EGI is issued in February 1, 2018, a calendar-year taxpayer would have until September 15, 2019 to prepare the required documentation (assuming a normal 6-month extension) for the issuance of that EGI.

Consequences of Compliance

Full compliance with the Documentation Rule does not establish that a particular interest is indebtedness for US federal income tax purposes. Instead, such compliance only allows such determination to proceed, with the IRS conducting its analysis of the instrument based on "general federal tax principles."

Consequences of Non-Compliance

Under the Proposed Regulations, a taxpayer's failure to comply with the Documentation Rule resulted in *per se* equity treatment for the instrument for which the lapse occurred. Commentators questioned the fairness of such a harsh outcome and instead suggested a number of alternatives, including simply punishing such non-compliance with a monetary penalty, consistent with other Code provisions. Treasury and the IRS rejected such entreaties, arguing that the Documentation Rule served important tax administration purposes.

Taxpayers also argued that the recast equity should ***not*** cause the borrower to de-consolidate for US federal income tax purposes. Although the government heeded this request in connection with the Per Se Recast Rule (see below) the government did not similarly agree to automatically treat recast EGIs as plain-vanilla preferred stock, the issuance of which would not trigger a deconsolidation event. Thus, if an EGI is recast as stock, it is still possible, under the Final Regulations, that the Covered Member that issued the EGI would be de-consolidated from the rest of its consolidated group. In justifying the disparate treatment, the government stated in the preamble that:

> The final regulations also do not adopt the request to limit the consequences of characterizing an EGI as stock under Treas. Reg. §1.385-2, for example, by disregarding such stock for purposes of determining affiliation. The Treasury Department and the IRS view the characterization of an EGI as stock under Treas. Reg. §1.385-2 as a determination that general federal tax principles would preclude a characterization of the interest as indebtedness. Thus, the Treasury Department and the IRS have determined that it is appropriate to treat an EGI characterized as stock pursuant to Treas. Reg. §1.385-2 as stock for federal tax purposes generally.

Nevertheless, the Final Regulations expand on the reasonable cause relief provided for in the Proposed Regulations and provide two additional means to avoid equity recharacterization.

Reasonable Cause Defense

The Final Regulations retain the rule that allows taxpayers to demonstrate that they had reasonable cause for failure to comply with the Documentation Rule. Despite comments advocating for a more lenient standard, the Final Regulations retain the heightened reasonable cause relief standard from the Proposed Regulations. Specifically, unlike other reasonable cause relief standards in, for example, Treas. Reg. §§1.367(a)-8 (gain recognition agreements) and 1.1503(d)-6 (dual consolidated losses), the Documentation Rule explicitly cross-references the standard in Treas. Reg. §301.6724-1, which is a heightened standard. In response to the comments, the preamble simply stated, "The Treasury Department and the IRS have determined that given the rebuttable presumption rule and the ministerial error rule adopted in the final regulations, the scope of the reasonable cause exception is appropriate."

Ministerial Error Defense

In response to comments that even the slightest omission could result in equity recast, the Final Regulations also include an exception for ministerial or non-material errors. If a taxpayer discovers and corrects such a minor non-compliance error ***prior to the IRS's discovery of such error***, such error is disregarded in determining whether the requirements of the Documentation Rule have been satisfied.

Highly Compliant Defense

Lastly, the Documentation Rules introduce a new concept for "highly compliant" taxpayers. If an Expanded Group can demonstrate that, despite its failure to comply with the Documentation Rule for a given EGI, the taxpayer is otherwise "highly compliant," then the EGI will not ***automatically*** be recast. Instead, the non-compliance will result in only a rebuttable presumption of equity treatment, instead of *per se* recharacterization. A taxpayer can overcome the presumption that an EGI is stock if the taxpayer clearly establishes that there are sufficient common law factors present to treat the EGI as indebtedness, with significant weight placed on the four "indebtedness factors" in the Documentation Rule. This is the good news.

The bad news is that the test for "high compliance" contains a strict numerical threshold (not facts and circumstances), is frequent (quarterly), and utterly complex that only the most sophisticated Expanded Groups with significant effort will be able to monitor this on an ongoing basis. Instead, as a practical matter, the test for high compliance will likely be something that is reviewed after the fact. Moreover, if the taxpayer comes close to achieving the standard, but the standard is not satisfied, it will likely be used by the taxpayer as support for a reasonable cause defense (see above).

An Expanded Group is treated as being highly compliant if, during the calendar year in which the lapse occurs, either of two tests are satisfied. Importantly, it appears that the taxpayer can choose either test in a given year, but it does not appear that the taxpayer can use different tests in the ***same*** year (*i.e.*, one test for one non-compliant EGI in one quarter and another test for another non-compliant EGI in another quarter).

- Treas. Reg. §1.385-2(b)(2)(i)(B)(1) ("Adjusted Issue Price Exception"). The average total adjusted issue price of all EGIs that are "undocumented" and outstanding as of the close of each calendar quarter is less than 10 percent of the average amount of total adjusted issue price of all EGIs that are outstanding as of the close of each calendar quarter.

  OR

- Treas. Reg. §1.385-2(b)(2)(i)(B)(2) ("Size and Number Exception"). If the undocumented EGIs are of sufficiently small size, and the group can demonstrate a high degree of compliance:

Size of Undocumented EGIs	**Non-Compliance Rate (measured at each Quarter and Averaged)**	
No Undocumented EGI > $100,000,000	Number of Undocumented EGIs Number of EGIs Outstanding	< 5 percent
OR		
No Undocumented EGI > $25,000,000	Number of Undocumented EGIs Number of EGIs Outstanding	<10 percent

Importantly, these exceptions differ qualitatively. The Adjusted Issue Price Exception looks at the ratio of the size of the undocumented EGI to the size of all EGIs outstanding, thus ensuring the undocumented EGIs are small in relative terms. In contrast, the Size and Number Exception seeks to ensure the undocumented EGIs are small in absolute terms.

Application of the Documentation Rule to Disregarded Entities and Partnerships

Under the Proposed Regulations, the Documentation Rule applied to both partnerships and disregarded entities at the level of the legal entity issuing the debt instrument. If a Controlled Partnership issued an EGI and failed to satisfy the Documentation Rules, the EGI would be recast as equity in the Controlled Partnership. This could then result in significant shifts of allocable liabilities under section 752 with serious correlative effects to the historic partners. The deemed exchange consequences were even worse for disregarded entities. Specifically, under the Proposed Regulations, if a disregarded entity issued an EGI that was not properly documented under the requirements of the Documentation Rules and was subsequently recast as equity, the EGI would be treated as equity issued directly by the disregarded entity, causing the disregarded entity to become a partnership. This could then lead to various negative second-order effects - *i.e.*, like causing debt issued by that disregarded entity to its owner to “spring” to life.

The treatment of disregard entities and partnerships was not only harmful. It was also disconnected from the treatment under the Per Se Recast Rule (discussed below), which “deemed” the partner or regarded owner (as the case may be) to issue its stock in satisfaction of the EGI.

The Final Regulations take a very different approach. As a preliminary matter, the Final Regulations’ Documentation Rule does ***not*** apply to debt instruments issued by partnerships. Thus, as a general matter, the Documentation Rule ought not apply. The preamble cautions, however, that the regulations could conceivably apply if the debt in question were issued with the principal purpose of avoiding the Documentation Rules.

The Final Regulations do continue to apply to EGIs issued by disregarded entities. Unlike the Proposed Regulations, however, the Final Regulations provide that if an EGI issued by a disregarded entity is recast, the Regarded Owner (defined below) of the disregarded entity is the entity that is deemed to issue its equity in satisfaction of the EGI. This avoids the possibility that the Documentation Rule could result in a disregarded entity being converted into a regarded partnership. The Final Regulations (unlike the Proposed Regulations) also conform the Documentation Rule and Per Se Recast Rule (discussed below) on this point.

Per Se Recast Rule

Effective Date

The Per Se Recast Rule in Treas. Reg. §1.385-3 applies to taxable years ending on or after January 19, 2017, *i.e.*, 90 days after the Final Regulations were published in the Federal Register. Debt instruments issued before April 5, 2016 are exempt. In addition, for purposes of the Funding Rule discussed below, distributions and acquisitions before April 5, 2016 are not taken into account.

Under the transition rules in the Final Regulations, a CDI that would otherwise be treated as stock by reason of the Per Se Recast Rule for a taxable year ending before January 19, 2017, and that is held by a member of the issuer's Expanded Group immediately after January 19, 2017, is deemed exchanged for stock immediately after January 19, 2017. Moreover, even for a taxable year ending on or after January 19, 2017, any CDI that would otherwise be treated as stock on or before January 19, 2017 is not treated as stock until immediately after that date, at which point the CDI is deemed to be exchanged for stock.

Thus, as the Proposed Regulations foreshadowed, the Final Regulations allow taxpayers a brief window to identify their CDIs issued after April 4, 2016, determine which ones may be subject to recast, and have them repaid before January 19, 2017. Otherwise, the instruments will be recast as equity.

Despite the ability to repay CDIs before they are recast, the repayment may generate second and third order effects under the Per Se Recast Rule. Specifically, any payments made with respect to a CDI (except for stated interest) ***after the CDI would otherwise have been recharacterized as stock but for the transition rule*** are treated as property distributions for the purposes of applying the Funding Rule for taxable years ending on or after January 19, 2017. This "transition funding rule" is intended to prevent taxpayers from taking advantage of the transition rules by issuing debt during the transition period that does not finance new investment.

Taxpayers have the option to apply the Proposed Regulations to debt instruments issued after April 4, 2016 and before October 13, 2016, provided that the Proposed Regulations are applied consistently.

Scope

The scope of the Per Se Recast Rule is limited to CDIs issued by a Covered Member to another member of the Expanded Group. As noted above, Covered Members are defined to include only domestic corporations. Thus, foreign issuers are exempt from these rules. The term Expanded Group is also defined above. Notably, the Expanded Group excludes S Corporations. It also excludes regulated investment corporations (RICs) and real estate investment trusts (REITs), provided those RICs or REITs are not controlled by a "C" corporation or members of an Expanded Group of "C" Corporations.

This then begs the question as to how CDIs are defined. As discussed below, CDIs are defined by both the type of instrument and the nature of the issuer.

Types of Instrument that Can Be CDIs

A CDI must be an interest that would be treated as a debt instrument under section 1275(a) and Treas. Reg. §1.1275-1(d). Section 1275(a) defines a debt instrument as "a bond, debenture, note, or certificate or other evidence of indebtedness," while Treas. Reg. §1.1275-1(d) broadens the definition to include "any instrument or contractual arrangement that constitutes indebtedness." This requirement is broader than the requirement for an EGI under the Documentation Rule, which states that the instrument must be issued in the legal form of a debt instrument or as an intercompany payable and receivable documented in the company's accounting system.

At the same time, a CDI does not include debt instruments that are specifically treated as debt under certain provisions of the Code and Treasury Regulations, or debt instruments that are deemed to arise under Treas. Reg. §1.482-1(g)(3) as a result of a transfer pricing adjustment (an "excluded statutory or regulatory debt instrument").

Nature of Companies that Can Issue CDIs

A CDI does not include a debt instrument issued by a dealer in securities in the ordinary course of the dealer's business (a "qualified dealer debt instrument"). Moreover, a CDI does not include debt issued by a regulated financial company (such as a bank or a registered broker-dealer), a subsidiary thereof, or a regulated insurance company.

Consequences of Per Se Recast Rule

If the Per Se Recast Rule applies, the CDI is deemed to be considered stock. This recast could occur from inception, or later. If later, the holder of the debt instrument is deemed to surrender the instrument for stock. Importantly, a CDI that is recast is treated as stock for all federal tax purposes, ***except*** for purposes of section 1504(a) and testing for affiliation. Treasury and the IRS rejected comments that recommended exceptions for other specific Code sections, but included an exception under section 1504(a) so that the Per Se Recast Rule will not trigger a deconsolidation. It is important to note that this exception does ***not*** apply under the Documentation Rule, the application of which ***can indeed*** trigger a deconsolidation of a domestic corporation. It is also important to note that the exemption does not apply to, for example, section 368(c) which defines the term "control" in both section 351 transfers and section 368 reorganizations.

General Rule

Under the General Rule of Treas. Reg. §1.385-3(b)(2), a CDI is treated as stock if the CDI is issued by a Covered Member to another member of the Expanded Group in one of three types of "tainted" transactions:

(1) in a distribution to another member of the Expanded Group;

(2) in exchange for stock in a member of the Expanded Group, other than an "exempt exchange"; or

(3) in exchange for property in an asset reorganization, but only to the extent that a shareholder of the target that is a member of the issuer's Expanded Group before the reorganization receives the CDI in exchange for its target stock as part of the reorganization.

This list is identical to the Proposed Regulations. The Final Regulations, however, expand the definition of an "exempt exchange." Like the Proposed Regulations, the Final Regulations define an "exempt exchange" to include an acquisition of stock in which both the transferor and the transferee are parties to an asset reorganization, and either: (i) section 361(a) or (b) applies to the party transferring the stock and the stock is not transferred by issuance; or (ii) section 1032 applies to the party transferring the stock and the transferee distributes the stock pursuant to the plan of reorganization.

> EXAMPLE: USCO owns all of the outstanding shares of S1 and S2. S2 owns all of the stock of S3. All entities are domestic corporations but they choose not to file a consolidated tax return. S2 transfers its assets (including shares of S3) to S1 in exchange for S1 shares and debt then liquidates, distributing the S1 shares and debt to USCO. The transaction is considered a section 368(a)(1)(D) reorganization. The first exception in (i) outlined above exempts S2's transfer of the S3 shares to S1 from being a "tainted" transaction. The second exception in (ii) outlined above exempts S1's issuance of stock to S2 from being considered a "tainted" transaction. In this example, the only "tainted" transaction is USCO's surrender of S2 stock for the note issued by S1.

The Final Regulations expand the definition of "exempt exchange" to explicitly include liquidations under section 331 or 332 in which the transferor-shareholder receives property in exchange for its stock in the liquidating corporation, and deemed issuances of stock as a result of a deemed capital contribution under Treas. Reg. §1.1032-3(b).

Treasury and the IRS view exchanges for Expanded Group stock or property as economically similar to distributions. The preamble to the Final Regulations emphasizes that, in these transactions, the debt does not finance new investment in the issuer. Although acquisitions of stock or property may, in form, involve a value-for-value exchange, the ultimate ownership of the target does not change.

Funding Rule

The Funding Rule of Treas. Reg. §1.385-3(b)(3) operates as a backstop to the General Rule. Under the Funding Rule, a CDI that is issued by a Covered Member to another member of the Expanded Group in exchange for property is treated as stock if it is issued within 36 months before or 36 months after one of the three types of "tainted" transactions.

The types of "tainted" transactions that trigger application of the General Rule are almost identical to the tainted transactions that trigger application of the Funding Rule. However, the Funding Rule has a concept of "exempt distributions" in addition to the concept of "exempt exchanges." Specifically, a corporation's distribution of stock to an Expanded Group member in a tax-free reorganization or spin-off is an "exempt" distribution. Similarly, a distribution of any property in a taxable or tax-free liquidation is an exempt distribution.

The 72-month window period (which the regulations refer to as the "per se period") is extended indefinitely if the CDI is issued with "a" principal purpose of funding a tainted transaction. The use of "a" instead of "the" was intentional and requires the application of a lower standard for concluding that taxpayer had a bad intent. Whether such a "principal purpose" exists is based on the facts and circumstances. It is unclear why the government felt the need for this extended per se period when it also has an extremely broad anti-abuse rule (see below).

Several comments suggested shortening the 72-month per se period, but Treasury and the IRS declined to do so. Several comments also recommended making the Funding Rule a rebuttable presumption. This comment was rejected as well.

Solely for purposes of the non-rebuttable 72-month presumption under the Funding Rule, if a CDI is treated as exchanged for a modified CDI under Treas. Reg. §1.1001-3(b), the modified CDI is generally treated as issued on the original date of the CDI. Thus, a CDI modifying a grandfathered CDI issued before April 5, 2016 is itself grandfathered. If, however, the modification involves a substitution of a new obligor, an addition or deletion of a co-obligor, or a material deferral of scheduled payments, the CDI is deemed issued on the date of the deemed exchange. If one of these three events occurs after April 4, 2016, the resulting CDI could be subject to the Funding Rule.

Exception to the Funding Rule for Short-Term Loans and Cash Pooling

Numerous commentators identified the adverse impact of the Proposed Regulations to cash pooling and other short-term loans in the ordinary course of business. While the Proposed Regulations included a limited exception for ordinary course debt instruments issued in connection with the purchase of inventory property or deductible payments, comments expressed concern that this exception did not cover many everyday business transactions, including payments for capital assets, royalties and leases.

A number of other comments focused on the application of the regulations to cash pooling arrangements. Multinational businesses commonly use a cash pooling or short-term lending arrangement in which entities from various jurisdictions lend to and borrow from a treasury center or cash pool. These arrangements are not tax motivated. Rather, they allow multinational groups to minimize their borrowing costs, aggregate excess cash so that it can be more effectively invested, and centralize and hedge foreign currency risk. The Proposed Regulations would have recast those internal financing arrangements as equity.

In response to these concerns, the preamble to the Final Regulations clarifies the fact that only loans for cash or other property can be CDIs in the first instance. Thus, payables for services, rental rights or license rights are not within the Funding Rule *ab initio*.

For other loans, the regulations provide an exception to the Funding Rule (but not the General Rule) for "qualified short term debt instruments," or "QSTDIs." A QSTDI is a CDI that is described in one of the following four categories: (1) short-term funding arrangements, (2) ordinary course loans, (3) interest-free loans, and (4) deposits under certain cash pooling arrangements. These exemptions will keep many deposits with (and withdrawals from) treasury centers outside the ambit of the Funding Rule. Moreover, because the Per Se Recast Rule is generally limited to US issuers, and Code Section 956 generally discourages loans from foreign subsidiaries to their US parents, in practice these rules will only be relevant to US subsidiaries of foreign multinationals that borrow money from their foreign parent or brother companies. These transactions will need to fit within one of the four exceptions below or risk being recast as equity.

Treas. Reg. §1.385-3T(b)(3)(vii)(A): Short-Term Funding Arrangement. The first category of QSTDIs applies to short-term funding arrangements that meet one of two tests: (1) the "specified current assets test," or (2) the "270-day test." An issuer may only apply ***one*** of these tests to CDIs it issues in any one taxable year. As a practical matter, taxpayers will probably find the 270-day test easier to apply.

Specified Current Assets Test

The specified current assets test focuses on allowing an issuer to borrow to satisfy short-term financing needs in the ordinary course of its business. Under this test, the interest rate on a CDI may not exceed an arm's length rate that would be charged with respect to a comparable debt instrument with a term no longer than 90 days or, if longer, the issuer's normal operating cycle. In addition, immediately after the debt instrument is issued, the issuer's outstanding balance under CDIs that are issued to members of the Expanded Group and that qualify for the QSTDI exceptions for short-term debt, ordinary course loans, and interest-free loans may not exceed the issuer's expected short-term financing needs.

The issuer's expected short-term financing needs are measured by the maximum amounts of specified current assets reasonably expected to be reflected on the issuer's balance sheet from transactions in the ordinary course of business during the longer of 90 days or the issuer's normal operating cycle. For this purpose, specified current assets are assets that are reasonably expected to be converted into cash or to be sold (including sold as inventory) during the normal operating cycle of the issuer, but do not include cash, cash equivalents, or assets that are reflected on the books and records of a QCPH (discussed in more detail below).

The Preamble to the Final and Temporary Regulations provides some useful guidance on applying financial accounting principles. Specifically, the preamble indicates that US GAAP or IFRS should apply in making determinations under the specified current assets test. Neither the Preamble nor the Temporary Regulations, however, provide guidance on potential foreign currency issues in this context.

The 270 Day Test

The 270-day test provides an alternative path for short-term debt that cannot qualify for the specified current assets test, for example when the issuer has a relatively small amount of current assets but large temporary borrowing needs. Under the 270-day test, the CDI must have a term of 270 days or less or be an advance under a revolving credit agreement. The CDI must bear a rate of interest that does not exceed an arm's length rate for a comparable instrument. The issuer must not be a net borrower from the lender for more than 270 days during a taxable calendar year or 270 consecutive days across taxable years. Moreover, the issuer must not be a net borrower under CDIs issued to all members of the Expanded Group for more than 270 days during a taxable year. This is the so-called "disinvestment period." For purposes of both of the "net borrower" tests, only CDIs that satisfy the 270-day test are counted, excluding any CDIs that qualify as ordinary course loans and interest-free loans as discussed below.

An inadvertent failure to comply with the 270-day test will not cause an automatic recast of the debt if the taxpayer cures the error promptly, and if the taxpayer maintains a due diligence and compliance procedure to prevent such failures or the taxpayer's failure was otherwise reasonable.

The 270-day test is a bright-line test based on the term of the CDI. Yet, the disinvestment requirement will likely prevent significant gaming of the rules. For instance, if a taxpayer borrows money for 269 days, and then repays the amount owed, it cannot simply re-borrow the same amount from a different lender within the Expanded Group without violating the disinvestment requirement.

The 270-day test is the more practical of the two exceptions to apply. Specifically, if a taxpayer can identify all of its non-interest bearing loans payable by US group members to Expanded Group members and address them separately, under the exception described below, then it narrows the scope of loans to worry about. It then needs to monitor the US group and ensure that the US group pays down its borrowings so that it is not a "net" borrower at least 95 days during each taxable year. This is obviously easier said than done, but the 270-day test appears to be easier to apply than the Specified Current Assets test.

Treas. Reg. §1.385-3T(b)(3)(vii)(B): Ordinary Course Loans. A second category of QSTDIs covers CDIs that are issued as consideration for the acquisition of property other than money, in the ordinary course of the issuer's trade or business. To qualify, the CDI must be reasonably expected to be repaid within 120 days of issuance. This represents an expansion of the Proposed Regulations' ordinary course exception. Specifically, the Proposed Regulations limited the exception to purchases of "inventory." The Final Regulations expand it to include any acquisition of property other than money. Thus, acquisitions of capital assets would be included, provided the purchase is made in the ordinary course of business.

It is important to note what the exception does ***not*** include. The ordinary course exception does ***not*** cover CDIs issued for services, rents, or royalties. This should not be problematic, however, because the Funding Rule is limited to CDIs issued in exchange for property in the first instance. Thus, CDIs issued for rent or royalties are not, at present, subject to the Funding Rule. These instruments are, however, potentially subject to the Documentation Rule.

Treas. Reg. §1.385-3T(b)(3)(vii)(C): Interest-Free Loans. A third category of QSTDIs covers CDIs that do not give rise to actual or imputed interest. Specifically, this exception applies where: (1) the CDI does not have stated interest, or no interest is charged; (2) the CDI does not have original issue discount; (3) no interest is imputed under section 483 or section 7872; and (4) no interest is required to be charged under section 482. This exception may apply to, for instance, certain intercompany trade receivables for which no interest is required to be charged under Treas. Reg. §1.482-2(a)(1)(iii).

Treas. Reg. §1.385-3T(b)(3)(vii)(D): Deposits with Cash Pools. A number of comments requested that some accommodation be made for "cash pooling" arrangements. Different comments focused on different aspects of the problem. One problem the comments noted is that deposits with a cash pool are typically not short-term. Instead, many multinationals have entities that are consistent cash-flow generators and other entities that periodically need cash. Hence, the depositors tend to deposit money with (or loan money to) the cash pool for an indefinite duration, potentially decades. Thus, many comments requested that deposits be exempted from the Funding Rule. Other comments requested unique exceptions for entities that borrow from cash pools.

The Final Regulations address the deposit side of cash pooling but not the withdrawal side. Specifically, QSTDIs exempt demand deposits with a "qualified cash pool header," or "QCPH." A QCPH is an Expanded Group member, Controlled Partnership, or qualified business unit that has a principal purpose of managing a "cash-management arrangement" for participating Expanded Group members. The excess (if any) of funds deposited with a QCPH must be maintained on the QCPH's books and records as cash or cash equivalents, or invested through deposits with (or in obligations or portfolio securities of) an unrelated person. A "cash-management arrangement" is an arrangement to manage cash for participating Expanded Group members by borrowing and lending funds with participating Expanded Group members. The cash management arrangement may include foreign exchange management, clearing payments, investing excess cash with an unrelated person, depositing excess cash, and settling intercompany accounts.

If an Expanded Group member makes a demand deposit with a QCPH as part of a cash-management arrangement, the demand deposit would be a QSTDI that is exempt from the Funding Rule. Because the Temporary Regulations do not provide a time limit on the deposit, as long as a cash-management arrangement exists, even a long-term deposit can qualify as a QSTDI.

One potential trap for the unwary is the "principal purpose" language in the QCPH definition. The QCPH's principal purpose must be managing a cash-management arrangement. If a QCPH performs multiple roles within an Expanded Group, such as ordinary business operations and administrative functions, the QCPH may not have a "principal purpose" of managing a cash-management arrangement and a demand deposit with that QCPH may be subject to the Funding Rule. Thus, a taxpayer may wish to separate its cash-management arrangement into a dedicated subsidiary if it is not segregated at present.

Another potential issue is the exception's application to notional cash pooling. In a "physical" cash pooling arrangement, one member of the group holds an account into which other members may make deposits, typically in their functional currency. Loan transactions are between depositing or borrowing members and the treasury center. In a "notional" cash pooling arrangement, the transactions are between members and an intermediary bank. The bank traditionally takes on all currency risk such that depositors can deposit in their own functional currency and borrowers can withdraw in their own functional currency.

The Proposed Regulations did not differentiate between physical and notional pooling. The Preamble to the Final and Temporary Regulations explains that a notional cash pool can be subject to the Per Se Recast Rule ***to the extent that***, for US tax purposes, the notional pooling arrangement is treated as giving rise to loans between Expanded Group members. It is not clear how the demand deposit exception in the Temporary Regulations would apply to notional cash pooling, in which: (1) the deposits and loans are not reflected on the QCPH's books and records; and (2) there is no excess of loans receivable over loans payable. Moreover, the Preamble remains silent on foreign currency and interest rate differential issues, such as the impact on hedging transactions if a loan in a particular foreign currency is recast as equity but its hedging transaction is not. As noted above in the case of the Documentation Rule, the government appears to have reserved the right to apply the Final Regulations to notional cash pools, while punting on the complex issues associated with that application.

Anti-Abuse Rule

The Final Regulations, like the Proposed Regulations, contain a very broad anti-abuse rule. Under the ant-abuse rule, a CDI that would not otherwise be caught under the General Rule or the Funding Rule may be recast. Similarly, an instrument issued by an entity that is not a Covered Member may be recast. The only requirement is that a member of an Expanded Group enter into a transaction with "a" principal purpose of avoiding the application of the Per Se Recast Rule. A number of commentators complained about the sheer breadth of the rule and the use of “a” principal purpose instead of “the” principal purpose as the governing standard. The government largely rejected these criticisms but did provide a non-exclusive list of scenarios that it believes would trigger application of the anti-abuse rules.

Exceptions that Apply to Both the General Rule and Funding Rule

The Proposed Regulations contained three exceptions to the list of “tainted transactions” that would trigger the application of the General Rule and the Funding Rule. First, the Proposed Regulations excepted distributions of property made out of the issuer’s current earnings and profits. Second, the Proposed Regulations contained an exception if the aggregate adjusted issue price of all instruments held by members of the issuer’s Expanded Group did not exceed $50 million. Lastly, the Proposed Regulations excepted certain acquisitions of subsidiary stock by issuance.

The Final Regulations organize the exceptions into three subparagraphs: Treas. Reg. §1.385-3(c)(2), (c)(3), and (c)(4) (we refer to these exceptions as the “(c)(2) Exceptions,” “(c)(3) Exceptions,” and “(c)(4) Exception,” respectively). The (c)(2) Exceptions exempt certain acquisitions of Expanded Group stock from the list of “tainted transactions.” The (c)(3) Exceptions exempt certain distributions or acquisitions of property from the list of “tainted transactions.” The (c)(4) Exception modifies the $50 million threshold exception.

The (c)(2) and (c)(3) Exceptions apply independently of any exclusion from the definition of CDI or the exception for QSTDIs. The (c)(2) Exceptions apply ***before*** the (c)(3) Exceptions. A description of the exceptions follows.

The (c)(2) Exceptions

The (c)(2) Exceptions exempt five types of acquisitions of Expanded Group stock from the list of “tainted transactions” that trigger the application of the Per Se Recast Rule.

Treas. Reg. §1.385-3(c)(2)(i): Acquisition of Controlled Subsidiary Stock by Issuance. The (c)(2) Exceptions exempt an acquisition of stock if the acquirer controls the transferor immediately after the acquisition and does not relinquish control of the transferor as part of an existing plan (except in a transaction in which the transferor leaves the Expanded Group). This exception applies to both newly issued stock and acquisitions of existing stock of an Expanded Group member from a controlled subsidiary. For this purpose, “control” means direct or indirect ownership of more than 50 percent of the vote and value of the transferor’s stock. A plan is presumed to exist if the acquirer relinquishes control of the transferor within 36 months after the acquisition, but this presumption is rebuttable. If there is a loss of control pursuant to a plan, the (c)(2) Exceptions are treated as never having applied to the transaction. This exception reflects Treasury’s view that, where the acquirer retains control of the transferor, the transaction is not economically similar to a distribution because the property used to acquire the stock is not moved “out from under” the acquirer. Commentators suggested there was no danger of assets moving “out from under” so long as the contribution of value for newly issued shares was performed on an arm’s length basis. Nevertheless, the government rejected the comments and refused to expand the exception.

Treas. Reg. §1.385-3(c)(2)(ii): Acquisition of Stock Used for Compensation. A number of commentators expressed concern that something as routine as a foreign subsidiary receiving (or deeming to receive) parent stock as part of a stock-based compensation plan could be a tainted transaction under the Proposed Regulations. The government acknowledged these concerns and so the Final Regulations exempt acquisitions of Expanded Group stock that is delivered to employees, directors, or independent contractors as compensation. This exception, coupled with the expanded definition of "exempt exchange" to cover deemed stock acquisitions under Treas. Reg. §1.1032-3(b) (as discussed above), means that payments of stock-based compensation to a subsidiary's employees should not represent a "tainted transaction" that triggers the application of the Per Se Recast Rule, whether the costs are recharged to the subsidiary or not.

Treas. Reg. §1.385-3(c)(2)(iii): Deemed Acquisition of Stock Due to Transfer Pricing Adjustments. The (c)(2) Exceptions also exempt distributions or acquisitions resulting from transfer pricing adjustments. For example, if a Covered Member establishes a receivable owing from a foreign affiliate to itself it may decide to capitalize the receivable in exchange for paid in capital or new shares. The Final Regulations clarify that this is not a tainted transaction. It would seem that the Final Regulations should also have a similar exclusion for receivables created under section 367(d) and Treas. Reg. §1.367(d)-1T(g), but they do not.

Treas. Reg. §1.385-3(c)(2)(iv): Acquisitions of Stock by Dealer in Securities. A further exception applies to dealers in securities if the dealer is buying the stock as part of its business as a dealer. Thus, it must sell any Expanded Group member stock it buys to unrelated parties or another dealer that qualifies for this exception.

Treas. Reg. §1.385-3(c)(2)(v): Cascading Acquisitions of Stock Resulting From Per Se Recast Rule. The purpose of the last (c)(2) exception is to limit the potential for "cascading" or iterative recasts. Specifically, commentators expressed concerns that if a Covered Member issued a CDI which funded a tainted transaction, and the CDI was recast as stock of the Covered Member, then the acquisition of that stock by the Expanded Group member would, in turn, represent a tainted transaction for the holder. That tainted transaction could cause CDIs issued by the holder to be recast and so on.

> <u>EXAMPLE</u>: P owns all of the stock of S1 and S2. All three entities are domestic corporations that do not file a consolidated tax return. P loans $100 to S1, S1 loans $100 to S2 and S2 makes a dividend distribution to P. Under the Proposed Regulations, the Funding Rule recasts S1's loan to S2 as equity of S2. This constitutes an acquisition by S1 of S2 stock. The Funding Rule then recasts P's loan to S1 into equity.

The Final Regulations limit (but do not eliminate) the possibility of cascading recasts. Specifically, the regulations provide that if a CDI is treated as stock as a result of the Funding Rule, or is deemed issued by a regarded owner of a disregarded entity or partner of a partnership, then the acquisition of that stock is not a "tainted" transaction. Thus, in the example above, S1's loan to S2 would still be recast, but P's loan to S1 would not be recast.

The (c)(2) Exceptions do not prevent ***all*** cascading consequences, however. For example, a CDI that is recast under the General Rule is not automatically exempt in the holder's hands unless it qualifies for the controlled subsidiary exception identified above. Moreover, once a CDI is recharacterized as stock, a payment on (or redemption of) that CDI could be a distribution that triggers the Funding Rule.

The (c)(3) Exceptions

The Proposed Regulations possessed a very limited exception which reduced the dollar amount of an Expanded Group member's distributions or acquisitions. The reduction was limited to the member's earnings and profits generated within the year in which the distribution or acquisition occurred. A number of commentators complained that this exception was far too narrow and that the exception did not align with the government's stated aim to ensure that debt issued by a corporation was used to finance new investment.

The Final Regulations create a much broader exception that is better designed to identify whether assets are truly leaving corporate solution. Specifically, the Final Regulations allow a Covered Member to reduce the amount of its distributions or acquisitions that would otherwise be considered "tainted transactions" by the sum of its accumulated earnings plus qualified contributions of property made to the corporation. Each concept is described in more detail below.

Expanded Group Earnings Account. A Covered Member's distributions or acquisitions that would otherwise be considered "tainted" are reduced by the member's earnings and profits accumulated while the issuer was a member of an Expanded Group with the same Expanded Group Parent (the "expanded group earnings reduction"). Importantly, however, the earnings and profits taken into account are limited to those accumulated in taxable years ending ***after*** April 4, 2016, however. By taking into account accumulated earnings rather than only current year earnings and profits, the (c)(3) Exceptions expand on the earnings and profits exception in the Proposed Regulations. This expansion responds to taxpayer comments that, among other things, an exception limited to current year earnings and profits would incentivize a company to distribute their earnings and profits annually (a "use it or lose it" approach).

To track the relevant earnings, the Final Regulations introduce the concept of the "expanded group earnings account" or "EGEA." The EGEA tracks a Covered Member's earnings and profits for the relevant period, with some modifications. For example, a distribution or acquisition that would otherwise be a "tainted transaction" reduces the EGEA to the extent that the expanded group earnings reduction applied to reduce the amount of the distribution or acquisition in a prior year. Look-through treatment applies to dividends, so that a dividend from another member of the Expanded Group does not increase the EGEA unless it is paid out of earnings and profits accumulated while the payor was a member of the Expanded Group and in a taxable year ending after April 4, 2016. A Covered Member that acquires the assets of another member of the Expanded Group in a section 332 liquidation, reorganization, or spin-off succeeds to some or all of the acquired member's EGEA.

The expanded group earnings reduction applies regardless of whether the distribution or acquisition would otherwise be treated as funded by a CDI. Thus, "unfunded" distributions or acquisitions could potentially use up the expanded group earnings account if they are not otherwise exempted.

Qualified Contributions. Unlike the Proposed Regulations, the (c)(3) Exceptions ***also*** reduce the amount of distributions and acquisitions that could otherwise be considered "tainted transactions" by the fair market value of any stock issued by the Covered Member in a Qualified Contribution (the "qualified contribution reduction"). The qualified contribution reduction reflects the fact that distributions funded out of capital contributions do not reduce net equity. Treasury and the IRS determined that it is appropriate to treat distributions or acquisitions as funded by new equity before related-party borrowing.

A Qualified Contribution means a contribution of property, other than Expanded Group stock, property that the Covered Member acquired from another member in an asset reorganization, a CDI of any member of the Expanded Group, property that the Covered Member acquired in exchange for a CDI recharacterized under the Funding Rule, a debt instrument issued by a controlled partnership of the Expanded Group, or any other property acquired with a principal purpose of avoiding the purposes of the regulations.

To be a Qualified Contribution, the contribution must take place within 36 months before or after the distribution or acquisition that is potentially being reduced, while the Covered Member is a member of the same Expanded Group, and no later than the last day of the first taxable year in which a CDI issued by the Covered Member would otherwise be recharacterized under the Per Se Recast Rule. The timing provisions allow taxpayers some ability for self-help if an inadvertent distribution or acquisition causes a CDI to be recharacterized, by making a contribution before the end of the year.

Certain types of contributions are not treated as Qualified Contributions for this purpose. These include a contribution upstream from a controlled subsidiary (*i.e.*, a contribution for "hook stock"), and a contribution from a corporation of which the Covered Member is a predecessor or successor (or a controlled subsidiary of such a corporation). The same is true even if the Covered Member acquires control, or becomes a predecessor or successor, of the contributing entity after the contribution. In that case the contribution ceases to be a Qualified Contribution only on the date the Covered Member acquires control or becomes a predecessor or successor. To the extent that the contribution has already triggered a Qualified Contribution reduction, this reduction is recaptured by deeming an additional distribution to occur (but only if the contribution ceases to be a qualified contribution within 36 months after it occurs). Finally, a contribution that does not increase the aggregate fair market value of the Covered Member's stock, taking into account all related transactions, is not treated as a Qualified Contribution.

A Covered Member that acquires the assets of another member of the Expanded Group in a section 332 liquidation, reorganization, or spin-off succeeds to some or all of the acquired member's history of qualified contributions.

The (c)(4) Exception

Both the Proposed and Final Regulations include a threshold exception which is now contained in Treas. Reg. §1.385-3(c)(4). Under the (c)(4) Exception, a CDI is not treated as stock under the Per Se Recast Rule if, immediately after the CDI would otherwise have been recharacterized, the aggregate adjusted issue price of CDIs held by members of the issuer's Expanded Group that would be treated as stock but for the (c)(4) Exception does not exceed $50 million. If a CDI exceeds this threshold, only the excess amount is recast as stock. Thus, the Final

Regulations do away with the “cliff effect” of the Proposed Regulations, which turned off the exception completely if the $50 million threshold was crossed.

Once a CDI subject to the $50 million exception has been “matched” with a distribution or acquisition, that distribution or acquisition cannot be matched with any other CDI for purposes of recast that other CDI under the Funding Rule.

Operating Rules

Like the Proposed Regulations, the Final Regulations provide a series of complex operating rules.

Timing of Recast

If the Per Se Recast Rule applies to a CDI, the CDI is treated as stock when it is issued, except as provided below. If the CDI is recast under the Funding Rule as a result of a distribution or acquisition that occurs after the CDI is issued, then the recast takes effect on the date of the distribution or acquisition. The CDI is deemed to be exchanged for stock on that date. Similarly, if a CDI is treated as stock because the issuer is treated as the predecessor or successor of another member of the Expanded Group, the CDI is deemed to be exchanged for stock on the later of: (1) the date the CDI would otherwise be recast under the rules discussed above; or (2) the date of the transaction that causes the issuer to become a predecessor or successor.

CDI Leaves the Expanded Group

When a holder and an issuer of a CDI cease to be members of the same Expanded Group, the CDI ceases to be treated as stock under the Per Se Recast Rules. This can occur if the holder or the issuer leaves the Expanded Group, or if the CDI is transferred to a person outside the group. In that case, the issuer is deemed to issue a new CDI in exchange for the existing one. Even though the existing CDI is treated as stock under the Per Se Recast Rule, the deemed surrender of the stock for new debt does not trigger the Per Se Recast Rule with respect to the new CDI.

In some cases, a CDI leaving the Expanded Group can affect the treatment of other CDIs. If the CDI leaving the group was matched with a distribution or acquisition under the Per Se Recast Rule, that distribution or acquisition is now available to be matched with another CDI, potentially causing the other CDI to be recharacterized. Accordingly, on the date that a CDI leaves the Expanded Group, all other CDIs of the issuer that are not treated as stock on that date are re-tested. If a re-tested CDI is recharacterized under the Per Se Recast Rule, the CDI is deemed to be exchanged for stock on the later of the date of the re-testing or the date the CDI would otherwise be treated as stock under the rules discussed above.

Application to Consolidated Groups

Consistent with the Proposed Regulations, the Final Regulations treat all members of the same US consolidated group as “one corporation” for purposes of the Per Se Recast Rule. Thus, so long as a CDI is between members of the same consolidated group (a “Consolidated Group Debt Instrument”), the Per Se Recast Rule does not apply.

Importantly, a CDI issued by one member of a consolidated group to ***another*** member of a different consolidated group, that happens to be part of the same Expanded Group (*i.e.*, two consolidated groups owned by a single foreign parent) is not excepted from the rules. This situation frequently arises when a foreign-based multinational acquires one US target and then, for example, acquires a foreign target that owns a separate US consolidated group. Those two consolidated groups are within the same Expanded Group but not the same US consolidated group. As a result, a loan between these groups is still caught by the regulations.

The Final Regulations flesh out a number of unanswered questions taxpayers had about the "one corporation" concept. At the risk of overgeneralizing, the Final Regulations apply a separate entity approach to the application of operating rules and exceptions to the debt instrument itself. At the same time, the regulations apply a "one corporation" concept to determine whether a "tainted transaction" has occurred, unless the consolidated group member departs the group and the tainted transaction was a regarded transaction at the time it occurred. Specifically, the Final Regulations clarify that:

- If a debt instrument is issued by a consolidated group member, only ***that member's*** activities and attributes are considered in determining whether the debt instrument is a CDI. Thus, for example, a debt instrument issued by a Covered Member that is a "regulated insurance company" described in Treas. Reg. §1.385-3(g)(3)(v) is not considered a CDI. Whether that member is a regulated insurance company is determined by the issuing member's status, not the status of other consolidated group members.

- Even if a debt instrument ***is*** considered a CDI, it may not be subject to the Funding Rule if it is considered a QSTDI. Again, the QSTDI determination is made based on the activities of ***that member***, and not the activities or attributes of the consolidated group as a whole.

- Any deemed issuance or satisfaction of a CDI under the Final Regulations is independent of, and not integrated with, any deemed satisfaction or reissuance of that same debt instrument under consolidated return regulations governing intercompany debt obligations in Treas. Reg. §1.1502-13(g).

- Moreover, Treas. Reg. §1.385-4T(d)(4) provides that separate entity treatment applies to a given consolidated group member if it makes a "regarded" distribution or acquisition before leaving the consolidated group, and then the member subsequently leaves the consolidated group. The impact of this rule is illustrated in Treas. Reg. §1.385-4T(f) Example (4) below:

  EXAMPLE: FP, a foreign corporation, owns all of the stock of USS1, a domestic corporation, and FS, a foreign corporation. USS1 and FP each own 90 percent and 10 percent, respectively, of DS1, a domestic corporation. On Date A, Year 1, DS1 distributes $80 of cash and a newly issued DS1 note with a value of $10 to USS1. At the exact same time, DS1 distributes $10 of cash to FS. The distributions to USS1 are "disregarded" under the "one corporation" concept. The $10 distribution to FS is "regarded," however, because FS is not a member of the same consolidated group. On Date B, in Year 2, FS purchases the DS1 stock owned by USS1. As a result, DS1 ceases to be a member of USS1's consolidated group. When the DS1 Note ceases to be a Consolidated Group Debt Instrument, the note is deemed satisfied and then reissued for property immediately ***before*** leaving the consolidated group under the Treas. Reg. §1.1502-13(g) regulations. Then, immediately ***after*** the DS1 Note leaves the group, DS1 is deemed to satisfy the note with cash and reissue it for the same amount of cash. Then, the Per Se Recast Rule is applied. Given that DS1 is deemed to have made a "regarded" distribution of $10 during the 72-month window period of the deemed issuance of the DS1 Note, $10 of the DS1 Note is considered stock that was issued in partial satisfaction of the DS1 Note.

- Notwithstanding the above, the Final Regulations apply a "one corporation" concept in determining whether a distribution of property or acquisition of Expanded Group member stock is a tainted transaction.
  - The Expanded Group Earnings Account Exception:
    - The consolidated group maintains a single Expanded Group Earnings Account. Only earnings and profits that "bubble up" to the consolidated group parent under Treas. Reg. §1.1502-33 are considered. This is generally a good thing, in that more E&P will be beneficial in reducing the amount of tainted acquisitions and dispositions a group makes. Having said that, taxpayers need to consider the fact that E&P accumulated by subsidiaries that were acquired (not formed) by the consolidated group members prior to being acquired does ***not*** tier up. *See generally*, Treas. Reg. §1.1502-33(b)(2). Thus, taxpayers ***cannot*** simply aggregate the accumulated E&P of all of their consolidated return members to determine the Expanded Group Earnings Account.
    - Notwithstanding the foregoing rule, the Final Regulations provide that a consolidated group ***can*** add a domestic corporate target's Expanded Group Earnings Account (which may be a smaller number than that target's E&P) to its Expanded Group Earnings Account under specific rules provided in Treas. Reg. §1.385-3(c)(3)(i)(F)(2)(ii).
    - If a consolidated group member ceases to be a consolidated group member, the general rule is that it leaves the consolidated group with no Expanded Group Earnings Account. Importantly, this rule does not apply if one consolidated group acquires an entire consolidated group target. In that case, the consolidated group target's Expanded Group Earnings Account can be added to the acquiring group's account. Moreover, if a domestic corporation ceases to be a member of a given consolidated group because it's stock is distributed (*i.e.*, in a straight section 355 distribution or a divisive section 368(a)(1)(D) reorganization), then a portion of the consolidated group's Expanded Group Earnings Account is allocated to the spun-off corporation in proportion to the way E&P is allocated.

  - The Final Regulations also apply a “one corporation” concept to the Qualified Contribution Exception. Effectively, any contribution of property made by a non-consolidated group member to any consolidated group member will be considered a contribution to the consolidated group as a whole unless the contribution causes that consolidated group member to cease being a member of the consolidated group. Moreover, the rules for allocating qualified contributions to joining and departing consolidated group members mirror the rules described above under the Expanded Group Earnings Account exception.

- If a CDI issued by a consolidated group member is recast, then it is considered stock of ***that specific member***, not the parent of the consolidated group. Many commentators expressed concern that this could lead to a significant number of companies being inadvertently de-consolidated, thereby triggering deferred gains. To address this concern, Treas. Reg. §1.385-3(d)(7) provides that if any CDI is recast as stock, but is not considered “plain vanilla preferred stock” within the meaning of Code Section 1504(a)(4), then it will simply be ignored in determining whether the consolidated group member remains consolidated.

- Treas. Reg. §1.385-4T(d)(2) provides that if a consolidated group member issues a CDI and the CDI is recast as stock, that CDI retains its character as stock even after the domestic corporation ceases to be a consolidated group member.

A number of comments questioned how the “one corporation” concept applied when a Controlled Partnership: (i) was wholly owned by members of the same consolidated group; and (ii) issued a debt instrument to a member of that consolidated group. This is because the principles undergirding the regulations augured in favor of different results. On the one hand, one could argue that the loan should be respected. On the other hand, one could argue that the loan should be ignored. Treas. Reg. §1.385-4T(b)(6) clarifies the fact that the partnership is respected as a partnership, and the loan is respected as a loan, but because the partnership rules (in Treas. Reg. §1.385-3T) treat the partners of the partnership as issuing the debt instrument, the loan is considered a “Consolidated Group Debt Instrument” within the meaning of Treas. Reg. §1.385-4T(c). As such, the Per Se Recast Rules do not apply so long as the entire debt instrument is deemed to be owed from a consolidated group member to another member of the same consolidated group.

CDI Becomes a Consolidated Group Debt Instrument

The Proposed and Final Regulations both set forth rules governing what happens when a CDI becomes a Consolidated Group Debt Instrument. If the CDI was considered stock before becoming a Consolidated Group Debt Instrument, then the issuer is deemed to issue a new debt instrument in redemption of the old CDI immediately after the instrument becomes a Consolidated Group Debt Instrument. Importantly, because the CDI is no longer treated as stock under the Final Regulations, all of the issuer’s other CDIs must be retested to ascertain whether or not they should be recast as stock.

There is no special rule for CDIs that were treated as debt ***before*** becoming Consolidated Group Debt Instruments. Those instruments must simply comply with the deemed satisfaction and reissuance rules of Treas. Reg. §1.1502-13(g) that pre-date the Final Regulations.

Consolidated Group Debt Instrument Leaves a Consolidated Group but Remains within Expanded Group

The Proposed Regulations and Final Regulations both set forth rules governing what would happen if a Consolidated Group Debt Instrument ceases to be a Consolidated Group Debt Instrument. There are two (2) different ways in which a Consolidated Group Debt Instrument may leave cease to be a Consolidated Group Debt Instrument but remain a CDI. First, the holder or issuer may leave the consolidated group. Second, the instrument itself could cease to be between consolidated group members. The Final Regulations provide special rules for each instance. Treas. Reg. §1.385-4(c)(iv) of the Final Regulations clarifies that an instrument does not cease to be a Consolidated Group Debt Instrument if the issuer and holder cease to be part of one consolidated group, but remain in a consolidated group with one another.

Holder or Issuer Ceases to Be a Consolidated Group Member. If the holder or issuer of a Consolidated Group Debt Instrument ceases to be a consolidated group member, the issuer is deemed to issue a new debt instrument to the holder in exchange for property immediately ***after*** the departure. If the CDI is then considered "stock" under the Funding Rule, that debt instrument is then deemed to be satisfied for stock issued by the issuer.

The Debt Instrument Itself Ceases to Be Between Consolidated Group Members. If the debt instrument itself ceases to be between consolidated group members (*i.e.*, the holder of the instrument contributed the receivable to a corporation that is not a consolidated group member) then the regulations provide that the consolidated group (as a whole) is considered to have issued the debt instrument to the transferee holder immediately ***after*** the instrument ceases to be a Consolidated Group Debt Instrument. The Final Regulations provide that if, after the new instrument is deemed to be issued, it is considered "stock" under the Per Se Recast Rule, then the newly issued instrument will be deemed exchanged for stock of the issuing member. In the event of an overlap such that a Consolidated Group Debt Instrument ceased to be a Consolidated Group Debt Instrument because the holder or issuer leave the group and the instrument leaves the group as part of the same transaction, then the rules governing departing instruments (not departing holders or issuers) apply.

Application to Disregarded Entities and Partnerships

The application of the Final Regulations to disregarded entities and Partnerships can be complex. We describe each separately below.

Application of Final Regulations to Disregarded Entities

The consequences under the Final Regulations in regards to disregarded entities are similar to the consequences resulting under the Proposed Regulations. Specifically, if a disregarded entity issues an EGI that is recast as equity under the Per Se Recast Rule, the holder of the recast debt is treated as owning deemed equity in the disregarded entity's owner (the "Regarded Owner"), not in the disregarded entity itself.

Application of Final Regulations to Partnerships

Under the Proposed Regulations, the Per Se Recast Rule applied an aggregate or look-through approach to debt instruments issued by partnerships and disregarded entities. Concerning partnerships, the Proposed Regulations treated a Controlled Partnership as the aggregate of its partners. Therefore, if a Controlled Partnership issued an EGI that was recast as equity under the Per Se Recast Rule, the corporate partners (and not the partnership itself) would be treated as having issued equity to the holders of the EGI. In other words, the recast EGI would be treated as stock of the partners in proportion to the partners' interest in the partnership's profits.

This look-through or aggregate approach adopted by the Proposed Regulations generated several questions about corollary effects that were simply not addressed. For example, the Proposed Regulations did not clarify: (i) whether a debt instrument issued by a Controlled Partnership to an Expanded Group Partner is subject to recast under the Per Se Recast Rule (aggregate theory would suggest the Expanded Group Partner as both the borrower and issuer of the debt); (ii) how payments on debt instruments issued by Controlled Partnerships should be treated; or (iii) how the recast would affect the Controlled Partnership's allocation of tax items and liabilities. Thus, the Proposed Regulations generated a lot of unanswered questions about how they would apply in practice.

The Final Regulations answer a number of the questions that arose under the Proposed Regulations. The cost, however, is a complicated morass of rules and deemed transactions.

The Final Regulations continue to apply an aggregate approach with respect to Controlled Partnerships. This aggregate approach takes the form of three rules that apply when: (1) a Controlled Partnership acquires property from an Expanded Group member (the "Property Acquisition Rule"); (2) an interest in a Controlled Partnership that owns Expanded Group stock is acquired (the "Interest Acquisition Rule"); and (3) a Controlled Partnership issues a debt instrument to an Expanded Group member (the "Debt Issuance Rule"). Each rule is described below and illustrated with an example. The examples all assume that US1 and US2 are Covered Members but not members of a consolidated group, FC1 and FC2 are Expanded Group members that are not Covered Members, and US1 and FC 1 are partners in PRS, a Controlled Partnership. The rules are provided in Temp. Reg. §1.385-3T(f) and the relevant definitions are set forth in Temp. Reg. §1.385-3T(g).

The Property Acquisition Rule**.** Property that a Controlled Partnership acquires from an Expanded Group member is treated as acquired by its EG Partner(s). EG Partners are treated as acquiring their shares of the property acquired by the Controlled Partnership in the same manner that the property was actually acquired by the Controlled Partnership (*i.e.*, via taxable distribution, tax-free distribution, taxable acquisition, etc.). An EG Partner's share of property acquired by the Controlled Partnership from an Expanded Group member (the "Transferor Member") is determined according to the EG Partner's liquidation value percentage ("LVP"). Essentially, a partner's LVP is calculated as a percentage. The numerator is the amount of property that would be distributed to that tested partner in a hypothetical liquidation of the Controlled Partnership. The denominator is the value of all distributions that would be made to all partners. For this purpose, the taxpayer is told to assume all partnership property has been sold at fair market value. LVP is determined as of the date that the Controlled Partnership acquired the property, not the beginning or end of a year. This will likely prove very challenging for those Controlled Partnerships which repeatedly buy and sell property to Expanded Group members during a year.

An exception to the Property Acquisition Rule occurs when an EG Partner is also the Transferor Member. Under these circumstances, the EG Partner (who is also the Transferor Member) is not treated as acquiring any of the property acquired by the Controlled Partnership.

> EXAMPLE: Assume that PRS borrows $100 in cash (which is treated as "property") from FC2 in exchange for a note. Under the Property Acquisition Rule, US1 is treated as receiving a proportionate share of the $100 cash (in proportion to US1's LVP) in exchange for a note, causing US1 to be treated as a Funded Member. Thus, if, for example, US1 were to make a distribution, the Funding Rule would apply.   However, if PRS had borrowed from US1 (and not from FC2), the Property Acquisition Rule would not have applied to US1 because US1 is the Transferor Member.

Interest Acquisition Rule. An Expanded Group member's acquisition of an interest in a Controlled Partnership is treated as an acquisition of a proportionate share of any Expanded Group stock that the Controlled Partnership happens to own. The acquiring EG Partner's share of Expanded Group stock (owned by the Controlled Partnership) that the acquiring EG Partner is treated as acquiring is determined according to the acquiring EG Partner's LVP, determined at the time the acquiring EG Partner acquired its interest in the Controlled Partnership. Regardless of the manner in which the Controlled Partnership acquired the Expanded Group stock, the acquiring EG Partner is treated as acquiring its share of such stock in exchange for property other than Expanded Group stock. However, the Interest Acquisition Rule does not apply when an Expanded Group member acquires an interest in a Controlled Partnership either: (i) from a EG Partner, in exchange solely for Expanded Group stock or (ii) from the Controlled Partnership in exchange solely for Expanded Group stock.

> EXAMPLE: US2 borrows $100 from FC2 and, within the 72-month window period, US2 contributes $100 in cash to PRS in exchange for an interest in PRS. Assume that US2 has a 50 percent LVP in PRS. PRS owns $200 of Expanded Group stock. US2 is treated as using the proceeds of the loan from FC2 to acquire $100 of Expanded Group stock (50 percent x $200). The acquisition of the stock is a "tainted transaction" which then invokes the Funding Rule.

Alternatively, if US1 had contributed $100 worth of Expanded Group stock to PRS instead of acquiring the interest in PRS with cash, in the foregoing example, the Interest Acquisition Rule would not apply.

Debt Issuance Rule. When a Controlled Partnership issues a debt instrument to an Expanded Group member, a portion of the debt instrument is treated as having been issued by the Controlled Partnership's partners who are Covered Members (the "Covered Partners"). Here, LVP is not used to determine the portion of a debt instrument treated as issued by the Covered Partners. Instead, a Covered Partner's portion of the debt instrument (the "Specified Portion") has to be determined. The "Specified Portion" is determined by multiplying the debt by the "Issuance Percentage." The Issuance Percentage is the Controlled Partner's share of Controlled Partnership interest deductions (from all sources) divided by all partnership interest expense. This percentage is determined on the date the debt instrument is issued and is supposed to take into account anticipated borrowings.

The Final Regulations provide that if a triggering event occurs and a recast is necessary, the holder of the debt instrument issued by the Controlled Partnership (the "Holder-in-Form") is deemed to transfer the Specified Portion of the debt receivable (the "Deemed Transferred Receivable") to the Covered Partner in exchange for stock of the Covered Partner (the "Deemed Partner Stock" received in a "Deemed Transfer," under the "Deemed Transfer Rule"). Then, to the extent that a debt instrument is treated as a Deemed Transferred Receivable, it ceases to be considered debt issued by the Covered Partner to the Holder-in Form. Instead, it is represented by the Deemed Transferred Receivable held by the Covered Partner and such portion of the actual debt instrument is disregarded for US federal tax purposes.

> <u>EXAMPLE</u>: PRS issues a $100 note (the "PRS Note") to FC 2 in exchange for X Corporation stock. X Corporation is an Expanded Group member. Assume that US 1's issuance percentage in PRS is 50 percent. Assume that US1's LVP in PRS is 50 percent. Using aggregate principles, as a preliminary matter, US 1 is treated as issuing $50 of the PRS Note to FC 2 in exchange for Expanded Group stock (*i.e.*, X Corporation stock). This is clearly a "tainted" transaction. Yet, $50 of the PRS Note is not simply recast. Instead, under the Deemed Transfer Rule, FC 2 is deemed to contribute $50 of the PRS Note receivable to US 1 in exchange for shares of US 1.

An exception to the Debt Issuance Rule applies when a Covered Partner is the Holder-in-Form of a debt instrument. In such a circumstance, the Deemed Transfer Rule does not apply with respect to the Covered Partner's Specified Portion of the debt instrument and the Specified Portion is not treated as stock.

Prospects for Judicial Challenge

The Proposed Regulations, issued in April 2016, were Treasury's first regulations under section 385 in more than 35 years. They were unique. In the 47-year life of the statute, Treasury had never previously used section 385 as a basis to recast bona fide indebtedness as equity solely because it was issued in a transaction that Treasury dislikes. Due to novelties like the Per Se Recast Rule and the 72-month irrebuttable presumption under the Funding Rule—both of which remain intact in the Final Regulations—many taxpayers began to consider challenging the Final Regulations under the Administrative Procedure Act ("APA").

The APA provides for pre-enforcement judicial review of final agency regulations. It states that a court must "set aside"—*i.e.*, invalidate—an agency regulation that is contrary to statute, arbitrary or capricious, or procedurally defective. 5 U.S.C. § 706(2)(A), (C), and (D).

Standards of Judicial Review

Courts typically determine whether a regulation is contrary to statute based on the standards in *Chevron U.S.A., Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837 (1984). A court first asks "whether Congress has directly spoken to the precise question at issue." If so, a court "must give effect to the unambiguously expressed intent of Congress." A regulation that exceeds the authority in the statute is invalid. But if the statute is silent or ambiguous regarding the pertinent issue, then a court asks whether the regulation "is based on a permissible construction of the statute." Under that test, a court will uphold the regulation unless it is "procedurally defective, arbitrary or capricious in substance, or manifestly contrary to statute." *United States v. Mead Corp.*, 533 U.S. 218, 227 (2001).

To determine whether a regulation is arbitrary or capricious, courts generally apply the framework that the Supreme Court established in *Motor Vehicle Mfrs. Ass'n of the United States, Inc. v. State Farm Mut. Auto Ins. Co.*, 463 U.S. 29 (1983). In *State Farm*, the Court said that an agency regulation is not the product of "reasoned decisionmaking"—and thus is arbitrary and capricious under the APA—if the agency "relied on factors which Congress has not intended it to consider, entirely failed to consider an important aspect of the problem, offered an explanation for its decision that runs counter to the evidence before the agency, or is so implausible that it could not be ascribed to a different in view of the product of agency expertise." The Tax Court has already applied the *State Farm* framework to invalidate a Treasury regulation in the context of deficiency litigation—*i.e.*, in an enforcement proceeding. *Altera Corp.& Subs. v. Commissioner*, 145 T.C. 91 (2015), *appeal docketed*, Nos. 16-70496 and 16-70497 (9th Cir.).

A regulation is procedurally defective if it is not the product of notice-and-comment rulemaking, the standards for which are set forth in 5 U.S.C. § 553. Among other reasons, a regulation may be procedurally defective if an agency issues rules that have the immediate force and effect of law but have not been first provided to the public for comment. *See, e.g.*, *In re Telephone Service Federal Excise Tax Refund Litigation*, 853 F. Supp. 2d 138 (D.D.C. 2012).

Agency regulations that are "otherwise contrary to law"—*e.g.*, those that violate treaties—are also invalid. 5 U.S.C. § 706(2)(A); *see also Cardenas v. Smith*, 733 F.2d 909 (D.C. Cir. 1984) (concluding, in an APA suit, that "[a] treaty may create judicially enforceable rights if the signing parties so desire").

The Administrative Record

To seek pre-enforcement review of the validity of regulations, a regulated party files suit in federal district court. The litigation focuses on the administrative record, which generally comprises:

- the preamble to and text of the proposed regulations;
- any written comments to those proposed regulations;
- statements made at any hearing on the proposed regulations;
- other statements—including statements from Congress—regarding the proposed regulations; and
- the preamble to and text of the final regulations.

See Camp v. Pitts, 411 U.S. 138, 142 (1973) ("the focal point for judicial review [under the APA] should be the administrative record already in existence, not some new record made initially in the reviewing court"); Administrative Conference of the United States, Administrative Conference Recommendation 2013-4, "The Administrative Record in Informal Rulemaking," at 8-9 (June 14, 2013).

Because the administrative record is the focal point for judicial review, there's relatively little opportunity for discovery or fact-finding in district court. Instead, the district court functions like an appellate court and reviews the process by which the regulations were issued to determine whether they were the product of reasoned decision making.

Procedural Considerations in a Pre-enforcement Challenge

The government likely will raise two procedural issues to pre-enforcement judicial review of Treasury regulations—standing and the Anti-Injunction Act. To have standing to sue, a plaintiff must show:

(i) harm—an injury that is:

(a) concrete and particularized, and

(b) actual or imminent;

(ii) causation—that the harm is fairly traceable to the regulation; and

(iii) ability to redress—that the court likely can provide a remedy for the harm.

See Lujan v. Defenders of Wildlife, 504 U.S. 555, 560 (1992). An organization has "associational standing" to sue on behalf of its members if it can establish that one of its members has standing to sue in its own right. *Hunt v. Wash. State Apple Advertising Commission*, 432 U.S. 333, 343 (1977).

The government has raised standing as the primary basis on which to dismiss a pre-enforcement suit challenging the validity of Treasury regulations. *Chamber of Commerce v. IRS*, No. 1:16-cv-00944-LY (W.D. Tex.). In responding to the Chamber's challenge to the temporary Treasury regulations under section 7874, the government argued that the Chamber lacked associational standing to sue. In particular, the government claimed that the Chamber had not shown that any one of its members had suffered a present injury or faced an imminent threat of harm. At the time of this writing, the Chamber has not yet replied to the motion to dismiss.

There are many ways to establish standing. For instance, a plaintiff could show that it will be harmed by the application of a regulation to a transaction that it plans to enter into. The Supreme Court has held that a plaintiff sufficiently establishes standing through sworn statements that a plaintiff will avoid future activity due to the action of a federal agency. *Friends of the Earth v. Laidlaw*, 528 U.S. 167 (2000). In the context of a challenge to a tax regulation, a plaintiff likely could establish standing by providing sworn statements that it intended to enter into a transaction that would be negatively affected by the regulation but declined to do so because of the harm caused by the regulation. Moreover, companies have already suffered harm—in the form of increased costs of borrowing and more limited borrowing options—based on the potential application of the Final Regulations. Through these and other ways, a plaintiff could establish standing in a pre-enforcement challenge to a tax regulation.

The government will also likely argue that Code Section 7421—the Anti-Injunction Act—bars suit. That Act provides, in pertinent part, that "no suit for the purpose of restraining the assessment or collection of any tax shall be maintained in any court. . . ." In the Chamber's challenge to the section 7874 regulations, the government has argued that the Anti-Injunction Act bars suit because invalidating the regulations would restrain the assessment of taxes, as the government would be unable to assess or collect taxes on the basis of the regulations.

The government broadly construes the Anti-Injunction Act to prohibit ***any*** pre-enforcement litigation under the APA. Among other things, this expansive interpretation of the Act overlooks the Supreme Court's recent decision in *Direct Marketing v. Brohl*, 135 S.Ct. 1124 (2015). There, the Court interpreted the term "restrain" in the Tax Injunction Act, 28 U.S.C. § 1341, to mean "to stop." The Tax Injunction Act and the Anti-Injunction Act contain nearly identical terms and serve nearly identical purposes, and the Court has long recognized that the interpretation of one act informs the interpretation of the other. *Enochs v. Williams Packing*, 370 U.S. 1, 6 (1962) ("The enactment of the comparable Tax Injunction Act . . . throws light on the proper construction to be given [the Anti-Injunction Act]."). The Court in *Direct Marketing* also held that the terms "assessment" and "collection" are terms that have specific meaning under the Code—assessment is "the official recording of the taxpayer's liability," and collection is "the act of obtaining payment of taxes due." The actions of assessment and collection are focused on the government's activities with respect to particular taxpayers. Because the government has not engaged in any assessment or collection activity with respect to any particular taxpayer, pre-enforcement litigation under the APA does not "stop" the government from assessing or collecting tax from any specific taxpayer. For these and other reasons, the Anti-Injunction Act is a surmountable hurdle.

Challenges to the Final Regulations

Although Treasury has attempted to reduce its litigation risk in the Final Regulations by providing exceptions to the Per Se Recast Rule and reserving on portions of the Final Regulations in the hopes that fewer taxpayers will be motivated to sue, it is unclear whether this strategy will be successful, since it requires taxpayers to accept the impact of the Documentation Rules and assume that Treasury will not issue additional rules in the future on the reserved items. For those taxpayers who bear a disproportionate burden under the Final Regulations today, such as foreign-based multinationals, their procedural and substantive arguments challenging the Final Regulations largely align with the arguments made against the Proposed Regulations because the fundamental architecture of the Per Se Recast Rule remains the same in the Final Regulations.

The Per Se Recast Rule is Still Contrary to the Governing Statute.

After Treasury issued the Proposed Regulations, many taxpayers commented that Treasury lacked the authority to promulgate the Per Se Recast Rule. Despite these comments, the Final Regulations retain that rule.

Section 385(a) generally provides that Treasury has the authority to prescribe regulations that are "necessary or appropriate" to determine whether an advance is debt or equity. Section 385(b) limits the scope of that authority by requiring that the Secretary "shall set forth factors which are to be taken into account in determining with respect to a particular factual situation whether a debtor-creditor relationship exists or a corporation-shareholder relationship exists."

In the preamble to the Final Regulations, Treasury contends that section 385(b) does not limit its authority to promulgate per se rules. It also contends that section 385(b) "authorizes the Secretary to prescribe factors 'with respect to a particular factual situation,' as opposed to all possible fact patterns."

This interpretation misreads the statute. First, if Congress had intended to grant Treasury the authority to issue bright-line per se rules, then section 385(b) would be unnecessary because section 385(a) would provide sufficient authority to issue any "necessary or appropriate" rules to distinguish debt from equity—including dispositive per se rules. Treasury's interpretation makes section 385(b) mere surplusage. Second, the text of the statute shows that the factors are guidelines that are to be "taken into account" in particular factual situations to distinguish debt from equity. The phrase "with respect to a particular factual situation" describes how the factors will be applied—it does not grant authority to issue dispositive rules that apply only to specific transactions. Third, the legislative history, which repeatedly refers to regulations under section 385 as guidelines, supports the conclusion that Congress did not grant authority to issue bright-line rules that automatically recast debt as equity solely because the debt was issued in a particular transaction. Fourth, the structure of the Code—which includes sections 163(j) and 279, that respectively address the treatment of interest-expense deductions and debt used in corporate acquisitions—shows that Congress developed a comprehensive scheme for the treatment of debt and equity in a wide variety of circumstances. Indeed, Treasury's prior efforts to amend section 163(j) contradict its current position that it can issue regulations that recast related-party debt solely because it was issued in certain transactions that Treasury dislikes. Fifth, the timing of Treasury's novel interpretation of section 385 also makes the regulations suspect. The Supreme Court recently explained that "[w]hen an agency claims to discover in a long-extant statute an unheralded power to regulate . . . we typically greet its announcement with a measure of skepticism." *Utility Air Regulatory Group v. EPA*, 134 S.Ct. 2427, 2444 (2014). To our knowledge, this is the first time in the 47-year life of the statute that Treasury has ever contended that section 385 provides the authority to promulgate bright-line rules like the Per Se Recast Rule. These are some of the many problems with the interpretation of the rulemaking authority under section 385 that is set forth in the preamble to the Final Regulations. The preamble does not help to resolve the several issues that regulated parties raised in comments to the Proposed Regulations, and the Per Se Recast Rule remains contrary to statute.

The Per Se Recast Rule Is Arbitrary and Capricious.

Reasoned decision making is required for a regulation to be valid and, in the Final Regulations, Treasury repeats the error that it made in the Proposed Regulations when it failed to explain Treasury's departure from the long-standing practice that a factor-based test consisting of objective economic criteria should be used to determine whether an instrument is debt or equity. The Supreme Court has noted that "unexplained inconsistency is" a "reason for holding an interpretation to be an arbitrary and capricious change from agency practice." *National Cable & Telecomms. Ass'n v. Brand X Internet Servs.*, 545 U.S. 967, 981 (2005). As discussed above, for decades, taxpayers, Treasury, the government, and the courts have used factor-based tests to determine whether an instrument is properly characterized as debt. In proposed regulations promulgated in 1980, for example, Treasury emphasized that "[t]he regulations under section 385 are designed to ensure that the treatment is in accordance with objective economic criteria, and not according to any other standard." *See* 45 Fed. Reg. at 18958 (Mar. 24, 1980).

Although numerous commenters pointed out Treasury's change in position and identified Treasury's failure to explain its rationale for this change, Treasury took the same approach in the Final Regulations by refusing to acknowledge that it had changed its position, let alone explain its rationale. Instead, Treasury merely repeated the unsupported factual assumptions that it cited as justification for its policy choices in the Proposed Regulations.

Furthermore, by reserving on the application of the Per Se Recast Rule to debt issued by foreign issuers while continuing to rely on the same unsupported factual assumptions that it relied upon to support the Proposed Regulations, Treasury only highlighted the arbitrariness of its approach in the Final Regulations. There are other instances of arbitrariness in the Final Regulations that render them subject to challenge under the APA.

The Temporary and Final Regulations Are Procedurally Defective Under the APA.

Among other things, the APA requires agencies to respond to all significant comments received during the rulemaking process. In response to the Proposed Regulations, commentators explained to Treasury that the enactment of section 279 at the same time as the enactment of section 385 demonstrates that Congress knows how to write a per se rule when it believes that a per se rule is appropriate. Commentators also told Treasury that, rather than interpreting section 385, the Per Se Recast Rule seeks to achieve policy results that President Obama's Administration attempted—and failed—to achieve through legislative proposals to modify other Code provisions, such as section 163(j). The preamble to the Final Regulations are silent on these and several other significant comments that Treasury received.

In addition, the APA requires agencies to provide regulated parties with the opportunity for notice-and-comment ***before*** rules take effect and prohibits agencies from issuing immediately effective rules that have the force of law without good cause. Although the Final Regulations reduce the retroactive effect that would have been caused by the Proposed Regulations, retroactive features still remain—for example, E&P accumulated before April 4, 2016 is not counted for the exception. In addition, the Final Regulations contain a "transition rule" providing that covered debt instruments issued on or before 90 days after the Final Regulations were published in the Federal Register will be recharacterized as equity if they are not retired during the 90-day period after publication. Because Treasury does not provide an explanation of why there is good cause under the APA to permit these retroactive features, their inclusion violates the APA. Moreover, Treasury's claim that "[t]he applicability dates governing these regulations are not retroactive" is incorrect. As Treasury notes, the Supreme Court has stated that regulations are retroactive when they "impair rights a party possessed when [that party] acted, increase a party's liability for past conduct, or impose new duties with respect to transactions already completed." The "transition" rule that recasts instruments that have not been retired within 90 days of the publication of the Final Regulations will increase a taxpayer's liability for its past conduct, thereby meeting the Supreme Court's test for a retroactive rule and maintaining the procedural defects that were present in the Proposed Regulations.

Treaties

Like the Proposed Regulations, the Final Regulations create a conflict with existing treaties that taxpayers can conceivably challenge in court. In this regard, taxpayers need to think of the applicable treaty provisions that apply at the shareholder level and at the Covered Member level.

Treaty Challenges at the Shareholder-Level. Imagine, for example, a Covered Member issues debt to its foreign shareholder/parent corporation, and the CDI is recast as equity under the Per Se Recast Rule. In that event, the domestic issuer will not receive a deduction and the foreign creditor will receive dividends rather than interest income. If the foreign parent is resident in a treaty jurisdiction the United States generally could not impose withholding tax on the interest payments made by the domestic issuer. But if the interest payments are recast as dividend payments, then the treaty would impose a 5 percent withholding tax. The zero percent withholding rate typically requires compliance with a more stringent limitations-on-benefit provision.

Thus, under the treaty, the foreign shareholder/parent has the right to receive interest paid by the Covered Member free of US withholding tax. The government, using the regulatory Per Se Recast Rule, imposes a 5 percent withholding tax.

Yet, treaties are contracts between sovereign states and Treasury lacks the authority to override treaty provisions by regulation. Article 11(4) of the 2016 US Model Treaty defines “interest” as “income on debt claims of any kind.” Although the treaty does not define “debt,” at common law, “debt” has an ordinary and common meaning. It has not historically depended on whether certain “tainted” transactions occur within a 72-month window period. Some authority suggests that courts will interpret treaties like contracts, and try to discern the shared understanding of the parties when they initially signed the treaty. If a court were to apply that standard, it is unlikely that the government will be able to persuade the court that the treaty counterparty shared Treasury’s novel definition of “debt claim” it now advances in the Final Regulations and the Per Se Recast Rule.

Treasury addressed this argument in the preamble in T.D. 9790, arguing that the term “dividends” is defined as “[i]ncome from shares or other rights, not being debt-claims, participating in profits, as well as income that is subject to the same taxation treatment as income from shares under the laws of the Contracting State of which the company making the distribution is a resident.” The government argues that because the term is defined to refer to income that is “subject to the same taxation” as shares under the laws of the source state, there is no conflict. Yet, it remains to be seen whether a reviewing court will accept the idea that the US can recast debt as equity using the completely new and unprecedented standards of the Per Se Recast Rule that treaty counterparties could not possibly have foreseen at the time the treaties were signed.

Baker & McKenzie
North America Tax

Chicago
+1 312 861 8000

Dallas
+1 214 978 3000

Houston
+1 713 427 5000

Miami
+1 305 789 8900

New York
+1 212 626 4100

Palo Alto
+1 650 856 2400

San Francisco
+1 415 576 3000

Toronto
+1 416 863 1221

Washington, DC
+1 202 452 7000

Treaty Challenges at the Covered Member Level. At the Covered Member level, a different treaty provision may apply. Specifically, the “harm” to a Covered Member is that it loses an interest deduction. Unlike withholding taxes (addressed above), the US taxation of a US corporation’s earnings is not generally governed by the terms of a treaty. Having said that, US tax treaties contain non-discrimination clauses. Article 24(5) of the United States’ 2006 Model Tax Convention on Income provides:

> Enterprises of a Contracting State, the capital of which is wholly or partly owned or controlled, directly or indirectly, by one or more residents of the other Contracting State, shall not be subjected in the first-mentioned State to any taxation or any requirement connected therewith that is more burdensome than the taxation and connected requirements to which other similar enterprises of the first-mentioned State are or may be subjected.

A similar provision appears in Article 24(5) of the United States’ 2016 Model Tax Convention on Income.

The Proposed Regulations were immune from a non-discrimination challenge, because they applied to every type of corporate issuer. By narrowing the scope, however, the Final Regulations create an opportunity to challenge the enforceability of the regulations under the non-discrimination grounds of a relevant treaty.

The government may contend that the Final Regulations are not so narrow that they only apply to foreign-owned Covered Members. The regulations also apply when a publicly traded or domestically controlled Covered Member has debt owing to its foreign subsidiaries. They also apply when a Covered Member issues debt to a domestic shareholder that owns 80 percent or more of the Covered Member, if the Covered Member and the shareholder are not members of the same US consolidated group. The government cites these facts as reasons why there should not be a treaty non-discrimination issue with the Final Regulations. Nonetheless, the non-discrimination provisions of applicable treaties may undermine the government’s arguments.

Concluding Remarks

In conclusion, we offer a high level view of what taxpayers can likely expect going forward. The sheer breadth of the Proposed Regulations created taxpayer opposition that was widespread, wholesale and uniform across industries and taxpayer types. By narrowing the scope of the Final Regulations, the government has successfully created a wedge between US-based multinationals and foreign-based multinationals. Specifically, for most US-based multinationals, the Final Regulations will prove to be an annoying and costly compliance burden, but will not likely change their tax planning strategies and operations. For foreign-based multinationals, the Final Regulations represent both a compliance nightmare and a substantive curb on their ability to fund their US operations with debt.

Thus, going forward, it will be important for US multinationals to work between now January 19, 2017 to ensure they have no CDIs that could be recast under the Per Se Recast Rule, and repay them before they are recast on January 19, 2017. Furthermore, they will need to work between now and January 1, 2018, to put systems in place to ensure they are compliant with the Documentation Rules.

They will also need to remain vigilant, and remember that the government did not foreswear applying the regulations to foreign issuers. Instead, the government simply reserved on the issue for further consideration.

Foreign-based multinationals need to identify any CDIs and develop a system of documentation just like US multinationals. However, they also need to put serious guardrails in place to monitor the creation of new CDIs and "tainted" transactions. In addition, foreign-based multinationals should seriously consider the viability of challenging the substantive and procedural validity of the Final Regulations and their conflict with applicable treaties in court. By substantially narrowing the scope of the Final Regulations, the government clearly targeted foreign-based multinationals. This potentially improves the ability of foreign-based multinationals to argue that the Final Regulations violate the non-discrimination provisions of various tax treaties executed by the United States.

www.bakermckenzie.com

For additional information please contact the authors of this Client Alert or any member of Baker & McKenzie's North American Tax Practice Group.

John D. McDonald
+1 312 861 8917
John.Mcdonald@bakermckenzie.com

Steven R. Schneider
+1 202 452 7006
steven.schneider@bakermckenzie.com

Paula R. Levy
+1 650 251 5936
paula.levy@bakermckenzie.com

Daniel V. Stern
+1 202 835 6102
daniel.stern@bakermckenzie.com

Alexandra Minkovich
+1 202 452 7015
alexandra.minkovich@bakermckenzie.com

Sukbae David Gong
+1 312 861 8600
David.Gong@bakermckenzie.com

Jordan Joseph Hughes
+1 312 861 8922
jordan.hughes@bakermckenzie.com

Joseph (Jud) B. Judkins
+1 202 835 6137
joseph.judkins@bakermckenzie.com

Samuel Pollack
+1 312 861 8603
Samuel.Pollack@bakermckenzie.com

Tax News and Developments is a periodic publication of Baker & McKenzie's North America Tax Practice Group. This Alert has been prepared for clients and professional associates of Baker & McKenzie. It is intended to provide only a summary of selected recent legal developments. For this reason, the information contained herein should not be relied upon as legal advice or formal opinion or regarded as a substitute for detailed advice in individual cases. The services of a competent professional adviser should be obtained in each instance so that the applicability of the relevant jurisdictions or other legal developments to the particular facts can be verified. To receive *Tax News and Developments* directly, please contact taxnews@bakermckenzie.com.

Your Trusted Tax Counsel®
www.bakermckenzie.com/tax