Proskauer

Client Alert

IRS Issues Final and Temporary Debt-Equity Regulations Under Section 385

October 26, 2016

I. Introduction.

On October 13, 2016, the Treasury Department ("Treasury") and the Internal Revenue Service (the "IRS") issued final and temporary regulations under section 385.[1] The final and temporary regulations recharacterize certain debt instruments as equity for all federal income tax purposes.

In short:

- The final and temporary regulations narrow considerably the proposed regulations and will principally apply to debt issued by domestic corporations to foreign corporations that are part of the domestic corporation's "expanded group" (generally based on an 80% vote or value test).
  - Issuers that are foreign corporations, S corporations, most regulated investment companies ("RICs" and real estate investment trusts ("REITs"), and "non-controlled" partnerships are not subject to the final and temporary regulations. Certain regulated financial companies and insurance companies are exempted from the per se stock rules and subject to relaxed documentation rules, as discussed below.
  - "Downward attribution" rules do not apply and therefore debt issued to a brother or sister corporation that is not owned by a common corporate parent is not subject to the final and temporary regulations.
- The controversial per se stock rules of the proposed regulations remain largely intact:
  - Certain debt instruments issued in connection with distributions or acquisitions continue to be treated as stock under the general rule.
  - Certain debt instruments issued to expanded group members within 36 months before and 36 months after certain distributions or acquisitions, or at any other time with a principal purpose of funding such a distribution or acquisition, continue to be treated as stock under the funding rule.
  - Debt generally is not recharacterized as equity to the extent of accumulated earnings and profits earned after April 4, 2016 by the debtor. This rule expands the exception that had been limited to current earnings and profits in the proposed regulations. In addition, the $50 million de minimis exception in the proposed regulations has been expanded to exempt from

[1] All references to section numbers are to the Internal Revenue Code or the Treasury regulations issued under it.

recharacterization the first $50 million of debt that otherwise would have been recharacterized. This expansion eliminates the cliff effect of the proposed regulations.

- New exceptions to both the general rule and the funding rule apply to (i) debt issued by certain regulated entities; (ii) distributions and acquisitions treated as having been funded by new capital contributions; (iii) distributions of expanded group stock to service providers; and (iv) debt issued by, and debt or expanded group stock acquired by, securities dealers in the ordinary course of business.
- The funding rule (but not the general rule) does not apply to (i) certain intragroup short-term debt instruments and other lending and cash pooling arrangements and (ii) tax-free liquidating distributions and distributions pursuant to a tax-free spinoff.

- The bifurcation rule has been eliminated.
- The documentation rules have been liberalized.
  - Only debt issued beginning in 2018 (including as a result of a significant modification) is subject to the documentation rules, and the documentation need not be prepared until the due date (including extensions) of the issuer's tax return. (It would have been required to be prepared within 30 days of the issuance of the debt under the proposed regulations.)
  - Streamlined documentation rules apply for debt issued by certain regulated entities, as well as for intragroup revolving credit and cash pooling arrangements.
  - Undocumented debt is generally treated as per se stock. However, in a liberalization of the proposed regulations, exceptions apply for (i) certain "highly compliant" expanded groups, for which a rebuttable presumption that an undocumented debt interest is equity applies, (ii) ministerial and non-material failures that have been timely cured, and (iii) taxpayers that establish reasonable cause for failing to comply.
- The final and temporary regulations do not apply to debt issued by "blocker" entities to investment partnerships. In addition, although the Preamble indicates that Treasury and the IRS will closely scrutinize and may challenge under the anti-abuse rule transactions in which a controlled partnership issues preferred equity (instead of debt) to an expanded group member, because the Preamble indicates that the scrutiny will apply only to controlled partnerships that issue preferred equity, investment funds that are not controlled partnerships should avoid this scrutiny.
- The effective dates have been liberalized.
  - The per se stock rules apply only to debt instruments issued after April 4, 2016, and only with respect to taxable years ending on or after January 19, 2017. Therefore, no debt instruments will be treated as equity prior to January 19, 2017.
  - Only distributions and acquisitions that occur after April 4, 2016 are subject to 72-month testing period in the per se funding rule. Transition rules treat distributions other than stated interest on debt instruments issued after April 4, 2016 and before January 19, 2017 and that would otherwise be recharacterized as equity under the per se stock rules as distributions for purposes of recharacterizing other instruments as equity under the funding rule.
  - The documentation rules apply only to debt instruments issued beginning in 2018.

II. Background.

The final and temporary regulations are the most recent in a series of measures implemented by Treasury and the IRS to discourage U.S. multi-national corporations from engaging in "inversion transactions". In an inversion transaction, a U.S. multi-national corporation is acquired by a foreign corporation that, in turn, is owned in large part by the same shareholders that originally owned the U.S. corporation. Inversion transactions had offered three potential tax benefits for U.S. multi-national corporations. First, the U.S. corporation could cause its foreign subsidiaries to pay their untaxed offshore earnings to the new foreign parent, and the foreign parent could then distribute that income to the shareholders without those earnings ever being subject to U.S. tax. Second, the foreign parent could begin to operate the offshore businesses of the U.S. corporation, thereby bypassing the U.S. tax system. And finally, the U.S. corporation could engage in "earnings stripping" by distributing a note to the foreign parent and paying deductible interest that would reduce the U.S. corporation's taxable income.

Beginning with a series of notices and ultimately regulations under section 7874,[2] Treasury and the IRS made it significantly more difficult for U.S. corporations to engage in inversion transactions, and for U.S. corporations that engage in inversion transactions to distribute the income of their foreign subsidiaries without tax.

In April 2014, it was suggested to Treasury and the IRS that section 385 provided authority for regulations that would recharacterize as equity the debt of U.S. corporations that was issued to their foreign parents to strip U.S. earnings.[3] Section 385 was enacted in 1969 and authorizes Treasury and the IRS to issue regulations that determine whether an interest in a corporation is treated as equity or debt for federal income tax purposes. Recharacterizing the debt issued by a U.S. corporation to its foreign parent as equity would convert the U.S. corporation's deductible interest expense to nondeductible dividends, thereby preventing earnings stripping. Regulations under section 385, however, cannot be used merely to deny interest deductions; section 385 authorizes only regulations that characterize an instrument as debt or equity for all federal income tax purposes.

On April 4, 2016, Treasury and the IRS issued sweeping proposed regulations under section 385 that would have recharacterized a broad range of related-party debt instruments as equity for tax purposes, including debt issued by U.S. corporations to other U.S. corporations and debt issued by foreign corporations. The proposed regulations were drafted to apply beyond the targeted earnings stripping situations for two important reasons.

First, section 385 was not enacted to address earnings stripping. It was intended to allow rules that distinguish debt from equity categorically, and it is questionable whether section 385 provides authority to address only earnings stripping. If the proposed regulations applied only to debt issued by U.S. corporations to their foreign parents, the regulations could be challenged for exceeding the authority granted by the statute.

Second, the foreign parent in an inversion transaction is invariably resident in a jurisdiction with a tax treaty with the United States. Many treaties have nondiscrimination provisions that prevent each country from treating the residents of the other country any worse than its own residents. If the section 385 regulations were to recharacterize only debt issued to treaty partners, the regulations arguably would violate the nondiscrimination provision of the treaties. By drafting the proposed regulations broadly, Treasury and the IRS could escape this attack.

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[2] T.D. 9761 (Apr. 4, 2016) (issuing temporary regulations under section 7874); Notice 2015-79, 2015-49 I.R.B. 775 (Nov. 19, 2015); Notice 2014-52, 2014-42 I.R.B. 712 (Sept. 22, 2014).

[3] *See* Stephen E. Shay, "Mr. Secretary, Take the Tax Juice Out of Corporate Expatriations," *Tax Notes* (July 28, 2014), at 473.

III. Summary of the Proposed Regulations.

The proposed regulations contained three sets of rules. The first set – the "per se stock" rules – automatically treated certain debt issued within an "expanded group" as equity.[4] The second set – the "bifurcation rules" – permitted the government to treat certain debt instruments issued within a "modified expanded group" as in part stock and in part debt.[5] The final set of rules – the "documentation rules" – required taxpayers to maintain contemporaneous documentation that established the factual basis for treating an instrument as debt for tax purposes.[6]

IV. The Final and Temporary Regulations.

Treasury and the IRS received nearly 30,000 largely negative comments on the proposed regulations. Treasury and the IRS responded by significantly paring back the proposed regulations and largely reducing the project to its original narrow purpose – to prevent earnings stripping using methods often used by inverted U.S. corporations and other controlled U.S. subsidiaries of foreign parents.

A. Expanded Groups and Expanded Group Instruments.

The rules in the final regulations generally apply to debt instruments between two members of an "expanded group" (or "EG"). Generally an "expanded group" (or "EG") is a group of corporations where (1) a common parent owns directly or indirectly at least 80% of the stock (by vote or value) of at least one other group member and (2) at least 80% of the stock (by vote or value of each corporate member is owned directly by one or more other corporate members.[7] The final and temporary regulations, as in the proposed regulations, treat all members of a consolidated group as a single corporation.[8]

Instruments issued in the form of debt by a member of an EG to another are referred to as expanded group interests or "EGIs". Although the proposed regulations applied to debt issued by S corporations, RICs, REITs, and foreign corporations, the final regulations apply only to debt instruments issued by U.S. C corporations and controlled partnerships;[9] they do not apply to debt issued by foreign corporations, S corporations, RICs or REITs (unless the RIC or REIT is controlled by members of an expanded group), or non-controlled partnerships (subject to an anti-abuse rule).[10] Treasury officials have stated that the next Administration will decide whether to expand the final regulations to apply to debt issued by foreign corporations.

Modified attribution rules under section 318 generally apply when determining if the 80% ownership threshold is satisfied. However, the final regulations reserve on application of the downward attribution rules,

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[4] Prop. Reg. § 1.385-3 (2016). Generally an "expanded group" is defined in the proposed regulations as a group of corporations where (1) a common parent owns directly or indirectly at least 80% of the stock (by vote or value) of at least one other group member and (2) at least 80% of the stock (by vote or value of each corporate member is owned directly by one or more other corporate members. Prop. Reg. 1.385-3(b)(3) (2016). Therefore, if a corporate parent owns all of the stock of two subsidiaries and all three corporations are members of an expanded group, then any instrument denominated as debt and issued by one member to another would be an EGI.

[5] Prop. Reg. § 1.385-1(d) (2016). A modified expanded group is the same as an expanded group, except replacing 80% with 50%. Prop. Reg. § 1.385-1(b)(5) (2016).

[6] Prop. Reg. § 1.385-2 (2016).

[7] Reg. § 1.385-1(c)(4).

[8] Reg. § 1.385-4T(b)(1); Prop. Reg. § 1.385-1(e) (2016).

[9] Reg. § 1.385-1(c)(2); Preamble, at 21-23.

[10] Reg. § 1.385-1(c)(2).

which under the proposed regulations would have caused members of "brother-sister" groups of corporations that are owned by a partnership or individual to be treated as members of the same EG even though no corporate parent owned interests in each.[11]

B. The Per Se Stock Rules.

The final and temporary regulations retain the general framework of the per se stock rules that were contained in the proposed regulations. Accordingly, certain debt instruments ("covered debt instruments") are automatically treated as equity even if they would otherwise be treated under general tax principles as indebtedness. The per se stock rules consist of a "general" rule and a "funding" rule. Under the general rule, a debt instrument issued between members of an EG is treated as stock if the instrument is issued:

- in a distribution (i.e., distributed by the debtor to the creditor),
- in exchange for stock of a member of the EG (other than in an exempt exchange), or
- in exchange for property in an asset reorganization, but only to the extent that an EG member that is a shareholder in the transferor corporation receives the instrument with respect to its stock of the transferor corporation pursuant to the plan of reorganization (e.g., a U.S. corporation buys back its stock from its foreign parent in exchange for a note).[12]

The general rule describes the transactions that are most commonly used by inverted corporations to strip earnings.

Under the funding rule, a debt instrument is also treated as stock if it is issued by a corporation (the "funded member") to a member of its EG and is treated as funding any of the following types of actions by the funded member:

- a distribution of property by the funded member to a member of the EG, other than certain distributions of stock pursuant to an asset reorganization,
- an acquisition of stock of an EG member, other than in an "exempt exchange",[13] by the funded member from an EG member in exchange for property (other than stock of an EG member), or
- an acquisition of property by the funded member in an asset reorganization, but only to the extent that an EG member that is a shareholder in the transferor corporation receives boot in the reorganization with respect to its stock in the transferor corporation pursuant to the plan of reorganization.[14]

Any debt instrument issued by the funded member within a 72-month "per se period" – beginning 36 months before, and ending 36 months after, the date of a distribution or acquisition – is treated as having been

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[11] Reg. § 1.385-1(c)(4)(iii), (v). In addition, the final regulations reserve on the application of downward attribution rules and provide clarifying guidance as to when options will trigger the option attribution rule in section 318(a)(4). Reg. § 1.385-1(c)(4)(vi); Preamble, at 28-41.

[12] Reg. § 1.385-3(b)(2).

[13] An exempt exchange is an acquisition of EG stock in which either (i) in the case where both the transferor and transferee of the EG stock are parties to an asset reorganization, either (A) section 361(a) or (b) applies to the transferor of the EG stock and the stock is not transferred by issuance, or (B) section 1032 or Treasury regulations section 1.1032-2 applies to the transferor of the EG stock, which is distributed by the transferee pursuant to the plan of reorganization; (ii) the transferor of the EG stock receives property in a complete liquidation under section 331 or 332; or (iii) the transferor of the EG stock is an acquiring entity that is deemed to issue the stock in exchange for cash from an issuing corporation in a transaction described in Treasury regulations section 1.1032-3(b).

[14] Reg. § 1.385-3(b)(3).

issued to fund a distribution or acquisition, and therefore is automatically treated equity.[15] This element of the funding rule is referred to as the "per se funding rule". It was one of the most controversial elements of the proposed regulations and remains the most controversial element of the final and temporary regulations. To ameliorate the harsh effect of this rule, no distributions or acquisitions that occurred before April 4, 2016 are considered for purposes of applying the per se funding rule.[16] In addition, a debt instrument issued outside the per se period may still be recharacterized as equity under the funding rule if, based on a review of all of the facts and circumstances, the funded member issued the debt with "a principal purpose" of funding a distribution or acquisition.[17]

The purpose of the funding rule is to prevent avoidance of the general rule. For example, assume that a foreign parent owns a U.S. subsidiary and a foreign subsidiary. A distribution of the U.S. subsidiary's note to the foreign parent would be subject to the general rule. However, instead, the U.S. subsidiary issues its note to buy property from the foreign subsidiary, and several months later, the U.S. subsidiary distributes that property to the foreign parent, which contributes it to the foreign subsidiary in exchange for the U.S. subsidiary's note. The end effect of these transactions is exactly the same as if the U.S. subsidiary had distributed its note to its foreign parent. However, absent the funding rule, the note issued to the foreign subsidiary would not be recharacterized as equity. Although the funding rule does serve an anti-abuse role, because it applies automatically and regardless of intent, it will inevitably apply to innocuous transactions.

C. Expansion of Existing Per Se Stock Rule Exceptions.

The final and temporary regulations expand the three exceptions to both per se stock rules that were included in the proposed regulations, and add several new exceptions. Taken together, these changes minimize the scope and effect of the per se stock rules in the proposed regulations.

1. Post-April 4, 2016 Accumulated Earnings and Profits. Under the final regulations, a debt instrument that would have been recharacterized as equity is only recharacterized to the extent the amount of the debt exceeds all current and accumulated earnings and profits beginning in tax years ending after April 4, 2016 through all periods during which the issuer was a member of the expanded group, rather than merely current earnings and profits (as under the proposed regulations).[18]

2. The De Minimis Rule. The final regulations contain a de minimis rule that excludes from recharacterization as equity the first $50 million of debt instruments that otherwise would be subject to recharacterization.[19] Although the proposed regulations had also contained a $50 million exception, an issuer could not benefit from the exception at all if it had issued more than $50 million of debt instruments that otherwise would be subject to recharacterization as equity.[20] Accordingly, the final regulations have eliminated this "cliff effect" of the de minimis rule in the proposed regulations.

3. The 50% Subsidiary Rule. Third, the final regulations liberalize the 50% subsidiary stock issuance exception that was present in the proposed regulations. This exception provides that the funding rule is not triggered by a funded member's acquisition of stock issued by subsidiary in its EG in exchange for

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[15] Reg. § 1.385-3(b)(3)(iii).

[16] Reg. § 1.385-3(b)(3)(viii).

[17] Reg. § 1.385-3(b)(3)(iv).

[18] Reg. § 1.385-3(c)(3); Preamble, at 209-12.

[19] Reg. § 1.385-3(c)(4); Preamble, at 227.

[20] Prop. Reg. § 1.385-3(c)(2) (2016).

a contribution of property, so long as the funded member does not sell stock in the subsidiary to below 50% of vote and value pursuant to a pre-existing plan. Although the proposed regulations had required that the funded company hold 50% of the vote and value of that subsidiary for at least 36 months after the acquisition to qualify for the exception, the final regulations provide merely that a holding period of less than 36 months creates a rebuttable presumption of a pre-existing plan to relinquish control of the subsidiary.[21]

D. New Exceptions to Per Se Stock Rules.

1. Securities Dealers, Regulated Financial Companies and Regulated Insurance Companies. Debt issued to (or acquired by) securities dealers in the ordinary course of business are exempt from the per se stock rules.[22] In addition, debt issued by regulated financial companies and their subsidiaries (other than subsidiaries engaged in commodity-related or merchant banking activities) and regulated insurance companies subject to specific regulatory capital or leverage requirements (but not captive insurance companies or non-insurance entities within an insurance group) are exempt from the per se stock rules.[23]

2. Qualified Contributions. The final regulations generally exclude debt instruments from being recharacterized under the per se stock rules to the extent that an EG member has contributed "qualified property" to the issuer within the three years before, and the three years after, the date of any distribution or acquisition. Qualified property generally includes any property, other than EG stock, covered debt instruments, and certain other excluded property.[24] Effectively, distributions and acquisitions will be treated as having been funded by new capital contributions (and therefore not recharacterized) before related-party borrowings.

3. Compensatory EG Stock. The final regulations permit distributions of EG stock to compensate service providers (including employees, directors, and independent contractors) without triggering the per se stock rules.[25]

4. Dealers in Securities. An EG member that is a dealer in securities and acquires the stock of an EG member in the ordinary course of its business will not trigger the per se stock rules.[26]

E. Special Exceptions From the Funding Rule (but not the General Rule).

One of the biggest concerns about the proposed regulations was their effect on cash pooling arrangements and other common short-term financing arrangements that arise in the ordinary course of treasury operations of multi-national corporations. The temporary regulations exempt four categories of "qualified short-term debt instruments" from recharacterization under the funding rule.[27]

1. Short-Term Funding Arrangements. Certain debt instruments that satisfy either the "270-day test" or the "current assets test" qualify as short-term funding arrangements that are exempt from the funding rule. Although the temporary regulations provide two alternative tests, an issuer may only claim the benefit of one of the two tests in any taxable year (and treat debt instruments that satisfy the selected test as exempt

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[21] *Compare* Reg. § 1.385-3(c)(2)(i), *and* Preamble, at 196-97, *with* Prop. Reg. § 1.385-3(c)(3) (2016).

[22] Reg. § 1.385-3(g)(3)(i); Preamble, at 250-53.

[23] Reg. § 1.385-3(g)(3)(i), (iii)-(iv); Preamble, at 250-53.

[24] Reg. § 1.385-3(c)(3)(ii); Preamble, at 219-25.

[25] Reg. § 1.385-3(c)(2)(ii); Preamble, at 203-04.

[26] Reg. § 1.385-3(c)(2)(iv); Preamble, at 203-04.

[27] Reg. § 1.385-3(b)(3)(i).

from the funding rule).[28] Accordingly, for each taxable year, an issuer must determine whether to treat its debt instruments that satisfy the 270-day test or its debt instruments that satisfy the current assets test as short-term funding arrangements that are exempt from the funding rule.

A debt instrument is a short-term funding arrangement under the 270-day test if:

- the instrument has a term of 270 days or less (or is advanced under a revolving credit or similar agreement),
- bears interest at no more than an arm's-length rate, and
- setting aside certain ordinary course loans and interest-free loans, the issuer is a net borrower for no more than 270 days during its taxable year:
  - from the lender (or 270 consecutive days, in the case of a covered debt instrument outstanding during consecutive tax years), and
  - under all covered debt instruments issued to EG members that satisfy the criteria described in the preceding bullet points.[29]

In the alternative, under the current assets test, a debt instrument is a short-term funding arrangement if the debt bears no more than an arm's-length interest rate, but only to the extent that the issuer's outstanding qualified short-term debt instruments (with certain exceptions) do not exceed its non-cash current assets that are reasonably expected to be realized in cash or sold during the longer of a 90-day period or the issuer's normal operating cycle.[30]

2. 120-Day Ordinary Course Loans. Second, debt issued to acquire non-cash property in the ordinary course of the issuer's trade or business and that is reasonably expected to be repaid within 120 days of issuance ("ordinary course loans") are also treated as qualified short-term debt instruments.[31]

3. Interest-Free Loans. Third, interest-free loans among EG members are also treated as qualified short-term debt instruments and excluded from the funding rules (even if the loan has a long-term maturity). Debt is an "interest-free loan" if it does not provide for stated interest, does not charge any interest, and is not issued with original issue discount, and if no interest is imputed under section 483 or section 7872 (or required to be imputed under section 482).[32]

4. Cash Management Arrangements. Fourth, demand deposits received by an EG member, controlled partnership or qualified business unit ("QBU") whose principal purpose is to manage cash for related members (including borrowing from, and lending to, EG members, settling intercompany accounts, and investing the EG's excess cash) are also qualified short-term debt instruments that are not subject to the funding rule.[33] This cash management exception is subject to a general anti-avoidance rule and does not

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[28] Reg. § 1.385-3T(b)(3)(vii)(A).

[29] Reg. § 1.385-3T(b)(3)(vii)(A)(2). Failures to satisfy the 270-day test will be excused if the failure is reasonable (considering all facts and circumstances) and cured promptly on discovery. Reg. § 1.385-3T(b)(3)(vii)(A)(v).

[30] Reg. § 1.385-3T(b)(3)(vii)(A)(1).

[31] Reg. § 1.385-3T(b)(3)(vii)(B).

[32] Reg. § 1.385-3T(b)(3)(vii)(C).

[33] Reg. § 1.385-3T(b)(3)(vii)(D).

apply if a demand deposit is made with a QBU whose principal purpose is other than cash management for group members.[34]

5. Nontaxable Distributions. A new exception provides that distributions in complete liquidation of a funded member pursuant to a plan of liquidation (whether under section 331 or section 332) will not be subject to recharacterization under the funding rule.[35] In addition, the final regulations expand the spinoff exemption so that all spinoffs described in section 355, whether or not preceded by a reorganization described in section 368(a)(1)(D), are exempt from the funding rule.[36]

6. Transfer Pricing Adjustments. Finally, under the final regulations, deemed distributions or acquisitions that occur in connection with transfer pricing adjustments are also exempt from the funding rule.[37]

F. Effect of Recharacterization of Debt as Equity.

The final regulations clarify and more fully describe the consequences of an EGI that is recharacterized as equity. Under the final regulations, if an EGI is recharacterized as equity, the EGI is treated as having been exchanged for stock of the issuer in what is generally a nontaxable exchange.[38] The holder is deemed to realize an amount equal to its adjusted basis in the debt (or portion thereof), and the issuer is deemed to retire the debt (or portion thereof) for its adjusted issue price, in either case, as of the date of the deemed exchange and for all federal income tax purposes.[39] For purposes of the cancellation of indebtedness rules and to calculate foreign exchange gain or loss, the stock received is treated as having a fair market value equal to the adjusted issue price of the debt (or portion thereof) exchanged and therefore should not give rise to cancellation of indebtedness income.[40]

The final and temporary regulations helpfully provide that, to the extent a debt instrument is recharacterized as equity under the per se stock rules and would not otherwise be treated as preferred stock under section 1504(a)(4), it will not be treated as "stock" that could exclude the issuer from a consolidated group.[41]

If an EGI that has been recharacterized as equity under the per se stock rules later exits the expanded group (e.g., because it has been transferred or sold to an unrelated third party), as in the proposed regulations, the EGI is treated as a newly debt instrument (rather than a reinstatement of the original debt instrument).[42] By contrast, under the final regulations, when an EGI that has been recharacterized as equity under the documentation rules later exits the expanded group, the EGI is tested at that time under general tax

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[34] Reg. § 1.385-3T(b)(3)(vii)(D)(i).

[35] Reg. § 1.385-3(g)(10), (11); Preamble, at 168-70.

[36] Reg. § 1.385-3(g)(10)(i); Preamble, at 168-70. Previously, under the proposed regulations, only spinoffs preceded by a reorganization described in section 368(a)(1)(D) were exempt from the funding rule. Prop. Reg. § 1.385-3(b)(3)(ii)(A) (2016).

[37] Reg. § 1.385-3(c)(2)(iii); Preamble, at 205.

[38] Reg. § 1.385-1(d)(1)(i); Preamble, 46-47. The deemed exchange could, however, give rise to foreign exchange gain or loss by operation of section 988 or cancellation of indebtedness income. Reg. § 1.385-1(d)(1)(ii), (iii).

[39] Reg. § 1.385-1(d)(1)(i); Preamble, 46-47.

[40] Reg. § 1.385-1(d)(1)(ii), (iii); Preamble, 47.

[41] Reg. § 1.385-3(d)(7). Section 1504(a)(4) provides that "stock" does not include stock that (i) is not entitled to vote, (ii) is limited and preferred as to dividends and does not participate in corporate growth to any significant extent, (iii) has redemption and liquidation rights that do not exceed the issue price of the stock (except for a reasonable redemption or liquidation premium), and (iv) is not convertible into another class of stock.

[42] Reg. §§ 1.385-3(d)(2); 1.385-3(d)(1)(i); Preamble, 48.

principles to determine whether the debt instrument should be treated as equity or tax for tax purposes and, if debt treatment is appropriate, a debt instrument is deemed newly issued and exchanged for the EGI immediately before it exits the expanded group.[43] For these purposes, the general principles under section 1273 and 1274 apply when determining the issue price of any such debt instrument issued for stock.[44]

G. Disregarded Entities.

Under the proposed regulations, a recharacterization of debt issued by a disregarded entity as stock could cause that entity to be treated as a partnership for tax purposes, and trigger gain and other adverse tax consequences.[45] By contrast, under the final and temporary regulations, debt issued by a disregarded entity and recharacterized as stock under either the documentation rules or the per se stock rules is treated as stock of its regarded owner.[46] The stock deemed issued by the regarded owner is treated as having terms identical to the EGI issued by the disregarded entity and payments under the stock are determined by reference to payments made on the EGI by the disregarded entity.[47] In addition, with respect to the per se stock rules, to the extent the regarded owner of the disregarded entity is a controlled partnership (as discussed below), the controlled partnership rules will apply as if the partnership were the issuer of the debt instrument.[48]

H. Controlled Partnerships.

As discussed above, only controlled partnerships – partnerships for which at least 80% of the capital or profits interests are owned directly or indirectly by EG members – are subject to the final and temporary regulations.[49] With respect to the per se stock rules, as in the proposed regulations, a controlled partnership is treated as an aggregate of its partners that are EG members ("EG partners"). In general, the per se stock rules apply to controlled partnerships that acquire property from an EG member, or issue debt to an EG member.

First, when a controlled partnership acquires property from an EG member, then each EG partner is treated as acquiring its share of the property directly from the transferring EG member on the date on which it was acquired by the controlled partnership.[50] Each EG partner is treated as owning a share of the controlled partnership's assets by reference to its liquidation value in the partnership.[51] If the transferring EG member is a partner in the controlled partnership, then this rule does not apply to that transferring EG member.[52] Second, when a controlled partnership issues debt to an EG member, each EG partner is treated as the issuer with respect to its share of debt issued by the controlled partnership, generally to the extent those

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[43] Reg. §§ 1.385-2(e)(2); 1.385-1(d)(2)(i); Preamble, 48.

[44] Reg. § 1.385-1(d)(2); Preamble, 48.

[45] Prop. Reg. § 1.385-2(c)(5) (2016).

[46] Reg. §§ 1.385-1(d)(1)(i); 1.385-2(e)(4); 1.385-3(d)(4); Preamble, 60-61.

[47] Reg. §§ 1.385-2(e)(4), 1.385-3(d)(4); Preamble, 60-61. The regarded owner will be treated as the issuer of the stock even if the regarded owner is treated as a member of a consolidated group (and the one-corporation rule in the final regulations would otherwise apply). Reg. § 1.385-4T(b)(3).

[48] Reg. § 1.385-3(d)(4), (f).

[49] Reg. § 1.385-3(f); Preamble, at 23-28, Part V.H.3 and 4.

[50] Reg. § 1.385-3T(f)(2)(i)(A).

[51] Reg. § 1.385-3T(f)(2)(i)(B); Preamble, at 267.

[52] Reg. § 1.385-3T(f)(2)(i)(C).

partners are subject to the final and temporary regulations.[53] An EG partner's proportionate share is determined by reference to its expected allocation of interest expense under the partnership agreement.[54]

If, as a result of either transaction, debt issued by a controlled partnership would be otherwise be subject to recharacterization under the per se stock rules then, under the temporary regulations, the debt is not recast as equity of the controlled partnership. Rather, the holder of the debt would be deemed to transfer the debt to the EG partners for stock in such partner.[55] This deemed transfer occurs for all federal tax purposes (other than for making section 752 allocations or upon certain specified events described in the temporary regulations).[56]

I. Other Operating Rules.

The final and temporary regulations modify certain operational aspects of the rules.

1. Significant Modifications. For purposes of the documentation rules, a significant modification generally requires a new credit analysis with respect to the issuer, but not with respect to the other documentation requirements.[57] For purposes of the funding rules, if a debt instrument that is otherwise subject to the funding rules is modified, that instrument is generally treated as if issued on the date the original instrument was issued.[58] However, if the modification results in a change of obligor or a material deferral of scheduled payments under the instrument, then that instrument is treated as reissued as of the date of the significant modification.[59]

2. No Duplicative Applications of the Funding Rule. The final regulations generally prevent duplicative and cascading effects of the funding rule. If a distribution or acquisition causes one debt instrument to be recast as equity, the same distribution or acquisition cannot cause other debt instruments to be so recharacterized, even after the first debt instrument is repaid.[60] This change prevents a payment with respect to an EGI that is recharacterized as equity as also being treated as a distribution for purposes of the funding rule.

3. Partial Recharacterization. In certain cases, the per se stock rules may apply so as to recharacterize only a portion of an EGI as equity in the issuer for tax purposes. Under the final regulations, an issuer may designate the allocation of prepayments and any other payments that are not required under the terms of the instrument. In other words, an issuer is entitled to allocate payments under the instrument to the equity portion or the debt portion of the instrument, with payments that are not specifically designated by the issuer treated as allocated on a pro rata basis with respect to each portion of the EGI.[61]

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[53] Reg. § 1.385-3T(f)(3)(i).

[54] Reg. § 1.385-3T(f)(3)(ii)(A); Preamble, at 269.

[55] Reg. § 1.385-3T(f)(4); Preamble, at 261-63.

[56] Reg. § 1.385-3T(f)(4).

[57] Reg. § 1.385-2(c)(4)(ii)(B).

[58] Reg. § 1.385-3(b)(3)(iii)(E); Preamble, at 242-44.

[59] Reg. § 1.385-3(b)(3)(iii)(E)(2); Preamble, at 242-44. In addition, a modification that increases the principal amount of such debt instrument, the portion of the instrument attributable to the increase is treated as issued on the modification date. Reg. § 1.385-3(b)(3)(iii)(E)(3).

[60] Reg. § 1.385-3(b)(6); Preamble, at 117-20.

[61] Reg. § 1.385-3(d)(5)(ii); Preamble, at 115-16.

4. Transactions That Straddle Different EGs. If (i) a U.S. corporate member of an EG makes a distribution or acquisition before the member is funded, (i) the distribution or acquisition occurs when the member's expanded group parent is different than the expanded group parent when the member is funded, and (iii) the member and the counterparty to the distribution are not members of the same EG on the date the member is funded, then unless the principal purpose of the transaction is to avoid the final regulations, the debt instrument is not treated as issued within the 72-month per se period, and therefore is not recharacterized as equity.[62]

Thus, assume that a foreign corporate parent wholly owns a U.S. corporation, and the U.S. corporation distributes $100 to the foreign parent in 2017. In 2018, the foreign parent sells all of the stock of the U.S. corporation to an unrelated foreign corporate acquirer. In 2019, the foreign acquirer loans $100 to the U.S. corporation. Under the final regulations, unless the principal purpose of the loan by the foreign acquirer to the U.S. corporation was actually to fund the distribution to the prior foreign parent, the loan will not be recharacterized as equity.

J. The Bifurcation Rule.

The final regulations have eliminated the bifurcation rule pending further study of the issue.[63]

K. The Documentation Rules.

The documentation rules have been significantly liberalized under the final regulations. Whereas the proposed regulations required that the documentation be prepared within 30 days of issuance, the final regulations provide that the documentation need not be prepared until the due date of the issuer's federal income tax return (including any applicable extensions) for the year in which the instrument was issued.[64] Second, the documentation requirements apply only to EGIs issued on or after January 1, 2018.[65]

Third, although regulated entities are generally required to comply with the documentation rules, an EGI issued by an "excepted regulated financial company" that contains terms required by a regulator in order for the EGI to satisfy regulatory capital or similar rules that govern resolution or orderly liquidation are not required to satisfy the documentation requirements if, at the time of issuance, it is expected that the EGI will be paid according to its terms. Similar rules apply to an EGI issued by a "regulated insurance company" that requires the issuer to receive approval or consent of an insurance regulatory authority prior to making payments of principal or interest.[66]

Fourth, debt issued by controlled partnerships generally is not subject to the documentation rules, but may nevertheless be recharacterized as equity under the general anti-abuse rule.[67]

Finally, failure to satisfy the documentation requirement will not cause a debt instrument to be automatically treated as equity in three circumstances:

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[62] Reg. § 1.385-3(b)(3)(iii)(D).

[63] *Compare* Reg. § 1.385-1(e) (reserving on bifurcation of instruments by Treasury and IRS), *with* Prop. Reg. § 1.385-1(d) (proposed bifurcation rule).

[64] Reg. § 1.385-2(a)(3)(i); Preamble, at 54-55.

[65] Reg. § 1.385-2(d)(2)(iii).

[66] Reg. § 1.385-2(c)(1)(iii); Preamble, at 67-71.

[67] Reg. § 1.385-2(a)(3)(i); Preamble, at 64-65. The Preamble reflects a concern that EG members might issue debt through controlled partnerships with a principal purpose of avoiding the documentation rules.

- if the failure consists of a ministerial or non-material failure or error that is cured before the IRS discovers it;[68]
- the taxpayer established reasonable cause for a failure;[69] and
- if the EG is "highly compliant", but in this case the failure would create a rebuttable presumption that the debt instrument is stock.[70]

For purposes of the rebuttable presumption, an EG would be treated as highly compliant if, during the calendar year in which it failed to document one or more EGIs:

- at the end of each quarter, the aggregate adjusted issue price of undocumented EGIs is less than 10% of the aggregate adjusted issue price of all outstanding EGIs,
- the issue price of each undocumented EGI is $100 million or less and, at the end of each quarter, less than 5% of all EGIs are undocumented; or
- the issue price of each undocumented EGI is $25 million or less and, at the end of each quarter, less than 10% of all EGIs are undocumented.[71]

The final regulations also simplify the documentation requirements for revolving credit, omnibus, umbrella, master, cash pooling and other similar agreements.[72] Furthermore, the documentation requirements do not apply to obligations between members of a consolidated group, production payments treated as a loan under section 636(a) or (b), REMIC regular interests and debt instruments that are deemed to arise as a result of the transfer pricing adjustments.[73]

L. Rules Concerning Investment Funds.

The preamble to the proposed regulations requested comments on two points with implications for investment funds. First, Treasury and the IRS had requested comments as to whether debt issued by certain "blocker" entities to an investment partnership should be subject to the regulations. (Debt to a partnership was not subject to the proposed regulations.) Ultimately, however, the final and temporary regulations were not expanded to apply to debt issued by "blocker" entities to investment partnerships.[74]

In addition, the Preamble indicates that Treasury and the IRS will closely scrutinize and may challenge under the anti-abuse rule transactions in which a controlled partnership issues preferred equity instead of debt to an EG member presumably to allow a U.S. corporate member of the controlled partnership to avoid allocations of income or claim deductions for guaranteed payments made to the foreign EG partners. The Preamble suggests that the IRS would seek to characterize the preferred equity as equity of the U.S. corporate member rather than of the controlled partnership. However, because the Preamble indicates that

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[68] Reg. § 1.385-2(b)(2)(iii) (ministerial or non-material failures); Preamble, at 59.

[69] Reg. § 1.385-2(b)(2)(ii) (reasonable cause exception); Preamble, at 59.

[70] Reg. § 1.385-1(b)(2)(i); Preamble, at 55-59.

[71] Reg. § 1.385-2(d)(2)(i)(B); Preamble, at 57-58.

[72] Reg. § 1.385-2(c)(3)(i); Preamble, at 71-76.

[73] Reg. § 1.385-3(d)(2)(ii).

[74] Preamble, at 44-45.

the scrutiny will apply only to controlled partnerships that issue preferred equity, most investment funds (which are not controlled partnerships) should avoid this scrutiny.[75]

M. Effective Dates.

The final and temporary regulations liberalize the effective dates contained in the proposed regulations.

- The per se stock rules apply only to debt instruments issued after April 4, 2016, and only with respect to taxable years ending on or after January 19, 2017 (90 days after October 21, 2016, the date on which the final and temporary regulations were published in the federal register).[76]
- Therefore, no debt instruments will be treated as equity prior to January 19, 2017.
- Only distributions and acquisitions that occurred after April 4, 2016 are subject to the 72-month testing period in the per se funding rule.
- Transition rules treat distributions other than stated interest on debt instruments issued after April 4, 2016 and before January 19, 2017 that would otherwise be recharacterized as equity under the per se stock rules as distributions for purposes of recharacterizing other instruments as equity under the funding rule.[77]
- The documentation rules apply only to EGIs issued beginning in 2018.[78]
- Taxpayers may elect to apply the proposed regulations to all debt instruments issued by a particular issuer (and members of its expanded group that are covered members) after April 4, 2016 solely for purpose of determining whether a debt instrument is treated as stock so long as the proposed regulations are consistently applied.[79]

V. Long-Term Implications of the Final and Temporary Regulations.

As mentioned above, section 385 was not enacted to address earnings stripping. It was intended to allow rules that distinguish debt from equity categorically, and it is questionable whether section 385 provides authority to address only earnings stripping.

Although the proposed regulations would have applied to debt issued by U.S. corporations to other U.S. corporations and by foreign corporations, the final and temporary regulations principally will apply to debt issued by U.S. corporations to their 80% foreign parents.[80] Taxpayers will certainly argue that applying section 385 only to earnings stripping by U.S. corporations to foreign parents is beyond the authority that Congress granted.

Second, because, as a practical matter, the final and temporary regulations will apply only to debt of U.S. corporations held by their foreign parents, taxpayers will argue that the final and temporary regulations violate the non-discrimination provision of many treaties. For example, Article 25(3) of the U.S-U.K. tax treaty

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[75] Preamble, at 289-90; *see also* Reg. § 1.385-3(b)(4) (anti-abuse rule).

[76] Reg. § 1.385-3T(k)(1).

[77] Reg. § 1.385-3T(k)(2)(iii).

[78] Reg. § 1.385-3(d)(2)(iii).

[79] Reg. § 1.385-3(j)(2)(v).

[80] Theoretically, the final regulations could apply to debt issued by a profitable U.S. corporation to its 80% nonconsolidated U.S. corporate parent with net operating losses, as a means to strip the earnings of the profitable corporation. However, because most 80% owned subsidiaries are members of a consolidated group with their parents, this set of facts would be unusual.

provides that, generally, interest paid by a U.S. resident corporation to a resident of the United Kingdom "shall, for purposes of determining the taxable profits of the first-mentioned resident, be deductible under the same conditions as if they had been paid to a resident of the first-mentioned State."[81] Because the final and temporary regulations have very little practical effect on interest paid by one U.S. corporation to another, and generally will apply to deny interest deductions to treaty residents, taxpayers will argue that the final and temporary regulations violate this provision.

Treasury and the IRS acknowledge that section 385 is the wrong tool to address earnings stripping because section 385 authorizes only recharacterization of a debt instrument to equity for all federal income tax purposes, rather than simply deny interest deductions. Consequently, the final and temporary regulations contain complicated mechanics for recharacterizing debt as equity (and back again if necessary).

We would hope that Congress, as part of a fundamental business tax reform package introduced after the next Administration takes office in 2017, would supercede the final and temporary regulations with a more narrowly-tailored and simpler earnings stripping provision.

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[81] *See also* U.S. Model Tax Treaty, at Art. 24, ¶ 4 ("[I]nterest . . . paid by an enterprise of a Contracting State to a resident of the other Contracting State shall, for the purpose of determining the taxable profits of such enterprise, be deductible under the same conditions as if they had been paid to a resident of the first-mentioned Contracting State.").