

The Government Speaks on the Recently Issued Section 385 Regulations

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Agenda

- Section 385, Overview of Proposed and Final Regulations, and Definitions
 - The Bifurcation Rule: Prop. Treas. Reg. Section 1.385-1(d)
 - The Documentation Rules: Treas. Reg. Section 1.385-2
 - The Transaction Rules: Treas. Reg. Sections 1.385-3 and -3T
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Section 385

- Section 385(a) provides Treasury with the authority to issue regulations as may be necessary or appropriate to:
 - Determine whether an instrument is debt or equity for purposes of this title, and
 - Bifurcate an instrument as part debt and part equity.
- Section 385(b) includes the following non-exhaustive list of factors that may be taken into account in determining whether an instrument is debt or equity for U.S. tax purposes:
 - Whether the instrument includes a written unconditional promise to pay a sum certain and fixed interest rate
 - Whether the instrument is subordinated to, or given preference over, other indebtedness
 - The issuer's debt-to-equity ratio
 - Whether the instrument is convertible into the issuer's stock; and
 - The relationship between holding stock of the issuer and the instrument.
- Section 385(c) states that the issuer's characterization of an instrument at the time of issuance is binding on the holder, but not the IRS, unless the holder discloses the inconsistent treatment, and provides Treasury with authority to require information necessary to carry out the provisions of the subsection.

Proposed Regulations: Overview

- Proposed regulations (REG-108060-15) issued on April 4, 2016 under section 385 (the “Proposed Regulations”) included rules:
 - Providing the IRS with the ability to bifurcate an instrument as part debt and part stock
 - Setting forth documentation and maintenance requirements that must be satisfied for a related-party instrument to be characterized as debt for U.S. tax purposes
 - Subject to certain exceptions, re-characterizing related-party debt instruments as stock for all U.S. tax purposes when issued: (i) as a distribution, (ii) in exchange for related-party stock (e.g., section 304 sale), (iii) as consideration in an internal asset reorganization (e.g., a boot D reorganization), or (iv) to fund a distribution, acquisition of related-party stock, or boot in an internal asset reorganization; and
 - Providing treatment for when related-party debt comes into or leaves a U.S. consolidated group.
- The rules of the Proposed Regulations applied without regard to whether (i) the parties are domestic or foreign, or (ii) the corporate group effected an inversion.
- The Proposed Regulations treated members of a U.S. consolidated group as a single entity, and thus did not apply to debt between consolidated group members.
- The Proposed Regulations provided that, when finalized, they would be applicable to debt instruments issued on or after April 4, 2016.

Proposed Regulations: Overview (cont'd)

- The **documentation requirements** and **bifurcation provisions** would generally be effective for certain debt instruments issued or deemed issued after the regulations were published as final.
 - The **re-characterization provisions** (including those addressing the treatment of U.S. consolidated groups) would generally be effective for certain “debt instruments”—i.e., an interest treated as debt under section 1275(a) and Treas. Reg. section 1.1275-1(d)—issued on or after April 4, 2016, and to any debt instrument treated as issued before April 4, 2016, as a result of a check-the-box election filed on or after April 4, 2016.
 - The **re-characterization provisions**, however, included limited transition rules providing that a debt instrument issued on or after April 4, 2016 that would be re-characterized as stock under the regulations would be treated as debt until 90 days after the regulations were finalized; on the 90th day any outstanding instruments would be deemed exchanged for stock.
 - Instruments issued on or after April 4, 2016 included:
 - Instruments issued before April 4, 2016 but that were subject to amendment on or after that date resulting in a deemed exchange of the instrument under section 1001; and
 - Instruments arising on or after April 4, 2016 under intercompany debt facilities (e.g., cash sweep arrangements, draw downs under revolving credit facilities, etc.) in existence prior to April 4, 2016.
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Final Regulations: Overview

- Final and temporary regulations (T.D. 9790) issued on October 13, 2016 under section 385 (the “Final Regulations”) implemented portions of the Proposed Regulations with significant changes, including:
 - Eliminating the bifurcation rule.
 - Exempting cash pools and short-term loans from the recharacterization provisions of the general rule and funding rule, discussed below:
 - In response to feedback regarding the treatment of cash pools, cash sweeps, and short-term loans, the Final Regulations generally provide exemptions for cash pools and cash sweeps as well as loans that are short-term in both form and substance.
 - Exempting certain types of issuers, including foreign corporations:
 - The Final Regulations generally exempt from the application of these rules debt instruments issued by S corporations, certain RICs and REITs, foreign corporations, and certain partnerships.

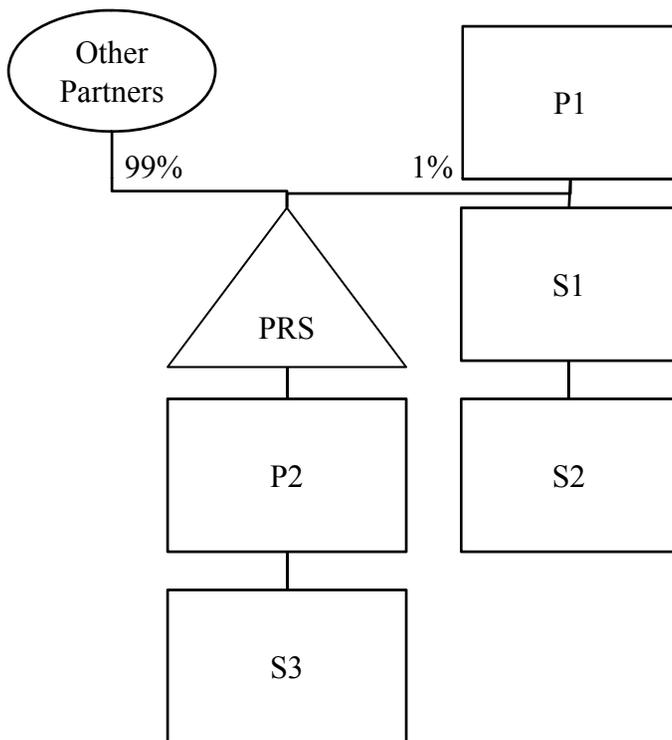
Final Regulations: Overview (cont'd)

- Expanding exceptions for ordinary business transactions, including:
 - Expanding the exception for distributions of E&P (“E&P”) to include all future earnings;
 - Allowing corporations to net distributions and acquisitions against certain capital contributions; and
 - Excepting acquisitions of stock associated with employee compensation plans.
- Easing documentation requirements:
 - The Final Regulations require documentation to be in place as of the deadline (with extensions) for filing the tax return for the relevant year; and
 - The documentation requirements only apply to instruments issued on or after January 1, 2018.
- Many of these items were reserved in the Final Regulations and the subject of a request for further comments, so future guidance may eliminate or modify some of these exceptions.

Some Relevant Definitions in the Proposed Regulations

- **Expanded Group (“EG”)**: a section 1504(a) affiliated group determined:
 - Without regard to section 1504(b) (which prohibits certain types of corporations from being considered “includible corporations” (i.e., an EG includes foreign corporations, tax-exempts, RICs and REITs, among others));
 - Changing the requisite ownership threshold from “at least 80% vote *and* value” to “at least 80% vote *or* value”; and
 - Allowing the common parent to own directly *or indirectly* (determined by applying the rules of section 304(c)(3)) at least 80% of the vote or value of at least one includible corporation.
- **Applicable Instrument (“AI”)**: any interest issued or deemed issued that is in form a debt instrument.
- **Expanded Group Instrument (“EGI”)**: an AI an issuer of which is one member of an EG and the holder of which is another member of the same EG, a disregarded entity (“DRE”) owned by a member of the same EG or a Controlled Partnership with respect to the same EG.
- **Controlled Partnership**: A partnership in which 80% or more of the capital or profits interests are owned, directly or indirectly, by one or more members of the EG.

Expanded Group in the Proposed Regulations – Example



Discussion

- Under the Proposed Regulations, P2, S1, S2, and S3 were all considered members of the same EG, applying section 318(a)(3)(A).
- Commentators recommended limiting attribution under section 318(a)(3)(A) to situations where the partnership and the partner are highly related.
- As described below, this issue has been eliminated in the Final Regulations because attribution under section 318(a)(3) has been removed. Therefore, neither PRS nor P2 are considered as owning any of the stock of S1.

Significant Changes to Relevant Definitions in the Final Regulations

- Significant changes in the Final Regulations include:
 - Foreign corporations, S corporations, and certain RICs and REITs are excluded from the regulations;
 - Indirect ownership rules are modified, including the elimination of downward attribution;
 - Guidance provided regarding overlapping EGs and hook stock; and
 - Brother-sister groups with non-corporate owners eliminated (potentially unclear in the Proposed Regulations depending on the fact pattern).
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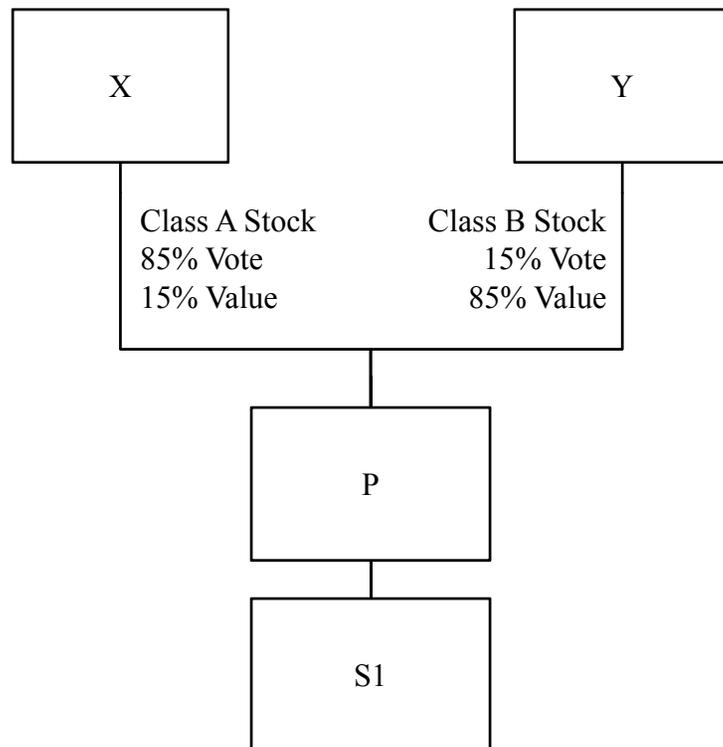
Exclusion of Certain Issuers

- S corporations are excluded from the definition of an EG member.
- The documentation rules and transaction rules generally do not apply to debt instruments issued by foreign corporations.
 - Foreign corporations remain EG members for other purposes.
- RICs and REITs can no longer be parents of EGs, although they can still be EG members.
- Tax-exempt organizations are still included in the EG, however.
- These changes resolve certain ancillary issues discussed below.

Revised Definitions in the Final Regulations

- **Expanded Group (“EG”)**: one or more chains of corporations (other than S corporations) connected through stock ownership with a common parent corporation that is not an S corporation, RIC, or REIT, but only if—
 - The EG parent owns, *directly or indirectly*, at least 80% vote *or* value in at least one of the other corporations; and
 - At least 80% of the vote *or* value in each of the other corporations (except the EG parent) is owned *directly or indirectly* by one or more of the other corporations.
- **Indirect Ownership** is determined by applying the constructive ownership rules of section 318(a) except—
 - Family attribution and downstream attribution do not apply;
 - Threshold for upstream attribution from corporations is reduced to 5%; and
 - Option attribution only applies if the options are reasonably certain to be exercised (as described in Treas. Reg. section 1.1504-4(g)).
- **Covered Member**: A domestic corporation that is a member of an EG.

Treas. Reg. Section 1.385-1(c)(4)(vii) *Example 1*— Overlapping EGs



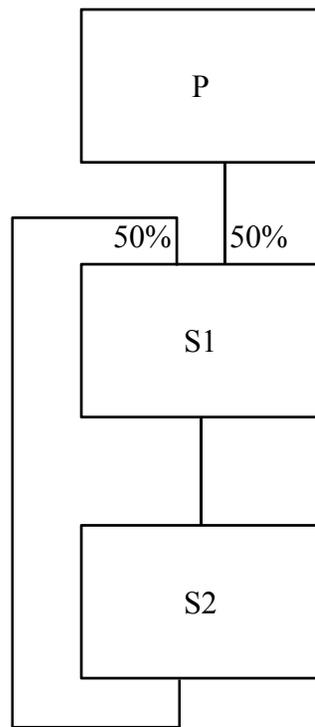
Description

- P has two classes of common stock outstanding: Class A and Class B.
- X directly owns all shares of P's Class A common stock, which is high-vote common stock representing 85% of the vote and 15% of the value of the stock of P.
- Y directly owns all shares of P's Class B common stock, which is low vote common stock representing 15% of the vote and 85% of the value of the stock of P.
- P directly owns 100% of the stock of S1.

Discussion

- X is the parent of the EG that includes X, P, and S1.
- Y is the parent of the EG that includes Y, P, and S1.
- X and Y are not members of the same EG because X does not directly or indirectly own any stock of Y and Y does not directly or indirectly own any stock of X.

Treas. Reg. Section 1.385-1(c)(4)(vii) *Example 3*— Hook Stock



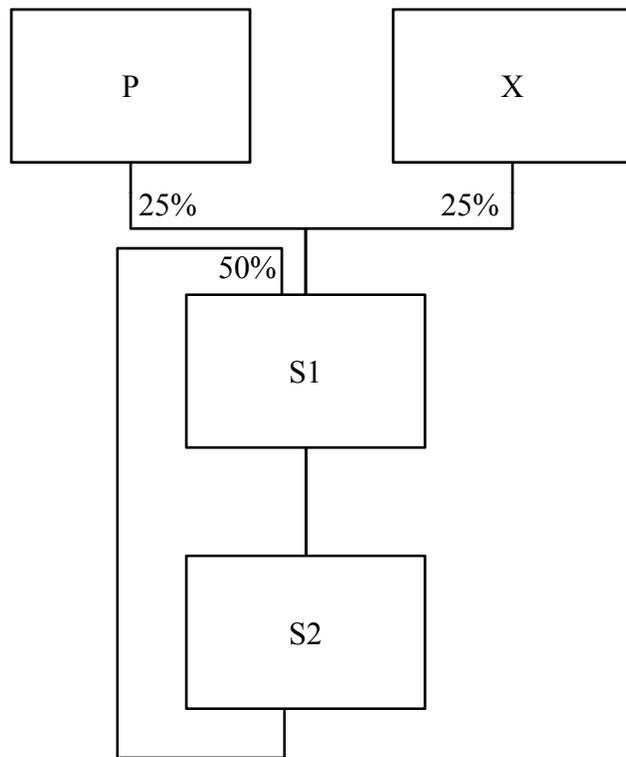
Description

- P owns 50% of the stock of S1.
- S1 owns 100% of the stock of S2.
- S2 owns the remaining 50% of the stock of S1.

Discussion

- Because P owns 50% of the stock of S1, P constructively owns 50% percent of the stock of S2.
- Because P constructively owns 50% of the stock of S2, P constructively owns 50% of the stock of S1 held by S2 (25% of the stock of S1 outstanding).
- Because P constructively owns an additional 25% of the stock of S1, P constructively owns an additional 25% of the stock of S2.
- Because P constructively owns an additional 25% of the stock of S2, P constructively owns an additional 25% of the stock of S1 held by S2 (12.5% of the stock of S1 outstanding).
- Through iterative calculations, P ultimately winds up owning (actually or constructively) 100% of the stock of S1.

Treas. Reg. Section 1.385-1(c)(4)(vii) *Example 4*— Hook Stock



Description

- P and X each own 25% of the stock of S1.
- S1 owns 100% of the stock of S2.
- S2 owns the remaining 50% of the stock of S1.

Discussion

- Because P owns 25% of the stock of S1, P constructively owns 25% percent of the stock of S2.
- Because P constructively owns 25% of the stock of S2, P constructively owns 25% of the stock of S1 held by S2 (12.5% of the stock of S1 outstanding).
- Because P constructively owns an additional 12.5% of the stock of S1, P constructively owns an additional 12.5% of the stock of S2.
- Because P constructively owns an additional 12.5% of the stock of S2, P constructively owns an additional 12.5% of the stock of S1 held by S2 (6.25% of the stock of S1 outstanding).
- Through iterative calculations, P ultimately winds up owning (actually or constructively) only 50% of the stock of S1.
- The same analysis applies to X.

Questions

- Does P ultimately wind up owning (actually or constructively) exactly 50% of the stock of S1 or almost 50% of the stock of S1?
- Are P and S1 members of the same EG if P owns 40% of the stock of S1, X owns 10% of the stock of S1, and S2 owns 50% of the stock of S1?

Potential Future Guidance

- The Final Regulations reserved and further comments were requested on:
 - The application of the regulations to foreign issuers; and
 - The treatment of brother-sister groups without a corporate owner.
- If future guidance is released addressing these issues, it will not apply to interests issued before the date of such guidance.
- **Questions**
 - **What types of circumstances involving foreign issuers are of concern to the Government?**
 - **What types of brother-sister groups are of concern to the Government?**

The Bifurcation Rule:

Prop. Treas. Reg. Section 1.385-1(d)

Prop. Treas. Reg. Section 1.385-1(d): Bifurcation

- General Rule: The IRS may bifurcate certain interests between related parties into part debt and part equity “**to the extent an analysis, as of the issuance of the [interest], of the relevant facts and circumstances concerning the [interest] . . . under general federal tax principles results in a determination that the [interest] is properly treated for federal tax purposes as indebtedness in part and stock in part**”
- Although the IRS may bifurcate certain interests into debt and equity components in the above circumstances, the issuer of the interest, the holder of the interest and any other person relying on the characterization of the interest for federal tax purposes are required to treat the interest consistent with the issuer’s initial characterization. Thus, for example, a holder may not disclose on its return under section 385(c) that it is treating the interest as indebtedness in part or stock in part if the issuer treats the interest as indebtedness

Treas. Reg. Section 1.385-1(e): Bifurcation

- **The Final Regulations reserved on the treatment of an instrument as indebtedness in part and stock in part.**
- This eliminates many concerns, including:
 - The bifurcation rule did not articulate clear standards for its application;
 - Special rules were needed for debt issued by partnerships and disregarded entities; and
 - It was unclear why the rule was limited to related-party debt.
- In addition, numerous recommendations are rendered moot, including:
 - The rule should be limited to thin capitalization cases;
 - The rule should only apply above a specified dollar threshold;
 - The rule should only apply when a significant fraction of the debt would be characterized as equity; and
 - Safe harbors should be provided.

Potential Future Guidance

- The preamble to the Final Regulations requests comments on the bifurcation rule.
- **Questions**
 - What types of guidance is the Government contemplating with respect to the bifurcation rule?

The Documentation Rules:
Treas. Reg. Section 1.385-2

The Documentation Rules under the Proposed Regulations

- Treas. Reg. section 1.385-2 sets forth minimum threshold documentation, timing, and maintenance requirements (collectively referred to herein as the “documentation requirements”) that must be satisfied regarding the preparation and maintenance of documentation and information with respect to an EGI.
- The documentation requirements are intended to enable an analysis to be made as to whether an EGI is appropriately treated as debt or stock for federal tax purposes.
- Failure to satisfy the documentation requirements generally means an EGI is stock.
 - The type of stock (e.g., common or preferred) is based on the EGI’s terms and conditions.
- If the documentation requirements are satisfied, then the EGI must still be analyzed under U.S. tax principles to determine whether it is treated as debt or stock for federal tax purposes; for example, the EGI could be recharacterized as stock (i) under case law, or (ii) under the transaction rules of Prop. Treas. Reg. section 1.385-3 (now Treas. Reg. sections 1.385-3 and -3T).

Final Regulations: Significant Changes

- Only applies to EGIs issued by Covered Members (a “Covered EGI”).
 - Debt instruments issued by foreign corporations, S corporations, partnerships, and certain RICs and REITs are no longer subject to these rules.
- Timely preparation requirement for documentation extended to the time the issuer’s federal income tax return is filed (taking into account all applicable extensions).
- Where the EG demonstrates a high degree of compliance with the documentation requirements, failure to satisfy such rules with respect to a given EGI results in a rebuttable presumption of stock treatment, rather than *per se* recharacterization.
- Certain EGIs issued by certain regulated entities are treated as satisfying the documentation requirements if the EGI contains terms required by a regulator of the issuer in order to satisfy regulatory capital or similar rules.
- Rules for revolving credit facilities and cash pools clarified.
- Same credit analysis can be used to satisfy these requirements for multiple EGIs issued by the same issuer.
- Requirements only apply to instruments issued on or after January 1, 2018.

Applicable Interests

- The Final Regulations clarified the definition of an Applicable Interest (“AI”) that was provided in the Proposed Regulations.
 - An AI is any:
 - Interest that is issued or deemed issued in the legal form of a debt instrument; or
 - Intercompany payable and receivable documented in a ledger, accounting system, open account intercompany debt ledger, trade payable, journal entry or similar arrangement if no written legal instrument or written legal arrangement governs the legal treatment of such payable and receivable.
 - An AI is not any:
 - Sale-repurchase agreement treated as indebtedness under federal tax principles;
 - Intercompany obligation as defined in Treas. Reg. section 1.1502-13(g)(2)(ii) or debt instrument issued by a member of a consolidated group that is held by another member of the same consolidated group;
 - Production payment treated as a loan under section 636(a) or (b);
 - “Regular interest” in a real estate mortgage investment conduit (“REMIC”) described in section 860G(a)(1);
 - Debt instrument that is deemed to arise under Treas. Reg. section 1.482-1(g)(3) (including adjustments made pursuant to Revenue Procedure 99-32, 1999-2 C.B. 296); or
 - Any other instrument or interest that is specifically treated as indebtedness for federal tax purposes.
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Documentation Required

- The documentation required under Treas. Reg. section 1.385-2(b)(2) includes written documentation evidencing:
 - an unconditional obligation to pay a sum certain;
 - creditor’s rights;
 - a reasonable expectation that the issuer intended to, and would be able to, repay the EGI; and
 - payments of principal or interest (or, in the event of default, a holder’s reasonable exercise of diligence and judgment of a creditor).
- The required documentation must be timely prepared in accordance with detailed timing rules provided under Treas. Reg. section 1.385-2(c)(4).
 - In general, under the Final Regulations, the documentation requirements must be satisfied by the time the issuer’s federal income tax return is filed (taking into account all applicable extensions).
- The required documentation must be maintained for all taxable years that the EGI is outstanding and until the period of limitations expires for any return with respect to which the treatment of the EGI is relevant.

New Safe Harbors

- Regulated Entity Safe Harbor: The documentation requirements are deemed satisfied for the following EGI's so long as documentation necessary to establish that the EGI is one of the following EGI's is prepared and maintained and at the time of issuance it is expected that the EGI will be paid in accordance with its terms:
 - An EGI issued by a regulated financial company (as defined in Treas. Reg. section 1.385-3(g)(3)(iv) and discussed below) that contains terms required by a regulator of that entity in order to satisfy regulatory capital or similar rules that govern resolution or orderly liquidation of the issuer; and
 - An EGI issued by a regulated insurance company (as defined in Treas. Reg. section 1.385-3(g)(3)(v) and discussed below) that requires the issuer to receive approval or consent of an insurance regulatory authority prior to making payments of principal or interest on the EGI.
- Market Trading Safe Harbor: Documentation of a kind customarily used in comparable third-party transactions treated as indebtedness for federal tax purposes may be used to satisfy the of sum certain and creditor's rights requirements.

Anti-Avoidance and No Affirmative Use

- Anti-Avoidance: If an AI that is not an EGI is issued with a principal purpose of avoiding Treas. Reg. section 1.385-2, the instrument will be treated as an EGI subject to Treas. Reg. section 1.385-2.
- No Affirmative Use: The Proposed Regulations provided that the documentation rules did not apply if failure to satisfy the documentation requirements had a principal purpose of reducing the U.S. tax liability of any member of the same EG as the issuer and the holder or any other person relying on the EGI being characterized as debt. This rule was removed and reserved on in the Final Regulations. **What does this mean for taxpayers?**

Rebuttable Presumption

- Failure to satisfy the documentation requirements with respect to a given Covered EGI (an “Undocumented EGI”) generally results in the Undocumented EGI being characterized as stock *per se*.
 - This rule only creates a rebuttable presumption that the instrument is stock if the EG demonstrates a high degree of compliance with the documentation requirements.
 - A high degree of compliance exists if, during the calendar year in which the failure occurs, one of two tests is satisfied:
 - 1) The average total adjusted issue price of all Undocumented EGIs outstanding as of the close of each calendar quarter is less than 10% of the average total adjusted issue price of all Covered EGIs outstanding as of the close of each calendar quarter.
 - 2) If no Undocumented EGI has an issue price in excess of \$100 million, the average total number of Undocumented EGIs outstanding as of the close of each calendar quarter is less than 5% of the total number of all Covered EGIs outstanding as of the close of each calendar quarter. The threshold is increased to 10% if no Undocumented EGI has an adjusted issue price in excess of \$25 million.
 - Increases in the adjusted issue price or number of outstanding Covered EGIs with a principal purpose of satisfying these requirements are disregarded under an anti-stuffing rule.
 - The presumption that an Undocumented EGI is stock can be rebutted if the taxpayer clearly establishes that there are sufficient common law factors present to treat the EGI as indebtedness, including that the issuer intended to create indebtedness when the EGI was issued.
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Reasonable Cause and Ministerial Error Rules

- The Proposed Regulations provided that a failure to satisfy the documentation requirements could be disregarded where there was reasonable cause for such failure, applying the principles of Treas. Reg. section 301.6724-1.
- The Final Regulations further provide that if the reasonable cause exception applies, the taxpayer must satisfy the documentation requirements with respect to the relevant EGIs within a reasonable time.
 - Question: What constitutes a “reasonable time” for this purpose?
- The Final Regulations also provide that if a taxpayer discovers and corrects a ministerial or non-material failure or error in complying with the documentation requirements before the IRS discovers such failure, the failure will not be taken into account in determining whether the documentation requirements are satisfied.
 - Question: What constitutes a “ministerial or non-material failure or error”?

Partnerships and Disregarded Entities

- The Proposed Regulations provided that EGIs issued by Controlled Partnerships and disregarded entities (“DREs”) were subject to the documentation rules.
- Further, the Proposed Regulations provided that an Undocumented EGI issued by a Controlled Partnership or DRE was treated as equity in the issuing Controlled Partnership or DRE, rather than the corporate owner or owners of such issuer.
- The Final Regulations provide that an Undocumented EGI issued by a DRE, the owner of which is a Covered Member, is treated as stock in the Covered Member rather than the DRE.
 - If the Covered Member has limited liability with respect to the debt of the DRE, only the financial position of the DRE, and not the Covered Member, is relevant for purposes of determining the issuer’s ability to repay the EGI.
- The documentation rules do not apply to debt instruments issued by partnerships (or DREs owned by partnerships), but the anti-avoidance rule may apply to debt instruments issued by Controlled Partnerships (or their DREs) where the requisite intent is found.
- Similarly, a debt instrument issued by a Covered Member and held by a Controlled Partnership is not an EGI.

Revolvers, Cash Pools and Multiple EGIs Issued by the Same Issuer

- The Proposed Regulations required a separate credit analysis for each individual draw under a credit facility, cash pooling arrangement or other similar arrangement.
 - Similarly, the Proposed Regulations required separate credit analysis for each EGI issued by the same issuer.
 - The Final Regulations limit the number of separate credit analyses required.
 - A credit analysis generally satisfies the reasonable expectation of repayment requirement for all draws during the period beginning on the relevant date of the analysis and ending on the earlier of one year and a “Material Event” of the issuer.
 - Similar rules apply where multiple EGIs are issued by a single issuer.
 - Notional cash pools are subject to these rules to the extent they would be treated as EGIs issued directly between EG members.
 - In addition, the documentation of sum certain and creditor’s rights must be updated for any credit facility, cash pooling arrangement or other similar arrangement if such arrangement is amended to provide for an increased maximum amount of principal or to permit an additional entity to borrow (but only with respect to EGIs issued by the new borrower).
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Revolvers, Cash Pools and Multiple EGIs Issued by the Same Issuer (cont'd)

- Material Event means, with respect to an entity, that:
 - The entity comes under the jurisdiction of a court in a case under Title 11 or a receivership, foreclosure, or similar proceeding;
 - The entity becomes insolvent within the meaning of section 108(d)(3);
 - The entity materially changes its line of business;
 - The entity sells, leases or otherwise disposes of 50% or more of the total fair market value of certain of its non-inventory assets; or
 - The entity consolidates or merges into another person that does not assume liability for the entity's outstanding EGIs.

Treas. Reg. Section 1.385-2(h)—*Example*

Facts

- USS1, USS2 and FP are members of the same EG. USS1 and USS2 timely file their federal income tax returns on September 15 of each year.
- USS1 issues an EGI (“EGI A”) to FP on **February 1 in Year 1**. USS1 issues an EGI (“EGI B”) to USS2 on **July 1 in Year 1**. USS1 issues another EGI (“EGI C”) to FP on **February 1 in Year 2**.
- USS1 **prepares a credit analysis on September 1 in Year 2** concluding that as of July 1 in Year 1, USS1 would be able to pay interest and principal on an amount greater than the combined principal amounts of EGI A, EGI B and EGI C.
- There are no Material Events of USS1 during Year 1 or Year 2.

Discussion

- The documentation requirements are not satisfied with respect to EGI A because no credit analysis was prepared with a relevant date on or before the issuance of EGI A.
 - The documentation requirements are satisfied with respect to EGI B because a credit analysis was prepared with a relevant date on or before the issuance of EGI B before the filing of USS1’s federal income tax return for Year 1.
 - The documentation requirements are satisfied with respect to EGI C because a credit analysis was prepared with a relevant date within a year prior to the issuance of EGI C before the filing of USS1’s federal income tax return for Year 1.
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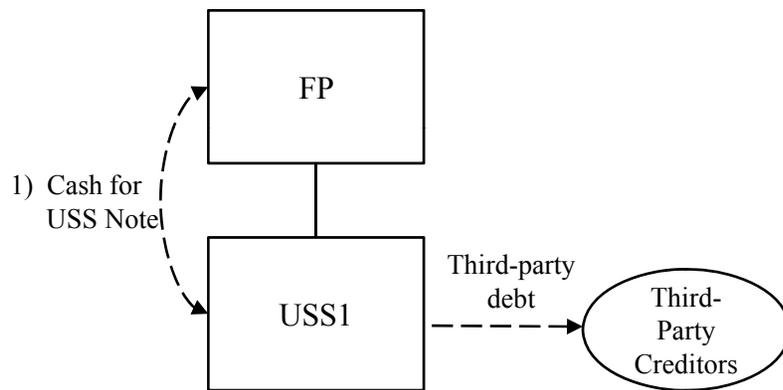
Threshold Requirements and Other Provisions

- The documentation requirements only apply to an EGI if:
 - The stock of any EG member is traded on, or subject to the rules of, an “established financial market” within the meaning of Treas. Reg. section 1.1092(d)-1(b),
 - On the date the AI first becomes an EGI, the EG’s total assets exceed \$100 million on any “Applicable Financial Statement” (defined by Treas. Reg. section 1.385-2(d)(1)), or
 - On the date the AI first becomes an EGI, the EG’s total annual revenue exceeds \$50 million on any Applicable Financial Statement.
- The Final Regulations provide guidance regarding the application of the threshold requirement where there are overlapping or multiple Applicable Financial Statements.
- If the issuer characterizes the EGI as debt, the issuer, the holder, and any other person relying on that characterization must treat the EGI as indebtedness for all federal tax purposes; the IRS, however, is not bound by such characterization.

Significant Modifications

- In general, the Final Regulations retain the rule from the Proposed Regulations that a significant modification of an EGI pursuant to Treas. Reg. section 1.1001-3 constitutes the issuance of a new EGI for purposes of the Documentation Rules.
- New credit analysis is required for an EGI that undergoes a significant modification.
 - The preamble to the Final Regulations specifically provides that the Documentation Rules are applied before the application of Treas. Reg. section 1.1001-3(f)(7)(ii)(A) (which generally disregards a deterioration in the creditworthiness of the issuer for purposes of determining whether an instrument is debt or stock following a significant modification).
- New documentation of the sum certain and creditor's rights requirements is not required unless the significant modification relates to an alteration to the terms of the EGI reflected in an express written agreement or written amendment to the EGI.
 - Does this exception apply to an EGI that is issued before January 1, 2018, and undergoes a significant modification after that date?

Financially Troubled Issuers



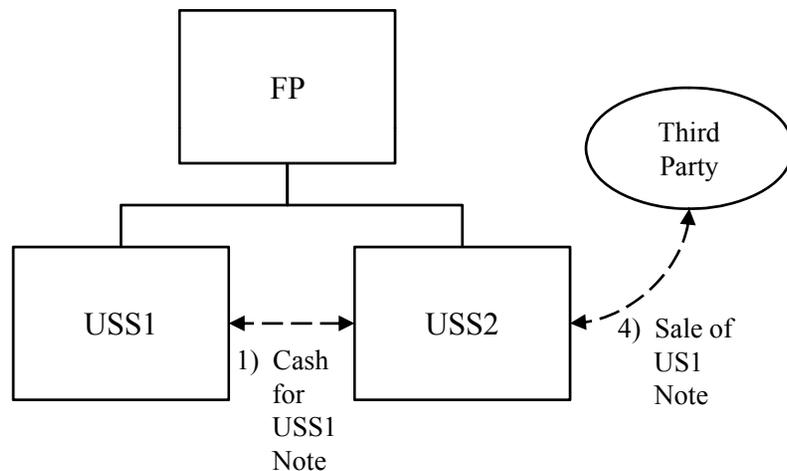
Facts

- 1) FP loans money to USS1 in exchange for a note (“USS1 Note”).
- 2) USS1 has third-party creditors.
- 3) USS1 enters financial difficulties and becomes unable to pay all of its debts.
- 4) The USS1 Note is modified as part of a workout with USS1’s third-party creditors.

Discussion

- Under the Final Regulations, if the modification constitutes a significant modification under Treas. Reg. section 1.1001-3, the workout constitutes a new testing date for the issuer’s ability to repay the instrument.
- This may result in the instrument being recharacterized as stock, even though the financial deterioration of the issuer would otherwise have been disregarded under Treas. Reg. section 1.1001-3(f)(7)(ii)(A).
- Commentators recommended that a modification subject to Treas. Reg. section 1.1001-3(f)(7)(ii)(A) be exempt from the retesting requirement so as to avoid discouraging debt workouts.
- The preamble to the Final Regulations explains that these recommendations were rejected and that Treas. Reg. section 1.385-2 applies before Treas. Reg. section 1.1001-3(f)(7)(ii)(A).

EGI Becomes a Non-EGI



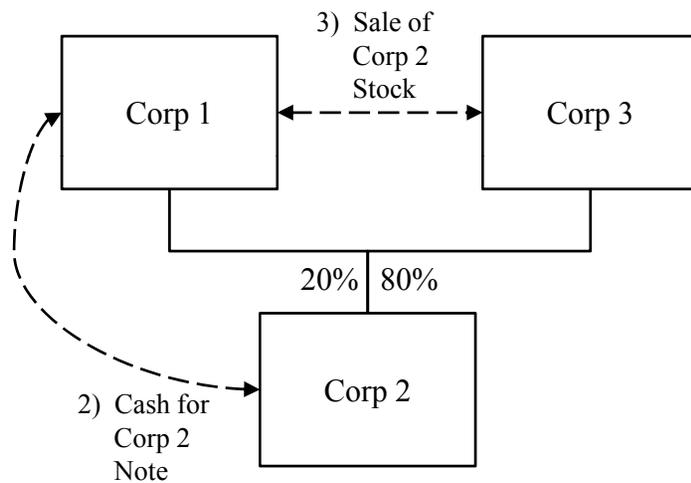
Facts

- 1) USS2 loans money to USS1 in exchange for a note (“USS1 Note”).
- 2) The USS1 note is recharacterized as stock under the documentation rules.
- 3) USS1 has E&P in excess of the adjusted basis of the USS1 Note.
- 4) USS2 sells the USS1 Note to a third party.

Discussion

- Under the Final Regulations, the USS1 Note treated as stock is deemed exchanged for a debt instrument immediately before the instrument is transferred to the third party.
- This results in a deemed distribution by USS1 to USS2 under section 302(d) even though no property is distributed to USS2. This result may also raise unsettled issues regarding what happens to the basis that USS2 had in the USS1 Note that was recharacterized as stock.
- Commentators recommended that the deemed exchange of the USS1 Note treated as stock for a debt instrument take place immediately after the transfer to the third party.
- The preamble to the Final Regulations explains that these recommendations were rejected so as to avoid causing the treatment of the third-party purchaser to be impacted by the documentation rules.

Non-EGI Becomes an EGI



Facts

- 1) Corp 1 owns 20% of the stock of Corp 2 and Corp 3 owns 80% of the stock of Corp 2.
- 2) Corp 1 loans money to Corp 2 in exchange for a note (“Corp 2 Note”).
- 3) Years after the issuance of the Corp 2 Note, Corp 1 acquires the rest of the Corp 2 stock from Corp 3.

Discussion

- Under the Final Regulations, the Corp 2 Note must satisfy the documentation rules as of the date Corp 1 acquires the remainder of the Corp 2 stock, even though the Corp 2 Note was issued at a time when Corp 1 and Corp 2 were not under common control.
- Commentators recommended that the relevant date for purposes of the documentation rules be restricted to eliminate instances in which a non-EGI becomes an EGI because such instruments would have been negotiated at arm’s length.
- The preamble to the Final Regulations explains that these recommendations were rejected because after the instrument becomes an EGI, the issuer and holder may not follow the terms and conditions of the instrument.

Potential Future Guidance

- The Final Regulations reserved and further comments were requested on:
 - Debt not in form; and
 - The no affirmative use rule.
- Questions
 - Is the Government considering applying the Documentation Rules to instruments that are not in form debt?
 - What does it mean for taxpayers that the regulations reserve on the no affirmative use rule?

The Transaction Rules:
Treas. Reg. Sections 1.385-3 and -3T

Prop. Treas. Reg. Section 1.385-3—Overview

- The transaction rules under Prop. Treas. Reg. section 1.385-3 would treat as stock certain interests held by an EG member that would otherwise be treated as debt for federal tax purposes—i.e., the interest satisfied the documentation requirements of the Proposed Regulations and would otherwise be treated as debt.
- A debt instrument, or portion thereof, treated as stock under Prop. Treas. Reg. section 1.385-3 would be treated as such for all federal tax purposes.
- The transaction rules would provide a general rule applicable to certain note distributions and similar transactions, as well as a funding rule applicable to certain note issuances undertaken to fund certain distributions and similar transactions.
- Both the general rule and the funding rule would be subject to certain limited exceptions.

Treas. Reg. Sections 1.385-3 and -3T— Overview

- Treas. Reg. section 1.385-3 generally contains the rules issued in Prop. Treas. Reg. section 1.385-3 (with significant modifications) except for (1) expanded ordinary course exceptions (including cash pooling) and (2) treatment of disregarded entities and partnerships, both of which are located in Treas. Reg. section 1.385-3T.
- Although the overarching general rule and funding rule of Prop. Treas. Reg. section 1.385-3 have been retained, additional (generally taxpayer-favorable) operating rules have been added in response to comments.
- The limited exceptions introduced in the Proposed Regulations are significantly expanded, and new exceptions have been added.
- Treas. Reg. sections 1.385-3 and -3T apply only to Covered Debt Instruments (defined below), thereby excluding foreign issuers and S corporations.
- Rules regarding the treatment of instruments issued and held by Controlled Partnerships were substantially revised. Those revisions are not described in this presentation.

Definition of a “Covered Debt Instrument”

- The general rule and funding rule apply only to a “Covered Debt Instrument,” which is any debt instrument issued after April 4, 2016 that is issued by a Covered Member and is not:
 1. A qualified dealer debt instrument;
 2. An excluded statutory or regulatory debt instrument; or
 3. Issued by a regulated financial company or regulated insurance company.

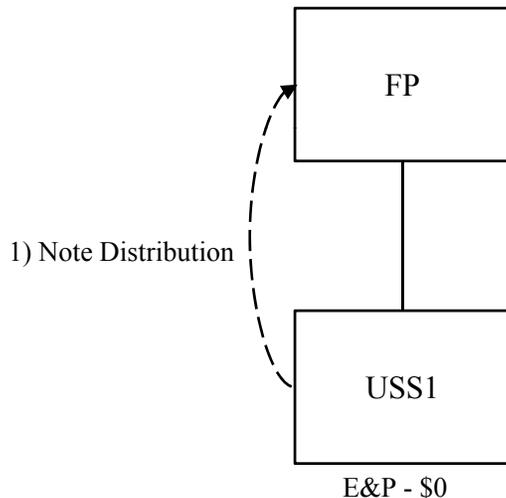
The General Rule: Treas. Reg. Section 1.385-3(b)(2)

- Unless an exception applies, a Covered Debt Instrument issued to a member of the issuer’s EG is treated as stock if it is issued:
 1. In a distribution with respect to a corporation’s stock;
 2. In exchange for the stock of a member of the same EG (“EG Stock”), other than in an “exempt exchange”; or
 3. In exchange for property in an asset reorganization, but only to the extent that, pursuant to the plan of reorganization, a shareholder that is a member of the issuer’s EG immediately before the reorganization receives the debt instrument with respect to its stock in the transferor corporation.

The General Rule: Treas. Reg. Section 1.385-3(b)(2) (cont'd)

- Under Treas. Reg. section 1.385-3(g)(11), an “exempt exchange” is:
 1. In a case where the transferor and transferee of the EG Stock are parties to an asset reorganization, either:
 - Section 361(a) or (b) applies to the transferor of the EG Stock and such stock is not transferred by issuance; or
 - Section 1032 or Treas. Reg. section 1.1032-2 applies to the transferor of the EG Stock and the stock is distributed by the transferee pursuant to the plan of reorganization;
 2. The transferor of the EG Stock is a shareholder that receives property in a complete liquidation to which section 331 or 332 applies; or
 3. The transferor of the EG Stock is an acquiring entity deemed to issue EG Stock in exchange for cash from an issuing corporation in a transaction described in Treas. Reg. section 1.1032-3(b).
- Liquidations and Treas. Reg. section 1.1032-3 were added as “exempt exchanges” in the Final Regulations in response to comments on the Proposed Regulations.

General Rule Example 1: Note Distribution



Facts

- 1) In Year 1, when USS1 has no E&P, USS1 distributes a note to FP (alternatively, USS has E&P but FP is in a jurisdiction with a US tax treaty providing for no withholding tax on dividends).

Issues

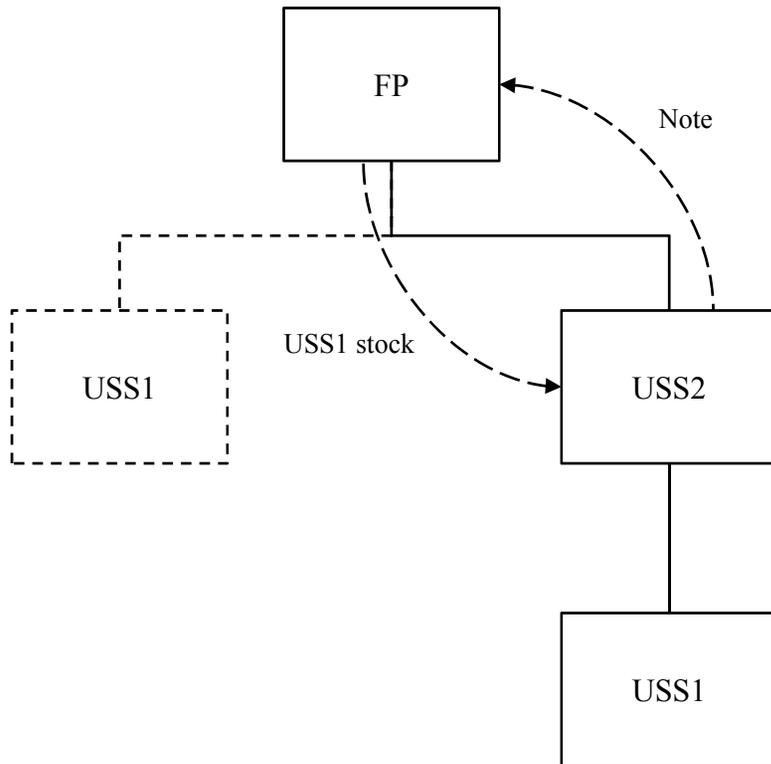
- Absent the application of Treas. Reg. section 1.385-3, the Year 1 note distribution is not taxable (section 301(c)(3) gain, if any, is not subject to U.S. tax so long as USS is not a USRPHC).
- Interest payments reduce the U.S. tax base and the principal can be repaid without U.S. tax.

Result under General Rule

- The note is recharacterized as equity under Treas. Reg. section 1.385-3(b)(2)(i).

Assumption: No exceptions to the general rule are applicable

General Rule Example 2: Section 304 Transaction



Facts

- 1) USS2 acquires the stock of USS1 from FP in exchange for a note (assume that neither USS1 nor USS2 has any current or accumulated E&P).

Issues

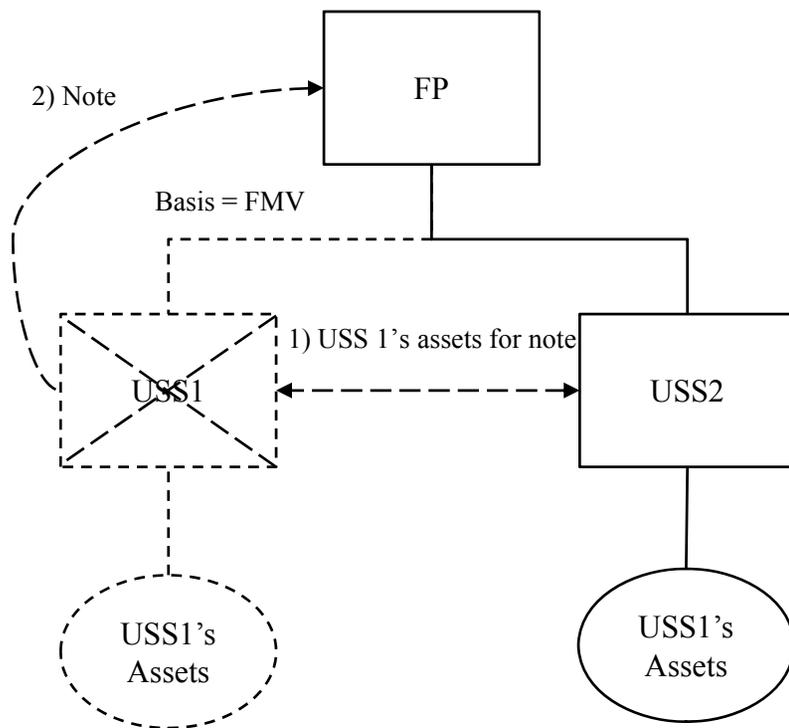
- Absent the application of the section 385 regulations, the transaction would constitute a dividend-equivalent section 304(a)(1) transaction that may be treated as a section 301(c)(2) return of basis.

Result under General Rule

- The note is recharacterized as equity under Treas. Reg. section 1.385-3(b)(2)(ii).
- The transaction is no longer subject to section 304(a)(1) because USS 2 stock is not “property” under section 317(a). *See also* Treas. Reg. section 1.385-3(h)(3) Ex. 3.

Assumption: No exceptions to the general rule are applicable

General Rule Example 3: All Boot D Reorganization



Assumption: No exceptions to the general rule are applicable

Facts

- 1) USS1 transfers all of its assets and liabilities to USS2 in exchange for a note in a transaction that qualifies as a reorganization under section 368(a)(1)(D).
- 2) Pursuant to the plan of reorganization, USS1 distributes the note to FP in liquidation. FP has a tax basis in its USS1 stock equal to fair market value.

Issues

- Absent the application of Treas. Reg. section 1.385-3(b)(2), the “dividend-within-gain” limitation of section 356(a)(2) prevents any of the note distribution from being treated as a dividend.

Result under General Rule

- The note is recharacterized as equity under Treas. Reg. section 1.385-3(b)(2)(iii).

Ancillary Consequences

- Because the regulations rely on section 385, which provides authority to characterize an instrument as debt or equity “for purposes of this title,” recharacterization of debt as equity under the regulations could potentially impact many unrelated transactions.
- Commentators pointed out many of these collateral issues with respect to the Proposed Regulations, some of which are highlighted on the following slide.

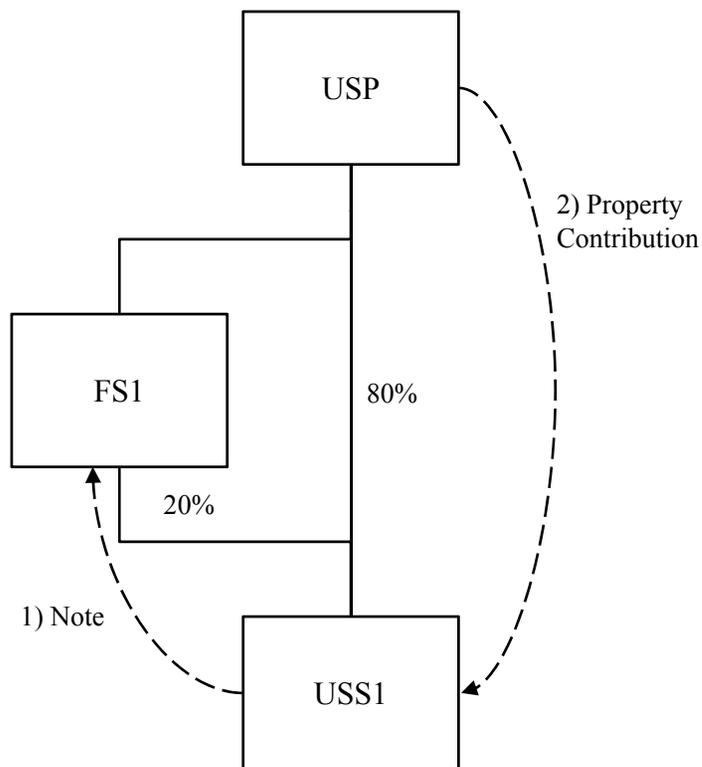
Ancillary Effects (cont'd)

- Examples:
 - Deconsolidation of, or application of section 1503(f) limitations to, a domestic subsidiary with debt owed to a foreign EG member.
 - Losing “control” for purposes of sections 332, 351, 355, and 368.
 - Loss of “separate affiliated group” status for purposes of section 355.
 - Altering the potential application of section 304.
 - Loss of the dividend received deduction under Rev. Rul. 94-28.
 - Loss of section 902 foreign tax credits and application of section 909 splitter rules.
 - Potential increase in withholding taxes under applicable tax treaty if interest payments are recharacterized as dividends.
 - Status as a U.S. real property holding company.
 - Affecting the ability of a company to qualify for treaty benefits under an ownership test in a limitation on benefits provision.
 - Causing or delaying a section 382 ownership change of a loss corporation.
 - Eligibility for hedging provisions, such as Treas. Reg. sections 1.954-2(a)(4)(ii), 1.988-5, and 1.1275-6.
 - Potentially creating fast-pay stock.

Ancillary Effects in the Final Regulations

- Treas. Reg. section 1.385-3(b)(1) provides that except for one limited exception, any Covered Debt Instrument treated as stock under Treas. Reg. section 1.385-3(b) is treated as stock for all federal tax purposes.
- The preamble confirms that “the Treasury Department and the IRS have determined that it is appropriate to treat the purported debt instrument as stock for all federal tax purposes.”
- Some of the ancillary effects are deferred or eliminated due to the narrower scope of the Final Regulations (e.g., sections 902/909 due to the exclusion of foreign issuers, section 1361 due to the exclusion of S corporations).
- The only explicit exception to Treas. Reg. section 1.385-3(b)(1) is contained in Treas. Reg. section 1.385-3(d)(7), which provides that a Covered Debt Instrument treated as stock that is not described in section 1504(a)(4) is not treated as stock for purposes of determining whether the issuer is a member of an affiliated group (within the meaning of section 1504(a)).
 - This means that debt treated as stock under Treas. Reg. section 1.385-3 does not affect EG membership.
 - Does this also apply to other Code provisions that apply section 1504(a) “with modifications” (e.g., section 199(d)(4), 7874(c))?

Ancillary Effects Example 1: Impact of Recharacterization on “Control”



Facts

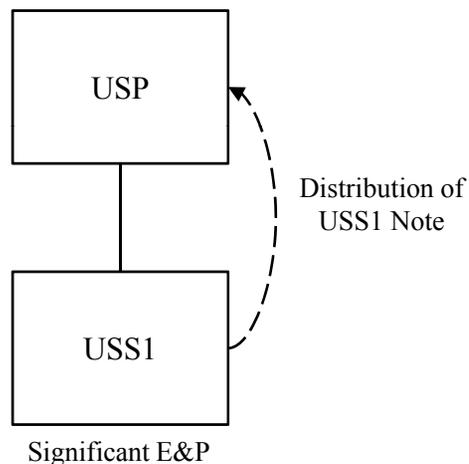
- 1) In Year 1, when FS1 owns 100% of the single class of voting stock of USS1, USS1 issues a note to FS1 in a distribution.
- 2) In Year 2, USP contributes assets to USS1 for use in USS1's business in exchange for stock which results in USP owning 80% of the actual vote and value of the stock of USS1 (i.e., not including the note).

Conclusions

- The note is treated as equity under Treas. Reg. section 1.385-3(b)(2)(i).
- Assuming the note does not have voting power, it would presumably be treated as non-voting stock, which would cause USP's contribution of property to fail section 368(c).

Assumption: No exceptions to the general rule are applicable

Ancillary Effects Example 2: Dividends Received Deduction



Facts

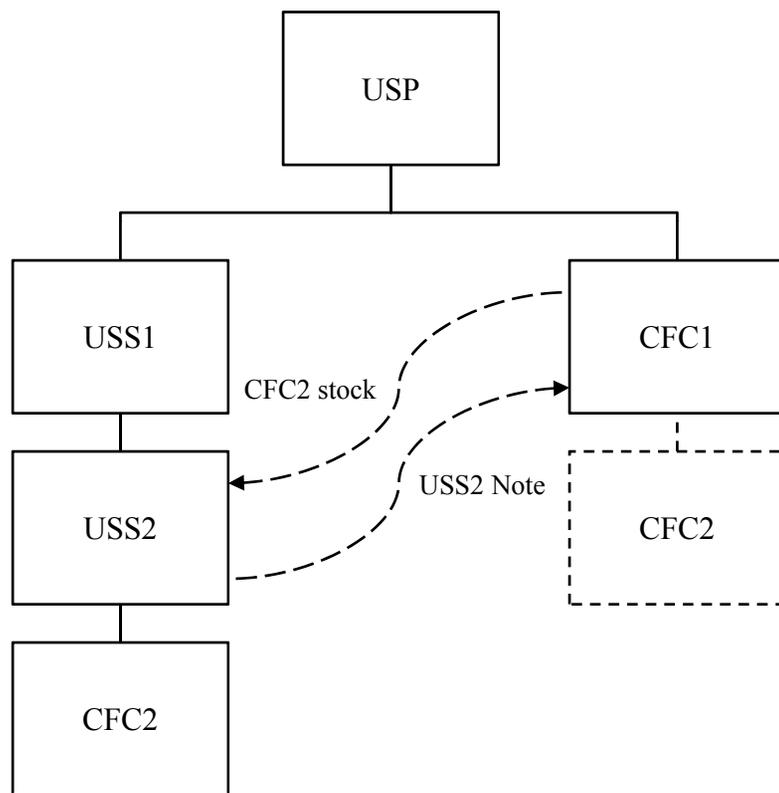
- 1) USP wholly owns USS1, which has significant E&P. USP and USS1 are not consolidated.
- 2) In Year 1, USS1 distributes a note to USP (the “USS1 Note”).
- 3) USS1 pays interest on the USS1 Note.

Analysis

- The USS1 Note is recharacterized as stock under Treas. Reg. section 1.385-3(b)(2)(i), and so the interest payments on the USS1 Note would be characterized as dividend distributions.
- Section 246(c)(1)(A) requires a 45-day holding period of stock in order to qualify for the section 243 dividends-received deduction with respect to dividends paid on such stock.
- Section 246(c)(4) provides that the holding period is tolled for periods in which the risk of loss is diminished, and Rev. Rul. 94-28 provides that section 246(c)(4) applies to an instrument that affords the holder the rights of a creditor and is not stock for corporate law purposes but is stock for federal income tax purposes.
- Section 246(c)(4) may prevent payments of interest on the USS1 Note from qualifying for the dividends-received deduction.
- This issue is less relevant under the Final Regulations due to the exclusion of foreign issuers.

Assumption: No exceptions to the general rule are applicable

Ancillary Effects Example 3: Fast-Pay Stock



Assumption: No exceptions to the general rule are applicable

Facts

- 1) USP wholly owns USS1 and CFC1; USS1 wholly owns USS2 and CFC1 wholly owns CFC2.
- 2) In Year 1, USS2 purchases the stock of CFC2 from CFC1 in exchange for a note (the “USS 2 Note”)
- 3) The USS2 Note has a 5-year term and is fully amortizing.

Analysis

- The USS2 Note is recharacterized as stock under Treas. Reg. section 1.385-3(b)(2)(ii), and payments on the USS2 Note would constitute dividends.
- Because the USS2 Note is fully amortizing, the payments received are economically a return of the holder’s investment, potentially causing the USS2 Note to be considered fast-pay stock under Treas. Reg. section 1.7701(l)-3.
- Treas. Reg. section 1.7701(l)-3 permits the IRS to recharacterize fast-pay stock where it determines that a principal purpose of the arrangement is the avoidance of tax.
- Can such a principal purpose be found here, given that the instrument is formally debt? The preamble to the Final Regulations notes but does not resolve the issue.

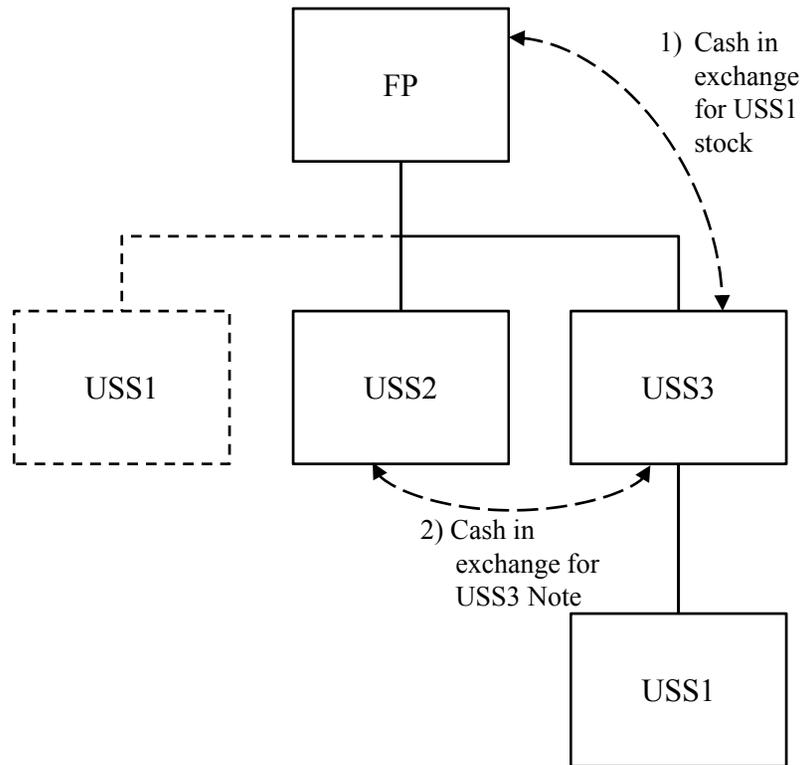
The Funding Rule: Treas. Reg. Section 1.385-3(b)(3)(i) and (ii) (Prohibited Transactions)

- Under the funding rule, a Covered Debt Instrument that is not a qualified short-term debt instrument (discussed below) is treated as stock to the extent it is issued by a Covered Member of the EG (the “funded member”) to an EG member in exchange for property and such debt is treated as funding one of the following distributions or acquisitions (a “Prohibited Transaction”):
 - A distribution of property by the funded member to an EG member, other than an “exempt distribution”;
 - An exempt distribution is (i) a distribution of stock received without recognition of gain under section 354(a)(1) or 355(a)(1), or, if section 356 applies, that is not treated as “other property” or money under section 356; or (ii) a distribution of property in complete liquidation under section 336(a) or 337(a).
 - An acquisition of EG Stock (except in an exempt exchange, defined above) by the funded member from an EG member in exchange for property other than EG Stock; or
 - An acquisition of property by the funded member in an asset reorganization, but only to the extent that, pursuant to the plan of reorganization, a shareholder that is a member of the funded member’s EG immediately before the reorganization receives “other property” or money within the meaning of section 356 with respect to its stock in the transferor corporation.

The Funding Rule: Principal Purpose and the *Per Se* Rule

- Under a *per se* rule, a Covered Debt Instrument is treated as funding a Prohibited Transaction if it is issued by the funded member during the 72-month period beginning 36 months before the date of the Prohibited Transaction (the “*per se* period”).
- If the Covered Debt Instrument in question is not issued by a funded member during the *per se* period, the determination of whether the Covered Debt Instrument funded the Prohibited Transaction is made based on all the facts and circumstances. A Covered Debt Instrument can fund a Prohibited Transaction regardless of whether it is issued before or after a Prohibited Transaction.
- Some commentators requested that the *per se* rule be removed or turned into a rebuttable presumption, but it has not been significantly modified from the Proposed Regulations.

Funding Rule Example 1



Facts

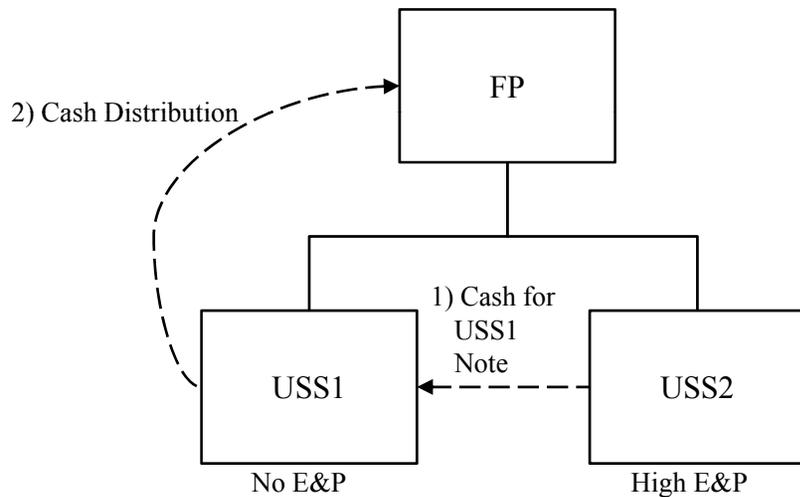
- 1) USS3 acquires the stock of USS1 from FP in exchange for \$100 of cash.
- 2) In the same year, USS3 borrows \$100 from USS2 in exchange for a note (the “USS3 Note”).
- 3) Assume that neither USS1 nor USS2 has any current or accumulated E&P.

Result under Funding Rule

- The USS3 Note is treated as equity in USS3 pursuant to Treas. Reg. section 1.385-3(b)(3), and the transaction constitutes a dividend-equivalent section 304(a)(1) transaction.

Assumption: No exceptions to the general rule or funding rule are applicable

Funding Rule Example 2: Leveraged Distribution



Facts

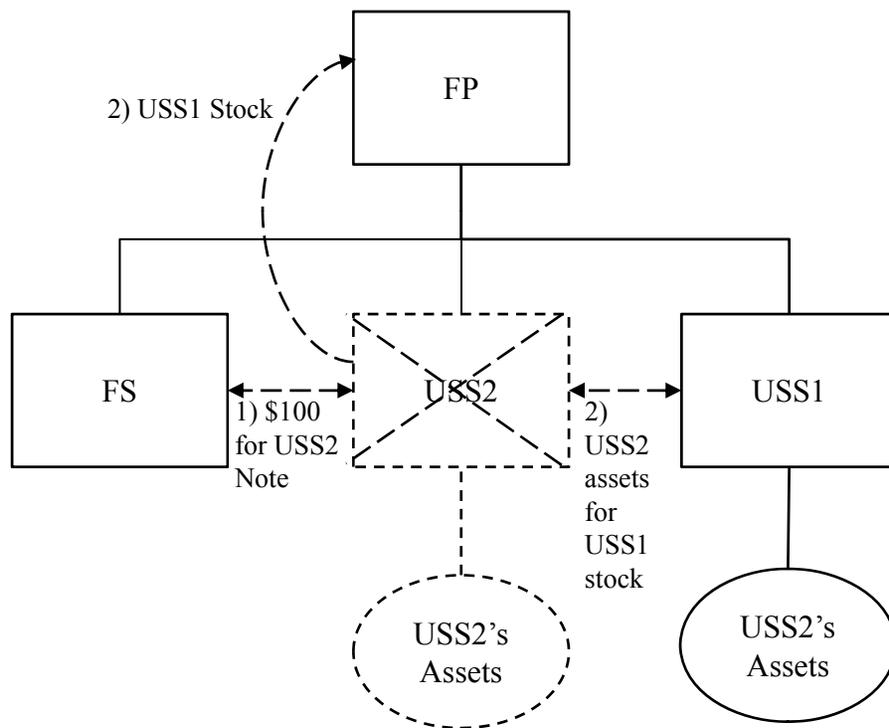
- 1) USS2 has substantial cash and E&P. USS1 has no E&P. In Year 1, USS2 lends cash to USS1 for a USS1 note (“USS1 Note”)
- 2) In Year 3, USS1 distributes cash to FP. Assume FP’s basis in its USS1 stock exceeds the distribution amount (and there are no basis blocks)

Analysis

- The loan from USS2 to USS1 supplies cash to USS1 without a corresponding movement of USS2’s E&P.
- Most/all of the distribution could be a tax-free return of basis.
- USS1 Note is recharacterized as equity under Treas. Reg. section 1.385-3(b)(3)(i)(A).

Assumption: No exceptions to the funding rule are applicable

Funding Rule Example 3: Reorganization



Facts

- 1) On Date A in Year 1, FS loans \$100 to USS2 in exchange for a USS2 note (“USS 2 Note”).
- 2) On Date B in Year 2, USS2 transfers all of its assets to USS1 in exchange for USS1 stock, and USS2 distributes the USS1 stock received to FP in liquidation in a reorganization.

Analysis

- The distribution of property by USS2 to FP in the reorganization is an exempt distribution.
- USS2’s acquisition of USS 1 stock is an exempt exchange.
- FP’s receipt of USS1 stock is not a Prohibited Transaction because FP does not receive any “other property.”
- No Prohibited Transaction has occurred, so the funding rule does not apply. Note, however, that USS1 is a successor to USS2, so USS1 is now a funded member with respect to the USS 2 Note. See Treas. Reg. section 1.385-3(h)(3) Ex. 10.

Assumption: No exceptions to the funding rule are applicable

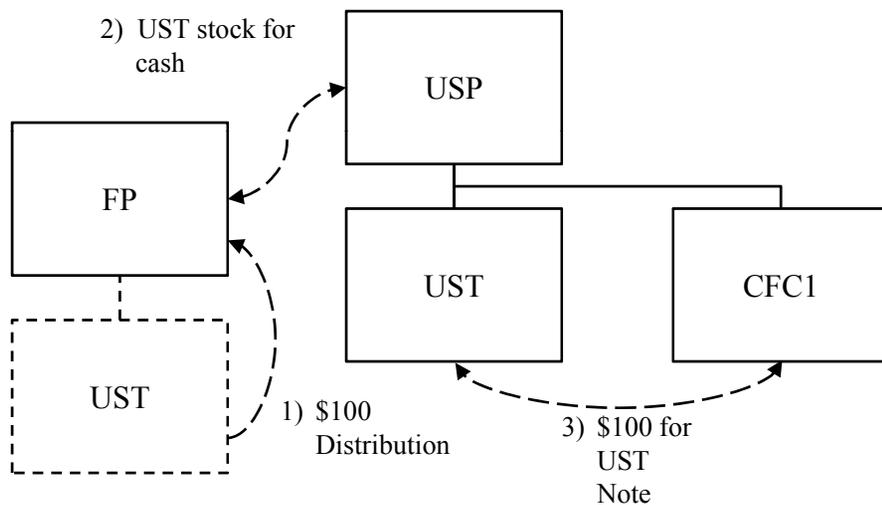
Payments on Partially Recharacterized Covered Debt Instruments

- Treas. Reg. section 1.385-3(d)(5) contains new ordering rules for payments on debt partially recharacterized as stock under the general rule or the funding rule.
 - In general, a payment with respect to a debt instrument partially recharacterized as stock is treated as made pro rata between the portion treated as stock and the portion treated as debt.
 - However, a payment that is not required to be made pursuant to the terms of the instrument (e.g., a prepayment of principal) may be designated by the issuer and holder as being with respect to the portion treated as stock or the portion treated as debt.

Transactions that Straddle Different EGs (Treas. Reg. section 1.385-3(b)(3)(iii)(D))

- In response to comments received with respect to the Proposed Regulations, a Covered Debt Instrument is not treated as issued by a funded member during the *per se* period with respect to a Prohibited Transaction if:
 1. The Prohibited Transaction occurs prior to the issuance of the Covered Debt Instrument (or, if the funded member is treated as engaging in the Prohibited Transaction of a predecessor or successor, the predecessor or successor is not a member of same EG as the funded member on the date of the Prohibited Transaction);
 2. The Prohibited Transaction occurs when the funded member is a member of an EG that has a different EG parent than when the funded member issues the Covered Debt Instrument; and
 3. On the date of issuance of the Covered Debt Instrument, the “recipient member” is not a member of the same EG as the funded member.
 - A “recipient member” is the transferee of property in a Prohibited Transaction (including predecessors or successors).

Straddle Example



Assumption: No exceptions to the funding rule are applicable

Facts

- 1) In Year 1, UST distributes \$100 to FP.
- 2) In Year 3, unrelated USP acquires UST from FP for cash.
- 3) Later in Year 3, CFC 1 loans \$100 to UST in exchange for a note (the "UST Note").

Analysis

- Under the Proposed Regulations, the funding rule could apply because FP was a member of UST's EG when the distribution was made, causing the loan from CFC 1 to UST to be treated as the acquisition of additional UST stock, even though USP would have had no control over, or even knowledge of, the prior distribution to FP.
- Under Treas. Reg. section 1.385-3(b)(3)(iii)(D), the *per se* prong of the funding rule does not apply because:
 - The Prohibited Transaction (UST's distribution to FP) occurs prior to the issuance of the UST Note;
 - The Prohibited Transaction occurs when UST is a member of a different EG than when it issues the UST Note; and
 - When the UST Note is issued, the recipient member (FP) is not a member of the same EG as the funded member (UST).
- Note that the UST Note could still be subject to the funding rule under the principal purpose prong.

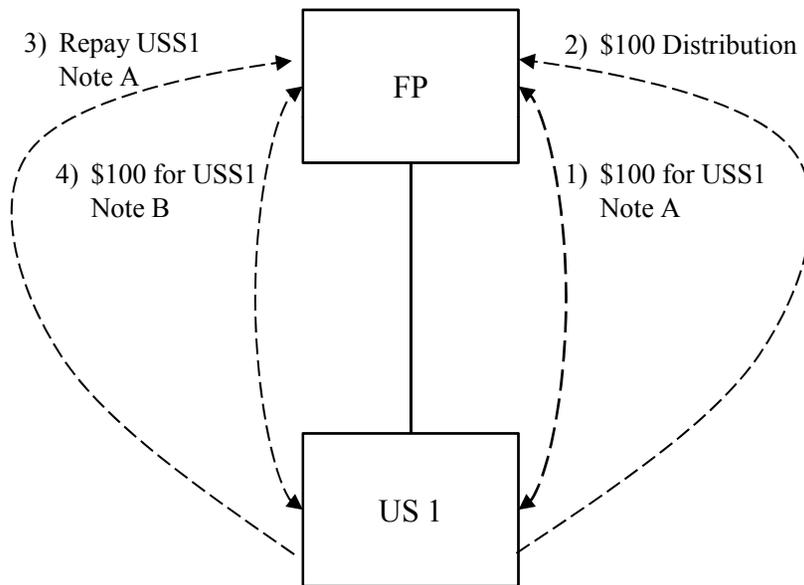
Cascading Recharacterizations and Non-Duplication

- Certain cascading and duplicative consequences of recharacterization were raised by comments to the Proposed Regulations.
- In response, the Final Regulations incorporate certain operating rules that avoid particular cascading and duplicative recharacterizations:
 - When two or more Covered Debt Instruments may be treated as stock under the funding rule, they are tested under the *per se* rule based on the order they are issued, with the earliest tested first. Treas. Reg. section 1.385-3(b)(3)(iii)(B).
 - When a Covered Debt Instrument may be treating as funding more than one Prohibited Transaction, the Covered Debt Instrument is treated as funding Prohibited Transactions in the order in which they occur, with the earliest tested first. Treas. Reg. section 1.385-3(b)(3)(iii)(C).
 - When a Covered Debt Instrument is treated as stock pursuant to the funding rule, the Prohibited Transaction that is funded by such Covered Debt Instrument is not recharacterized as a result of the treatment of the Covered Debt Instrument as stock. Treas. Reg. section 1.385-3(b)(3)(vi).
 - Except for retesting that occurs when a Covered Debt Instrument leaves the EG (discussed below), a Prohibited Transaction that is treated as funded by a Covered Debt Instrument cannot be treated as funded by a different Covered Debt Instrument, and to the extent a Covered Debt Instrument is treated as funding one Prohibited Transaction, it cannot be treated as funding another Prohibited Transaction. Treas. Reg. section 1.385-3(b)(6).

Cascading Recharacterizations and Non-Duplication (cont'd)

- Other cascading and non-duplication rules:
 - An acquisition of a Covered Debt Instrument that is treated as stock under the funding rule is not treated as an acquisition of EG Stock. Treas. Reg. section 1.385-3(c)(2)(v)(A).
 - A transaction described under the general rule is not also a Prohibited Transaction subject to the funding rule. Treas. Reg. section 1.385-3(b)(5).
 - If a transaction would constitute more than one type of Prohibited Transaction, the funded member is treated as making only a single Prohibited Transaction. Treas. Reg. section 1.385-3(b)(3)(ii).

Cascading Example



Facts

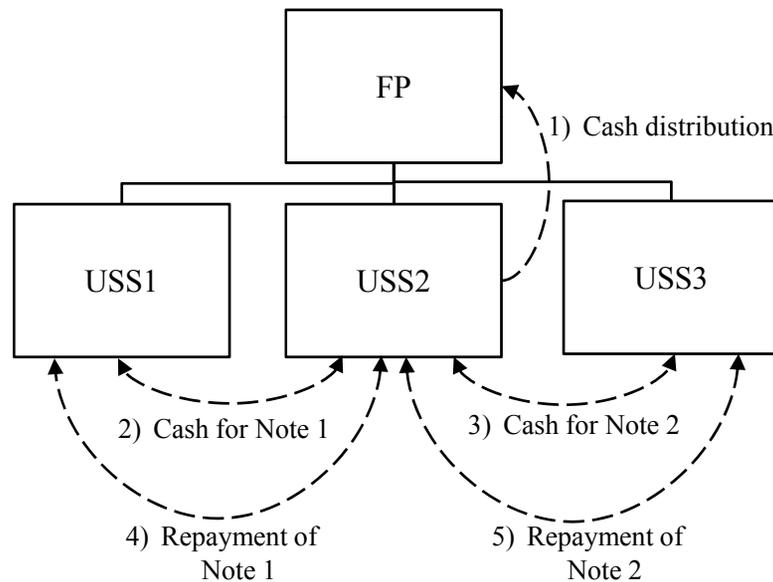
- 1) In Year 1, FP lends \$100 to USS1 for a USS1 note (“USS1 Note A”).
- 2) In Year 1, USS1 distributes \$100 to FP.
- 3) In Year 2, USS1 repays USS1 Note A.
- 4) In Year 3, FP lends \$100 to USS1 for another USS1 note (“USS1 Note B”).

Analysis

- Because the distribution of cash in step 2 is a Prohibited Transaction, USS1 Note A is recharacterized as stock.
- As a result, the repayment of USS1 Note A in Year 2 is a section 302(d) redemption of USS1 stock treated as a distribution with respect such stock, resulting in USS1 Note B being recharacterized as USS1 stock.
- This iterative consequence is not prevented by any provision of the Final Regulations, and is affirmed in the Preamble: “the funding rule could be circumvented if the repayment of a note that is treated as stock were not treated as a distribution.” See Preamble at 119.

Assumption: No exceptions to the funding rule are applicable

Cascading Example 2



Facts

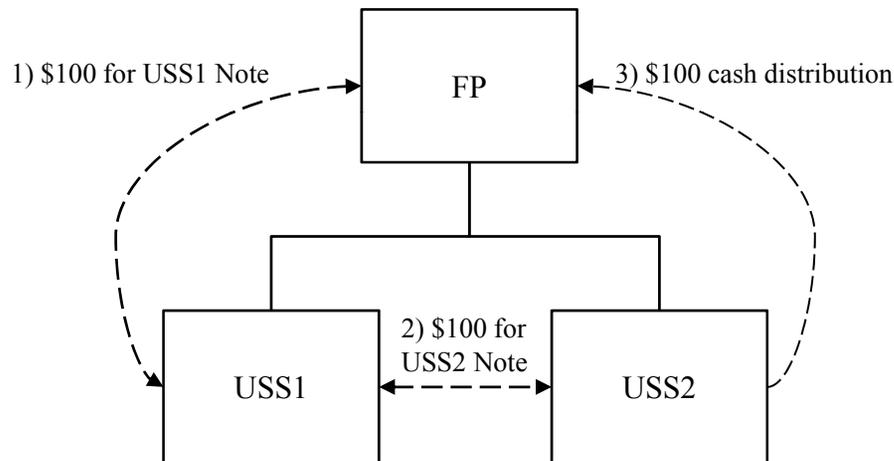
- 1) In Year 1, USS2 distributes \$100 to FP.
- 2) In Year 2, USS1 lends \$100 to USS2 in exchange for a note ("Note 1").
- 3) Later in Year 2, USS3 lends \$100 to USS2 in exchange for a note ("Note 2").
- 4) In Year 3, USS2 repays Note 1.
- 5) In Year 4, USS2 repays Note 2.

Conclusion

- The result appears to be the same as in the prior example—the repayment of Note 1 is a Prohibited Transaction that causes Note 2 to be recharacterized.
Why is this result appropriate?

Assumption: No exceptions to the funding rule are applicable

EG Stock Acquisition and Cascading Example



Facts

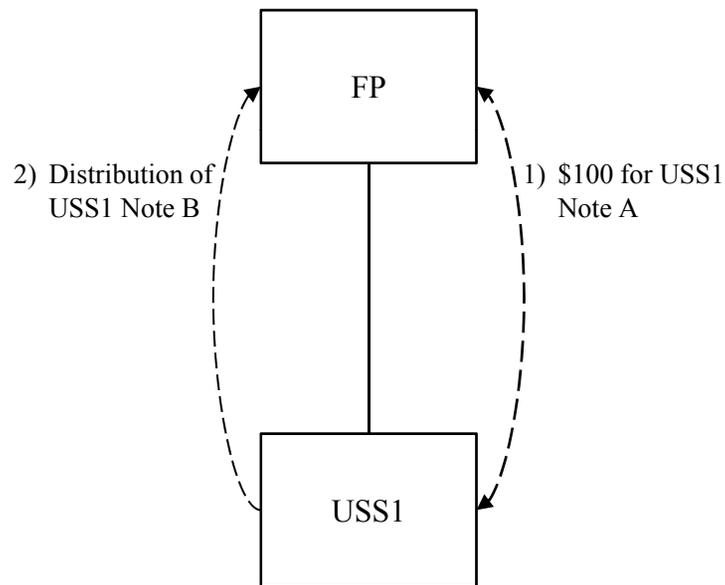
- 1) In Year 1, FP loans \$100 to USS1 for a USS1 note (“USS1 Note”).
- 2) In Year 2, USS1 loans \$100 to USS2 for a USS2 note (“USS2 Note”).
- 3) In Year 3, USS2 distributes \$100 cash to FP.

Analysis

- USS2’s Year 3 distribution is a Prohibited Transaction that recharacterizes USS2 Note into stock.
- Because USS2 Note is stock, USS1 would generally be treated as acquiring EG Stock for cash in Year 2, which would be a Prohibited Transaction that recharacterizes USS1 Note into stock.
- Treas. Reg. section 1.385-3(c)(v)(A) prevents this iterative result by providing that “an acquisition of a Covered Debt Instrument that is treated as stock” under the funding rule is not treated as an acquisition of EG Stock.

Assumption: No exceptions to the funding rule are applicable

Non-Duplication Example 1



Facts

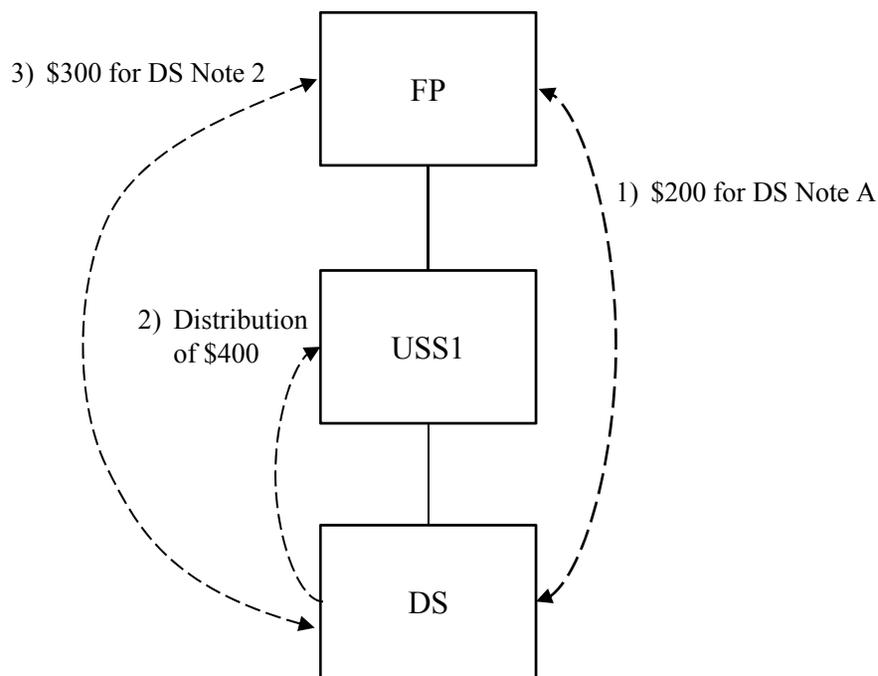
- 1) In Year 1, FP lends \$100 to USS1 for a USS1 note (“USS1 Note A”).
- 2) In Year 2, USS1 distributes a \$100 note (“USS1 Note B”) to FP.

Analysis

- The distribution of USS1 Note B is described in the general rule, and is thus recharacterized as stock.
- Pursuant to Treas. Reg. section 1.385-3(b)(5), the distribution of USS1 Note B cannot also be a Prohibited Transaction for purposes of the funding rule. Therefore, the distribution of USS1 Note B is not a Prohibited Transaction that causes USS1 Note A to be recharacterized. *See* Treas. Reg. section 1.385-3(h)(3) Ex. 1.

Assumption: No exceptions to the general or funding rule are applicable

Non-Duplication Example 2



Facts

- 1) In Year 1, FP lends \$200 to DS for a DS note (“DS Note A”).
- 2) In Year 2, DS distributes \$400 to USS1.
- 3) In Year 3, FP lends \$300 to DS for another DS note (“DS Note B”).

Analysis

- The distribution of \$400 in Year 2 causes DS Note A to be recharacterized as stock under the funding rule.
- Due to the non-duplication rules and ordering rules, only the remaining \$200 of the Year 2 distribution not used to recharacterized DS Note A can be used to recharacterize DS Note B. Therefore, \$200 of DS Note B is recharacterized as stock and \$100 of DS Note B continues to be treated as debt. *See* Treas. Reg. section 1.385-3(h)(3) Ex. 5.

Assumption: No exceptions to the funding rule are applicable

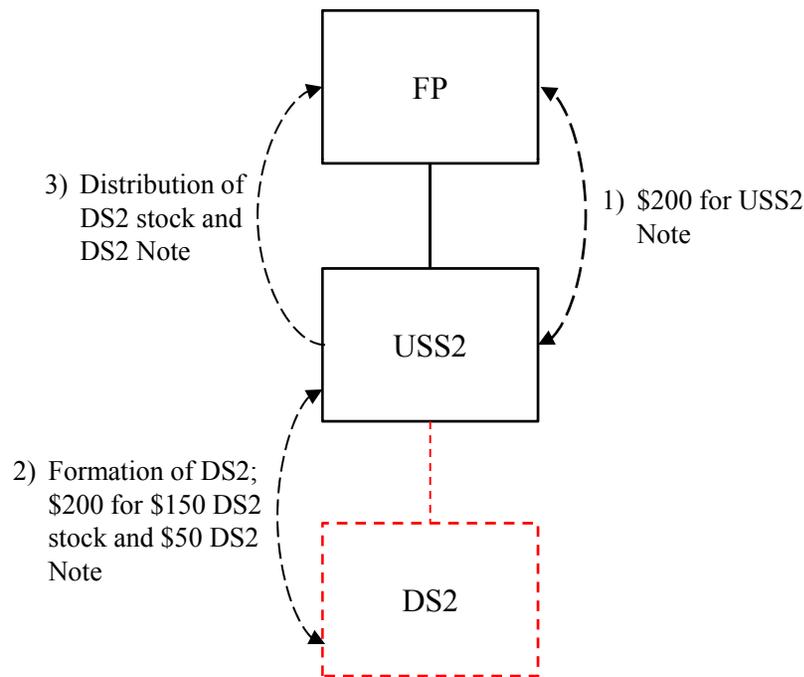
Treas. Reg. Section 1.1001-3

- The Final Regulations provide guidance regarding when a significant modification of an instrument under Treas. Reg. section 1.1001-3 implicates the funding rule
 - If a Covered Debt Instrument is treated as exchanged for a deemed “new” Covered Debt Instrument due to a significant modification, the “new” Covered Debt Instrument is generally treated as issued on the original issue date of the Covered Debt Instrument for purposes of the funding rule.
 - However, this special rule does not apply if the modification(s) triggering the deemed exchange include(s):
 - The substitution of the primary obligor
 - The addition/deletion of a co-obligor; or
 - The material deferral of scheduled payments.
 - Also note that this special rule only applies to modifications and not refinancings
 - If a Covered Debt Instrument is upsized, the portion of the debt instrument attributable to the upsize is treated as issued on the date of the upsize.

Predecessors and Successors

- The funding rule contains provisions addressing predecessor and successor corporations. Generally, references to a funded member include references to any predecessor or successor of such member.
 - Under these rules:
 - A predecessor of a corporation means (i) the distributor or transferor in a section 381(a) transaction in which the corporation is the acquiring corporation, or (ii) Distributing in a section 355 transaction in which the corporation is Controlled.
 - A successor of a corporation is defined as (i) the acquiring corporation in a section 381(a) transaction in which the corporation is the distributor or transferor, (ii) Controlled in a section 355 transaction in which the corporation is Distributing, or (iii) a seller in certain types of subsidiary stock acquisitions in which the corporation is the acquirer (discussed below).
 - The term predecessor does not including Distributing in a section 355 transaction as of the date that Distributing and Controlled are no longer in the same EG. The term successor does not include Controlled in a section 355 transaction as of the date that Distributing and Controlled are no longer in the same EG.
 - A corporation may have multiple predecessors or successors.
 - The exception for section 355 transactions, and an exclusive definition of predecessor and successor (rather than what it “includes”), were incorporated into the Final Regulations as a result of comments.
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Predecessors and Successors Example Pt. 1



Facts

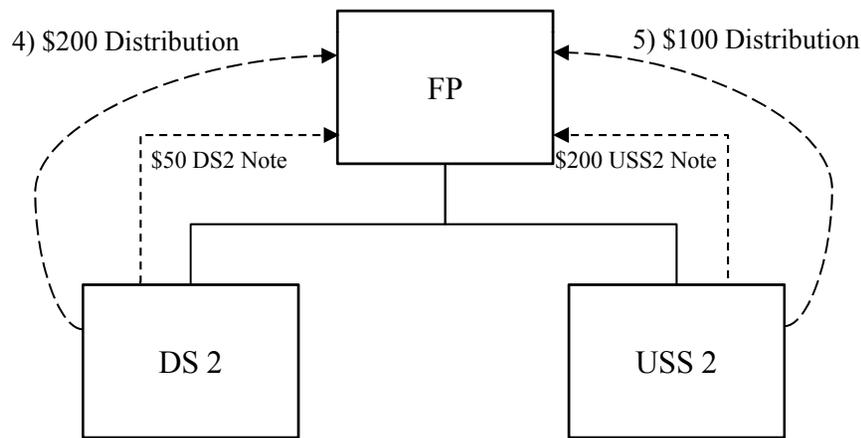
- 1) In Year 1, FP loans \$200 to USS2 for a USS2 note (“USS2 Note”).
- 2) In Year 2, USS2 forms DS2 and transfer \$200 to DS2 in exchange for \$150 of DS2 stock and a \$50 DS2 note (“DS2 Note”) in a section 368(a)(1)(D) reorganization.
- 3) Immediately after step 2, USS2 distributes the stock of DS2 and DS2 Note to FP in a section 355 spin-off.

Analysis

- DS2 Note is treated as stock under the general rule because it is issued in an asset reorganization and then distributed to FP as part of the plan of reorganization.
- Because DS2 Note is recharacterized under the general rule, its issuance is not treated as a Prohibited Transaction under the non-duplication rules, and does not cause USS2 Note to be recharacterized under the funding rule.
- USS2’s acquisition of DS2 stock is an exempt exchange, and USS2’s distribution of DS2 stock is an exempt distribution.

Assumption: No exceptions to the general or funding rule are applicable

Predecessors and Successors Example Pt. 2



Facts

- 4) In Date A in Year 3, DS2 distributes \$200 to FP.
- 5) In Date B Year 3, USS2 distributes \$100 to FP.

Analysis

- USS2 and DS2 are predecessors/successors of one another because of the spin-off.
- Distributions by USS2 and DS2 are treated as made by each other.
- DS2's distribution of \$200 is a Prohibited Transaction treated as funding USS2 Note. USS2 Note is recharacterized as stock as of Date A. *See* Treas. Reg. section 1.385-3(h)(3) Ex. 8, 9.
- USS2's distribution on Date B has no debt to recharacterize and so does not cause any debt to be treated as stock.
- If DS2 and USS2 were no longer members of the same EG after the spin-off, DS 2 and USS 2 would cease to be predecessor/successor and DS2's distribution would not affect the characterization of USS2 Note.

Assumption: No exceptions to the general or funding rule are applicable

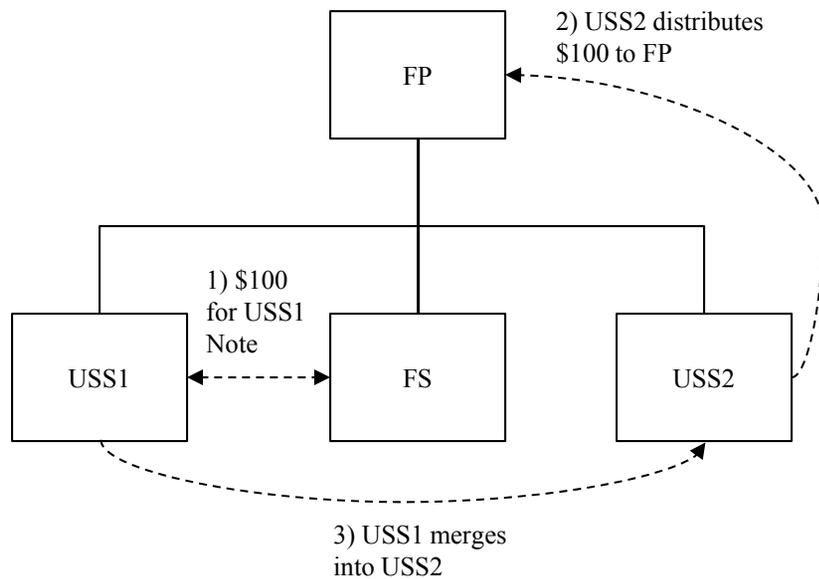
Predecessors and Successors—Acquisitions of Subsidiary Stock

- If one entity sells EG Stock to another EG member, and immediately thereafter, the acquirer controls the seller (more than 50% of vote and value) as described in Treas. Reg. section 1.385-3(c)(2)(i)(A), the seller is generally treated as a successor of the acquirer, subject to the following rules:
 - The seller is only treated as a successor of the acquirer to the extent of the value of the EG Stock acquired from the seller in exchange for property.
 - A Prohibited Transaction by the seller to or from the acquirer is not taken into account for purposes of applying the funding rule to a Covered Debt Instrument of the acquirer.
 - To the extent that a Covered Debt Instrument of the acquirer is treated as funding a Prohibited Transaction of the seller, the value of the EG Stock sold to the acquirer is reduced by an amount equal to the Prohibited Transaction for purposes of any further treatment of the seller as a successor of the acquirer.
- Successor status terminates once the seller and the acquirer cease to be members of the same EG.
- This rule complements the subsidiary stock acquisition exception, discussed below, and is an expanded version of a provision in Prop. Treas. Reg. section 1.385-3(d)(9)(ii).

Predecessors and Successor–Timing

- In response to comments, Treas. Reg. section 1.385-3(b)(3)(v)(B) provides that a Covered Debt Instrument issued by a funded member that funds a Prohibited Transaction made by a predecessor or successor is not treated as issued during the *per se* period unless:
 - The Covered Debt Instrument is issued by the funded member during the period beginning 36 months before and ending 36 months after the date when its predecessor or successor became a predecessor or successor; and
 - The Prohibited Transaction is made by the predecessor or successor during the period beginning 36 months before and ending 36 months after it became a predecessor or successor of the funded member.

Predecessors and Successors Timing Example



Facts

- 1) On Date A in Year 1, FS lends \$100 to USS1 in exchange for a USS1 note (“USS Note”).
- 2) On Date B in Year 3, USS2 distributes \$100 to FP.
- 3) On Date C in Year 10, USS1 merges with and into USS2 in a reorganization.

Results

- The predecessor/successor rule of the Proposed Regulations was written in such a way that it would cause USS1 Note to be recharacterized as stock as a result of the merger of USS1 with and into USS2.
- This is because the merger caused USS2 to be treated as issuing a Covered Debt Instrument and making a Prohibited Transaction within a 36-month period.
- Treas. Reg. section 1.385-3(b)(3)(v)(B) now applies to prevent the issuance of USS1 Note and the Prohibited Transaction from being treated as occurring within the *per se* period because neither occurred during the 36 months before or after the merger of USS1 into USS2.
- What if USS 1 was a foreign entity, such that it was not a Covered Member and USS 1 Note was not a Covered Debt Instrument until USS 1 merged into USS 2?

Exceptions Overview

- The Proposed Regulations contained certain limited exceptions to the general rule and/or the funding rule—a current E&P exception, ordinary course exception, subsidiary stock issuance exception, and threshold exception.
 - In response to comments, the Final Regulations have generally expanded the foregoing exceptions and added new exceptions.
 - Key exceptions now include:
 - Post-April 4, 2016 E&P exception
 - Qualified contribution exception
 - Threshold exception
 - Subsidiary stock acquisition exception
 - Short-term and ordinary course debt exceptions, including deposits with cash pool headers
 - Exceptions based on instrument type (e.g., interest-free loans, insurance/reinsurance contracts)
 - Exceptions based on issuer status (e.g., regulated financial companies, regulated insurance companies)
 - Exception for straight section 355 distributions
 - Exceptions for issuances of stock as compensation
-

1.1032-3 and Compensatory Stock

- Commentators to the Proposed Regulations requested an exception for all transactions described in Treas. Reg. section 1.1032-3, but particularly where a purchase of EG Stock was deemed to occur under Treas. Reg. section 1.1032-3(b) and no actual payment for stock was made
- Deemed purchases are now indirectly exempted due to separate recommendation adopted in the Final Regulations to reduce the amount of distributions or acquisitions described in the general rule or funding rule by “qualified contributions.”
 - “Qualified contributions” include a deemed cash contribution under Treas. Reg. section 1.1032-3(b).
- The Final Regulations also adopted exceptions from the general and funding rules in two situations where an actual payment for stock is made:
 1. Exception for EG Stock delivered to individuals in consideration for services rendered as an employee, a director, or an independent contractor; and
 2. Exception for the acquisition of EG Stock by a dealer in securities (within the meaning of section 475(c)(1)) to the extent the EG stock is acquired in the ordinary course of the dealer’s business of dealing in securities.

1.1032-3 and Compensatory Stock

- The Final Regulations add an exception for the acquisition of EG Stock by a dealer in securities (within the meaning of section 475(c)(1)) to the extent the EG Stock is acquired in the ordinary course of the dealer's business of dealing in securities, but solely to the extent that:
 - The dealer accounts for the stock as securities held primarily for sale to customers in the ordinary course of business;
 - The dealer disposes of the stock within a period that is consistent with the holding of the stock for sale to customers in the ordinary course of business, taking into account the terms of the stock and the conditions and practices prevailing in the markets for similar stock during the period in which it is held; and
 - The dealer does not sell or otherwise transfer the stock to a person in the same expanded group, other than in a sale to a dealer that in turn satisfies the requirements of Treas. Reg. section 1.385-3(c)(2)(iv).

E&P Exception

- The amount of any distribution or acquisition subject to the general rule or the funding rule are decreased by the amount of the in-question EG member’s current year E&P described in section 316(a)(2) and its accumulated E&P described in section 316(a)(1), but only to the extent such E&P accumulated after April 4, 2016.
 - The reduction is applied to the distributions or acquisitions in the order of occurrence
 - This exception in the Proposed Regulations had only covered current E&P. Commentators had noted several concerns with this, including the following:
 - A current year E&P exception would have put a premium on, for example, paying note dividends each year (“serial note dividends”) rather than a “bullet” note dividend after several years.
 - Since current year E&P is often difficult to determine until after the end of the year, it would have been difficult to know what portion of a current year transaction would be exempted under this exception, especially if the transaction occurs early in the year.
 - Many countries do not permit distributions of profits in the year in which they are earned, which would have potentially precluded taxpayers from availing themselves of this exception with respect to controlled foreign corporations.

E&P Exception (cont'd)

- The exception only applies to E&P accumulated by a corporation while it was an EG member.
- The Final Regulations implement the exception by introducing the concept of a member's "EG earnings account."
- The aggregate amount of a Covered Member's distributions or acquisitions described in the general rule or funding rule in a taxable year during an "EG period" is reduced by the member's "EG earnings account" for the EG period
 - "EG period" is the period during which the covered member is a member of an EG with the same EG parent.
 - "EG earnings account" with respect to an EG period is the Covered Member's EG earnings during the period minus the covered member's EG reductions during the period.
 - "EG earnings" are the E&P accumulated by the Covered Member during the EG period (but after April 4, 2016) without regard to any distributions or acquisitions by the Covered Member described in the general rule or funding rule.
 - "EG reductions" are the amounts by which acquisitions or distributions described in the general rule or funding rule were reduced by reason of the EG earnings reduction during the portion of the EG period preceding the taxable year.

E&P Exception (cont'd)

- The EG earnings reduction is applied to distributions and acquisitions by a Covered Member described in the general rule and funding rule before the reduction for qualified contributions.
- Dividends from other EG members are not taken into account in calculating EG earnings of a Covered Member unless attributable to E&P accumulated in a taxable year of the distributing member ending after April 4, 2016 and during its EG period.

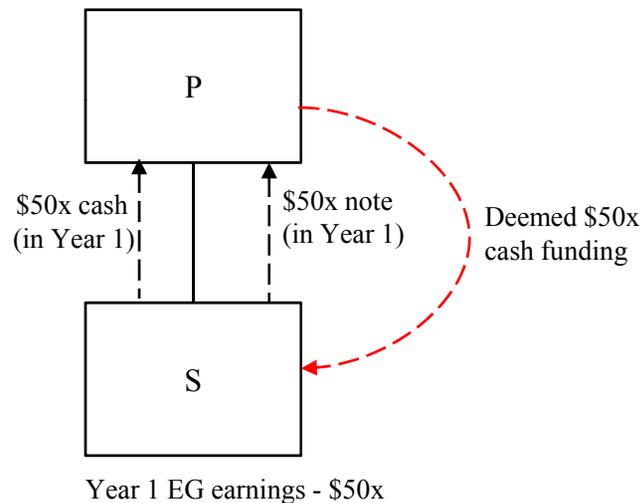
E&P Exception (cont'd)

- A consolidated group has one EG earnings account and only the E&P determined in accordance with Treas. Reg. section 1.1502-33 (with certain modifications) of the common parent of the consolidated group are considered in calculating the EG earnings for the EG period of a consolidated group.
- A consolidated group succeeds to the EG earnings account of a “joining member” (an EG member joining the consolidated group).
- If a “departing member” (an EG member that leaves the consolidated group but remains in the EG) leaves a consolidated group in a distribution under section 355, the EG earnings account of the consolidated group is allocated between the consolidated group and the departing member in proportion to the E&P of the consolidated group and the E&P of the departing member immediately after the transaction.
- No amount of the EG earnings account of a consolidated group is allocated to a departing member that leaves the consolidated group in a transaction other than a distribution to which section 355 applies.

E&P Exception (cont'd)

- Commentators to the Proposed Regulations had raised concerns regarding the sequencing rule that states that the reduction is applied to the distributions or acquisitions in the order of occurrence.
- The Final Regulations provide that, to the extent an exception applies to exclude or reduce the amount of a distribution or acquisition described in the general rule, the debt instrument issued in the transaction is treated as issued by a member in exchange for property solely for purposes of applying the funding rule to the debt instrument and the member (the “funded member rule”).
- The funded member rule reduces the impact of the sequencing rule.

Funded Member Rule – Example



Assumptions

- S makes no other distributions or acquisitions in Year 1
- S has not been funded by a debt instrument outstanding in Year 1

Facts

- 1) In Year 1, S has expanded group earnings of \$50x
- 2) In Year 1, S distributes \$50x cash and a note with a \$50x principal amount to P

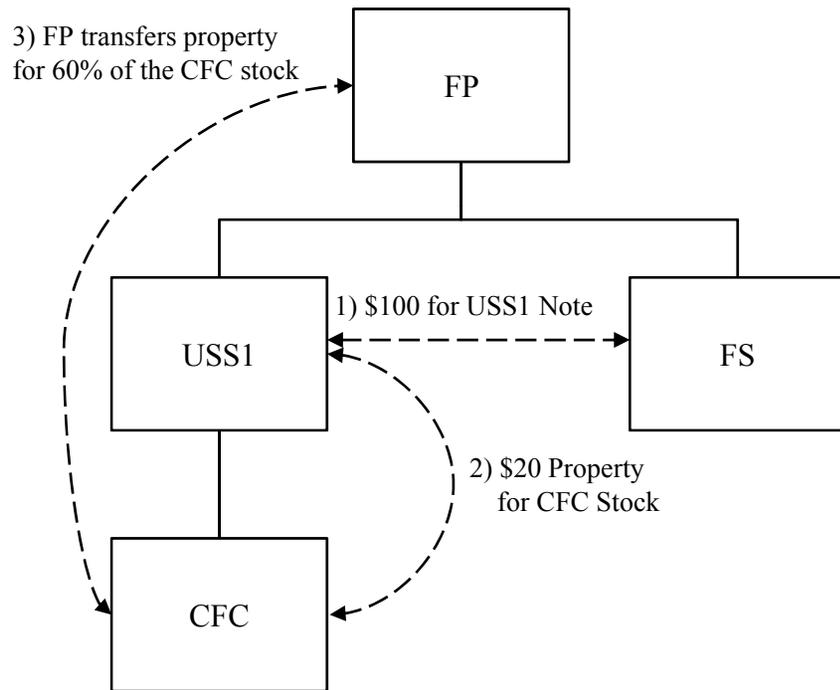
Conclusions

- Under the funded member rule, if the general rule distribution is reduced by \$50x under the expanded group earnings reduction, S is treated as having been funded by the issuance of the \$50x note.
- As a result, the ordering of the distributions does not materially affect the consequences of the transactions – either (1) the funding rule distribution occurs first, the amount of the cash distribution is reduced by \$50x, and the S note is recharacterized as stock under the general rule, or (2) the general rule distribution occurs first, the amount of the note distribution is reduced by \$50x, S is treated as having been funded by the note, and the S note is recharacterized as stock under the funding rule by reason of the cash distribution.
- In either sequence of events, the S note is recharacterized as stock, whether by reason of the general rule or the funding rule.

Proposed Regulations: Subsidiary Stock Issuance Exception

- The acquisition of EG Stock is not a Prohibited Transaction for purposes of the funding rule if the funded member is transferring property to an EG member in exchange for stock of such member (i.e., the issuer), provided that the funded member holds, directly or indirectly, more than 50% of the stock of the issuer (as measured by vote and value) during the 36-month period following the acquisition.
 - Indirect ownership is determined using the principles of section 958(a) without regard to whether an intermediate entity is foreign or domestic—i.e., a different standard than the section 304(c)(3) standard used elsewhere in the Proposed Regulations.
- If the funded member ceases to meet the 50% ownership requirement at any time during the 36-month period (the “cessation date”), the subsidiary stock issuance exception described above ceases to apply, and the acquisition of EG Stock is subject to the funding rule as of the cessation date.
 - In applying the *per se* rule, the EG Stock acquisition may be treated as having been funded by any debt instrument issued during the 72-month period that begins 36 months before the EG Stock acquisition, provided that the debt instrument (if issued prior to the cessation date) is treated as indebtedness as of the cessation date (i.e., it is not already treated as stock).

Proposed Regulations: Subsidiary Stock Issuance Exception – Example



Assumptions

- No exceptions other than the subsidiary stock issuance apply.

Facts

- 1) On Date A in Year 1, FS lends \$100 to USS1 in exchange for the USS1 Note, a debt instrument
- 2) On Date B in Year 1, USS1 transfers \$20 of property to CFC in exchange for \$20 of CFC stock
- 3) On Date C in Year 2, FP transfers property to CFC for 60% of the CFC stock

Results

- Step 1 and 2 alone - the USS1 Note is not subject to the funding rule because the subsidiary stock issuance exception applies.
 - The acquisition of CFC stock results from the transfer of property by USS1, the funded member, to CFC, an EG member and the stock issuer, and
 - USS1 directly owns more than 50% of CFC's vote and value.
- Step 3, however, results in termination of USS1's 50% or greater interest in CFC – causing the step 2 CFC stock acquisition to become a Prohibited Transaction. As of Date C in Year 2, \$20 of the \$100 USS1 Note is treated as stock under the funding rule because it was issued by USS1, the funded member, to FS, an EG member, during the 72-month period beginning 36 months before FP acquired \$20 of CFC stock (USS1 ceased to own 50% or more of the CFC stock within the 36-month period beginning on Date B, Year 1).

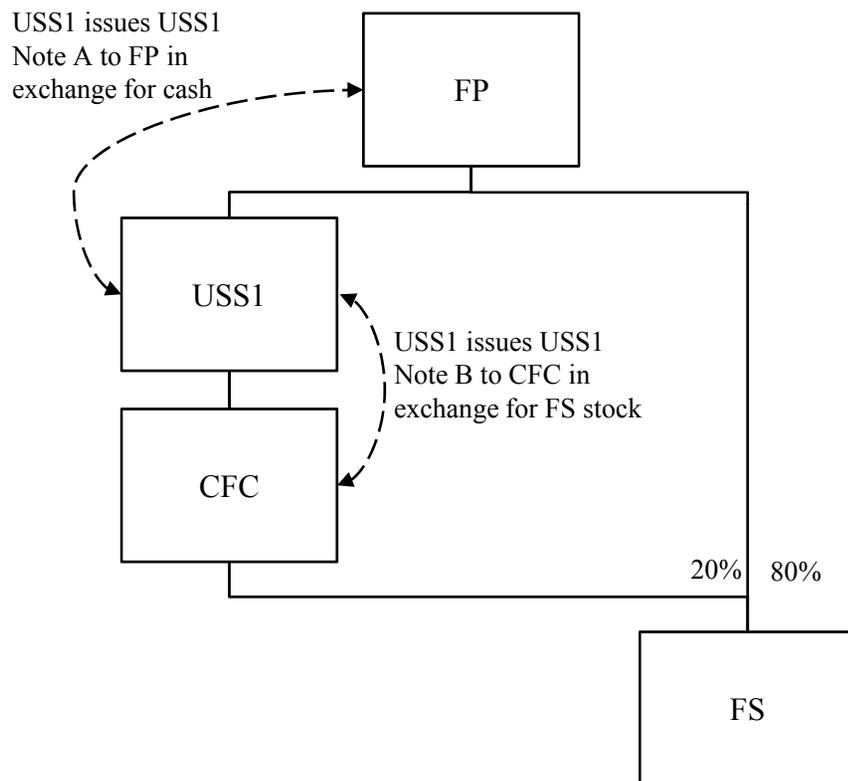
Final Regulations: Subsidiary Stock Acquisition Exception

- An acquisition of EG Stock is not treated as an acquisition of EG Stock for purposes of the general rule or the funding rule if, immediately after the acquisition, the Covered Member that acquires the stock (the acquirer) controls the EG member from which the stock is acquired (the seller), and the acquirer does not relinquish control of the seller pursuant to a plan that existed on the date of the acquisition, other than in a transaction in which the seller and acquirer cease to be members of the same EG.
 - Definition of control remains unchanged (50% by vote and value, including indirect section 958(a) ownership but not constructive ownership).
 - An acquirer and seller do not cease to be members of the same EG by reason of a complete liquidation described in section 331.
- The acquirer is presumed to have a plan to relinquish control of the seller on the date of the acquisition if the acquirer relinquishes control of the seller within a 36-month period following the date of the acquisition.
 - This presumption may be rebutted by facts and circumstances clearly establishing that the loss of control was not contemplated on the date of the acquisition and that the avoidance of the purposes of the section was not a principal purpose for the loss of control.

Subsidiary Stock Acquisition Exception— Highlight of Differences

- The exception applies for purposes of both the general rule and the funding rule.
- The exception applies to acquisitions of outstanding stock as well as stock by issuance.
- The exception applies to an acquisition of stock in an EG member that is not controlled by the acquirer.
- The strict 36-month rule is replaced with a rebuttable presumption.
- A loss of control pursuant to a cessation of the EG relationship (even if planned at the time of the acquisition) does not prevent the exception from applying.
- The exception no longer ceases to apply upon the cessation date.
 - If the acquirer loses control of the seller after the acquisition pursuant to a plan that existed at the time of the acquisition, the exception is treated as never having applied to the acquisition.
- Why was there a 50% threshold in the Proposed Regulations, and why is it retained in the Final Regulations?

Final Regulations: Subsidiary Stock Acquisition Exception—Example



Facts

- 1) FP wholly owns USS1, which wholly owns CFC. FP owns 80% of the stock of FS and CFC owns 20% of the stock of FS.
- 2) FP lends money to USS1 in exchange for a note (“USS Note A”) in Year 1.
- 3) USS1 acquires stock of FS from CFC in exchange for a note (“USS Note B”) in Year 1.
- 4) At the time of step 3, there is no plan or intent for USS1 to dispose of any of its stock of CFC.

Results

- The acquisition of FS stock by USS1 qualifies for the subsidiary stock acquisition exception because the stock is acquired from an EG member that USS1 controls and there is no plan or intent for USS1 to relinquish such control.
- The issuance of USS1 Note B in exchange for FS stock does not constitute an acquisition of EG member stock under Treas. Reg. section 1.385-3(b)(2)(ii).
- The acquisition of FS stock does not constitute a funded acquisition of EG member stock under Treas. Reg. section 1.385-3(b)(3)(i)(B).

Specified Ordinary Course Exceptions

- Ordinary Course loans with 120-day term
 - Treas. Reg. section 1.385-3T provides that a Covered Debt Instrument constitutes a “qualified short-term debt instrument” because it is an ordinary course loan if it is issued as consideration for the acquisition of property other than money, in the ordinary course of the issuer’s trade or business
 - To constitute an ordinary course loan, an obligation must be reasonably expected to be repaid within 120 days of issuance
- Short-term loans (with a 270-day term or not in excess of current assets)
 - For a Covered Debt Instrument to satisfy the 270-day test, three conditions must be met:
 - The Covered Debt Instrument must have a term of 270 days or less (or be a revolver);
 - The issuer must be a net borrower from the lender for no more than 270 days in the year; and
 - The issuer must be a net borrower under all Covered Debt Instruments issued to any lender that is a member of the issuer’s EG that otherwise would satisfy the 270-day test (other than ordinary course loans and interest-free loans) for 270 or fewer days during a taxable year
 - The specified current assets test provides an exception for short-term borrowing up to a limit determined by reference to specified current assets

Specified Exceptions (cont'd)

- Interest-free loans
 - A Covered Debt Instrument constitutes a qualified short-term debt instrument if the instrument does not provide for stated interest or no interest is charged on the instrument.
- Deposits with qualified cash pool headers
 - A Covered Debt Instrument is a qualified short-term debt instrument if it is a deposit payable by a qualified cash pool header and certain other conditions are met (e.g., it is a demand deposit received by a qualified cash pool header pursuant to a cash management arrangement and does not have a tax avoidance purpose).
 - A qualified cash pool header has as its principal purpose managing a cash-management arrangement for participating EG members, subject to certain conditions.
 - A cash-management arrangement is defined as an arrangement the principal purpose of which is to manage cash for participating expanded group members.

Qualified Contribution Exception

- Newly added to the Final Regulations, Treas. Reg. section 1.385-3(c)(3)(ii) reduces the amount of a distribution or acquisition by a Covered Member for purposes of the general rule and the funding rule by the aggregate fair market value of stock issued by the Covered Member in one or more “qualified contributions” during the “qualified period,” without duplication.
- The qualified contributions reduce distributions or acquisitions in the order of the distributions or acquisitions, regardless of whether those distributions or acquisitions would be subject to the funding rule.

Qualified Contribution Exception (cont'd)

- A “qualified contribution” to a corporation is a contribution of property other than “excluded property,” to the corporation by a member of its EG in exchange for stock.
- The “qualified period” means the period beginning on the later of the start of the following periods:
 - The period beginning 36 months before the date of the distribution or acquisition and ending 36 months thereafter; or
 - The period during which a Covered Member is a member of an EG with the same EG parent, and ending on the earliest of the last day of the following periods:
 - The period beginning 36 months before the date of the distribution or acquisition and ending 36 months thereafter;
 - The period during which a covered member is a member of an EG with the same EG parent; or
 - The first taxable year that a Covered Debt Instrument issued by the Covered Member would, absent this exception, be treated as stock under the general rule or the funding rule.

Qualified Contribution Exception—Excluded Property

- A contribution of “excluded property” cannot constitute a qualified contribution. Excluded property is:
 - EG Stock;
 - Property acquired by the Covered Member in an asset reorganization from a member of the same EG;
 - A Covered Debt Instrument of any member of the same EG;
 - Property acquired by the Covered Member in exchange for a Covered Debt Instrument issued by the Covered Member that is recharacterized under the funding rule;
 - A debt instrument issued by a Controlled Partnership of the Covered Member’s EG; or
 - Any other property acquired by the Covered Member with a principal purpose to avoid the purposes of Treas. Reg. sections 1.385-3 or -3T, including an indirect transfer of excluded property.
 - Does this last item significantly limit the scope of the qualified contribution exception? Is any cash contributed to a subsidiary to avoid recharacterization treated as excluded property?

Qualified Contribution Exception—Operating Rules

- In addition to contributions of excluded property, certain other contributions are not treated as qualified contributions:
 - A contribution from a corporation that the covered member controls (contribution by subsidiary to parent).
 - A contribution from a predecessor or successor or any corporation controlled by that predecessor or successor.
 - A contribution that does not increase the fair market value of the stock of the contributee.
- Special rules apply to distributions or acquisitions that constitute asset reorganizations:
 - If a Covered Member acquires the assets of another covered member in a section 381(a) transaction, and both parties are members of the same EG, the acquiring member succeeds to the qualified contributions of the acquired member.
 - If a Covered Member transfers property to another Covered Member in a Treas. Reg. section 1.312-10(a) transaction (D/355), the transferor's qualified contributions are allocated in the same proportion as E&P.
 - If a Covered Member distributes stock of another Covered Member in a Treas. Reg. section 1.312-10(b) transaction (355 not qualifying as a D), the Covered Member's qualified contributions are decreased as if it had allocated those contributions in a D/355.
 - Other than these rules, qualified contributions do not carry over to predecessors or successors.

Threshold Exception

- Under the threshold exception:
 - A Covered Debt Instrument is not treated as stock if, immediately after it would be recharacterized as stock, the aggregate adjusted issue price of Covered Debt Instruments held by members of the issuer’s EG that would be treated as stock but for the threshold exception does not exceed \$50 million.
 - To the extent that the aggregate issue price exceeds \$50 million, only the amount of the Covered Debt Instrument in excess of \$50 million is treated as stock.
 - The removal of this “cliff effect” came about as a result of comments on the Proposed Regulations.
 - There appear to be no operating rules explaining the potentially complex effects of removing the “cliff effect.” Can taxpayers choose which debts are subject to the \$50 million exemption? What happens if a taxpayer has two \$50M debt instruments, one subject to the threshold exception and one recharacterized as stock, and the excepted instrument is repaid? Does the exception jump to the other instrument and convert it back into indebtedness?

Qualified Dealer Debt Instrument

- A qualified dealer debt instrument is a debt instrument:
 - Issued to or acquired by an EG member that is a dealer in securities (within the meaning of section 475(c)(1)) in the ordinary course of business of dealing in securities;
 - Accounted for by the dealer as a security held primarily for sale to customers in the ordinary course of business;
 - Disposed of by the dealer within a period of time consistent with the holding of debt instruments for sale to customers in the ordinary course of business, taking into account the terms of the debt and the conditions and practices prevailing in the markets for similar instruments; and
 - That is not sold or otherwise transferred to another member of the dealer's EG unless that sale or transfer is to another dealer satisfying the foregoing requirements.
- *See* Treas. Reg. section 1.385-3(c)(2)(iv) for a complementary exception for acquisitions of EG Stock by dealers, discussed above.

Excluded Statutory or Regulatory Debt Instrument

- An excluded statutory or regulatory debt instrument is any debt instrument that is described in any of the following:
 - Production payments treated as a loan under section 636(a) or (b);
 - A “regular interest” in a REMIC described in section 860G(a)(1);
 - A debt instrument deemed to arise under Treas. Reg. section 1.482-1(g)(3) (including adjustments under Rev. Proc. 99-32), *see also* Treas. Reg. section 1.385-3(c)(2)(iii);
 - A stripped bond or coupon described in section 1286, unless it was issued with a principal purpose of avoiding the purposes of Treas. Reg. section 1.385-3 or -3T; or
 - A lease treated as a loan under section 467.

Regulated Financial Company

- Examples of a regulated financial company include the following (see Treas. Reg. section 1.385-3(g)(3)(iv)(A) for a full list):
 - A bank holding company (as defined in 12 USC 1841);
 - A covered savings and loan holding company (as defined in 12 C.F.R. 217.2);
 - A national bank;
 - An insured depository institution (as defined in 12 USC 1813(c)(2));
 - A broker or dealer registered with the SEC under 15 USC 78o(b);
 - A swap dealer (as defined in 7 USC 1a(49)); and
 - A small business investment company (as defined in 15 USC 662(3)).

Regulated Insurance Company

- A regulated insurance company is a Covered Member that is:
 - Subject to tax under subchapter L of chapter 1 of the Code;
 - Domiciled or organized under the laws of a U.S. state;
 - Licensed, authorized, or regulated by one or more states to sell insurance, reinsurance, or annuity contracts to persons other than related persons (within the meaning of section 954(d)(3)) in such states, but not if a principal purpose for obtaining such license, authorization, or regulation was to qualify the issuer as a regulated insurance company; and
 - Engaged in regular issuances of (or subject to ongoing liability with respect to) insurance, reinsurance, or annuity contracts with persons that are not treated as related persons.

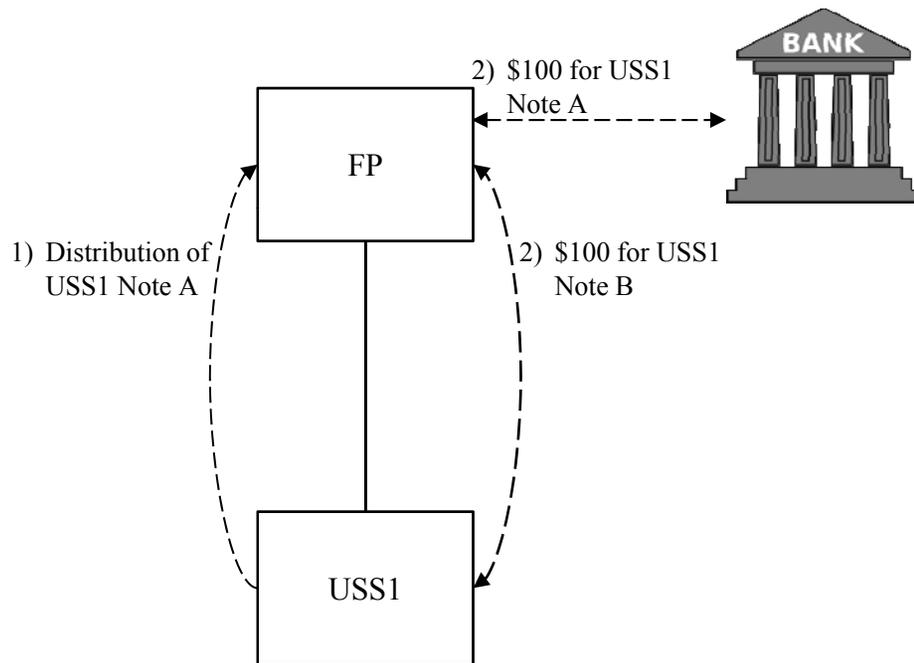
Anti-Abuse Rule: Treas. Reg. Section 1.385-3(b)(4)

- If an EG member enters into a transaction with a principal purpose of avoiding the purposes of Treas. Reg. section 1.385-3 or -3T, any interest issued or held by that member or another EG member may be treated as stock.
 - A non-exhaustive list of interests that could be subject to such recharacterization includes:
 - An interest that is not a Covered Debt Instrument, including a section 483 contract (what does it mean for a contractual earnout to be treated as stock?);
 - A Covered Debt Instrument issued to a person that is not a member of the issuer's EG, if the Covered Debt Instrument is later acquired by a member of the issuer's EG or such person later becomes a member of the issuer's EG;
 - A Covered Debt Instrument issued to an entity that is not taxable as a corporation for U.S. federal tax purposes;
 - A Covered Debt Instrument issued in connection with a reorganization or similar transaction; or
 - A Covered Debt Instrument issued as part of a plan or series of transactions to expand the applicability of the transition rules.
-

Anti-Abuse Rule: Treas. Reg. Section 1.385-3(b)(4) (cont'd)

- In addition to the foregoing, a Covered Debt Instrument is treated as stock if the funded member or any member of its EG engages in a transaction with a principal purpose of avoiding the purposes of Treas. Reg. section 1.385-3 or -3T.
- Examples include:
 - A member of the issuer's EG is substituted as a new obligor or added as a co-obligor on an existing debt instrument;
 - A Covered Debt Instrument is transferred in connection with a reorganization or similar transaction;
 - A Covered Debt Instrument funds a distribution or acquisition where the distribution or acquisition is made by a member other than the funded member and the funded member acquires the assets of the other member in a transaction that does not make the other member a predecessor; or
 - Members of a consolidated group engage in transactions as part of a plan or a series of transactions through the use of the consolidated group rules set forth in Treas. Reg. section 1.385-4T, including through the use of the departing member rules.
- The Proposed Regulations contained an anti-abuse rule that applied to a principal purpose of avoiding the “application” of the regulations; the Final Regulations use “purpose” instead. What is the substantive difference, and what is the “purpose” of these regulations?

Anti-Abuse Rule Example



Facts

- 1) In Year 1, USS1 distributes a \$100 note to FP (“USS1 Note A”).
- 2) In Year 1, with a principal purpose of avoiding the purposes of Treas. Reg. section 1.385-3, FP sells USS1 Note A to a bank for \$100 and lends \$100 to USS1 in exchange for another USS1 note (“USS 1 Note B”).

Analysis

- USS1 Note A is recharacterized as stock from issuance under the general rule. When USS1 Note A is sold to the bank, it is deemed exchanged for debt.
- USS1 Note B would not be treated as stock under the funding rule because there has not been a Prohibited Transaction.
- Because the transactions occurring in step 2 had a principal purpose of avoiding the purposes of Treas. Reg. section 1.385-3, USS1 Note B is treated as stock. *See* Treas. Reg. section 1.385-3(h)(3) Ex. 11.

Assumption: No exceptions to the general or funding rule are applicable

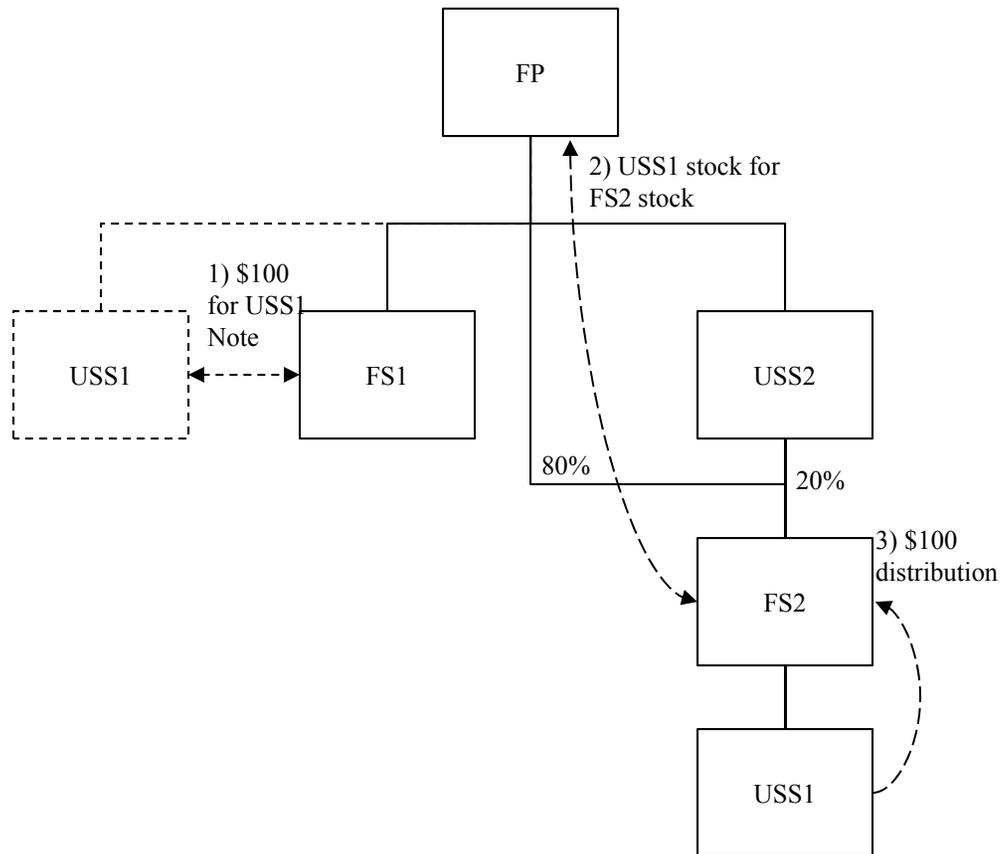
The “No Affirmative Use Rule”

- The Proposed Regulations contained a “No Affirmative Use” rule providing that they did not apply to the extent a person entered into a transaction that otherwise would be subject to the transaction rules with a principal purpose of reducing the federal tax liability of any member of the EG that included the issuer and holder of the debt instrument.
- The Final Regulations reserve on a No Affirmative Use rule. What does this mean for taxpayers?

Operating Rules—Timing

- In general, when a Covered Debt Instrument is recharacterized as stock, it is treated as stock from the date of issuance.
 - However, if a Covered Debt Instrument is treated as funding a Prohibited Transaction occurring after the instrument is issued, the Covered Debt Instrument is deemed to be exchanged for stock on the date of the Prohibited Transaction.
 - If a Covered Debt Instrument is treated as stock due to the predecessor/successor rules, it is deemed exchanged for stock on the latest of (i) the date of issuance; (ii) the date of the Prohibited Transaction; or (iii) the completion of the transaction creating the predecessor or successor.
 - Where a Covered Debt Instrument is treated as stock due to a retesting, it is deemed exchanged for stock on the latest of (i) the date of issuance; (ii) the date of the Prohibited Transaction; or (iii) the date of retesting.
 - The Proposed Regulations contained certain situations in which a debt instrument would be recharacterized from the date of issuance as a result of a later Prohibited Transaction, resulting in unintended consequences.
-

Timing Example



Facts

- 1) On January 1, Year 1, FS1 lends \$100 to USS1 for a USS1 note (“USS1 Note”).
- 2) On July 1, Year 1, FP transfers all of the USS1 stock to FS2 in exchange for FS2 stock.
- 3) On December 1, Year 1, USS1 distributes \$100 to FS2.

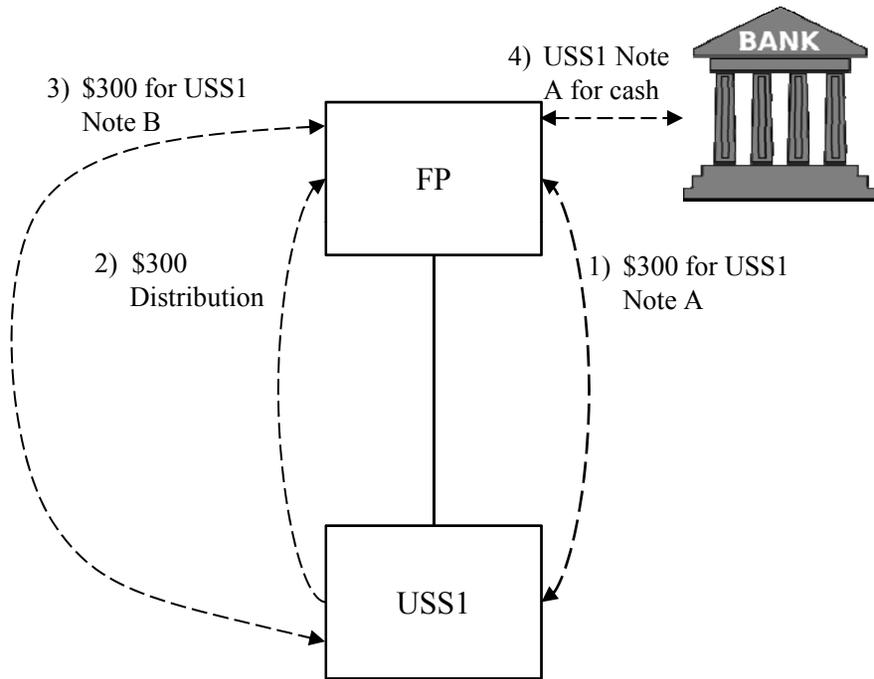
Analysis

- USS1 Note is recharacterized as stock under the funding rule.
- Under the Proposed Regulations, USS1 Note would be recharacterized as stock *as of issuance* because the Prohibited Transaction (the distribution of \$100) occurred in the same taxable year as the issuance of the note. This would prevent step 2 from qualifying as a section 368(a)(1)(B) reorganization.
- Under the Final Regulations, USS1 Note is not recharacterized until the date of the Prohibited Transaction. **Could the recharacterization still cause step 2 to fail reorganization treatment under step transaction principles?**

Operating Rules—Retesting

- When an instrument is recharacterized as stock, and the holder and issuer subsequently cease to be members of the same EG (including if the instrument is transferred outside the EG), the instrument ceases to be treated as stock.
- Immediately before the transaction causing the holder and issuer to cease to be members of the same EG, the issuer is deemed to issue a new Covered Debt Instrument to the holder in exchange for the deemed stock.
- At the same time, all other Covered Debt Instruments are retested under the funding rule.
- **What happens if the issuer is the target of an outbound reorganization? Does that have the same effect as leaving the EG?**

Retesting Example



Assumption: No exceptions to the general or funding rule are applicable

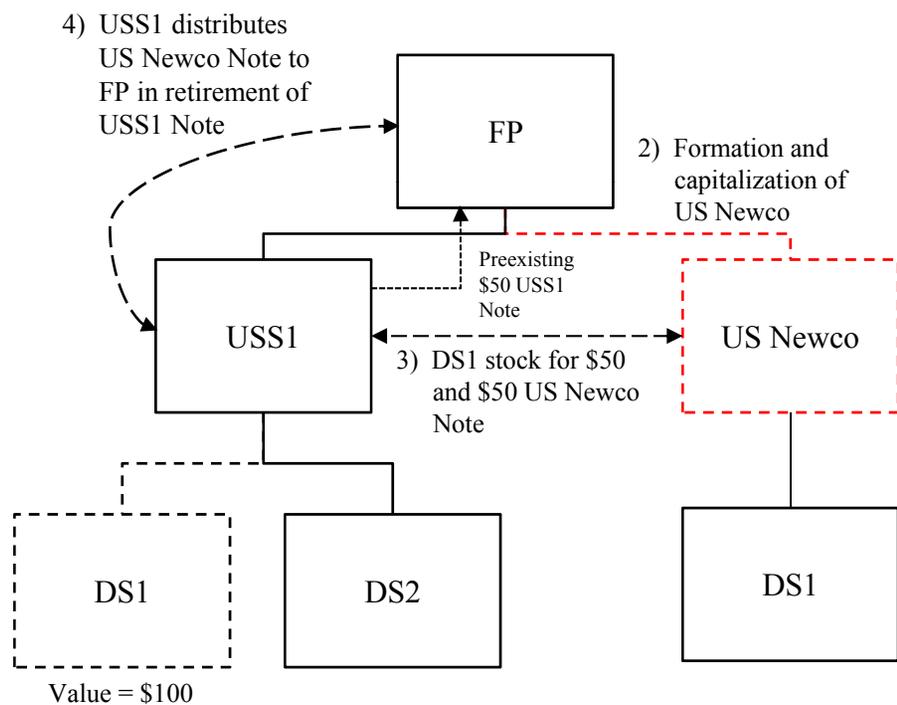
Facts

- 1) In Year 1, FP lends \$300 to USS1 for a USS1 note (“USS1 Note A”).
- 2) In Year 2, USS1 distributes \$300 cash to FP.
- 3) In Year 3, FP lends another \$300 to USS1 for another USS 1 note (“USS1 Note B”).
- 4) In Year 4, FP sells USS 1 Note 1 to a bank for cash.

Analysis

- Under the ordering and non-duplication rules, the distribution in Year 2 causes USS1 Note A to be treated as stock prior to the sale to the bank in Year 4.
- When USS1 Note A is sold to the bank in Year 4, USS1 Note B is re-tested and treated as stock because it is now funded by the Year 2 distribution. **What would be the result if USS1 Note B was sold in Year 6?**

Additional Example— Pre-Sale Restructuring



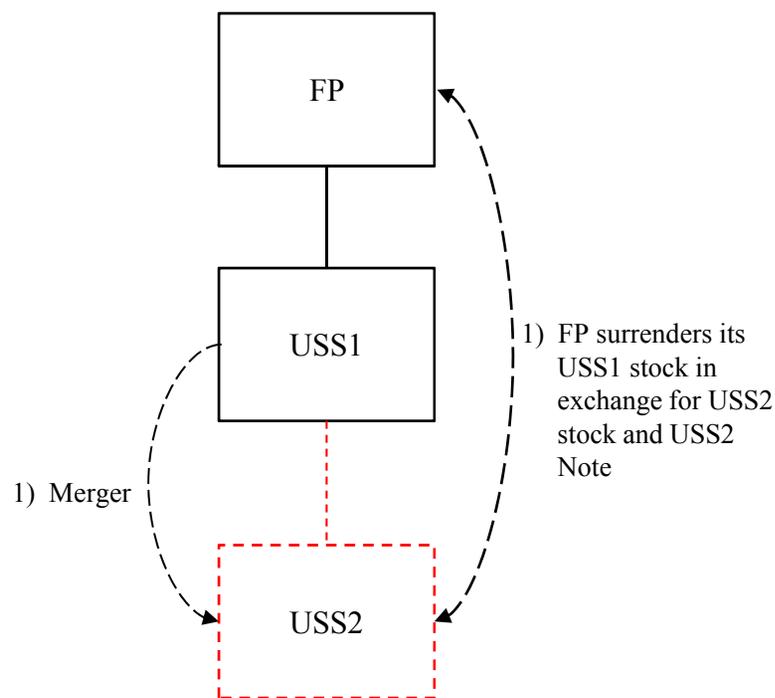
Facts

- 1) An unrelated third party wishes to acquire the stock of USS1, but it does not wish to acquire DS1. USS1 owes a preexisting \$50 USS1 Note to FP. To extricate DS1 from USS1, FP engages in the following transactions:
- 2) FP forms US Newco and capitalizes it with cash.
- 3) US Newco acquires all of the stock of DS1 from USS1 in exchange for \$50 cash and a \$50 US Newco Note.
- 4) USS1 retires the preexisting USS1 Note with US Newco Note.
- 5) FP sells USS1 to the unrelated party.

Analysis

- Under the general rule, the US Newco Note is treated as stock because it is issued in exchange for EG Stock.
- The subsidiary stock acquisition exception (discussed below) does not apply because US Newco does not have control USS1 after step 2, using section 958(a) attribution.
- Why is USS Newco Note treated as stock even though it does nothing more than preserve the status quo and is not “new” debt in an economic sense?
- Why does the result differ if US Newco acquires all of the DS1 assets (e.g., DS1 is a DRE) from USS1 instead of DS1 stock?

Additional Example— F Reorganization



Facts

- 1) USS1 forms USS2, then USS1 merges with and into USS2. In the merger, FP surrenders its USS1 stock for USS2 stock and a USS2 Note (“USS2 Note”) in a transaction qualifying as a section 368(a)(1)(F) reorganization.

Analysis

- Under Treas. Reg. section 1.368-2(m)(3)(iii), a transaction may be treated as an F reorganization even though a holder of stock in the transferor receives “money or other property” from the transferor or the resulting corporation. Such distribution is treated as an unrelated transaction.
- A commentator asked whether Treas. Reg. section 1.368-3(m)(3)(iii) created a circularity—if the issuance of the USS2 Note is treated as a separate distribution under Treas. Reg. section 1.368-2(m)(3)(iii), such note would be recharacterized as USS2 stock under the general rule, and would then arguably be treated as part of the reorganization, thereby turning off Treas. Reg. section 1.368-2(m)(3)(iii), which would in turn prevent the general rule from applying.
- The preamble to the Final Regulations provides that the issuance of USS2 Note is subject to Treas. Reg. section 1.368-2(m)(3)(iii), such that USS2 Note is treated as stock under the general rule. Such treatment does not then retroactively prevent Treas. Reg. section 1.368-2(m)(3)(iii) from applying. *See* Preamble at 317-18.
- Is this result intended to be provided for by the principles of Treas. Reg. section 1.385-3(b)(3)(vi)? That provision only applies to the funding rule, not the general rule.

Proposed Regulations—Effective Date and Transition Rules

- Proposed Effective Date: The Proposed Regulations were to be effective on the date they were published.
- Grandfather Provisions:
 - Under the Proposed Regulations, the transaction rules would have applied to any debt instrument issued on or after April 4, 2016, and to any debt instrument treated as issued before April 4, 2016, as a result of a check-the-box election that was filed on or after April 4, 2016.
 - An otherwise Prohibited Transaction (for example, a distribution by a funded member) would not have been taken into account for purposes of the *per se* rule if the Prohibited Transaction occurred before April 4, 2016 (but not if it was treated as occurring before April 4, 2016 as a result of a check-the-box election that was filed on or after April 4, 2016).
- Transition Rule: If the transaction rules would have treated a debt instrument as stock prior to the finalization date, the debt instrument would have been treated as debt for 90 days after the finalization date; if the debt instrument was held by an EG member on the 90th day after the finalization date, the debt instrument would have been deemed exchanged for stock on such date.

Final Regulations— Effective Date and Transition Rules

- General Effective Date: The Final Regulations generally are effective on the date they are published (the “Publication Date”) for taxable years that end on or after the date that is 90 days after they are published (the “Transition Date”).
- Grandfather Provisions:
 - The transaction rules only apply to a debt instrument issued on or after April 5, 2016, even if the instrument is deemed issued before April 5, 2016 by reason of an entity classification election filed after April 4, 2016.
 - An otherwise Prohibited Transaction (for example, a distribution by a funded member) will not be taken into account for purposes of the *per se* rule if the Prohibited Transaction occurred before April 5, 2016, even if it is deemed to occur issued before April 5, 2016, by reason of an entity classification election filed after April 4, 2016.
- Transition Rule: If the transaction rules would have treated a Covered Debt Instrument as stock prior to the Transition Date (including in taxable years ending before the Transition Date), the Covered Debt Instrument is treated as debt through the Transition Date; if the instrument is held by an EG member immediately after the Transition Date, the instrument will be deemed exchanged for stock on such date.
- Similar rules are provided for the partnership-related provisions in Treas. Reg. section 1.385-3T.

Effective Date and Transition Rules (cont'd)

- Transition Funding Rule:

- If a Covered Debt Instrument would be recharacterized as stock between April 5, 2016, and the Transition Date but is not recharacterized by reason of the effective date and transition rules, all payments made with respect to such instrument (other than stated interest) after the instrument would have been recharacterized as stock are treated as distributions for purposes of applying the funding rule.
- This applies to all principal payments, including refinancings.
- This applies even if the issuer and holder cease to be members of the same EG during the transition period (subject to the straddle rules).
 - **Question: What if the issuer and holder cease to be members of the same EG after April 4, 2016, but before the Publication Date?**
- If a Covered Debt Instrument would be recharacterized as stock between April 5, 2016, and the Transition Date but is not recharacterized by reason of the effective date and transition rules, the issuance of the instrument may be treated as a distribution or acquisition for purposes of the funding rule unless the issuer and holder are members of the same EG immediately after the Transition Date. This supersedes the general non-duplication rule.

Effective Date and Transition Rules—Example

Facts

- FP wholly owns USS1, and both corporations use a calendar year.
- On June 1, 2016, USS1 distributes a \$100x note to FP (“Note 1”).
- On January 1, 2017, USS1 distributes a \$200x note to FP (“Note 2”).
- On January 2, 2017, USS1 repays Note 1 in full.
- FP and USS1 remain EG members past the Transition Date.

Discussion

- The Final Regulations generally are not applicable to USS1 and FP until 2017.
- Treas. Reg. section 1.385-3 does not apply to Note 1 because it is issued in a previous taxable year.
- Treas. Reg. section 1.385-3 applies to Note 2 because it is issued in 2017, but Note 2 is not recharacterized as stock until immediately after the Transition Date.
- The repayment of Note 1 is a distribution for purposes of the funding rule because Note 1 is a Covered Debt Instrument that would have been recharacterized as stock in the absence of the effective date and transition rule provisions of the Final Regulations.
- The issuance of Note 1 will not be treated as a distribution or acquisition for purposes of the funding rule.

Potential Future Guidance

- The Final Regulations reserved and further comments were requested on:
 - The no affirmative use rule;
 - The application of these rules to foreign issuers;
 - The application of these rules to U.S. branches of foreign issuers in the absence of more comprehensive guidance with respect to foreign issuers; and
 - How the exceptions of Treas. Reg. section 1.385-3 would apply to brother-sister groups with non-corporate parents.
- If future guidance is released addressing these issues, it will not apply to interests issued before the date of such guidance.

Temporary Regulations

- Some of the significant new provisions are included in temporary, rather than final, regulations, including:
 - The ordinary course, 270 day and related exceptions;
 - Rules relating to cash pools;
 - Rules relating to DREs and Controlled Partnerships; and
 - Rules relating to consolidated groups.
 - Questions:
 - Why were these provisions separately promulgated as temporary regulations?
 - What are the consequences to taxpayers if these temporary regulations expire before they are finalized?
 - Does the Government anticipate significant changes to the temporary regulations when they are issued in final form?
-