The Proposed Section 385 Regulations: An In-Depth Look

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Agenda

- Section 385 and Overview of Proposed Regulations
- The Bifurcation Rules: Prop. Reg. Section 1.385-1
- The Documentation Rules: Prop. Reg. Section 1.385-2
- The Transaction Rules: Prop. Reg. Section 1.385-3
- The Consolidated Group Rules: Prop. Reg. Section 1.385-4
- Deemed Exchanges of Debt for Equity and Vice Versa
- Special Rules Applicable to Partnerships and Disregarded Entities ("DREs")

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 U.S. tax purposes, 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
  - 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 ("Proposed Regulations") include 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
  - Providing treatment for when related-party debt comes into or leaves a U.S. consolidated group
- Proposed Regulations apply without regard to whether (i) the parties are domestic or foreign, or (ii) the corporate group effected an inversion
- Members of a U.S. consolidated group are treated as a single entity, so the regulations do not apply to debt between consolidated group members
- Generally applicable to debt instruments issued on or after April 4, 2016

Proposed Regulations: Overview (cont’d)

- The **documentation requirements** and **bifurcation provisions** are generally effective for Applicable Instruments issued or deemed issued after the regulations are published as final
- The **re-characterization provisions** (including those addressing the treatment of U.S. consolidated groups) are generally effective for EG “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, include limited transition rules that provide that a Debt Instrument issued on or after April 4, 2016 that would be re-characterized as stock under the regulations is treated as debt until 90 days after the regulations are finalized; on the 90th day any outstanding instruments are deemed exchanged for stock
- Note that instruments issued on or after April 4, 2016 include:
  - Instruments issued before April 4, 2016 but that are subject to amendment on or after that date resulting in a deemed exchange of the instrument under section 1001
  - 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

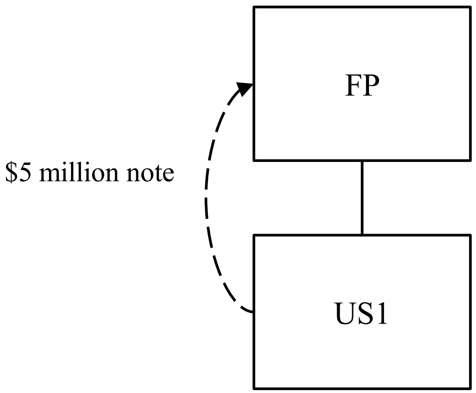
The Bifurcation Rules:
Prop. Reg. Section 1.385-1(d)

Prop. 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
  - Query: Can the issuer treat an instrument as being part debt and part stock if it determines "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"?

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

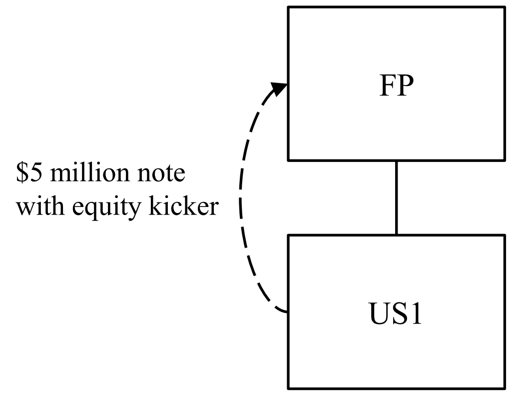
Example A



Facts: FP holds a $5 million note from US1. The IRS determines that, as of the issuance of the note, US1 cannot reasonably be expected to repay more than $3 million of the principal amount

Result: May the IRS treat the instrument as a $3 million debt instrument and $2 million of US1 stock? *See* Preamble, Section II.C; Prop. Reg. § 1.385-1(d)(1)

Example B



Facts: FP holds a $5 million note from US1 with an "equity kicker." *Cf. Farley Realty, Corp. v. Comm'r,* 279 F. 2d 701 (C.A. 2, 1960)

Result: May the IRS treat the "equity kicker" as stock and the rest of the instrument as debt?

- Query: What other circumstances might be treated by the IRS as justifying bifurcation? Convertible debt?

Prop. Reg. Section 1.385-1: Relevant Definitions

- In order for an interest potentially to be subject to bifurcation it must be an expanded group instrument ("EGI") that is an applicable instrument ("AI") an issuer of which is one member of a modified expanded group ("MEG") and the holder of which is another member of the same MEG
  - **AI:** any interest issued or deemed issued that is in form a debt instrument
  - **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
  - **EGI:** an AI an issuer of which is one member of an "expanded group" ("EG") and the holder of which is another member of the same EG
  - **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"
    - 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
  - **MEG:** an EG determined by substituting "50" for "80" in sections 1504(a)(2)(A) and (B) and including partnerships in which 50% or more of the capital or profits interests are owned, directly or indirectly, by one or more members of the MEG

Expanded Group – Example 1

Facts

- PE Fund owns 100% of USS 1 and USS 2.

Proposed Regulatory Language

- Prop. Reg. section 1.385-1(b)(3)(i)(B) substitutes "directly or indirectly" for "directly" in section 1504(a)(1)(B)(i), but not section 1504(a)(1)(B)(ii). Therefore, for purposes of these proposed regulations, section 1504(a)(1) is modified to read as follows:

  (1) In general — The term "affiliated group" means—

  (A) 1 or more chains of includible corporations connected through stock ownership with a common parent corporation which is an includible corporation, but only if—

  (B) (i) the common parent owns directly *or indirectly* stock meeting the [vote *or* value requirements] in at least 1 of the other includible corporations, and

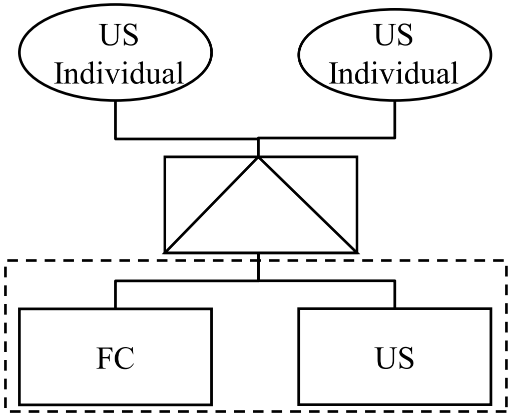
  (ii) stock meeting the [vote *or* value requirements] in each of the includible corporations (except the common parent) is owned directly by 1 or more of the other includible corporations.

Analysis

- As modified by the proposed regulations, USS 1 and USS 2 would not be members of the same EG, because, although USS 1 and USS 2 each indirectly own 100% of the stock of the other corporation (satisfying section 1504(a)(1)(B)(i)), no stock of either corporation is directly owned by 1 or more includible corporations (as required by section 1504(a)(1)(B)(ii)).
- Similar results apply if the common owner is an individual rather than a PE Fund.

Prop. Reg. Section 1.385-1: Controlled Partnership

- Controlled Partnership:
  - Before determining whether a partnership is a Controlled Partnership, the members of the Expanded Group must first be determined
  - The principles of attribution under section 304(c)(3) are applied to determine indirect ownership of a partnership interest
  - **Expanded Group Partner:** a member of an Expanded Group that holds an interest in a Controlled Partnership
- FC and US appear intended to be members of an Expanded Group, but is the partnership itself a member of the same Expanded Group?



Prop. Reg. Section 1.385-1: Bifurcation Summary

- In plainer English, bifurcation can potentially apply under the Proposed Regulations to interests that are in form debt instruments where the issuer and the holder are both members of a "50% control group", with the 50% being determined by vote or value and applying fairly broad constructive ownership rules
  - Note: Due to the way the partnership attribution rules of section 318 work, entities owned by partners with even a very small interest in a partnership and entities owned by the partnership can be treated as members of the same EG (and MEG)
- **Effective Date:** The bifurcation rule is applicable to interests otherwise meeting the requirements of the bifurcation rules:
  - Issued or deemed issued on or after the Finalization Date, or
  - Treated as debt issued or deemed issued before the Finalization Date if and to the extent the instrument was deemed issued as a result of a check-the-box election filed on or after the Finalization Date
- Note: The bifurcation rules only apply to AIs, and to be an AI an interest must be an in-form debt instrument. Accordingly, the bifurcation rules apparently do not apply to sale-repurchase agreements ("repos"), leases treated as debt, preferred equity certificates, or other instruments that are not in-form debt

Bifurcation Rules: Additonal Open Questions

- Question: If a taxpayer challenges the IRS's application of the bifurcation rule in court, will judicial review be limited to whether it was appropriate to apply the bifurcation rule at all, or will the court be able to impose a different bifurcation ratio than the IRS?
- Questions: If an AI that is treated as equity in part under the bifurcation rule ceases to be between members of the same MEG (for example, if the issuer or holder is sold to an unrelated party), does the instrument continue to be treated as part debt and part stock?
- Question: What are the consequences if an AI that is bifurcated is issued by a Controlled Partnership or a DRE? Is the equity portion considered equity in the issuing partnership or DRE or its owner(s)?
- Question: If the Bifurcation Rule applies, should taxpayers be able to designate the portion of an instrument that is stock or debt for purposes of characterizing later repayment or retirement of a portion of the instrument?
- Question: How does the Bifurcation Rule interact with the authorities governing whether or not to treat a given instrument as two separate instruments? See, e.g., *Chock Full O' Nuts Corp. v. United States*, 453 F.2d 300 (2d Cir. 1971); Rev. Rul. 88-31, 1988-1 C.B. 302.

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

In General

- Prop. 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 whether an EGI is appropriately treated as debt or stock for federal tax purposes
- Failure to satisfy the documentation requirements means an EGI is stock (*but see* No Affirmative Use rule below)
  - 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 is analyzed under U.S. tax principles to determine whether it is treated as debt or stock for federal tax purposes; for example, the EGI may be recharacterized as stock (i) under case law, or (ii) under the bifurcation or transaction rules of the Proposed Regulations

Documentation Required

- The documentation required under Prop. Reg. section 1.385-2(b)(2) included 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
  - 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 Prop. Reg. section 1.385-2(b)(3)
- Special rules apply for (i) revolving credit agreements and similar agreements and (ii) cash pooling arrangements
- 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

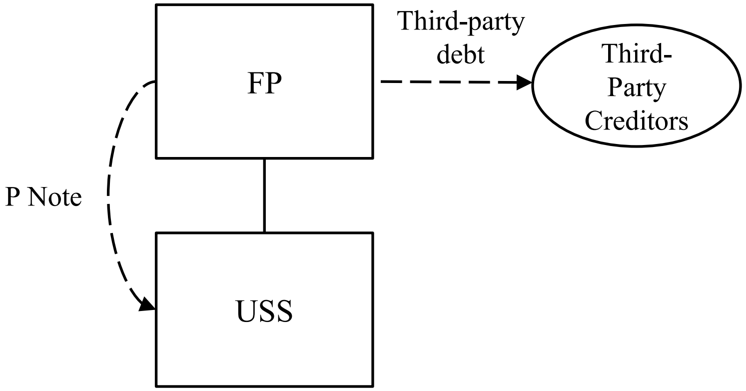
Threshold Requirements and Other Provisions

- 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 Prop. Reg. section 1.385-2(a)(4)(iv)), or
  - On the date the AI first becomes an EGI, the EG's total annual revenue exceeds $50 million on any Applicable Financial Statement
- 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

Threshold Requirements and Other Provisions (cont'd)

- Unlike the bifurcation rules, which can apply to interests between members of a MEG (50% relationship threshold), the documentation rules only apply to interests between members of an EG (80% relationship threshold); *but see* anti-avoidance rule below
- <u>No Affirmative Use</u>: Prop. Reg. section 1.385-2 does 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
- <u>Anti-Avoidance</u>: If an AI that is not an EGI is issued with a principal purpose of avoiding Prop. Reg. section 1.385-2, the instrument will be treated as an EGI subject to Prop. Reg. section 1.385-2

Financially Troubled Issuers



Facts

1) USS loans money to FP in exchange for a note (the "FP Note").

2) FP has third-party creditors.

3) FP enters financial difficulties and becomes unable to pay all of its debts.

Discussion

- If USS does not demand payment as the third-party creditors are paid, will such a failure cause the FP Note to be treated as equity in FP?
- What if the repayment of USS would be in violation of fraudulent conveyance laws, subordination agreements or similar?
- If the FP Note is modified as part of a workout with the third-party creditors, is the deterioration of FP's financial condition in the period prior to the modification ignored? *See* Treas. Reg. § 1.1001-3(f)(7)(ii)(A). Not ignoring such deterioration could penalize transactions in which related-party debt is modified as part of a workout of the EG's third-party debt.

Treatment of Cash Pools

- The regulations provide that an EGI issued pursuant to a cash pooling arrangement or similar arrangement only satisfies the documentation requirements if the material documentation governing the arrangement is prepared, maintained, and provided in accordance with the rules of Prop. Reg. section 1.385-2
- The preamble to the regulations further requests comments on "whether special rules are warranted for cash pools, cash sweeps, and similar arrangements for managing cash of an expanded group"
- For purposes of Prop. Reg. section 1.385-2, can documentation be established at the outset of the pooling arrangement that establishes the key terms of the pooling arrangement, rather than requiring new documentation for each particular transaction?
- Will the IRS and Treasury consider an ordinary course exception for debt issued or held by a company that is in the trade or business of being a treasury center for a related group of companies?
- See slide 55 for an illustration for potential issues related to recharacterizing the debt instruments of cash pools.

Treatment of Revolvers

- The regulations provide that an EGI issued pursuant to a revolving credit facility or similar arrangement only satisfies the documentation requirements if the material documentation governing the arrangement is prepared, maintained, and provided in accordance with the rules of Prop. Reg. section 1.385-2

- The proposed regulations are unclear as to the date that a draw on a revolver is considered issued
  - Are all of the draws considered issued on the date the revolver is entered into?
  - Is each draw on the revolver considered the issuance of a separate EGI?

Further Considerations

- Who is required to prepare and maintain this documentation? The debtor? The creditor?
- Unlike in Prop. Reg. section 1.385-3, described below, there is no exception for debt instruments that arise in the ordinary course of the issuer's trade or business. Will Treasury and the IRS consider an exception to the Documentation Rule for ordinary course indebtedness such as related party trade payables?
- Similarly, there is no exception for short-term loans. Will Treasury and the IRS consider an exception for short term loans, with an anti-avoidance rule preventing these loans from being rolled over indefinitely?
- Are instruments that are treated as debt pursuant to specific provisions of the Code or regulations (*e.g.*, REMIC regular interests and safe harbor debt of S corps) subject to Prop. Reg. section 1.385-2?
- Are debt-like instruments that are created pursuant to affirmative tax rules (*e.g.*, deemed accounts receivable under Treas. Reg. section 1.367(d)-1T(g)(1) and Rev. Proc. 99-32) subject to Prop. Reg. section 1.385-2?

Effective Date

- Prop. Reg. section 1.385-2 applies to any AI:
  - Issued or deemed issued on or after the Finalization Date, or
  - Treated as debt issued or deemed issued before the Finalization Date if and to the extent the instrument was deemed issued as a result of a check-the-box election filed on or after the Finalization Date
- Note that:
  - The documentation rules, like the bifurcation rules, apply only to interests that are in-form debt instruments
    - The Proposed Regulations reserve with respect to documentation of interests that are not in form debt; the government is requesting comments regarding whether other instruments should be subject to documentation requirements, and, if so what those requirements should be

Treatment of Partnership and DREs

- For purposes of Prop. Reg. section 1.385-2, a Controlled Partnership is itself treated as a member of the Expanded Group
  - Contrast with Prop. Reg. section 1.385-3
  - Would a Controlled Partnership wholly owned by a Consolidated Group be treated as an Expanded Group member subject to these documentation requirements?
- For purposes of Prop. Reg. section 1.385-2, the recharacterized debt is treated as equity in the entity that issued the debt
  - Recharacterized debt issued by a DRE is treated as equity in such DRE, potentially creating a partnership
  - Recharacterized debt issued by a Controlled Partnership is treated as equity in the Controlled Partnership
    - Contrast with Prop. Reg. section 1.385-3

The Transaction Rules:
Prop. Reg. Section 1.385-3

Overview

- The transaction rules under Prop. Reg. section 1.385-3 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 satisfies the documentation requirements of the Proposed Regulations and would otherwise be treated as debt under the bifurcation rule and case law.

- A debt instrument, or portion thereof, treated as stock under Prop. Reg. section 1.385-3 is treated as such for all federal tax purposes.

- The transaction rules provide a general rule that applies to certain note distributions and similar transactions, as well as a funding rule that applies to certain note issuances undertaken to fund certain distributions and similar transactions.

Overview (cont'd)

- Both the general rule and the funding rule are subject to a threshold exception and a current year E&P exception, and the funding rule is also subject to a subsidiary stock issuance exception; the current year E&P exception and the subsidiary stock issuance exception are discussed in more detail later in this section
- Under the threshold exception:
  - A debt instrument is not treated as stock if immediately after its issuance, the aggregate adjusted issue price of debt instruments held by EG members that would otherwise be subject to the general rule or the funding rule does not exceed $50 million
  - Once the $50 million threshold is exceeded, the threshold exception does not apply to any debt instrument issued by EG members so long as any debt instrument previously treated as debt under the threshold exception remains outstanding (i.e., the exception is subject to a "cliff")
  - Because of the expansive attribution rules described above, multiple publicly traded corporate groups may be members of the same EG and therefore have to share a single $50 million threshold, even in situations where they have no way of knowing the amount of related party debt in the other publicly traded group(s)
- Like the documentation rules, the transaction rules apply to interests between members of an EG (80% relationship threshold), and not, like the bifurcation rules, to interests between members of an MEG (50% relationship threshold); *but see* the anti-abuse rule discussed below under Predecessors, Successors and Other Rules

The "No Affirmative Use Rule"

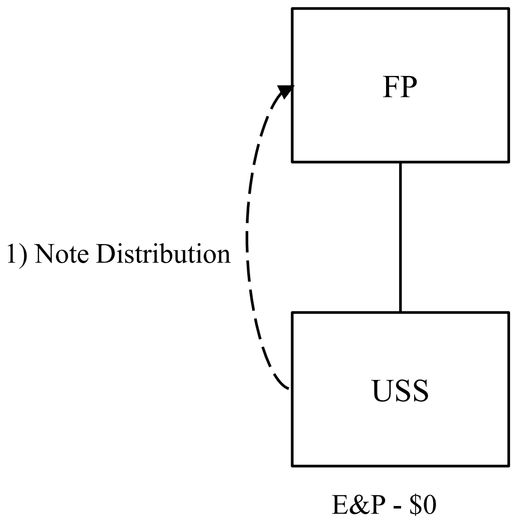
- No Affirmative Use: The transaction rules do not apply to the extent a person enters into a transaction that otherwise would be subject to the transaction rules with a principal purpose of reducing the federal tax liability of any member of the EG that includes the issuer and holder of the debt instrument by disregarding the treatment that would otherwise result in the absence of the application of the transaction rules
- Does the no affirmative use rule apply where there is a principal purpose of reducing the federal tax liability of one member of the EG but, as a result of the recharacterization, another EG member's federal tax liability is increased such that the aggregate tax liability of the whole EG remains unchanged?
- If a taxpayer inadvertently structures a transaction that results in the recharacterization of a debt instrument as equity under the transaction rules and later determines that a benefit results from such recharacterization, is the taxpayer still permitted to treat the instrument as equity on its federal income tax return?
- Does this rule apply where a taxpayer issues debt in multiple tranches so that some, but not all, of the tranches will be recharacterized?

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

- Unless an exception applies, a debt instrument issued by a corporation to a member of its 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"
     - For these purposes, an exempt exchange is an acquisition of EG Stock in which the transferor and transferee are parties to an asset reorganization and either:
       - Section 361(a)/(b) applies to the transferor and the stock is not transferred by issuance, or
       - Section 1032 or Treas. Reg. section 1.1032-2 applies to the transferor and the stock is distributed to the transferee pursuant to the plan of reorganization
  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

General Rule – Example 1: Note Distribution



Facts

1) In Year 1, when USS has no current or accumulated E&P, USS 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

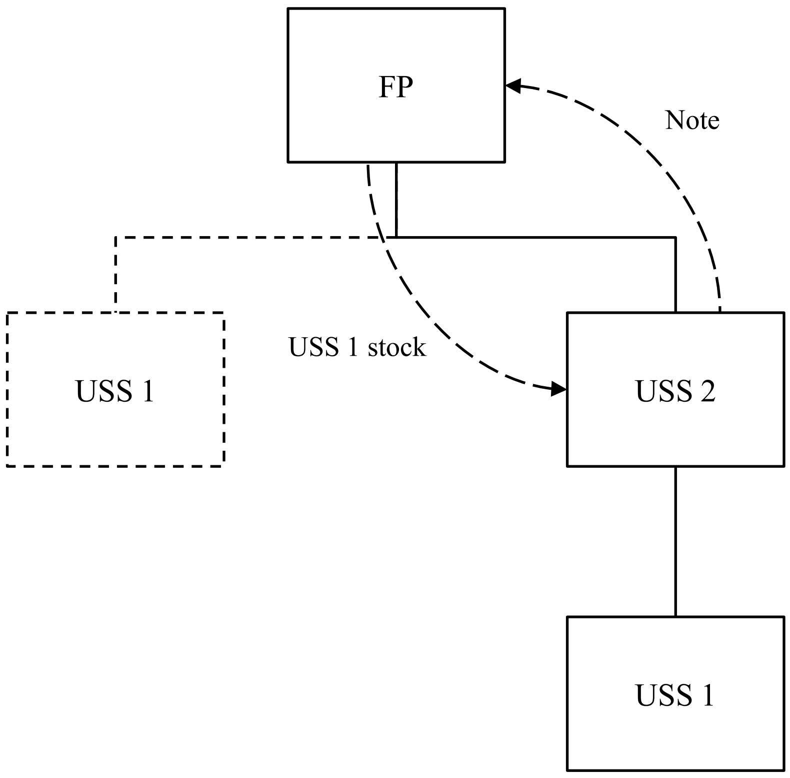
- Absent the application of the Proposed Regulations, Year 1 note distribution is not taxable (section 301(c)(3) gain, if any, not subject to U.S. tax so long as USS not a USRPHC)
- Interest payments reduce U.S. tax base and the principal can be repaid without U.S. tax

Result under General Rule

- *See* Prop. Reg. section 1.385-3(b)(2)(i) and (g)(3), Example 1
- Preamble, Section VI.C.2: "In many contexts, a distribution of a debt instrument…lacks meaningful non-tax significance, such that respecting the debt instrument as indebtedness for federal tax purposes produces inappropriate results"

Assumption: No exceptions to the general rule are applicable

General Rule – Example 2: Section 304 Transaction



Facts

1) USS 2 acquires the stock of USS 1 from FP in exchange for a note (assume that neither USS 1 nor USS 2 has any current or accumulated E&P)

Issues

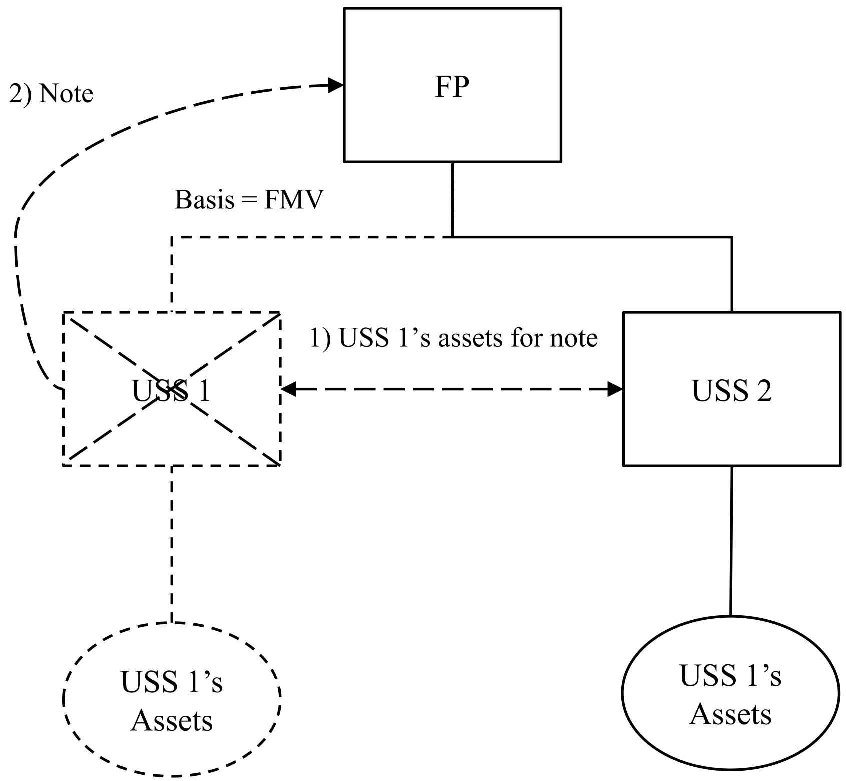
- Absent the application of the Proposed Regulations, the transaction would constitute a dividend-equivalent section 304(a)(1) transaction that is not taxable (section 301(c)(3) gain, if any, not subject to U.S. tax so long as USS 2 not a USRPHC)
- Interest payments reduce U.S. tax base and the principal can be repaid without U.S. tax

Result under General Rule

- *See* Prop. Reg. section 1.385-3(b)(2)(ii) and (g)(3), Example 3
- Preamble, Section VI.C.3: "the issuance of a related-party debt instrument to acquire stock of a related person is similar in many respects to a distribution of a debt instrument and implicates similar policy considerations"

Assumption: No exceptions to the general rule are applicable

General Rule – Example 3: All Boot D Reorganization



Facts

1) USS 1 transfers all of its assets and liabilities to USS 2 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, USS 1 distributes the note to FP in liquidation. FP has a tax basis in its USS 1 stock equal to fair market value

Issues

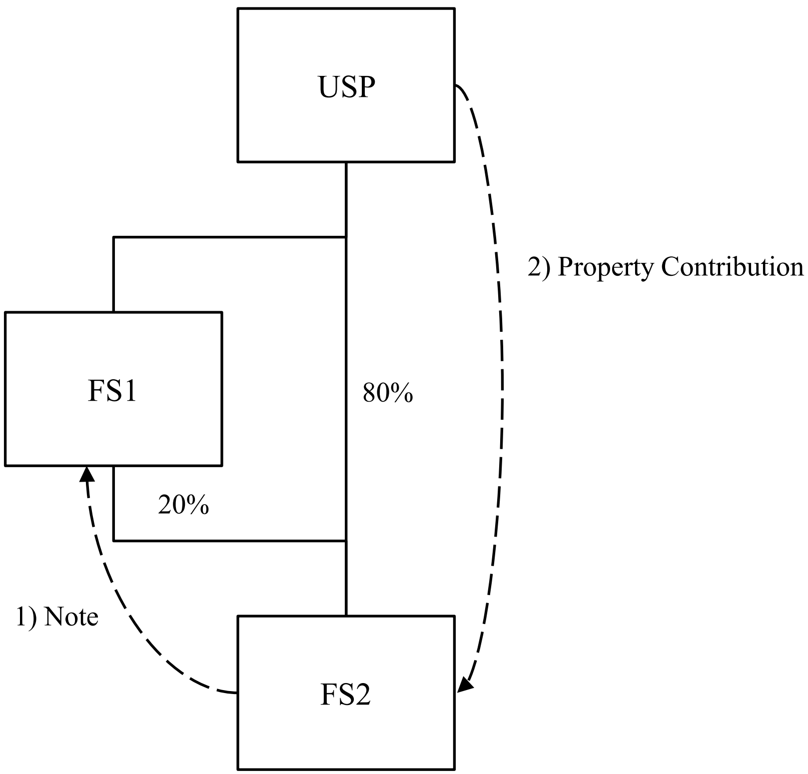
- Absent the application of the Proposed Regulations, the "dividend-within-gain" limitation of section 356(a)(2) prevents any of the note distribution from being treated as a dividend
- Interest payments reduce U.S. tax base and the principal can be repaid without U.S. tax

Result under General Rule

- *See* Prop. Reg. section 1.385-3(b)(2)(iii) and (g)(3), Example 8; *see also* Example in Preamble, Section VI.C.4
- Preamble, Section VI.C.4: "[i]nternal asset reorganizations can operate in a similar manner to section 304 transactions as a device to convert what otherwise would be a distribution into a sale or exchange transaction without having any meaningful non-tax effect"

Assumption: No exceptions to the general rule are applicable

General Rule – Example 4: Impact of Recharacterization on "Control"



Facts

1) In Year 1, when FS1 owns 100% of the single class of voting stock of FS2, FS2 issues a note to FS1 in a distribution
2) In Year 2, USP contributes foreign assets to FS2 for use in FS2's business in exchange for stock which results in USP owning 80% of the actual stock of FS2 (i.e., not including the note)

Questions

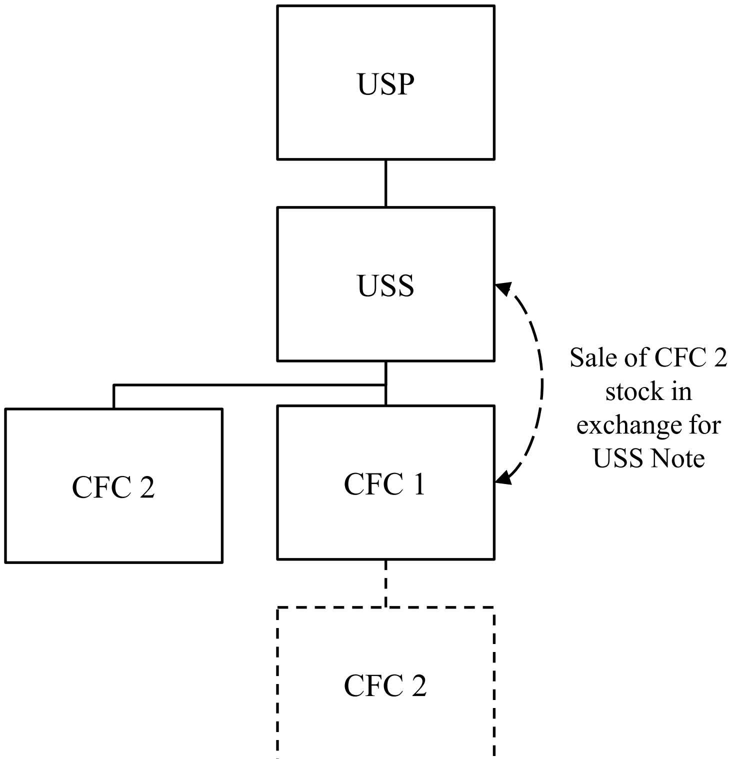
- Assuming the note does not have voting power, does the contribution qualify under section 351?
  - Control requires ownership of 80% of the voting power and 80% of the number of shares of non-voting stock
  - Thus, because the note is treated as non-voting stock, the transaction does not appear to satisfy the control requirement

Additional Considerations

- Similarly to control for purposes of section 351, recharacterization of debt as equity could potentially impact, *inter alia*:
  - Whether an entity is a member of an affiliated or controlled group
  - Whether a foreign corporation is a CFC or noncontrolled section 902 corporation
  - Whether a loss corporation undergoes a change in control
  - Whether an entity meets an applicable treaty's limitation on benefits article
  - Whether a redemption is essentially equivalent to a dividend
  - An election to be treated as an S corporation, REIT or RIC

Assumption: No exceptions to the general rule are applicable

General Rule – Example 5: Potential Application to Rev. Rul. 74-605 Transactions



Facts

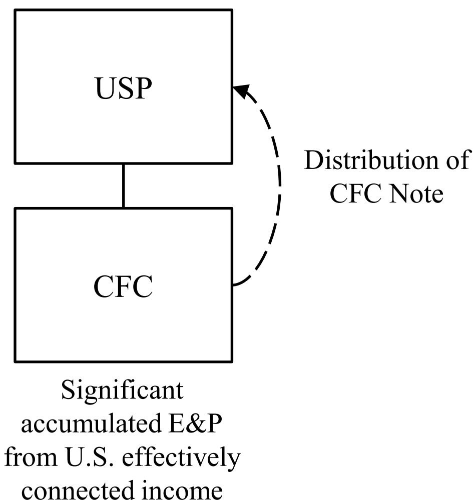
1) USP wholly owns USS, which wholly owns CFC 1, which wholly owns CFC 2
2) CFC 1 sells the stock of CFC 2 to USS in exchange for a note (the "USS Note")

Conclusion

- The acquisition of CFC 2 stock by USS is an acquisition of EG Stock for purposes of Prop. Reg. section 1.385-3
- Rev. Rul. 74-605, 1974-2 C.B. 97, provides that because CFC 1 cannot be treated as owning its own stock, CFC 1 cannot be attributed the stock of USS, and so section 304 does not apply to this transaction
- Should the same exception to section 304 treatment apply for purposes of Prop. Reg. section 1.385-3?

Assumption: No exceptions to the general rule are applicable

General Rule – Example 6: Dividends Received Deduction



Facts

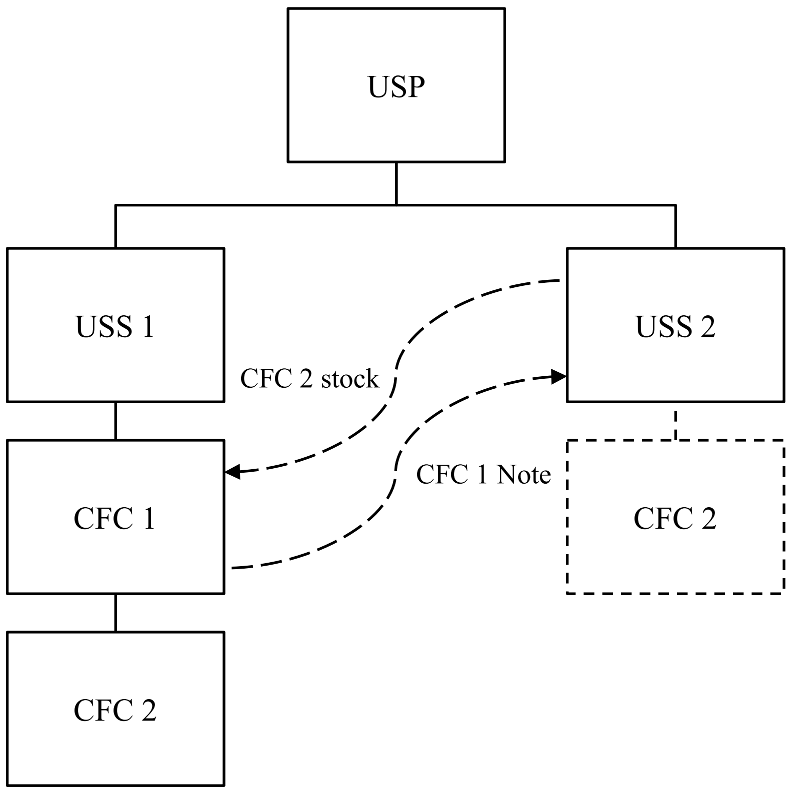
1) USP wholly owns CFC and CFC has significant accumulated E&P, all of which represents income effectively connected with a U.S. trade or business
2) In year 1, CFC distributes a note to USP (the "CFC Note")
3) In year 2, CFC pays interest on the CFC Note

Analysis

- The CFC Note is recharacterized as stock of CFC under Prop. Reg. section 1.385-3, and so the interest payments on the CFC Note in Step 2 would be characterized as a dividend distribution
- Section 245 generally provides dividends received deductions for certain dividends received from foreign subsidiaries out of U.S. effectively connected income if, *inter alia*, certain holding period requirements are satisfied.
- 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.
- Does section 246(c)(4) prevent USP from claiming a dividends received deduction for the interest payments on the CFC Note?

Assumption: No exceptions to the general rule are applicable

General Rule – Example 7: Fast-Pay Stock



Facts

1) USP wholly owns USS 1 and USS 2; USS1 wholly owns CFC 1 and USS 2 wholly owns CFC 2
2) In year 1, CFC 1 purchases the stock of CFC 2 from USS 2 in exchange for a note (the "CFC 1 Note")
3) The CFC 1 Note has a 5-year term and is fully amortizing

Analysis

- The CFC 1 Note is recharacterized as stock of CFC under Prop. Reg. section 1.385-3, and payments on the CFC 1 Note would constitute dividends
- Because the CFC 1 Note is fully amortizing, the payments received are economically a return of the holder's investment, rather than a return on the holder's investment, potentially causing the CFC 1 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 principle purpose of the arrangement is the avoidance of tax
- Can such a principal purpose be found here, given that the instrument is formally debt, and taking into account the affirmative use rule under Treas. Reg. section 1.385-3(e)?

Assumption: No exceptions to the general rule are applicable

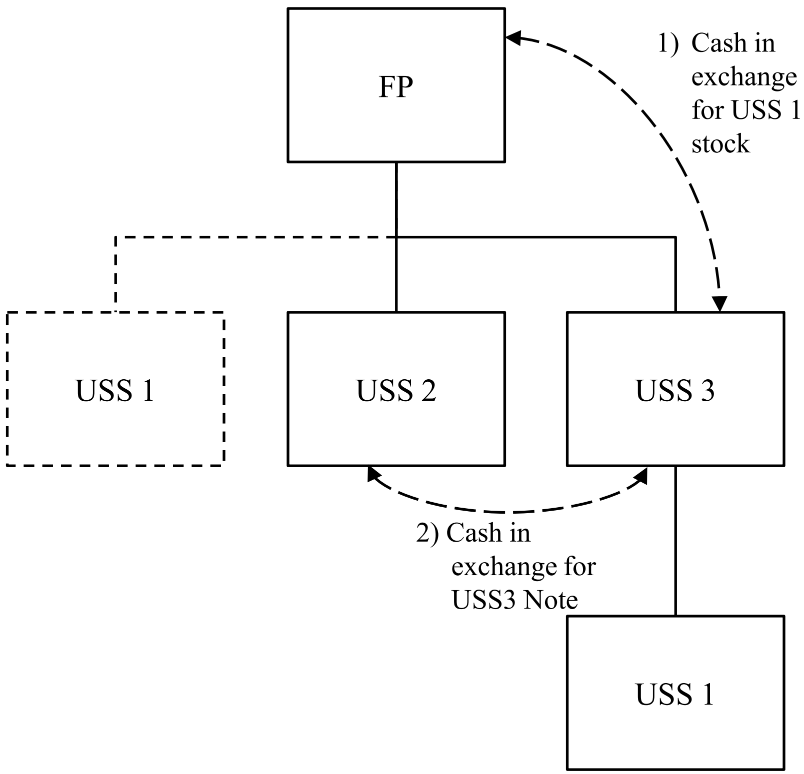
The Funding Rule: Prop. Reg. Section 1.385-3(b)(3)

- Under the funding rule, a debt instrument is treated as stock to the extent it is a "Principal Purpose Debt Instrument"
- A Principal Purpose Debt Instrument is a debt instrument issued by a corporation (the "funded member") to an EG member (the "funding member") in exchange for property ***with a principal purpose*** of 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 (i) a distribution of stock in an asset reorganization pursuant to which no gain or income is recognized under section 354(a)(1) or 355(a)(1), or (ii) a distribution of "other property" or money to which section 356 applies
  - An acquisition of EG Stock (except in an exempt exchange) 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 issuer'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
- There are no exceptions to the funding rule for cash sweeps or similar arrangements, but the government is requesting comments as to whether special rules should apply in such case

The Funding Rule: Comments Regarding Distributions

- A subpart F inclusion under section 951 should not be treated as a distribution for purposes of the Funding Rule, because there is no distribution of money or property. *Cf. Rodriguez v. Commissioner*, 722 F.3d 306 (5th Cir. 2013) (subpart F inclusion does not constitute a dividend).
- Tax-free distributions of common stock with respect to common stock under section 305(a) do not constitute distributions for purposes of the Funding Rule.
  - The Funding Rule applies only with respect to distributions of “property,” as defined in section 317. For this purpose, stock of a distribution corporation is not property.
- Because certain spin-offs are excluded, whether a spin-off is a distribution for purposes of the Funding Rule depends on whether or not it is pursuant to a D reorganization.
  - What is the policy rationale for treating similar spin-offs differently?
  - Assume a preexisting controlled corporation worth $100. If the distributing corporation contributes additional assets worth $100 to the controlled corporation before the spin-off, is the entire $200 distribution exempt, or only 50% of it?

Funding Rule – Example 1



Facts

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

Result under Funding Rule

- The USS 3 note to USS2 is treated as equity in USS 3, and the transaction constitutes a dividend-equivalent section 304(a)(1) transaction that is not taxable (section 301(c)(3) gain, if any, would not be subject to U.S. tax so long as USS 3 is not a USRPHC).

Alternative Transaction

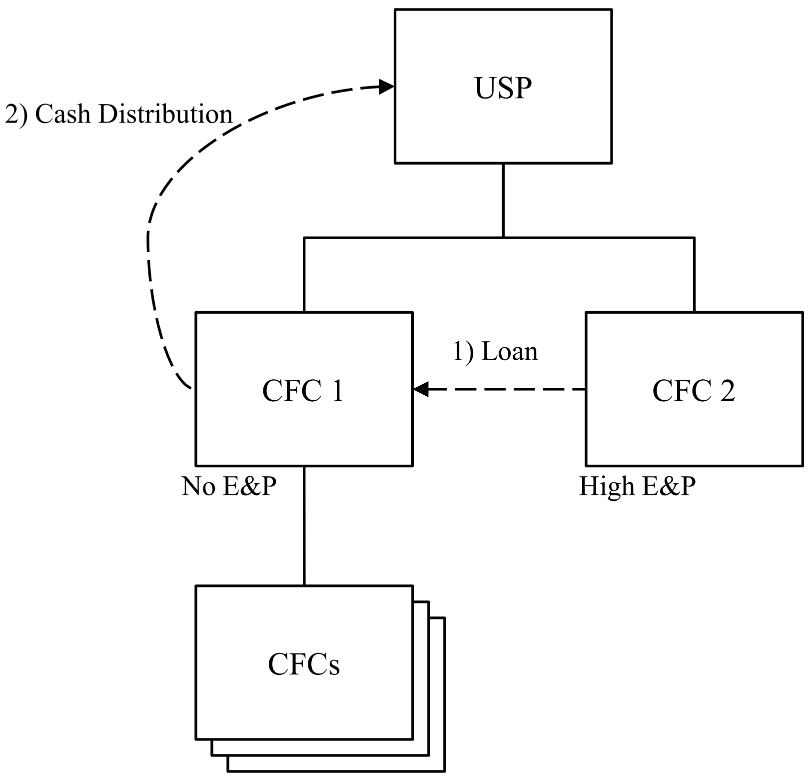
- If USS 3 purchases the USS 1 stock in exchange for its own note, section 304 does not apply to the transaction because the USS 3 note would be recharacterized as USS 3 stock.
- What is the policy rationale for the different treatment of these two similar transactions?

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

Principal Purpose Determination and the *Per Se* Rule

- Unless the *per se* rule discussed below applies, the determination of whether a debt instrument is a Principal Purpose Debt Instrument is made based on all the facts and circumstances.
- A debt instrument can be a Principal Purpose Debt Instrument regardless of whether it is issued before or after a Prohibited Transaction.
- Importantly, the funding rule contains a "*per se* rule" (that is not rebuttable, is not a safe harbor and applies regardless of purpose) under which:
  - unless the ordinary course exception discussed below applies, a debt instrument is treated as a Principal Purpose Debt Instrument automatically if it is issued by the funded member during the 72-month period beginning 36 months before the date of the Prohibited Transaction
    - This applies even if the debt instrument has been retired before the Prohibited Transaction takes place, if the Prohibited Transaction and debt issuance occur in the same year
  - <u>Ordinary Course Exception</u>: A debt instrument is not subject to the *per se* rule (but is still subject to the facts and circumstances test) if issued in the ordinary course of business in connection with the purchase of property or the receipt of services, and if:
    - The payments are currently deductible under section 162 or included in COGS or inventory, and
    - The amount outstanding never exceeds the amount ordinary and necessary to carry on the issuer's business if it were unrelated to lender

Funding Rule – Example 2: Leveraged Distribution



Facts

1) CFC 2 has substantial cash and E&P. CFC 1 has no E&P. CFC 2 lends cash to CFC 1 for a CFC 1 note

2) CFC 1 distributes cash to USP. Assume USP's basis in its CFC1 stock exceeds the distribution amount (and there are no basis blocks)

Issues

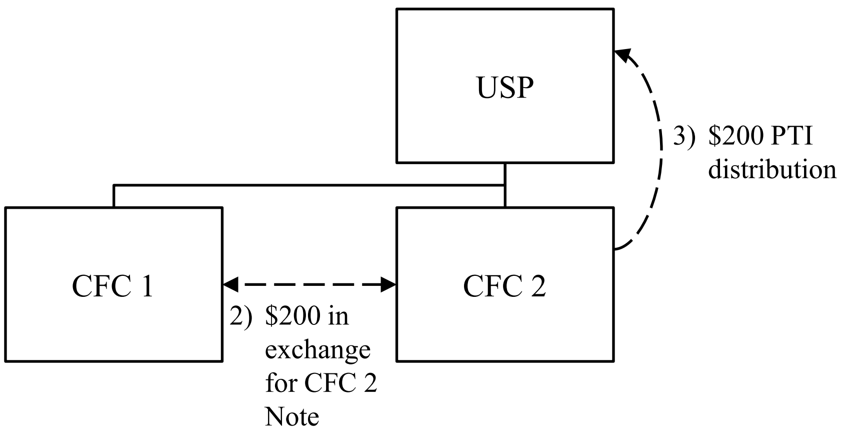
- The loan from CFC 2 to CFC 1 supplies cash to CFC 1 without a corresponding movement of CFC 2's E&P
- Most/all of the distribution could be a tax-free return of basis
- Preamble, Section VI.C.5: "[i]ssuances of debt instruments to an affiliate in order to fund a distribution of property…often confer significant federal tax benefits without having a significant non-tax impact"
- *See* Prop. Reg. section 1.385-3(b)(3)(ii)(A) and (g)(3), Example 4
- <u>Query</u>: How does treating CFC 2 loan to CFC 1 as stock change the above return of capital results? Compare a case where USP is foreign and CFC 1 is domestic.

Assumption: No exceptions to the funding rule are applicable

Current Year 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 earnings and profits described in section 316(a)(2) ("E&P")
  - The reduction is applied to the distributions or acquisitions in the order of occurrence
  - Note: Why doesn't this exception also cover accumulated E&P? The current year E&P exception puts a premium on, for example, paying note dividends each year ("serial note dividends") rather than a "bullet" note dividend after several years. *See* Funding Rule – Example 2 below
  - Note: Since current year E&P is often difficult to determine until after the end of the year, it may be difficult to know what portion of a current year transaction will be exempted under this exception, especially if the transaction occurs early in the year
  - Note: Many countries do not permit distributions of profits in the year in which they are earned, which could potentially preclude taxpayers from availing themselves of this exception with respect to CFCs.

Funding Rule – Example 3:
Current Year E&P Exception – PTI



Assumptions: No exceptions to the funding rule are applicable other than potentially the current E&P year exception, and neither CFC has any investments in US Property within the meaning of section 956.

Facts

1) In year 1, CFC 2 generates $100 of subpart F income, which is included into USP's income.
2) In year 2, CFC 1 loans $200 to CFC 2 in exchange for a note (the "CFC 2 Note") and CFC 2 generates an additional $100 of Subpart F income (resulting in $100 of current E&P in year 2).
3) In year 2, CFC 2 distributes $200 to USP.

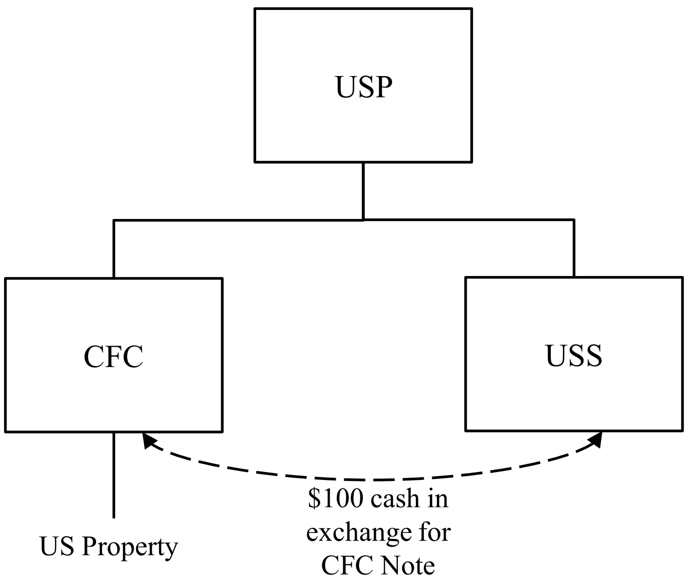
Results

- Even though USP has already been taxed on the full $200 of subpart F income, the CFC 2 note is bifurcated into a $100 debt instrument and $100 of CFC 2 stock.

Questions

- Is this what Treasury and the IRS intended?
- If yes, what is the policy rationale behind having distributions of PTI trigger the funding rule?
- The country in which CFC 2 is incorporated may not permit corporations to make distributions out of current earnings. Would Treasury and the IRS consider modifying the current year E&P exception so that it would apply to distributions of PTI from prior years?

Funding Rule – Example 4: Current Year E&P Exception – Section 956



Facts

1) CFC has $200 of accumulated E&P, none of which is PTI.
2) In year 1, CFC generates $100 of non-subpart F income (resulting in $100 of current E&P in year 1), invests in US Property resulting in a $100 Subpart F inclusion under section 956, and borrows $100 from USS in exchange for a note (the "CFC Note").
3) CFC disposes of its US Property so that it has no investment in US Property under section 956 in year 2.
4) CFC has no current E&P in year 2.

Results

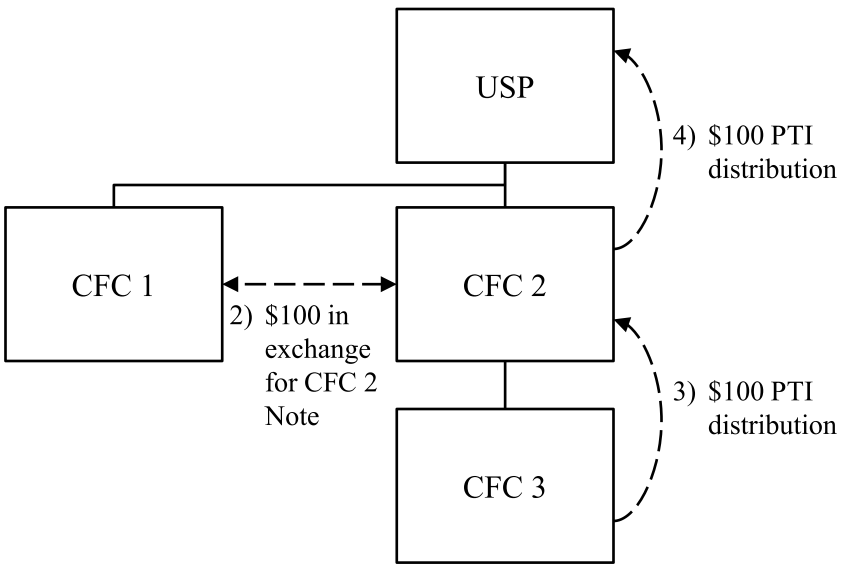
- USP has a section 956 inclusion in year 1 regardless of whether any distributions are made in that year, and the PTI from that inclusion cannot be distributed until year 2.
- A distribution of such PTI in year 2 will trigger the funding rule.

Question

- Do Treasury and the IRS intend for all section 956 related PTI to be ineligible for the current year E&P exception?

Assumption: No exceptions to the funding rule are applicable other than potentially the current year E&P exception.

Funding Rule – Example 5: Current Year E&P Exception – Tiered CFCs



Facts

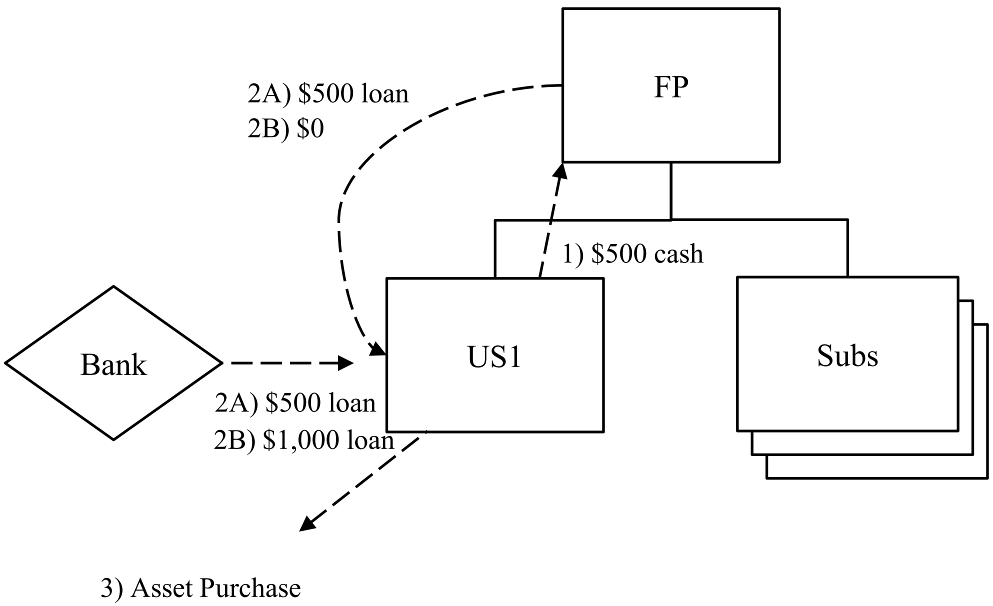
1) In year 1, CFC 3 generates $100 of subpart F income, which is included into USP's income.
2) In year 1, CFC 1 loans $100 to CFC 2 in exchange for a note (the "CFC 2 Note").
3) In year 2, CFC 3 distributes the $100 of PTI to CFC 2.
4) In year 2, CFC 2 distributes $100 to USP.

Analysis

- Does the distribution in step 4 does qualify for the current year E&P exception?
- Under the Treas. Reg. section 1.959-3(b)(3), the $100 of PTI received from CFC 3 retains its character as section 959(c)(2) PTI generated in year 1, so CFC 2 may have no current E&P in year 2.
- Provided that the distribution in step 4 does not qualify for the current E&P exception, would Treasury and the IRS consider expanding the current E&P exception to ameliorate this result?

Assumptions: No exceptions to the funding rule are applicable other than potentially the current year E&P exception, and none of the CFCs have any investments in US Property within the meaning of section 956

Funding Rule – Example 6: Internal vs. External Debt



Facts

1) In Year 10, US1 distributes $500 of excess cash
2) In Year 12, an unexpected opportunity arises and US1 decides to expand its business by purchasing $1,000 of assets. The acquisition is funded in one of two alternative ways:

   Alternative A: US1 borrows $500 from FP and $500 from Bank on identical terms to fund the acquisition

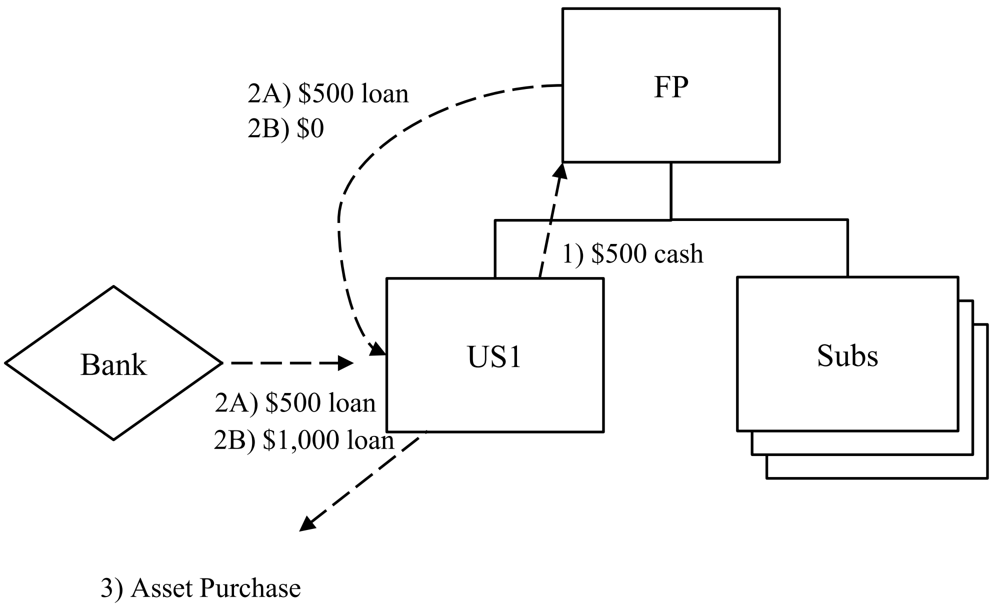
   Alternative B: US1 borrows the entire $1,000 from Bank
3) US1 uses the cash received in (2) to purchase the assets

Questions

- In Alternative A, should the presence of the unexpected business opportunity affect the treatment of FP's loan to US1?
- In Alternative B, is the entire $1,000 borrowing respected as debt?

Assumption: No exceptions to the funding rule are applicable

Funding Rule – Example 7:
Internal vs. External Debt (Current E&P)



Facts

1) For each year in question, US1 earns $100 of E&P which it reinvests into its business or otherwise keeps. In Year 10, when US1 has $100 of current E&P and $900 of accumulated E&P, US1 distributes $500 of excess cash for which it has no need.

2) In Year 12, an unexpected opportunity arises and US1 decides to expand its business by purchasing $1,000 of assets. The acquisition is funded in one of two alternative ways:

   Alternative A: US1 borrows $500 from FP and $500 from Bank on identical terms to fund the acquisition

   Alternative B: US1 borrows the entire $1,000 from Bank

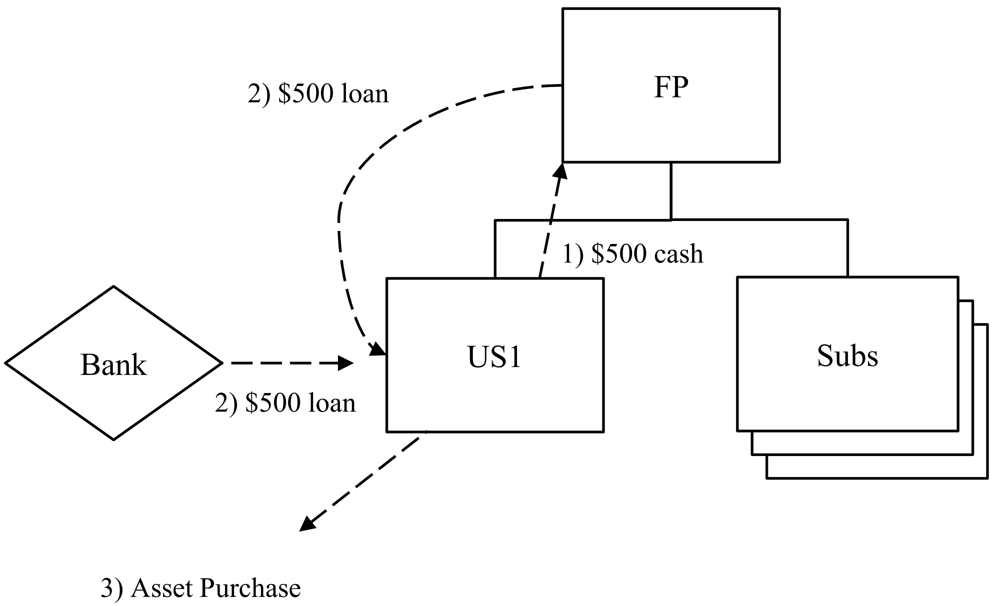
3) US1 uses the cash received in (2) to purchase the assets

Questions

- In Alternative A, is $400 of the $500 loan from FP recharacterized as stock of US1?
- In Alternative B, is the entire $1,000 debt respected as debt?
- Compare the result to what would have happened if US1 had kept all of its cash but in each of five years from years 1 to 12 US1 had distributed a $100 note to FP

Assumption: No exceptions to the funding rule, other than the current year E&P exception, are applicable

Funding Rule – Example 8: Internal vs. External Debt (Current E&P) (cont'd)



Facts

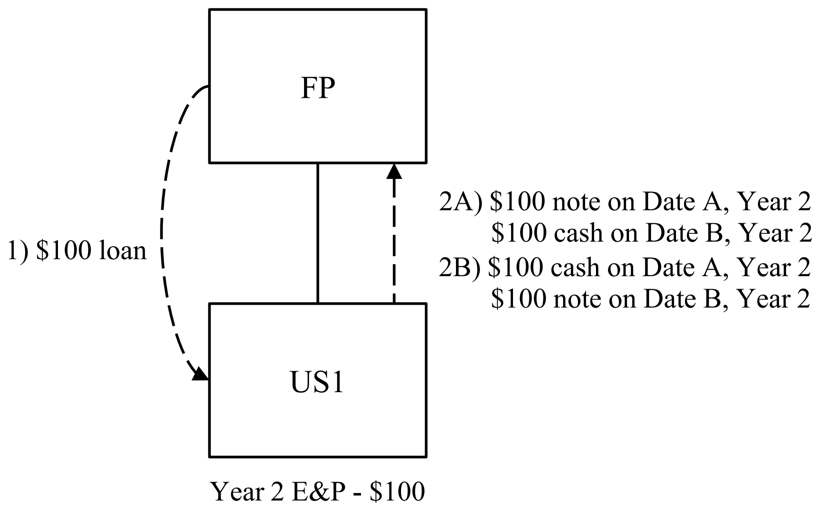
1) Same as Example 3, Alternative A, except that US1 owns highly depreciable assets (either directly or through an investment in a Fund). As a result, US1 has the same cash flow but no E&P

Questions

- Is the entire $500 loan from FP now recharacterized as stock of US1?
- Note that on these facts "serial note distributions" wouldn't change the answer

Assumption: No exceptions to the funding rule, other than the current year E&P exception, are applicable

Funding Rule – Example 9: Serial Distributions of Cash and Notes



Facts

1) In Year 1, US1 borrows $100 from FP ("Note A")
2) In Year 2, US1 has $100 of current year E&P and $100 of cash on hand. One of the following alternatives occurs:

   Alternative A: US1 distributes a $100 note ("Note B") to FP on Date A of Year 2, and subsequently distributes $100 cash to FP on Date B of Year 2

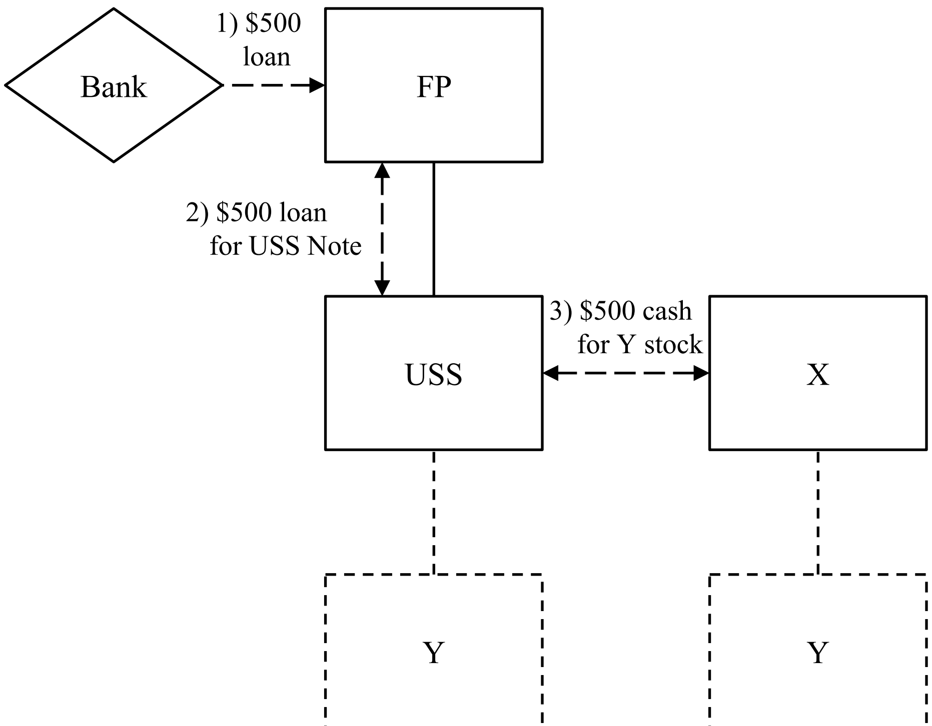
   Alternative B: US1 distributes $100 cash on Date A of Year 2, and subsequently distributes a $100 note (i.e., Note B) to FP on Date B of Year 2

Questions

- Why is a specific ordering rule applied rather than the normal E&P allocation rules of section 316?
  - In Alternative A, the distribution of Note B would be ignored, but the $100 cash distribution would cause Note A to be treated as a Principal Purpose Debt Instrument
  - In Alternative B, the $100 cash distribution would be ignored, but the entire $100 of Note B would be subject to the general rule

Assumption: No exceptions to the general rule or the funding rule, other than the current year E&P exception, are applicable

Funding Rule – Example 10: Ordering of Transaction



Facts

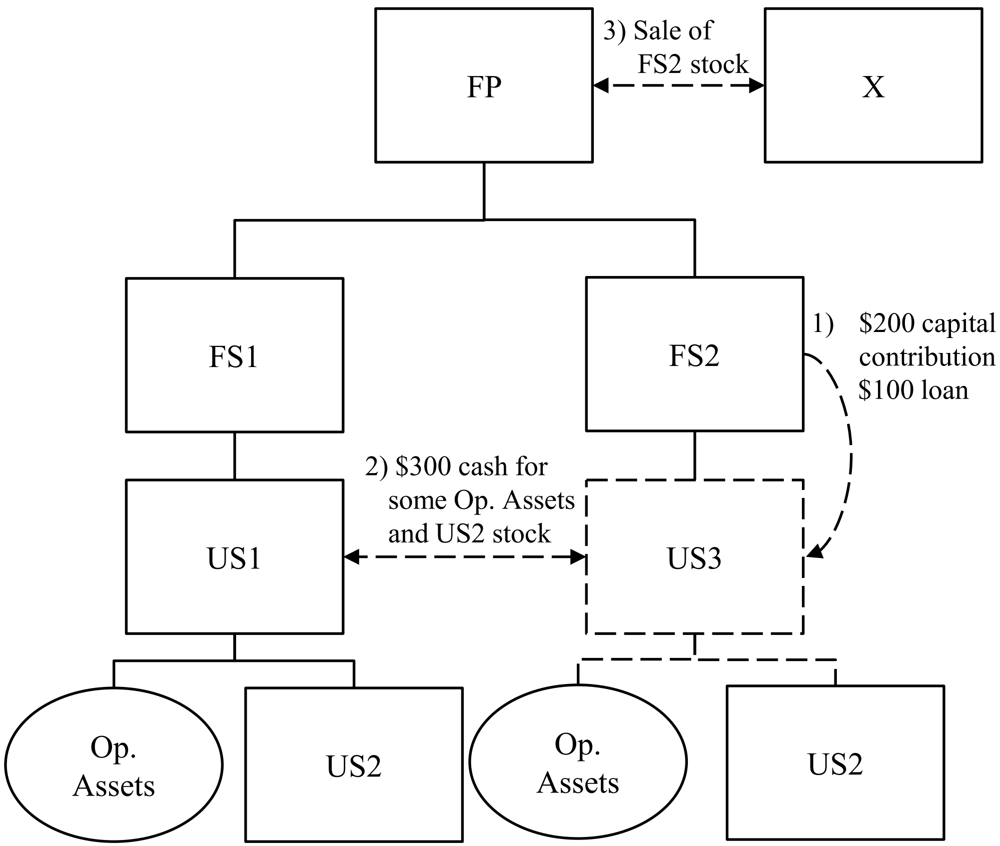
1) FP borrows $500 from bank
2) FP lends the $500 to USS in exchange for a note ("USS Note")
3) USS uses the loan proceeds to purchase the stock of Y from unrelated X

Questions

- What if instead of FP lending the cash to USS, FP first uses the cash borrowed from bank to purchase the stock of Y from X, then FP transfers the Y stock to USS for USS Note? In both situations, at the end of the series of transactions, FP has a loan outstanding to bank, FP holds USS Note, and USS owns the stock of Y
- Yet if FP purchases the Y stock first and then sells that stock to USS for USS Note, it appears under the Proposed Regulations USS Note is treated as equity, whereas if FP loans cash to USS and USS purchases the Y stock from X, the Proposed Regulations don't apply (assuming no other facts such as distributions from USS to FP), and USS Note is treated as debt assuming (i) it is otherwise so treated under the bifurcation rule and case law and (ii) the documentation requirements are met

Assumption: No exceptions to the funding rule are applicable

Funding Rule – Example 11: Funded Section 304 Transaction



Facts

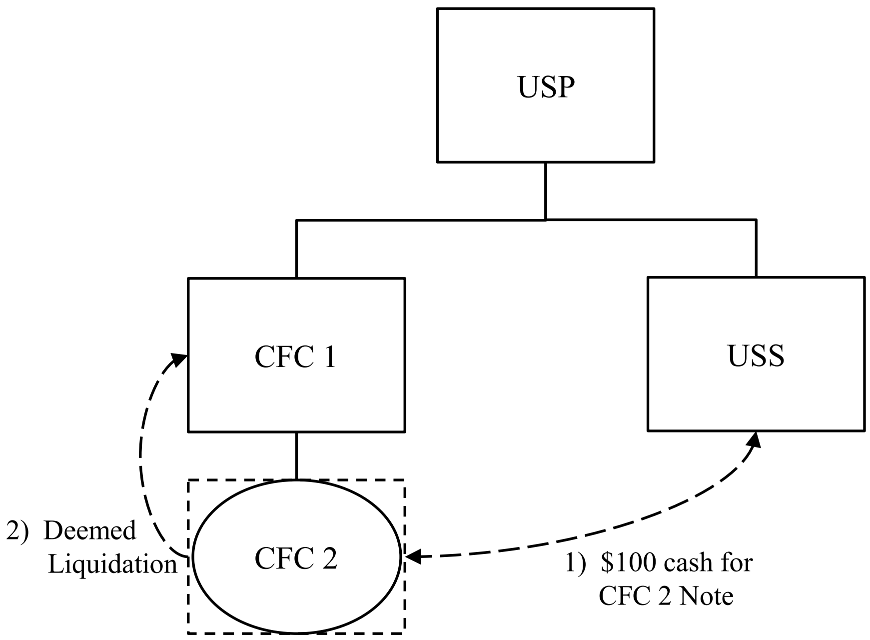
1) FS2 forms US3, making a capital contribution of $200 to US3 and lending another $100 to US3
2) US3 buys some of the operating assets of US1 and the stock of US2 from US1 in exchange for the cash received in (1). US1 retains substantial operating assets and other assets
3) As part of the same plan, unrelated X buys all of the stock of FS2 from FP

Questions

- Is all or some of the $100 loan from FS2 to US3 recharacterized as stock of US3?
- Does the outcome depend on whether the deemed redemption in the section 304 transfer is governed by section 302(a) versus section 302(d)?

Assumption: No exceptions to the funding rule are applicable

Funding Rule – Example 12: Application to Check-the-Box Elections



Facts

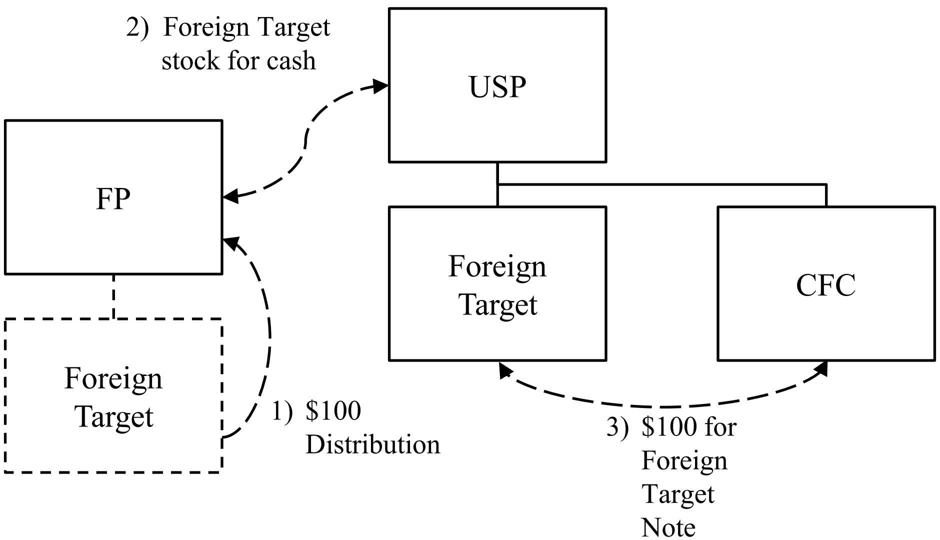
1) USS loans $100 to CFC 2 for a note (the "CFC 2 Note") when CFC 2 is classified as a corporation
2) Within the next three years, CFC 2 elects to be disregarded as separate from CFC 1

Questions

- Is the deemed acquisition of CFC 2 stock by CFC 2 in the deemed liquidation pursuant to the change in entity classification an acquisition of EG Stock?
- If so, and if the values of the CFC 2 stock and the CFC 2 Note are similar, would this cause section 331 to apply to the deemed liquidation?
- Alternatively, would the rule for DREs apply to treat USS as owning stock in CFC 1? Does this result depend on whether the CFC 2 Note is issued in the same or a previous year as the deemed liquidation?

Assumption: No exceptions to the funding rule are applicable

Funding Rule – Example 13: Potential Application in M&A Context



Assumption: No exceptions to the funding rule are applicable

Facts

1) In year 1, Foreign Target distributes $100 to FP
2) In year 3, unrelated USP acquires Foreign Target from FP for cash
3) Later in year 3, CFC loans $100 to Foreign Target in exchange for a note (the "Foreign Target Note")

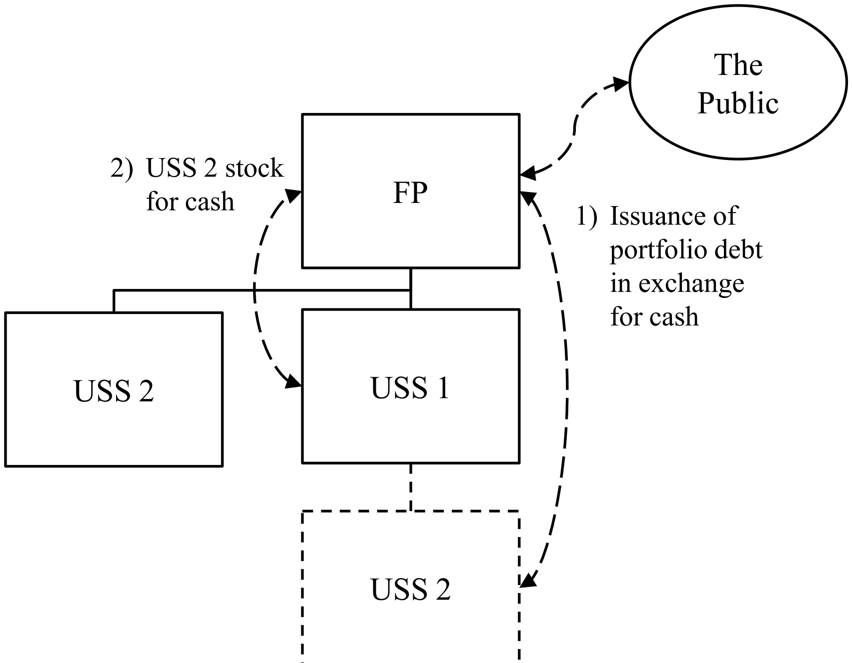
Issues

- Because FP was a member of Foreign Target's EG when the distribution was made, the Funding Rule would apply, causing the loan from CFC to Foreign Target to be treated as the acquisition of additional Foreign Target stock, even though USP would have had no control over, or even knowledge of, the prior distribution to FP.

Issues

- Should the EG member to which the distribution is made and the EG member which makes the funding loan be required to be members of the same EG in order for the Funding Rule to apply?
- Does the analysis change if USP makes a section 338(g) election for Foreign Target?
- The proposed regulations significantly increase the due diligence that must be performed in corporate acquisitions.
- See slide [64] for further comments regarding foreign targets.

Funding Rule – Example 14: Publicly Traded Debt



Facts

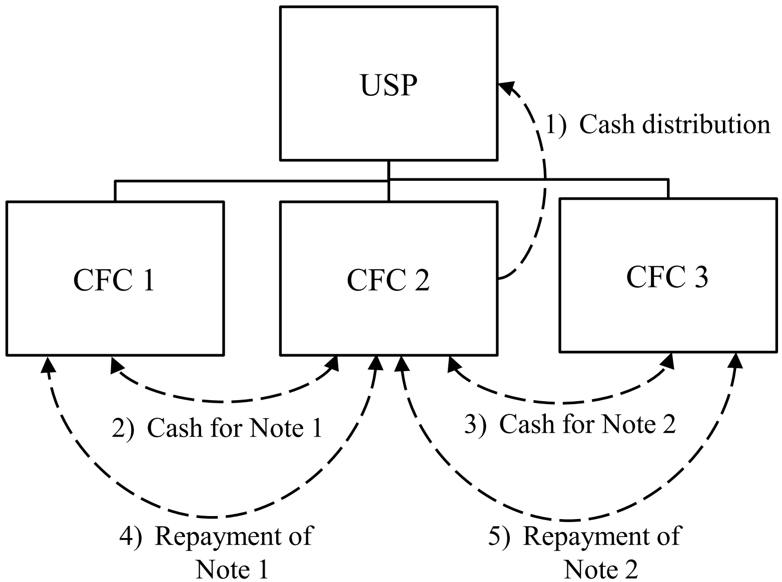
1) FP issues portfolio debt instruments to the public in a single issuance, and USS 2 participates in the offering
2) Within the six year window, FP acquires stock of USS 2 from USS 1 in exchange for cash

Conclusion

- The debt of FP is considered acquired by USS 1 for a principal purpose of funding the acquisition of USS 2 stock under the *per se* rule
- Is it appropriate to treat identical debt instruments issued to the public differently to the extent they are acquired by related parties?
- What if USS 1 acquires the FP debt from a third party on the open market?

Assumption: No exceptions to the funding rule are applicable.

Funding Rule – Example 15: Iterative Consequences



Facts

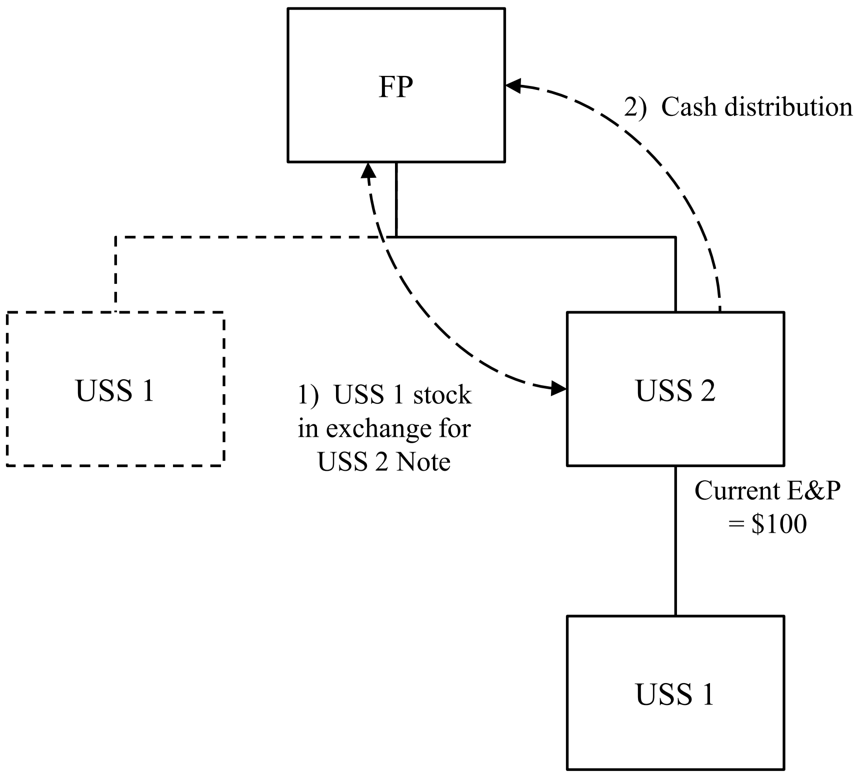
1) In year 1, CFC 2 distributes $100 to USP
2) In year 2, CFC 1 lends $100 to CFC 2 in exchange for a note ("Note 1").
3) Later in year 2, CFC 3 lends $100 to CFC 2 in exchange for a note ("Note 2").
4) In year 3, CFC 2 repays Note 1.
5) In year 4, CFC 2 repays Note 2.

Conclusion

- Because the distribution of cash in step 1 is a Prohibited Transaction, Note 1 is recharacterized as CFC 2 stock upon its issuance.
- As a result, the repayment of Note 1 in year 3 is a section 302(d) redemption of CFC 2 stock treated as a distribution with respect such stock, resulting in Note 2 being recharacterized as CFC 2 stock on the date of the repayment of Note 1.
- Is it appropriate to have the repayment of debt pursuant to its terms and consistent with the behavior of third parties be a Prohibited Transaction? Were the above iterative consequences anticipated? Are they appropriate?

Assumption: No exceptions to the funding rule are applicable

Funding Rule – Example 16:
E&P Limitation and the Funding Rule



Facts

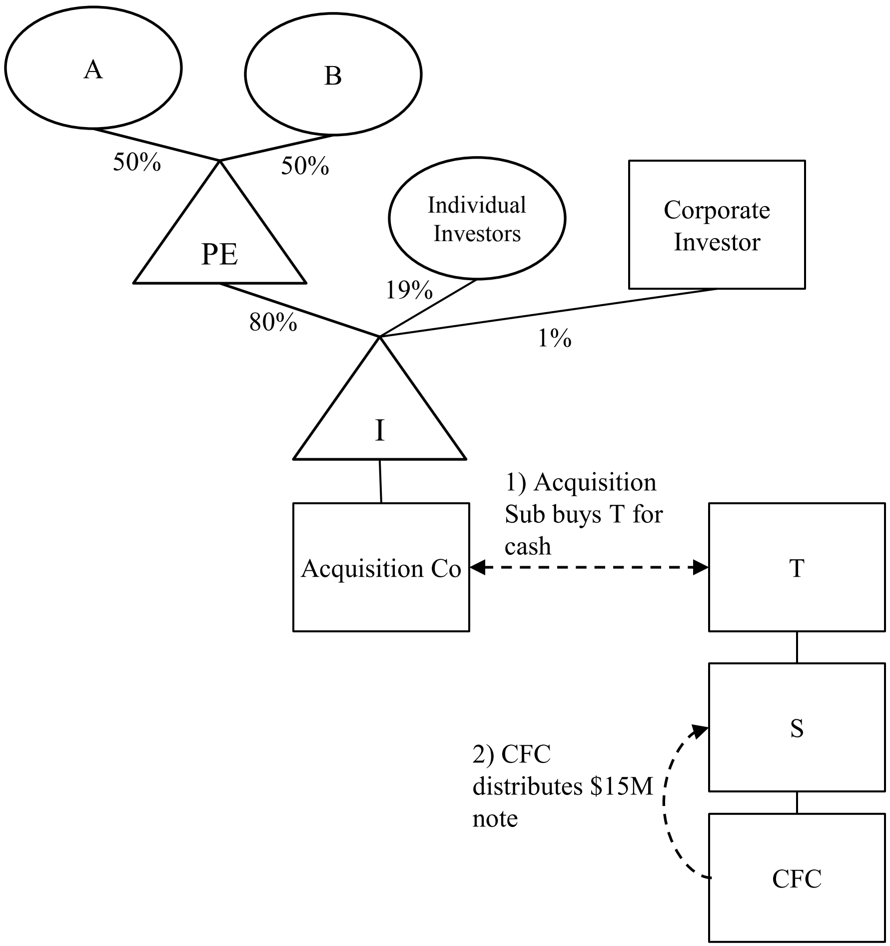
1) In year 1, when USS 2 has $100 of current E&P, FP sells USS1 to USS 2 in exchange for a $100 note
2) In year 2, when USS 2 has $0 of current E&P, USS 2 distributes $100 to FP

Analysis

- Because USS 2 has $100 of current E&P in year 1, the USS 2 Note is not recharacterized as stock in year 1 as the current E&P exception applies to turn off the General Rule.
- However, it is unclear whether the USS 2 Note can be treated as a "funding" that can be subject to the Funding Rule in a subsequent year.
- In other words, does the current E&P exception cleanse the first leg of a potential two-legged funding transaction or will the cash distribution in Step 2 cause the USS 2 Note to be recharacterized as stock?

Assumption: No exceptions to the funding rule are applicable.

Funding Rule – Example 17: Attribution and Threshold Exception



Facts

1) Acquisition Co purchases all of the stock of T for cash.
2) As part of the transaction, CFC distributes a $15 million note to S (the "CFC Note").

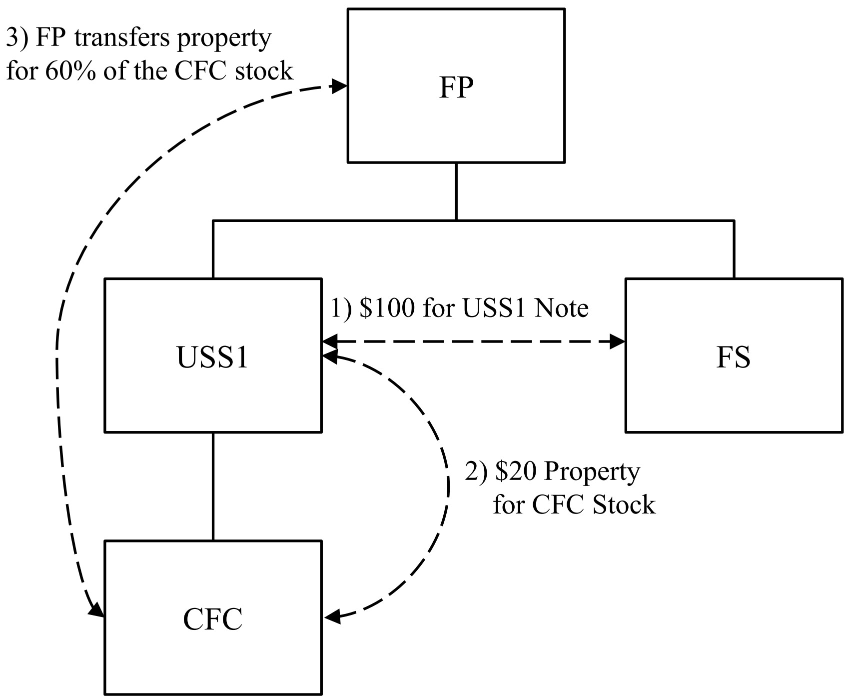
Analysis

- The Threshold Exception (Prop. Reg. § 1.385-3(c)(2)) only applies to the CFC Note if the aggregate issue price of Debt Instruments held by the Expanded Group immediately after the CFC Note is issued is $50 million or less.
- Under the attribution rules of sections 304(c)(3) and 318, I is treated as owning all stock owned by Corporate Investor, and Acquisition Co is treated as owning all stock owned by I. Therefore, Acquisition Co is treated as holding all the stock of Corporate Investor's 80% subsidiaries, bringing them into the Expanded Group.
  - The other investors are unable to determine whether Corporate Investor has intercompany debts that would cause the Expanded Group's intercompany debts to exceed $50 million. Therefore, the taxpayer is unable to determine whether the CFC Note is eligible for the Threshold Exception. If not, the CFC Note is treated as stock under the General Rule.

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
  - Note: There is no application of section 958(b) constructive ownership, which would have brought in section 318 attribution
- 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)

Subsidiary Stock Issuance Exception – Example



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 a Principal Purpose Debt Instrument under the *Per Se* Rule for Funding Rule purposes 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 a Principal Purpose Debt Instrument under the *Per Se* 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).

Assumptions

- The Threshold Exception, the Current Year E&P Exception, and the Ordinary Course Exception do not apply.

Predecessors, Successors and Other Rules

- The funding rule also contains provisions addressing predecessor and successor corporations. Under these rules:
  - a predecessor generally includes the distributor or transferor corporation in a section 381(a) transaction in which the corporation is the acquiring corporation
  - a successor generally includes the acquiring corporation in a section 381(a) transaction in which the corporation is the distributor or transferor corporation
- In addition, for purposes of applying the general rule, the funding rule and the consolidated group rules (discussed below), an anti-abuse rule applies that treats a debt instrument as stock if it is issued with a principal purpose of avoiding the application of those rules
- There are also rules that coordinate the application of the general rule and the funding rule to keep a single transaction from being subject to both rules

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

- A debt instrument is treated as stock if it is issued with a principal purpose of avoiding the application of Prop. Reg. sections 1.385-3 or -4.
- Examples may include situations where:
  - A debt instrument is issued to a person that is not a member of the issuer's EG, and such person later becomes a member of the issuer's EG;
  - A debt instrument is issued to an entity that is not taxable as a corporation; or
  - A member of the issuer's EG is substituted as a new obligor or added as a co-obligor on an existing debt instrument.

Effective Dates and Transition Rules

- General Effective Date: The transaction rules apply 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 is filed on or after April 4, 2016
- Transition Rules:
  - An otherwise Prohibited Transaction (for example, a distribution by a funded member) is not taken into account for purposes of the *per se* rule if the Prohibited Transaction occurred before April 4, 2016 (but not if it is treated as occurring before April 4, 2016 as a result of a check-the-box election that is filed on or after April 4, 2016)
  - If the transaction rules would treat a debt instrument as stock prior to the Finalization Date, the debt instrument is treated as debt for 90 days after the Finalization Date; if the debt instrument is held by an EG member on the 90th day after the Finalization Date, the debt instrument is deemed exchanged for stock on such date

Foreign Issues

- Relevancy: Instruments issued between foreign entities the characterization of which does not have any impact on a U.S. federal income tax return or information return are subject to these rules. Would Treasury and the IRS consider a relevancy requirement similar to Treas. Reg. section 1.7701-3 that would exempt instruments from Prop. Reg. section 1.385-3 if it has no relevance for U.S. federal income tax purposes at the time of issuance and is not issued with a tax avoidance motive?

- Section 909: There is no guidance about what happens to the split taxes when the debt instrument leaves the EG or otherwise ceases to be recharacterized as debt.

- Section 902: EG holders of recharacterized debt instruments may not own enough stock in the issuer to qualify for section 902 credits, but repayment of those instruments could effectively prevent the formal shareholder from claiming those credits through a later distribution. See, e.g., *First Chicago v. Comm'r*, 96 T.C. 421 (1991) (holding that members of a consolidated group calculate their ownership of the foreign subsidiary separately, rather than in the aggregate, for purposes of determining whether they qualify for section 902 credits).

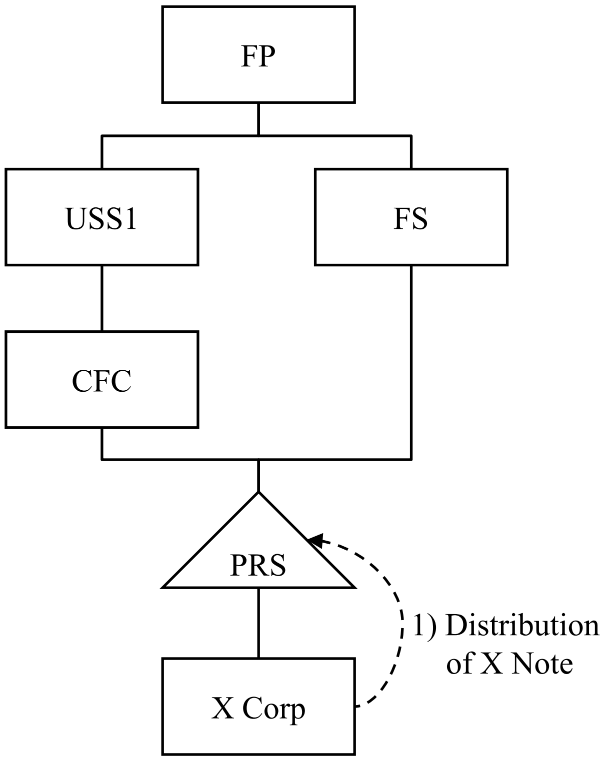
Prop. Reg. Section 1.385-3
Treatment of Partnerships and DREs

- For purposes of Prop. Reg. section 1.385-3, a Controlled Partnership is treated as an aggregate of its partners
  - When a corporation that is a member of an expanded group becomes a partner in a partnership that is a Controlled Partnership with respect to that Expanded Group, the corporation is treated as acquiring its proportionate share of the Controlled Partnership's assets
  - Each Expanded Group Partner in a Controlled Partnership is treated as issuing its proportionate share of any debt instrument issued by the Controlled Partnership
  - For this purpose, an Expanded Group Partner's proportionate share is determined in accordance with the partner's share of partnership profits
    - How should an Expanded Group Partner's share of partnership profits be determined?
    - Could liquidation value be used as an alternative in determining an Expanded Group Partner's proportionate share of the Controlled Partner's assets?
  - How do these rules apply in the context of debt instruments issued between a Controlled Partnership and its Expanded Group Corporate Partner?

Prop. Reg. Section 1.385-3
Treatment of Partnerships and DREs

- When a debt instrument issued by a Controlled Partnership is recharacterized, the holder of the recharacterized debt instrument is treated as holding equity in the Expanded Group Partners
- The Controlled Partnership and its partners must make appropriate conforming adjustments to reflect this treatment. Any such adjustments must be consistent with the purposes of Prop. Reg. section 1.385-3 and must be made in a manner that avoids the creation of, or increase in, a disparity between the Controlled Partnership's aggregate basis in its assets and the aggregate bases of the partners' respective interests in the partnership
  - Additional guidance needed on how to make appropriate conforming adjustments?
- Similarly, a debt instrument issued by a DRE may be recharacterized as equity in the owner of the DRE
  - Where the DRE is owned through a chain of DREs or partnerships, it is unclear whether this means the DRE's immediate owner, immediate regarded owner, or immediate regarded corporate owner.
- Should preferred equity in a Controlled Partnership be treated as equity in the Expanded Group Partners?

Prop. Reg. Section 1.385-3 Example 13: Distribution of a Debt Instrument to Partnership



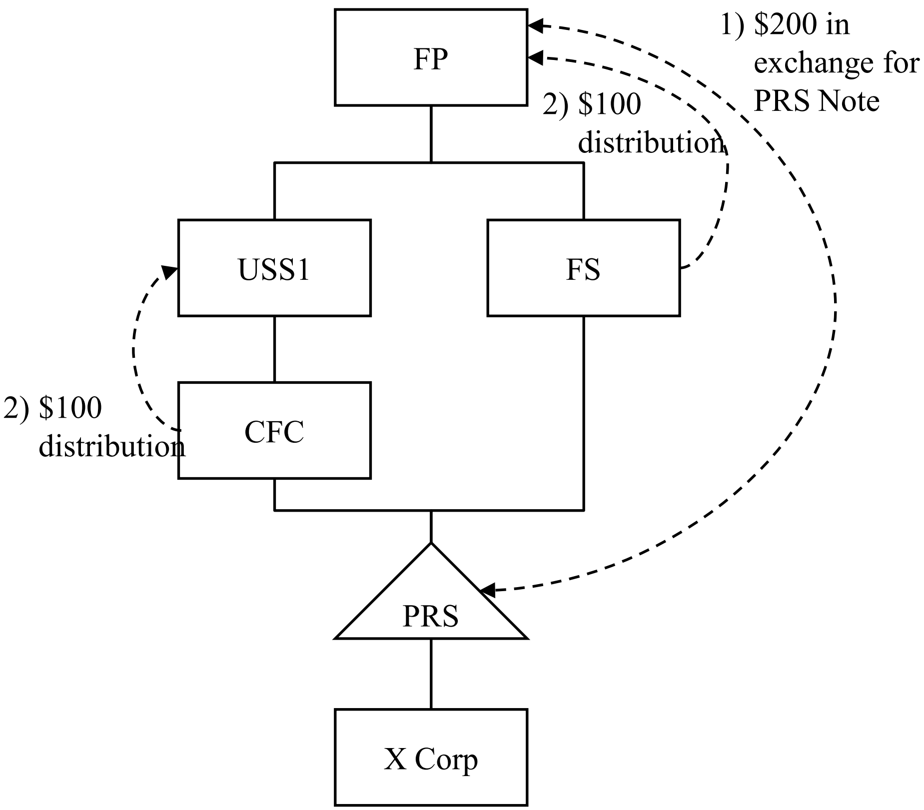
Steps

1) CFC and FS are equal partners in PRS. PRS owns 100 percent of the stock of X Corp, a domestic corporation. On Date A in Year 1, X Corp issues X Note to PRS in a distribution.

U.S. Tax Considerations

- Under section 1.385-1(b)(3), in determining whether X Corp is a member of the expanded group that includes CFC and FS, CFC and FS are each treated as holding 50 percent of the X Corp stock held by PRS. Accordingly, 100 percent of X Corp's stock is treated as owned by CFC and FS under section 1.385-1(b)(3)(i)(B), and X Corp is a member of the FP expanded group.
- Together CFC and FS own 100 percent of the interests in PRS capital and profits, such that PRS is a controlled partnership described in section 1.385-1(b)(1). Under paragraph (d)(5)(i) of this section, solely for purposes of this section, when X Corp issues X Note to PRS, proportionate shares of X Note are treated as issued to CFC and FS.
- Accordingly, for purposes of applying paragraph (b) of this section, in Year 1, 50 percent of X Note is treated as issued to CFC in a distribution and the other 50 percent of X Note is treated as issued to FS in a distribution. Therefore, under paragraphs (b)(2)(i) and (d)(1)(i) of this section, X Note is treated as stock beginning on Date A in Year 1. Under paragraph (d)(5)(i) of this section, CFC and FS are treated as holding X Note solely for purposes of this section. For all other federal tax purposes, X Note is treated as stock in X Corp that is held by PRS, and X Corp is treated as distributing its stock to its shareholder in a distribution that is subject to section 305.

Prop. Reg. Section 1.385-3 Example 14: Loan to Partnership; Same-Year Distribution



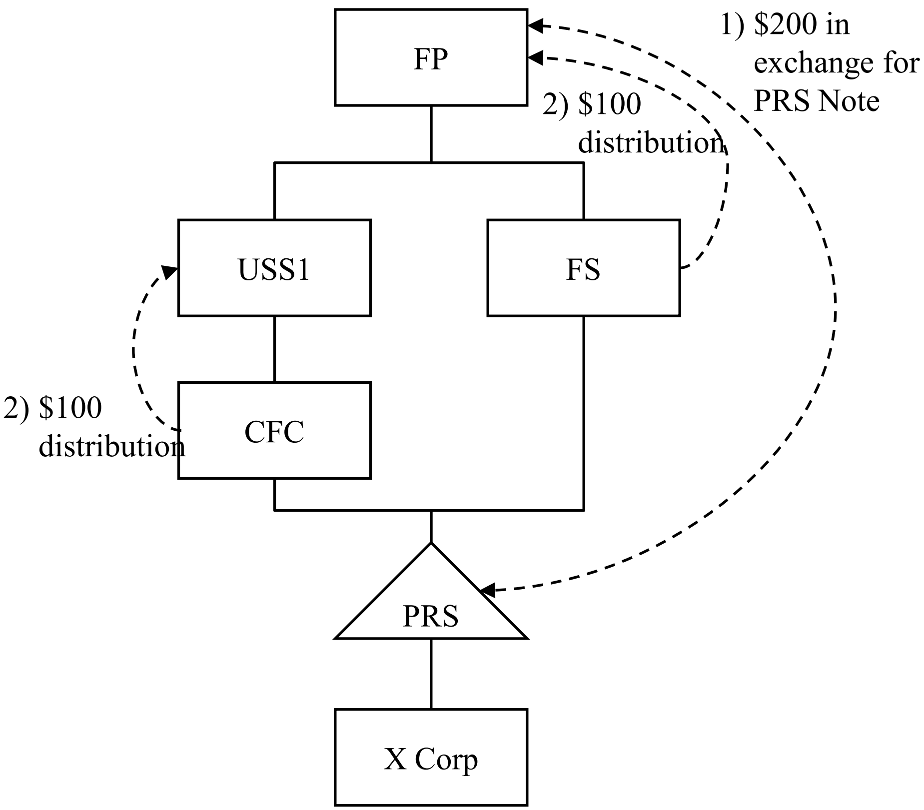
Steps

1) CFC and FS are equal partners in PRS. PRS owns 100% of the stock of X Corp, a domestic corporation. On Date A in Year 1, FP lends $200x to PRS in exchange for PRS Note.
2) On Date B in Year 1, CFC distributes $100x to USS1 and FS distributes $100x to FP.
3) CFC is not expatriated foreign subsidiary as defined in Treas. Reg. section 1.7874-12T(a)(9).

U.S. Tax Considerations

- Under paragraph (d)(5)(i) of this section, solely for purposes of this section, CFC and FS are each treated as issuing $100x of PRS Note on Date A in Year 1, which represents their proportionate shares of PRS Note.
- CFC's and FS's shares of PRS Note are each issued to FP, a member of the same expanded group, during the 72-month periods determined with respect to the distributions by CFC and FS.
- Under paragraph (b)(3)(iv)(B)(1) of this section, PRS Note is treated as issued with a principal purpose of funding the distributions by CFC and FS.
- Accordingly, under paragraphs (b)(3)(ii)(A) and (d)(1)(i) of this section, PRS Note is a principal purpose debt instrument that is treated as stock when it is issued on Date A in Year 1.
- Under paragraph (d)(5)(ii) of this section, CFC and FS are each treated as issuing $100x of stock to FP.

Prop. Reg. Section 1.385-3 Example 14: Loan to Partnership; Same-Year Distribution (Continued)



U.S. Tax Considerations (Continued)

- Appropriate conforming adjustments must be made to CFC's and FS's interests in PRS to reflect the deemed treatment of PRS Note as stock issued by CFC and FS, which must be done in a manner that avoids the creation of, or increase in, a disparity between PRS's aggregate basis in its assets and the aggregate bases of CFC's and FS's respective interests in PRS.
- For example, reasonable and appropriate adjustments may occur when the following steps are deemed to occur on Date A in Year 1:
  - CFC issues stock to FP in exchange for $100x;
  - FS issues stock to FP in exchange for $100x;
  - CFC contributes $100x to PRS in exchange for a partnership interest in PRS; and
  - FS contributes $100x to PRS in exchange for a partnership interest in PRS.

The Consolidated Group Rules:
Prop. Reg. Sections 1.385-1(e), -2(c)(4) and -4

Overview

- General Rule: "For purposes of [the Proposed Regulations], all members of a consolidated group are… treated as one corporation." Prop. Reg. § 1.385-1(e).
- Prop. Reg. section 1.385-2(c)(4) generally provides that when an AI ceases to be an intercompany obligation (as defined in Treas. Reg. section 1.1502-13(g)(2)(ii)) and, as a result, becomes an EGI, the AI is treated as an EGI immediately after it ceases to be an intercompany obligation (and thus is subject to the documentation requirements and, presumably, the bifurcation rule)
- Prop. Reg. section 1.385-4 provides rules (largely addressed in the next section titled "Deemed Exchanges of Debt for Equity and Vice Versa") for applying the transaction rules of Prop. Reg. section 1.385-3 to the U.S. consolidated group when an interest ceases to be or becomes a consolidated group debt instrument ("CGDI")
  - A debt instrument ***ceases*** to be a CGDI, but is subject to Prop. Reg. section 1.385-3, when:
    - The holder and/or issuer of the CGDI ceases to be a member of the U.S. consolidated group but continues to be an EG member (a "departing member"), or
    - The CGDI is transferred outside the U.S. consolidated group to an EG member
  - A debt instrument ***becomes*** a CGDI when:
    - The holder and issuer of the debt instrument becomes members of the same U.S. consolidated group, or
    - The debt instrument is transferred into the U.S. consolidated group of which the issuer is a member
- The effective date and transition rules for Prop. Reg. section 1.385-4 are effectively the same as those for Prop. Reg. section 1.385-3

Deemed Exchanges of Debt for Equity and Equity for Debt

Deemed Exchanges of Debt for Stock

- An interest that is subject to the Proposed Regulations may be treated as debt originally but then subsequently treated as stock. Examples of such deemed exchanges of debt for stock include instruments treated as debt upon issuance but subsequently:
  - Recharacterized as equity because the taxpayer failed to satisfy the documentation requirements of Prop. Reg. section 1.385-2
    - For example, the documentation rules are initially satisfied but the holder later fails to enforce its creditor rights

Deemed Exchanges of Debt for Stock (cont'd)

- Recharacterized as stock under the transaction rules or the consolidated group rules of Prop. Reg. sections 1.385-3 or -4
  - For example, there is a borrowing that is not initially treated as equity but is subsequently treated as equity because the funded member makes a distribution within 36 months of the borrowing to which no exception to the funding rule applies
  - Or a debt is issued that would otherwise be treated as stock under the transaction rule but is subject to the $50 million threshold exception and subsequently the $50 million threshold is exceeded
  - Or a debt that is initially a CGDI (solely because the departing member was in a U.S. consolidated group) but ceases to be a CGDI because the departing member is no longer a member of the U.S. consolidated group (but continues to be a member of the EG)

Deemed Exchanges of Debt for Stock (cont'd)

- Treated as stock under the transaction rules or the consolidated group rules once the transition period for application of those rules has expired
  - For example, a note that is treated as debt under case law but which would be treated as stock under the transaction rules of the Proposed Regulations is distributed with respect to an EG member's stock to another EG member on or after April 4th and before the Finalization Date and remains outstanding on the 90th day following the Finalization Date

- The government is seeking comments to the rule addressing deemed exchanges of an EGI and a debt instrument

Consequences of Deemed Exchanges of Debt for Stock

- If a debt is deemed exchanged for stock then, as of the date of the deemed exchange:
  - The holder is treated as having realized an amount equal to the holder's adjusted basis in the debt deemed exchanged
  - The holder is treated as having basis in the stock deemed received equal to the holder's adjusted basis in the debt deemed exchange
  - The issuer is treated as retiring the debt for an amount equal to its adjusted issue price
  - Neither the holder nor the issuer accounts for (i) accrued but unpaid qualified stated interest ("<u>QSI</u>") on the debt or (ii) section 988 foreign exchange gain or loss with respect to accrued but unpaid QSI
- Section 988 foreign exchange gain or loss is recognized, however, with respect to any amounts other than accrued but unpaid QSI
- If only a portion of a debt is deemed exchanged, then the above rules apply with respect to the portion of the debt deemed exchanged
- <u>Query</u>: Why is QSI carved out from the deemed exchange rules? What does it mean to "not account" for accrued but unpaid QSI?

Deemed Exchanges of Stock for Debt

- Just as an interest initially treated as debt can subsequently be treated as stock under the Proposed Regulations, an interest treated as stock under the Proposed Regulations can subsequently be treated as debt
  - For example, under the Proposed Regulations, subject to an anti-avoidance rule, when the holder and the issuer of a debt instrument treated as stock under the transaction rules cease to be members of the same EG, the debt instrument ceases to be treated as stock if it would not otherwise be treated as stock
  - More specifically, in such circumstances, immediately before the transaction that causes the holder and the issuer to cease to be members of the same EG, the issuer is deemed to issue a new debt instrument to the holder in exchange for the debt instrument that was treated as stock
    - Note: When the above rule causes debt that previously was treated as stock under the funding rule to cease to be treated as stock, all of the issuer's other debt instruments not currently treated as stock are re-tested under the funding rule to determine whether those instruments should be treated as funding a Prohibited Transaction that was previously funded by the debt instrument that ceases to be treated as stock
  - Similarly, when a debt instrument that is treated as stock under the transaction rules becomes a CGDI, immediately before that debt instrument becomes a CGDI, the issuer is deemed to issue a new debt instrument to the holder in exchange for the debt instrument that was treated as stock
    - Presumably, the same federal tax consequences that would follow from a debt instrument treated as stock ceasing to be an EGI follow from a debt instrument that is treated as stock becomes a CGDI

Consequences of Deemed Exchanges of Stock for Debt

- The Proposed Regulations do not delineate the specific federal tax consequences of the deemed issuance of a new debt instrument to the holder in exchange for the debt instrument that was treated as stock
  - Presumably if the new debt instrument is treated as debt there is a deemed redemption of the deemed stock and section 302 applies to that deemed redemption?
  - What is the "issue price" of the "new debt instrument"? Presumably generally determined under section 1274 rather than being deemed to be the fair market value of the instrument at the time of its deemed issuance (*cf.* Reg. § 1.1502-13(g))?
  - What happens to any "accrued dividends" on the deemed stock deemed redeemed for the deemed issued debt (which presumably become "accrued interest" on the deemed issued debt)?
  - Withholding tax consequences?