Proposed Treasury Regulations under Section 385 would have profound impact on related party financings

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In brief

On April 4, 2016, the IRS and Treasury issued proposed regulations (REG-108060-15) under Section 385 addressing whether an interest in a related corporation is treated as stock or indebtedness, or as in part stock and in part indebtedness (the 'Proposed Regulations'). The Proposed Regulations appear to be intended to limit the effectiveness of certain types of tax planning by characterizing related party financings as equity, even if they are in form straight debt instruments. The types of transactions targeted appear to include debt through note distributions in the inbound and outbound context, and debt repatriation in the outbound context. *It is critical to note, however, that the application of these Proposed Regulations is* ***not*** *limited to these types of transactions; the Proposed Regulations would instead apply generally to characterize as equity broad categories of related party debt transactions that routinely arise in the ordinary course of operations in both the domestic and international context.* The Proposed Regulations therefore could have a profound impact on a range of modern treasury management techniques, including cash pooling. The Proposed Regulations would generally apply to financial instruments issued after April 4, 2016, with effect from the date 90 days after regulations are issued in final form. Given this effective date, taxpayers must consider the potential impact of these Proposed Regulations on current transactions.

The key operation rules in the Proposed Regulations are the following:

- Prop. Reg. Secs. 1.385-3 and 1.385-4 characterize as equity (i) notes distributed to a related shareholder, (ii) notes issued to acquire equity of a related entity, and (iii) notes distributed to a related entity as boot in an asset reorganization. The rules also generally characterize certain loans to related entities as an equity investment if such a loan is issued within a 72-month period centered on the date that the issuer of the loan (i) distributes a dividend, (ii) acquires equity in a related entity, or (iii) distributes boot in an asset reorganization.
- Prop. Reg. Sec. 1.385-2 provides a new contemporaneous documentation requirement for related party debt. Taxpayers would be required to document both the commercial terms of the lending and an analysis of the creditworthiness of the borrower within thirty days of the lending. Taxpayers would

also be required to document events after the loan such as payments of principal and interest and events of default and similar events within 120 days of such events. If these contemporaneous documentation requirements are not satisfied, the financing generally is characterized as equity.

- Prop. Reg. Sec. 1.385-1(d)(1) provides that the IRS on exam (but not taxpayers) may bifurcate a single financial instrument issued between related parties into a combination of debt and equity.

A summary of the Proposed Regulations follows:

In detail

Generally applicable rules and definitions - Prop. Reg. Sec. 1.385-1

The applicability of the Proposed Regulations is generally limited to 'expanded group indebtedness' or 'EGI,' defined as an applicable instrument of which both the issuer and the holder are members of the same 'expanded group.' The preamble indicates that the definition of an expanded group limits the application of the Proposed Regulations to transactions between closely-related parties.

An 'expanded group' is defined as an affiliated group under Section 1504(a) but with certain modifications: (i) an expanded group includes all corporations (*e.g.*, foreign and tax-exempt corporations); (ii) an expanded group includes corporations held indirectly (*e.g.*, through partnerships); and (iii) an expanded group includes corporations connected by ownership of 80 percent vote or value, rather than vote and value. The Proposed Regulations also adopt the Section 304(c)(3) attribution rules for purposes of determining indirect ownership.

The Proposed Regulations do not apply to indebtedness between members of a consolidated group and instead treat a consolidated group as a single taxpayer (*i.e.*, one corporation). Certain indebtedness may, however, become an EGI if and when the instrument or a party to the instrument ceases to be within the consolidated group. In this regard, various transition rules generally provide that if an instrument or corporation enters or exits the consolidated group, then such instrument, or any instruments issued or held by such corporation, will be treated as repaid on the date of entry or issued on the date of exit, as appropriate.

Treatment of certain instruments as part debt and part stock

Prop. Reg. Sec. 1.385-1(d)(1) provides that the IRS (but not taxpayers) may treat an EGI as part indebtedness and part stock to the extent that an analysis under general federal tax principles of the relevant facts and circumstances, as of the issuance of the debt instrument, supports such treatment. The elimination of the 'all-or-nothing' characterization of a purported debt instrument applies to instruments issued on or after the date the regulations are finalized. Such bifurcation will occur only if the instrument has met the new documentation and information requirements discussed below, and the application of federal tax principles supports bifurcating the instrument. The scope of Prop. Reg. Sec. 1.385-1(d)(1) includes debt instruments between members of a 'modified expanded group,' defined as an expanded group but modified to use a 50 percent vote or value threshold, rather than 80 percent and includes certain partnerships and other persons.

Treatment of deemed exchanges

To the extent the Proposed Regulations require a deemed exchange in whole or in part (as discussed below), Prop. Reg. Sec. 1.385-1(c) provides that the holder of the relevant debt instrument is treated as having realized an amount equal to its adjusted basis in the portion of the debt instrument on the date of the deemed exchange, and the issuer is treated as having retired the same portion of the relevant debt instrument for an amount equal to its adjusted issue price on that date, without taking into account accrued but unpaid interest. Nevertheless, the holder and issuer must recognize foreign exchange gain or loss (if relevant) with respect to the deemed exchanged debt instrument (but not with respect to accrued but unpaid qualified stated interest) under the rules of Reg. Sec. 1.988-2(b)(13).

Contemporaneous documentation requirement for related-party indebtedness - Prop. Reg. Sec. 1.385-2

A significant aspect of the Proposed Regulations is the introduction of contemporaneous documentation requirements that must be satisfied in order to substantiate the existence and treatment of related-party indebtedness. These requirements are set forth in Prop. Reg. Sec. 1.385-2, which explicitly apply to EGIs.

In essence, the Proposed Regulations specify the nature of the documentation needed to substantiate debt treatment and require such documentation to be prepared within 30 days of the issuance of a related party debt instrument. If these contemporaneous documentation requirements are not satisfied, the purported indebtedness is treated as

stock, unless the taxpayer can establish that its failure to satisfy the documentation requirements is due to reasonable cause. If these requirements are satisfied, the purported indebtedness is analyzed as debt or stock (in whole or in part) under general federal tax principles, taking into account the documentation provided and other facts and circumstances.

The contemporaneous requirements only apply to expanded groups with (i) one or more members the stock of which is publicly traded, (ii) more than $100 million of total assets as reported on a non-tax audited financial statement the date the instrument first becomes an EGI, or (iii) more than $50 million of annual total revenue as reported on a non-tax audited financial statement the date the instrument first becomes an EGI.

General documentation requirements

Prop. Reg. Sec. 1.385-2(b)(2) provides, in relevant part, that the following written documentation must be prepared and maintained for all taxable years that the debt is outstanding and until the period of limitations expires for any return with respect to which treatment of the instrument is relevant:

i. evidence of an unconditional and legally binding obligation to pay a sum certain on demand or at one or more fixed dates

ii. evidence that indicates the holder has rights of a creditor, including a superior right to shareholders in the case of dissolution (but it is important to note that no distinction is mentioned between common and preferred shareholders)

iii. evidence of a reasonable expectation of the issuer's ability to repay the debt, such as cash flow projections, financial statements, business forecasts, asset appraisals, relevant financial ratios, or information on sources of funds, and

iv. evidence of timely interest and principal payments (*e.g.*, wire transfers or bank statements) or, in the case of either a failure to make required payments or an event of default, the holder's reasonable exercise of the diligence and judgment of a creditor.

Timing

Typically, the required documentation must be prepared no later than 30 calendar days after the instrument first becomes an EGI (generally the issue date), without regard to subsequent modifications of the debt instrument. In the case of documentation of a reasonable expectation of the issuer's ability to repay the debt, documentation must also be prepared no later than 30 calendar days after each issue date deemed to occur as a result of a significant modification of the original instrument. In the case of documentation of interest and principal payments (or with respect to defaults thereof), documentation must be prepared no later than 120 calendar days after the due date of each interest or principal payment and the date of each default or acceleration event. For example, if the debt instrument requires the issuer to maintain certain financial ratios, documentation must be prepared within 120 days of each date on which the issuer fails to maintain the specified financial ratio.

Special documentation requirements for revolvers and cash pools

With respect to EGI documented as part of a revolving credit agreement, all material documentation associated with the indebtedness, including all relevant enabling documents (*e.g.*, board of directors' resolutions, credit agreements, omnibus agreements, security agreements, etc.), must be prepared, maintained, and provided.

With respect to EGI issued pursuant to a cash pooling arrangement or internal banking service, all material documentation governing the ongoing operations of the arrangement or service (including any agreements with entities that are not members of the expanded group) must be prepared, maintained, and provided.

Partnerships

For purposes of the documentation requirements, the Proposed Regulations treat controlled partnerships (*i.e.*, partnerships more than 80 percent of the capital and profits interests of which are owned by members of the expanded group) as members of the expanded group. Any debt instrument issued by a controlled partnership treated as stock is treated as an equity interest in the controlled partnership.

Anti-abuse rules

The Proposed Regulations contain an anti-abuse rule and a no affirmative use rule within Prop. Reg. Sec. 1.385-2. If an applicable instrument that is not an EGI is issued with a principal purpose of avoiding the purposes of Prop. Reg. Sec. 1.385-2, the applicable instrument is treated as an EGI and subject to Prop. Reg. Sec. 1.385-2. The rules of Prop. Reg. Sec. 1.385-2 do not apply if there is a failure to satisfy the documentation requirements with a principal purpose of reducing the federal tax liability of any member or members of the expanded group or

any other person relying on the characterization of an EGI as indebtedness.

Effective date

The effective date of the Prop. Reg. Sec. 1.385-2 documentation requirements is set forth in Prop. Reg. Sec. 1.385-2(f), which provides that the documentation requirements apply to instruments issued or deemed issued on or after the date the Proposed Regulations are finalized and instruments deemed issued prior to the finalization date as a result of an entity classification election made on or after that date.

Certain distributions of debt instruments and similar transactions – Prop. Reg. Sec. 1.385-3

Prop. Reg. Secs. 1.385-3 and 1.385-4 (to the extent consolidated group transactions are relevant), generally treat certain debt instruments (*i.e.*, EGIs) as stock for all US federal tax purposes, irrespective of general US federal tax law principles, where the debt instrument is issued in, or funds, certain transactions. For purposes of Prop. Reg. Sec.Sec. 1.385-3 and 1.385-4, the term debt instrument means an instrument that satisfies the requirements of Prop. Reg. Sec.Sec. 1.385-1 and 1.385-2 and that is indebtedness under general principles of US federal income tax law.

General rule

Prop. Reg. Sec. 1.385-3(b) generally treats debt as stock for all US federal tax purposes if it is issued by a corporation to a member of the corporation's expanded group (i) in a distribution in which a subsidiary distributes a note to its parent; (ii) in exchange for expanded group stock (*e.g.*, in a Section 304 transaction) other than in an exempt exchange; or (iii) as consideration in an asset reorganization (*e.g.*, in a Section 368(a)(1)(D) reorganization) (the 'General Rule'). A debt instrument treated as stock under the General Rule is treated as stock as of the issuance of the instrument.

Note distributions

The first prong of the General Rule, which treats a debt instrument as stock if such debt instrument is distributed to a member of the issuing corporation's expanded group, would effectively overrule well-established case law, including *Kraft Foods Co. v. Comm'r*, 232 F.2d 118 (2d. Cir. 1956). The preamble provides that "the term distribution is broadly defined as any distribution by a corporation to a member of the corporation's expanded group with respect to the distributing corporation's stock, regardless of whether the distribution is treated as a dividend within the meaning of Section 316." The preamble further notes that "a debt instrument issued in exchange for stock of the issuer of the debt instrument (that is, in a redemption under corporate law) is a distribution that is covered by the first prong of the [General Rule] and an acquisition of expanded group stock covered by the second prong of the [General Rule]."

The first prong of the General Rule would apply in both the inbound and outbound contexts. For example, distributions of a note by a domestic subsidiary to its foreign parent in a Section 301 transaction would be covered by the General Rule. The instrument distributed is treated as stock rather than debt. As a result, future payments would be treated as dividends rather than interest. Importantly, many US income tax treaties currently in force eliminate US federal income tax on interest, but impose a US federal income tax rate on dividends. Thus, unless the foreign parent is eligible for a zero withholding rate on dividends, future payments of interest and principal on the instrument would be subject to a higher rate of US withholding tax. Moreover, the US corporation would not be entitled to an interest deduction with respect to payments on the instrument. In the outbound context, the first prong of the General Rule would apply, for example, where a CFC distributes a note to its shareholder, whether foreign or domestic.

Notes issued to acquire stock of a related party

The second prong of the General Rule, which treats debt as stock where it is issued in exchange for expanded group stock, appears to be aimed in part at triangular reorganizations where an acquiring corporation purchases stock of its parent to use as consideration in the reorganization. However, the rule would apply broadly to any note issued to acquire stock in an affiliate, including an issuer contributing its own note to the capital of an affiliate or issuing a note to purchase stock of an affiliate in what would otherwise be a Section 304 transaction. The preamble to the Proposed Regulations provides that this rule applies regardless of whether the expanded group stock is acquired from a shareholder of the issuer of the expanded group stock or directly from the issuer. Further, this rule would apply even to Section 351 exchanges where stock is not formally issued because the issuance would have no effect on the relative ownership interests in the issuing corporation (*i.e.*, the issuance would be a meaningless gesture) (see also discussion below with respect to the 'Exception for Funded Acquisitions of Subsidiary Stock by Issuance'). Example 11 in Prop. Reg. Sec. 1.385-3(g)(3) illustrates this situation in the context of a purported triangular reorganization where a foreign corporation (FP) issued its own stock and a note to its domestic subsidiary (USS1). USS1 then transferred the note and the FP stock to a related

domestic subsidiary (DS2) in exchange for all of DS2's assets and DS2 liquidated. Example 11 treats the note as stock beginning with the date of its issuance.

The second prong does not apply to 'exempt exchanges.' The term 'exempt exchange' means an acquisition of expanded group stock in which the transferor and transferee of the stock are parties to a reorganization that is an asset reorganization, and either (i) Section 361(a) or (b) applies to the transferor of the expanded group stock and the stock is not transferred by issuance; or (ii) Section 1032 or Reg. Sec. 1.1032-2 applies to the transferor of the expanded group stock and the stock is distributed by the transferee pursuant to the plan of reorganization. Thus, the second prong generally does not apply to a debt instrument that is issued by an acquiring corporation as part of the consideration in a reorganization in exchange for assets of the target corporation. However, such exchanges could be covered by the third prong of the General Rule, discussed below, which applies to exchanges that are part of an asset reorganization.

Notes issued in asset reorganizations

The third prong of the General Rule applies to a debt instrument issued in exchange for property in an asset reorganization among corporations that are members of the same expanded group, but only to the extent that, pursuant to the plan of reorganization, a shareholder that is a member of the issuer's expanded group immediately before the reorganization receives the debt instrument with respect to its stock in the transferor corporation. An asset reorganization is defined as a reorganization within the meaning of Section 368(a)(1)(A), (C), (D), (F), or (G). The preamble provides that "the second step receipt of the debt instrument by the expanded group shareholder could be in the form of a distribution of the debt instrument to shareholders of the distributing corporation in a divisive asset reorganization, or in redemption of the shareholder's stock in the transferor corporation in an acquisitive asset reorganization." The third prong of the General Rule appears to be directed at 'Cash D Reorganizations,' but would apply more generally.

The application of this rule can be illustrated by the following example: USP, a domestic corporation, owns all the stock of FT and FA, both foreign corporations. FA issues a note to FT in exchange for all of its assets and FT subsequently liquidates, distributing the note to USP in exchange for its FT stock. Because (1) USP, FT, and FA are all members of the same expanded group and (ii) the transaction should qualify as a reorganization under Section 368(a)(1)(D), the third prong of the General Rule would apply to treat the debt instrument as stock as of its issuance.

Funding rule

In addition to the General Rule, the Proposed Regulations would generally treat as stock any debt instrument issued to fund any of the three transactions targeted by the General Rule. Prop. Reg. Sec. 1.385-3(b)(3) generally treats a debt instrument as stock for all US federal tax purposes to the extent it is issued by a corporation (funded member) to a member of the funded member's expanded group in exchange for property with a principal purpose of funding certain distributions or acquisitions (the 'Funding Rule'). For purposes of this rule, references to the funded member include references to any predecessor or successor of such member.

Specifically, the Funding Rule applies where a debt instrument is issued to fund (i) a distribution of property by the funded member to a member of the funded member's expanded group, other than a distribution of stock pursuant to an asset reorganization that is permitted to be received without the recognition of gain or income under Section 354(a)(1) or 355(a)(1) or, when Section 356 applies, that is not treated as 'other property' or money described in Section 356; (ii) an acquisition of expanded group stock, other than in an exempt exchange by the funded member from a member of the funded member's expanded group in exchange for property other than expanded group stock; or (iii) 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 expanded group 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 can apply whether the debt instrument is issued before or after the relevant distribution or acquisition.

The determination of whether a debt instrument is issued with a forbidden principal purpose (*i.e.*, with a principal purpose of funding a distribution or acquisition) depends on all facts and circumstances. However, a debt instrument is generally *per se* treated (*i.e.*, no rebuttal allowed) as issued with a forbidden principal purpose if it is issued by the funded member during the period beginning 36 months before the date of the distribution or acquisition, and ending 36 months after the date of the distribution or acquisition. The IRS and Treasury indicate in the preamble to the Proposed Regulations that this non-rebuttable presumption is appropriate due to the fact that "money is fungible and because it is difficult for the IRS

to establish the principal purposes of internal transactions." A narrow exception to the *per se* rule exists for certain extensions of credit for sale of inventory and the receipt of services in the ordinary course of business, but as noted in the preamble, such exception is not intended to apply to, among other things, treasury center activities.

The breadth of this *per se* rule would affect a large number of routine intercompany financings. If, for example, a member of an expanded group pays a dividend, a borrowing of funds from a group cash pool at any time during the period beginning 36 months before the dividend and ending 36 months after the dividend, such a borrowing would be treated as issued with a principal purpose of funding a distribution and, therefore, treated as equity. The repayment of the borrowing is presumably transformed into a Section 302 redemption.

If a debt instrument is treated as stock pursuant to Prop. Reg. Sec. 1.385-3(b)(3), the distribution or acquisition that is treated as funded by such debt instrument is not recharacterized as a result of the treatment of the debt instrument as stock. For example, if a first-tier CFC borrows from a related CFC and distributes the proceeds, the CFC-to-CFC loan is recharacterized as stock, but the distribution of the proceeds is still treated as a Section 301 distribution.

Where a distribution or acquisition could be treated as funded by multiple debt instruments, it is treated as funded by the debt instruments in the order in which they were issued. Similarly, where a debt instrument could be treated as funding multiple distributions or acquisitions, the debt instrument is treated as funding the distributions or acquisitions based on the order in which the distributions or acquisitions occurred, with the earliest distribution or acquisition treated as funded first. When the holder and issuer of a debt instrument that is treated as stock under Prop. Reg. Sec. 1.385-3 cease to be members of the same expanded group, all other potential funding transactions are re-tested and treated as stock as appropriate.

Exceptions to Prop. Reg. Sec. 1.385-3

Prop. Reg. Sec. 1.385-3(c) provides three exceptions to the application of the General Rule and the Funding Rule.

1. *Current year E&P exception:* For purposes of applying the General Rule and the Funding Rule, the aggregate amount of any distributions or acquisitions described in Prop. Reg. Sec. 1.385-3 are reduced by an amount equal to the current year E&P of the distributing or acquiring corporation; such a reduction is applied to the relevant transactions based on the order in which the distribution or acquisition occurs.

2. *Threshold exception*: A debt instrument will not be treated as stock if, when the debt instrument is issued, the aggregate issue price of all expanded group debt instruments that would otherwise be treated as stock under the Proposed Regulations does not exceed $50 million. The threshold exception functions as a cliff; once the threshold is reached, all debt instruments that, but for the threshold exception, would have been treated as stock are treated as stock. Once the $50 million threshold is exceeded, the threshold exception will not apply to any debt instrument issued by members of the expanded group for so long as any instrument that previously was treated as indebtedness solely because of the threshold exception remains outstanding, in order to prevent the $50 million limitation from refreshing after those instruments are treated as stock.

3. *Exception for funded acquisitions of subsidiary stock by issuance*: An acquisition of expanded group stock will not be treated as an acquisition for purposes of the Funding Rule if (i) the acquisition results from a transfer of property by a funded member (the transferor) to an issuer in exchange for stock of the issuer, and (ii) for the 36-month period following the issuance, the transferor holds, directly or indirectly, more than 50 percent of the vote and value of the stock of the issuer.

Consequences of Prop. Reg. Sec. 1.385-3

If Prop. Reg. Sec. 1.385-3 applies to treat a debt instrument as stock, the instrument is treated as stock for all purposes of the Code. For example, a distribution of a note will be treated as a distribution of stock to which Section 305, rather than Section 301, applies. Similarly, an acquisition of stock for a note in what would otherwise constitute a Section 304(a)(1) transaction instead is treated as a stock-for-stock acquisition to which Section 304 does not apply. Additionally, a triangular B reorganization in which a domestic subsidiary (S) acquires stock of its foreign parent (P) from P in exchange for a note will not be subject to Reg. Sec. 1.367(b)-10 because S will be treated as acquiring P stock with S stock and not property.

The preamble to the Proposed Regulations explains that "[c]onsistent with the traditional case law debt-equity analysis, when a debt instrument is treated as stock under proposed [Reg. Sec.] 1.385-3, the terms of the debt instrument (for example, voting rights or conversion features) are taken into account for purposes of determining the type of

stock resulting from the recharacterization, including whether such stock is preferred stock or common stock." Note that this rule could result in the debt instrument being characterized as Section 351(g) nonqualified preferred stock, Section 306 stock, or fast pay stock, depending on the circumstances.

As described above, if Prop. Reg. Sec. 1.385-3 applies to treat a debt instrument as stock, the debt instrument generally is treated as stock as of its issuance. However, in the case of a funding transaction occurring in a taxable year during or before the funded distribution or acquisition, the debt instrument generally is instead treated as exchanged for stock of the issuer on the date of the distribution or acquisition. If the funding transaction is treated as stock as a result of a re-testing, the exchange is deemed to occur on the date of the re-testing. If a debt instrument treated as stock under Prop. Reg. Sec. 1.385-3 leaves the consolidated group (either directly or because its holder or issuer ceases to be a member of the expanded group), then the instrument is treated as stock until immediately before the exit transaction, at which time the stock is deemed exchanged for newly issued debt.

Treatment of partnerships

For purposes of Prop. Reg. Sec. 1.385-3, a partnership is treated as an aggregate of its partners if at least 80 percent of the capital and profits interests of the partnership is owned by members of the expanded group. To the extent that this aggregate approach causes a debt instrument issued by a partnership to be recharacterized as stock under Prop. Reg. Sec. 1.385-3(b), the debt instrument issued by the partnership is treated as stock of the partners, and debt issued to the partnership is determined as if the partners held the debt for purposes of applying Prop. Reg. Sec. 1.385-3(b). Where necessary, appropriate conforming adjustments must be made to reflect this treatment.

Anti-abuse rules

Prop. Reg. Sec. 1.385-3(b)(4) contains a broad anti-abuse rule under which "a debt instrument is treated as stock if it is issued with a principal purpose of avoiding the application of" Prop. Reg. Sec. 1.385-3 or Prop. Reg. Sec. 1.385-4. The Proposed Regulations include a non-exhaustive list of examples illustrating situations where the anti-abuse rule may apply. Further, Prop. Reg. Sec. 1.385-3(e) prevents the affirmative use of the Proposed Regulations by providing that Prop. Reg. Sec. 1.385-3 does not apply to the extent a person enters into a transaction that otherwise would be subject thereto with a principal purpose of reducing the federal tax liability of any member of the expanded group by disregarding the treatment of the debt instrument that would occur without regard to Prop. Reg. Sec. 1.385-3. This rule effectively provides that Prop. Reg. Sec. 1.385-3 does not apply to recharacterize a debt instrument as stock if doing so would result in the reduction of the federal tax liability of the taxpayer or any member of its expanded group.

Effective date

Prop. Reg. Sec. 1.385-3(h)(1) provides that Prop. Reg. Sec. 1.385-3 applies to debt instruments issued on or after April 4, 2016, and to any debt treated as issued before April 4, 2016, as a result of a retroactive check-the-box election filed on or after April 4, 2016.

Transition rules

For distributions or acquisitions occurring before April 4, 2016

For purposes of determining whether a debt instrument is issued with a principal purpose of funding a distribution or acquisition identified in the Funding Rule, a distribution or acquisition that occurs before April 4, 2016 (other than a distribution or acquisition that is treated as occurring before April 4, 2016, as a result of a check-the-box election filed on or after April 4, 2016) is not taken into account for purposes of applying the Funding Rule.

For debt instruments that would be treated as stock on or after April 4, 2016, but prior to the issuance of final regulations

As noted above, Prop. Reg. Sec. 1.385-3(h) provides that Prop. Reg. Sec. 1.385-3 applies to debt instruments issued on or after April 4, 2016, and to any debt treated as issued before April 4, 2016, as a result of a retroactive check-the-box election filed on or after April 4, 2016. If Prop. Reg. Sec. 1.385-3 would otherwise treat such a debt instrument as stock prior to the date the Proposed Regulations are published as final, the debt instrument is treated as indebtedness until the date that is 90 days after the date the Proposed Regulations are published as final. To the extent that the debt instrument is held by a member of the issuer's expanded group on the date that is 90 days after the date the Proposed Regulations are published as final, the debt instrument is deemed to be exchanged for stock on such date.

Treatment of consolidated groups – Prop. Reg. Sec. 1.385-4

As discussed above, Prop. Reg. Sec. 1.385-1(e) provides that members of a consolidated group are treated as *one corporation* for purposes of the Proposed Regulations. Thus, Prop. Reg. Sec. 1.385-3 does not apply to a debt instrument issued by one member of a consolidated group to another member of such group (*i.e.*, a consolidated group debt instrument). Prop. Reg. Sec. 1.385-4, however,

provides rules for applying Prop. Reg. Sec. 1.385-3 to consolidated groups when an interest ceases to be a consolidated group debt instrument or becomes a consolidated group debt instrument.

Consolidated member leaves the group

When a member ceases to be a member of a consolidated group but continues to be a member of the expanded group, a debt instrument that is issued or held by the departing member is treated as indebtedness or stock pursuant to Prop. Reg. Sec. 1.385-4(b)(1)(i) or (b)(1)(ii).

First, Prop. Reg. Sec. 1.385-4(b)(1)(i) provides that any exempt consolidated group debt instrument that is issued or held by the departing member is deemed to be exchanged for stock *immediately after* the departing member leaves the group. For these purposes, the term 'exempt consolidated group debt instrument' is defined as any debt instrument that was not treated as stock solely by reason of the departing member's treatment under Prop. Reg. Sec. 1.385-1(e) (*i.e.*, the departing member was part of a consolidated group).

Second, Prop. Reg. Sec. 1.385-4(b)(ii) generally provides that any consolidated group debt instrument issued or held by a departing member that is not an exempt consolidated group debt instrument (*i.e.,* a 'non-exempt consolidated group debt instrument') is treated as indebtedness unless and until the non-exempt consolidated group debt instrument is treated as a principal purpose debt instrument under Prop. Reg. Sec. 1.385-3(b)(3) and (d)(1) as a result of a distribution or acquisition (described in Prop. Reg. Sec. 1.385-3(b)(3)(ii)) that occurs after the departure. For these purposes, the term 'non-exempt consolidated group debt instrument' refers to a debt instrument that would not have been recharacterized as stock under Prop. Reg. Sec. 1.385-3(b) regardless of whether it was a consolidated group debt instrument.

Solely for purposes of applying the *per se* rule (Prop. Reg. Sec. 1.385-3(b)(3)(iv)(B)), a non-exempt consolidated group debt instrument is treated as having been issued when it was first treated as a consolidated group debt instrument. Prop. Reg. Sec. 1.385-4(b)(1)(ii)(B) further states that for all other purposes of applying Prop. Reg. Sec. 1.385-3, a non-exempt consolidated group debt instrument is treated as issued by the issuer of the debt instrument immediately after the departing member leaves the group.

Consolidated group debt instrument that is transferred outside of the group

In addition, solely for purposes of Prop. Reg. Sec. 1.385-3, when a member of a consolidated group that holds a consolidated group debt instrument transfers the debt instrument to an expanded group member that is not a member of the consolidated group, the debt instrument is treated as issued by the issuer of the debt instrument to the transferee expanded group member on the date of the transfer. Prop. Reg. Sec. 1.385-4(b)(2). For example, the sale of a consolidated group debt instrument to an expanded group member that is not a member of the consolidated group will be treated as an issuance of the debt instrument to the transferee expanded group member in exchange for property. To the extent the debt instrument is treated as stock upon being transferred, the debt instrument is deemed to be exchanged for stock immediately after the debt instrument is transferred outside the consolidated group.

Debt instrument entering a consolidated group

Lastly, Prop. Reg. Sec. 1.385-4(c) provides that when a debt instrument that is treated as stock under Prop. Reg. Sec. 1.385-3 becomes a consolidated group debt instrument, immediately before that debt instrument becomes a consolidated debt instrument, the issuer is treated as issuing a new debt instrument to the holder in exchange for the debt instrument that was treated as stock in a transaction that is disregarded for purposes of Prop. Reg. Sec. 1.385-3(b).

Effective date and transition rules

Prop. Reg. Sec. 1.385-4(e) applies the same effective date and transition rules to Prop. Reg. Sec. 1.385-4 as those discussed above with respect to Prop. Reg. Sec. 1.385-3.

The takeaway

The Proposed Regulations were issued as part of a larger regulation package targeting redomiciliations. However, it is important to note that these rules apply broadly and thus would not be limited to redomiciled companies or foreign transactions. The Proposed Regulations also attempt to impede many cross-border transactions by exercising the regulatory authority under Section 385 to recharacterize financing transactions as equity (or in part debt and in party equity).

The Proposed Regulations, as drafted, would dramatically impact typical international treasury management practices, such as cash pooling and related party financing. It would be a burden on the competitiveness of multinationals if they were effectively prevented from engaging in modern treasury management techniques designed to minimize external borrowings and manage internal liquidity.

The standards to be applied and the limits on the Commissioner's discretion to bifurcate debt instruments are not clear. Complex issues could arise on examination when, after the debt has been outstanding for several years and the principal has been partially paid, the IRS asserts, with the benefit of hindsight, that a given portion of the debt was equity.

The contemporaneous documentation requirements set forth in Prop. Reg. Sec. 1.385-2, which if not satisfied generally will result in the recharacterization of debt as equity for all US federal income tax purposes, will impose significant compliance burdens on taxpayers. It is not clear what a contemporaneous documentation requirement achieves, given that a taxpayer has always had the burden of proof and has always had to present the evidence necessary to establish that a related party financing qualifies as debt.

The proposed application of final regulations to debt issued after April 4, 2016, presents immediate concerns to taxpayers. As described above, any debt subject to the Proposed Regulations issued after April 4, 2016, would be deemed to convert into stock on the date 90 days after the regulations are issued in final form. Among the effects of such a deemed conversion would be the recognition of foreign currency gains with respect to the debt. Taxpayers need to be mindful that the payment of dividends, the purchase of stock in affiliates, and the issuance of boot in asset reorganizations taking place while the regulations are still in proposed form could result in debt issued on or after April 4, 2016, being recharacterized as stock when the regulations are issued in final form.

There will certainly be debate over the authority for and administrability of the Proposed Regulations. The IRS and Treasury have interpreted their authority under Section 385 broadly to address various transactions that have been targeted by Administration legislative proposals include basis return planning, 'Cash D reorganizations,' triangular reorganizations, and earnings stripping. Although Treasury has had broad regulatory authority under Section 385 since 1969, it has been over 30 years since the Treasury's last effort to promulgate regulations. The broad regulatory authority is not unlimited. It grants Treasury authority to write regulations distinguishing between debt and equity based on a series of factors that reflect the principles of long-standing common law. Rather than adopting the common law principles included in Section 385 in a coherent set of regulations, Proposed Regulations would treat debt that is clearly debt under common law principles as equity based solely on the common ownership of the issuer and holder.

Let's talk

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