

July 7, 2016

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and submitted electronically with the Federal eRulemaking Portal at:
www.regulations.gov (IRS REG-108060-15)

Re: REG-108060-15 Proposed Section 385 Regulations

Dear Sirs and Madam:

The Retail Industry Leaders Association (“RILA”) is the trade association of the world’s largest and most innovative retail companies. RILA members include more than 200 retailers, product manufacturers, and service suppliers, which together account for more than \$1.5 trillion in annual sales, millions of American

jobs, and more than 100,000 stores, manufacturing facilities, and distribution centers domestically and abroad.

With nearly 18 million Americans employed in retail jobs, and more than 10 million additional jobs supported by retailers, the retail industry is America's second-largest private employer. As a result of the retail industry's role as a significant employer, and billions of dollars paid in federal, state, and local taxes by retail, few industries have a greater impact on the U.S. economy than retail. While the retail industry pays an average effective tax rate of 36.4%, many retailers face rates significantly higher than that. In fact, the industry's effective tax rate is the fourth highest of all 18 major industrial sectors. Thus, taxes are a significant issue for RILA's members.

On April 4, 2016, the U.S. Department of the Treasury ("Treasury") and the Internal Revenue Service (the "Service") issued proposed regulations (the "Proposed Regulations")¹ under section 385 of the Code.² The Proposed Regulations contain three distinct sets of rules, which we refer to as the Part Stock Rule,³ the Documentation Requirements,⁴ and the Per Se Rules.⁵ RILA's members are especially concerned about the Proposed Regulations because the regulations will have a negative impact on our members, who already pay high federal, state, and local taxes as a result of their brick-and-mortar and e-commerce business models. Our members' businesses typically have low margins, putting American jobs at risk when those margins are further compressed by increased tax and compliance costs.

RILA appreciates the opportunity to provide comments on the Proposed Regulations, and we have focused our comments on potential changes that we believe can improve any final regulations that are issued. However, RILA has significant policy and technical concerns with the Proposed Regulations, which are further described below. Due to the broad reach of the Proposed Regulations, we are still evaluating them and attempting to determine their impact on our members' businesses. We respectfully request that the comment period be extended ninety days beyond July 7, 2016 to allow us and our members adequate time to fully analyze the Proposed Regulations, determine their impact on our members' businesses, and craft any additional recommendations to revise the Proposed Regulations to address both our members' concerns and those of the government. Where possible, we have recommended changes to the Proposed Regulations to address our concerns but, for the reasons discussed above, these recommendations may be incomplete.

A summarized list of our recommendations is set forth below:

Comment Period and Effective Dates.

- The comment period should be extended for three months to October 7.
- The effective date for the final regulations should be extended to apply to instruments issued or deemed issued no earlier than 24 months after the publication of the final regulations in the Federal Register, and the regulations should be prospective in effect.

¹ REG-108060-15, 81 Fed. Reg. 20,912 (Apr. 8, 2016).

² Unless otherwise noted, all "Code" and "section" references are to the United States Internal Revenue Code of 1986, as amended, and all "Treas. Reg. §" references are to the Treasury Regulations promulgated thereunder.

³ Prop. Treas. Reg. § 1.385-1(d).

⁴ Prop. Treas. Reg. § 1.385-2.

⁵ Prop. Treas. Reg. § 1.385-3.

Technical Recommendations.

Part Stock Rules

- The Part Stock Rule should apply for Expanded Group Instruments (“EGIs”) issued between members of the same Expanded Group (“EG”), not Modified Expanded Group (“MEG”).
- The Service should issue guidance to IRS auditors on when the application of the Part Stock Rule is appropriate, similar to the Section 7701(o) Directive.
- The Service should provide detailed guidance on the operation of the Part Stock Rule.
- The Part Stock Rule should provide a *de minimis* exception.

Documentation Requirements.

- If a taxpayer fails to satisfy the Documentation Requirements, the penalty should not be to automatically treat the instrument as equity.
- What qualifies as sufficient documentation to satisfy the Documentation Requirements should be clearly described.
- The relevant date for preparing required documentation should be extended.
- Regardless of how the Documentation Requirements are revised, trade receivables and ordinary course transactions should be excluded.
- A taxpayer should be exempt from satisfying the Documentation Requirements for all foreign-to-foreign instruments.
- Treasury should provide a *de minimis* rule exempting small borrowings from the Documentation Requirements.
- Treasury and the Service should confirm that taxpayers will not need to prepare documentation for each cash pool draw.
- The reasonable cause exception for failing to satisfy the Documentation Requirements should be expanded.

Per Se Rules.

- The exceptions to the Per Se Rules should be expanded.
- The 72-month window should be shortened and changed to a rebuttable presumption.
- Ordinary cash management systems such as cash pooling should be exempted from the Per Se Rules.
- Foreign-to-foreign instruments should be exempt from the Per Se Rules.

State and Local Tax Implications.

- We recommend revising the language in Prop. Treas. Reg. § 1.385-1(e) to provide that “all members of a consolidated group (as defined in §1.1502-1(h)) *that file (or that are required to file) consolidated U.S. federal income tax returns* are treated as one corporation.”

I. Policy Considerations.

This section describes RILA’s comments on both the policy decisions underlying the Proposed Regulations, as well as the negative effects those decisions will have on the retail industry.

A. The Proposed Regulations Apply Far More Broadly Than the Preamble and the Treasury Fact Sheet Suggest.

The Fact Sheet describes the rationale for the Proposed Regulations solely as “address[ing] the issue of earnings stripping.”⁶ But the Proposed Regulations clearly extend far beyond transactions involving earnings stripping. Both the Documentation Requirements and the Per Se Rules apply to transactions that present no opportunity for earnings stripping, and, of course, because the Part Stock Rule is not limited in any way, nothing prevents an exam team from attempting to recharacterize debt as part debt, part equity in a transaction that has no possibility of earnings stripping. RILA believes that Treasury and the Service should limit the final regulations to transactions that present earnings stripping concerns, but, to the extent that any final regulations apply more broadly, Treasury and the Service should clearly articulate the tax policy rationale for the broader rules and identify the “problem” that the government is concerned about, as well as how any final regulations will solve that problem in a way that increases taxpayer certainty and furthers effective tax administration.

B. The Proposed Regulations Increase Uncertainty and Impede Effective Tax Administration, Contrary to Congressional Intent When Section 385 Was Enacted.

When section 385 was enacted in 1969, Congress was concerned about the disparate tests applied by different circuits in determining whether an instrument was properly treated as debt or equity, and enacted section 385 because “it would be desirable to provide rules for distinguishing debt from equity in the variety of contexts in which this problem can arise.”⁷ This goal is not met by the Proposed Regulations. As discussed in more detail below, the Part Stock Rule increases uncertainty for taxpayers and impedes effective tax administration because no standards have been provided to the Service to use in recharacterizing debt as part debt, part equity. Without identifying standards to be applied across the Service and issuing instructions to the field on when and how the Part Stock Rule should be applied, field agents will necessarily make individualized decisions on an audit-by-audit basis, resulting in inconsistent determinations among similarly situated taxpayers. Without clearly articulated standards to apply, Appeals’s workload will be increased as taxpayers appeal what they perceive to be inconsistent, *ad hoc* determinations made by exam teams. If there are inconsistent decisions made at Appeals, the number of court cases filed to adjudicate Part Stock Rule determinations will significantly increase. None of this furthers effective tax administration; it merely wastes government and taxpayer resources.

Similarly, the Documentation Requirements also impose unnecessary burdens on taxpayers without providing a corresponding improvement in effective tax administration, increase uncertainty for taxpayers,

⁶ See Fact Sheet: Treasury Issues Inversion Regulations and Proposed Earnings Stripping Regulations, April 4, 2016, at <https://www.treasury.gov/press-center/press-releases/Pages/jl0404.aspx> (last accessed June 19, 2016).

⁷ S. REP. NO. 91-552, pt. 2, at 138 (1969).

and impede effective tax administration. Under current law, taxpayers bear the burden of proving that an instrument that purports to be debt is, in fact, debt. Forcing taxpayers to comply with the incredibly burdensome Documentation Requirements may require some to be more “diligent” than they have previously been, as the Preamble asserts, but it doesn’t change the burden of proof that *taxpayers already bear*. The Service should focus less on mandating *how* taxpayers satisfy their burden of proof, and more on denying debt treatment where taxpayers do *not* satisfy their burden of proof. Such an approach would not penalize already-diligent taxpayers by requiring them to comply with a one-size-fits-all approach to meeting their burden of proof.

Moreover, the Documentation Requirements increase uncertainty because, although they identify what factors must be documented, they provide no guidance on what qualifies as sufficient documentation to satisfy the requirements. Without clear guidance as to what is sufficient to satisfy the requirements, taxpayers will be uncertain about what is required of them and there is a risk that exam teams will apply the Documentation Requirements inconsistently to similarly situated taxpayers. Taxpayer confusion and inconsistent application of rules do not benefit taxpayers *or* the Service; rather, they simply increase burden without a corresponding benefit to tax administration.

C. The Proposed Regulations Increase the Cost of Borrowing, With No Tax Policy Justification for Doing So.

The Proposed Regulations treat economically similar transactions differently and create a bias towards third-party debt. One rational response by taxpayers to the Proposed Regulations is to replace related-party debt with third-party debt, since transactions that are prohibited for related parties under the Funding Rule, for example, can be undertaken with a third party with no adverse tax consequences. From a policy perspective, it makes little sense to treat these two otherwise economically similar transactions differently. This approach is also inconsistent with other provisions in the Code and regulations which seek to treat economically similar transactions the same, such as section 7701(o) and Treas. Reg. § 1.367(b)-10.

From a business perspective, it makes even less sense to replace related-party debt with third-party debt to fund operations since third-party debt is much more costly, especially when factoring in additional transaction costs. Based on a survey of RILA’s members, using third-party debt instead of related-party debt can increase cash management costs by a significant amount that could ultimately result in the loss of U.S. jobs. The effect is a higher cost of capital that will remove funding from other business activities. The impact of these rules will disproportionately affect U.S. retailers that seek to grow their business in emerging markets, for example, because the cost of third-party borrowing is much higher than U.S. or related-party borrowing. Additionally, the use of third-party debt for routine functions employs borrowing capacity that could be used to fund other items.

D. The Proposed Regulations Impose Punitive Results on Ordinary, Everyday Transactions.

The Proposed Regulations would make it nearly impossible for companies to continue to use their existing cash pooling arrangements and short-term intercompany lending outside a formal cash pool, which have been developed to minimize borrowing costs, manage currency risk, and streamline operations. Cash pooling and short-term lending are discussed in more detail below in Part III.C.3.

Moreover, the Proposed Regulations disadvantage retailers who are looking to expand by either hindering post-acquisition integration or, where such integration is not hindered, increasing its cost. Some of our members grow their businesses by acquiring other companies, which benefits their employees, their

consumers, and the public fisc. As drafted, the Proposed Regulations would complicate such acquisitions, especially in the due diligence process as the acquiring company would need to review *all* of the target's debt instruments to assess compliance with the Proposed Regulations.

In particular, if a U.S.-based retailer were interested in acquiring a foreign target, the Proposed Regulations could make it too costly for the U.S.-based retailer to do so, since the likelihood that a foreign target will have complied with the Documentation Requirements or the Per Se Rules is virtually nil. The only way for the U.S.-based retailer to have certainty is to have the foreign target retire all existing intercompany debt before the acquisition, which adds considerable cost and complexity to consummating the transaction. As a result, the U.S.-based retailer may lose out on such strategic acquisitions because they are too costly.

Finally, the retail industry pays an average effective tax rate of 36.4%,⁸ clearly demonstrating that RILA's members are not using the types of transactions about which Treasury is concerned to lower their effective tax rate.

E. To the Extent That Treasury and the Service Have Policy Concerns About Earnings Stripping Transactions, They Should Draft More Narrowly Tailored Rules to Address Those Specific Concerns.

The Proposed Regulations, by their terms, apply far more broadly than to earnings stripping transactions. If Treasury's concern is about limiting taxpayers' ability to engage in earnings stripping—as the Preamble to the Proposed Regulations and the Fact Sheet seem to suggest—then the Proposed Regulations should be revised to have a targeted effect on transactions that present earnings stripping opportunities only, and should not affect all related-party transactions equally.

II. The Effective Date Provisions Should Be Extended in Final Regulations.

RILA's members are concerned that the effective dates in the Proposed Regulations—particularly for the Documentation Requirements and the Per Se Rules—are too soon to give taxpayers adequate time to understand and apply the rules. Well-advised, sophisticated taxpayers will struggle to comply with the rules in a timely fashion and other taxpayers will be unaware of, or not understand the application of, the rules, getting caught in traps for the unwary. In the interest of fairness and effective tax administration, RILA believes that the effective dates should be extended in final regulations.

The effective date for the Documentation Requirements—proposed to apply to applicable instruments issued or deemed issued on or after the date final regulations are published in the Federal Register—should be postponed and should apply to applicable instruments issued or deemed issued no earlier than 24 months after the publication of the final regulations in the Federal Register. RILA believes that a delayed effective date is necessary because, similar to the requirements placed on taxpayers by the FATCA regulations, affected taxpayers will be required to build and test new systems, develop new processes, and hire new personnel to comply with these requirements. Taxpayers will also require time to catalog and centralize management of loans to ensure adherence to the Documentation Requirements and to prevent the inadvertent application of the Per Se Rules. Treasury officials have stated publicly that the Documentation Requirements may be revised in the final regulations, which RILA appreciates. However, taxpayers cannot

⁸ See *The Retail Industry Leaders Association 2016 Public Policy Agenda*, at 11, at <http://www.rila.org/Public-Policy/Documents/RILA%20Policy%202016%20final.pdf> (last accessed June 19, 2016).

begin developing systems and processes until they know what the final rules are, further justifying a delayed effective date.

Based on a poll of our membership, RILA believes that it will take our members a minimum of 18-24 months to update their IT systems or develop new ones to comply with the Documentation Requirements (whatever they may turn out to be). RILA members will also have to hire additional personnel to complete the recordkeeping and paperwork necessary to satisfy the Documentation Requirements. For our members outside major metropolitan areas, it may be difficult to attract a sufficient number of qualified new employees in a short time period. As a result, the effective date in the Proposed Regulations is impossible to meet. In addition to delaying the effective date for the Documentation Requirements, RILA requests that the Service apply a grace period during which it does not penalize taxpayers who have made a good faith effort to comply with the Documentation Requirements while both taxpayers and the Service are developing a working familiarity with the requirements.

In the final FATCA regulations, as an example, Treasury accepted comments that it would take a significant amount of time to develop, test, and implement the necessary systems and delayed the effective date for information reporting.⁹ We believe that the required IT build for the Documentation Requirements is similar to FATCA, and that Treasury and the Service should similarly extend the effective date here.

The need to revise the effective date for the Per Se Rules is even more significant—the effective date for the Per Se Rules is essentially retroactive, because the rule applies to debt instruments issued on or after April 4, 2016. Although there is a transition rule that would allow taxpayers to continue treating such an instrument as debt until the date that is 90 days after the date that final regulations are published, the transition period is not long enough to be useful to taxpayers. The Per Se Rules are a significant departure from existing case law, and Treasury did not publicly indicate its intentions to make such sweeping changes to existing law. As a result, taxpayers were caught completely by surprise. These new, and unanticipated, rules impose compliance burdens that require taxpayers to review existing processes, identify how existing processes must be changed to comply with the new requirements, hire new employees and train existing employees to comply with the requirements, and implement process and systems changes. As discussed above in the discussion of the Documentation Requirements, these changes will take time. As a result, RILA recommends that the effective date for the Per Se Rules be revised to apply prospectively only, to debt issued no earlier than 24 months after the publication of the final regulations in the Federal Register.

III. Key Technical Concerns.

A. Part Stock Rule.

1. Background.

As originally enacted in 1969, section 385(a) simply provided that “[t]he Secretary is authorized to prescribe such regulations as may be necessary or appropriate to determine whether an interest in a corporation is to be treated for purposes of this title as stock or indebtedness.”¹⁰ In 1989, Congress amended this provision to add the parenthetical “(or as in part stock and in part indebtedness)” to the end of the sentence.¹¹ The legislative history to the amendment is sparse and in fact consists of only three sentences:

⁹ See 78 Fed. Reg. 5,874, 5,877, 5,881 (Jan. 28, 2013).

¹⁰ Tax Reform Act of 1969, Pub. L. No. 91-172, § 415(a) (1969).

¹¹ Omnibus Budget Reconciliation Act of 1989, Pub. L. No. 101-239, § 7208(a)(1) (1989).

The characterization of an investment in a corporation as debt or equity for Federal income tax purposes generally is determined by reference to numerous factors that are deemed to reflect aspects of the economic substance of the investor's interest in the corporation. Generally, there has been a tendency by the courts to characterize an instrument entirely as debt or entirely as equity. . . . Section 385 is amended to allow the Treasury Department to characterize an instrument having significant debt and equity characteristics as part debt and part equity.¹²

Thus, Congress's only apparent guidance on when such action would be taken was when the instrument had "significant characteristics" of both debt and equity.

Although Congress was correct in summarizing the general state of the current law at the time, several courts and the Service have considered a bifurcation approach to the otherwise binary debt-equity analysis. One of the few cases supporting such an approach is *Farley Realty Corp. v. Commissioner*, a Second Circuit decision.¹³ In *Farley Realty*, a pair of investors organized the taxpayer corporation to acquire a building. Lacking sufficient funds to purchase the building themselves, the investors sought a third investor, Sorsby, to contribute the remainder of the cash. Sorsby agreed to advance \$70,000 and entered into a purported 10-year loan agreement with the taxpayer, pursuant to which the taxpayer agreed to pay Sorsby 15 percent annual interest for the first two years, and 13 percent for the remaining eight years. In addition to a return of his principal, Sorsby was also entitled to receive 50 percent of the appreciation in the value of the building in the event of any such appreciation. The taxpayer duly paid interest on the instrument and, after Sorsby's death, ultimately paid out both principal and an amount corresponding to the appreciation to Sorsby's estate. The sole question before the court was whether the amount corresponding to the appreciation was deductible as interest on indebtedness under the statutory predecessor of section 163. The court concluded that the amount at issue constituted a "right to share in the corporation's financial success" and therefore was equity and not debt, and the payment thereof was nondeductible by the corporation. The Service did not challenge—and the court did not dispute—the deductibility of the actual interest paid on the instrument.¹⁴ On these facts, the court was able to neatly divide the debt portion of the instrument from the equity portion. Nevertheless, the *Farley Realty* approach has not been adopted by other courts or the

¹² H.R. REP. NO. 101-386, at 562 (1989) (Conf. Rep.). Interestingly though, notwithstanding the fact that Congress acknowledged that it was departing from common law, Congress believed it was merely "clarify[ing]" Treasury's authority in this area. *Id.* (entitling the report section as "Clarify Treasury Regulation Authority Relating to Debt-Equity").

¹³ 279 F.2d 701 (2d Cir. 1960), *aff'g* T.C. Memo. 1959-93. *See also Richmond, Fredericksburg & Potomac R.R. Co. v. Commissioner*, 528 F.2d 917 (4th Cir. 1975) (guaranteed portion of "Guaranteed Stock" treated as debt, with any excess treated as stock; "[T]he guaranteed dividend was a characteristic of fixed obligations and not of equity capital. . . . [The] owners participated in current earnings distributions with the expectation of continued participation as earnings and dividends increased. These are among the common stock attributes of these securities and not a consequence of their debt characteristics.").

¹⁴ The Tax Court briefly addressed the interest: "The Souraskys' [Sourasky later changed his name to Sorsby] \$70,000 advance resulted in both a loan and the acquisition of an equity in the enterprise. *The specified interest of 15 per cent (reduced to about 13 per cent after the first two years) is not involved here, and was plainly deductible.* The payment here in controversy relates to the liquidation of the Souraskys' equity which was acquired simultaneously with the making of the loan, and without which the loan undoubtedly would not have been made." (Emphasis supplied.)

Service,¹⁵ perhaps due to its unique facts and easily separable components of the instrument at issue.¹⁶ Even the U.S. Supreme Court, when considering a “hybrid” instrument—an instrument with both equity and debt characteristics—did not bifurcate the instrument (apparently over some objections of the dissenting justice) and instead analyzed it in its entirety and made a determination based on which characteristics predominated.¹⁷

2. Overview.

In the Preamble, Treasury and the Service explained that the current “all-or-nothing” approach in the case law is “problematic” in close situations – where the facts and circumstances “provide only *slightly* more support for characterization of the entire interest as indebtedness than for equity characterization.”¹⁸ Relying on the grant of authority in section 385(a), the Part Stock Rule provides the Service with the express ability to treat certain related-party instruments as in part indebtedness and in part stock to the extent that an analysis of the relevant facts and circumstances concerning the instrument, as of the time of the issuance of the instrument, results in a determination by the Service that, “under general tax principles,” the instrument is properly treated for U.S. federal tax purposes as indebtedness in part and stock in part.¹⁹ In the sole example of the application of the Part Stock Rule, the Proposed Regulations indicate that, if the Service’s analysis supports a reasonable expectation that, as of the time of the issuance of the instrument, only a portion of the principal amount of the instrument will be repaid, the instrument may be treated as indebtedness in part and stock in part in accordance with such determination if the Service so concludes and “the application of federal tax principles supports this treatment.”²⁰ The Preamble further provides that the Part Stock Rule allows the Service to bifurcate the instrument “consistent with its substance.”²¹

The related party instruments subject to the Part Stock Rule are referred to as “expanded group instruments” (“EGIs”). An EGI is defined as an “applicable instrument,” an issuer of which is one member of an “expanded group” (“EG”) and the holder of which is another member of the same EG.²² An “applicable instrument” is further defined as any interest issued or deemed issued that is in form a debt instrument.²³ There are then two types of EGs – the general EG and the “modified” EG (“MEG”). An EG is defined by

¹⁵ See, e.g., FSA 774 (Aug. 27, 1993) (citing *Farley Realty*, but noting that “the Service has not adopted this bifurcation approach”); GCM 36702 (Apr. 12, 1976) (“there are substantial difficulties in applying the Solomon-like approach taken in *Farley* [to] the instant case”). But see CCA 199952015 (Dec. 30, 1999) (in heavily redacted advice, the National Office suggested that the instrument in question could be bifurcated, citing *Farley Realty*); GCM 39144 (Mar. 1, 1984) (citing *Farley Realty* as “legal support for the conclusion that the right to receive a contingent amount is a property interest separate and distinct from the indebtedness”).

¹⁶ PLR 8735008 (May 22, 1987) (“Where a corporate obligation contains both debt and equity characteristics, the courts have generally applied an ‘all or nothing’ approach by which the instrument is classified as all debt or all equity.”).

¹⁷ *Paulsen v. Commissioner*, 469 U.S. 131 (1985).

¹⁸ 81 Fed. Reg. at 20,914 (emphasis supplied).

¹⁹ Prop. Treas. Reg. § 1.385-1(d)(1).

²⁰ *Id.* See also 81 Fed. Reg. at 20,919 (“For example, under the proposed regulations, if an analysis of a related-party interest that is documented as a \$5 million debt instrument demonstrates that the issuer cannot reasonably be expected to repay more than \$3 million of the principal amount as of the issuance of the interest, the Commissioner may treat the interest as part indebtedness (\$3 million) and part stock (\$2 million).”).

²¹ 81 Fed. Reg. at 20,915.

²² Prop. Treas. Reg. § 1.385-2(a)(4)(ii).

²³ Prop. Treas. Reg. § 1.385-2(a)(4)(i).

reference to the consolidated group rules with certain modifications²⁴ and thus, as modified, requires common ownership of at least 80 percent of the total voting power *or* 80 percent of the total value.²⁵ A MEG is defined as an EG with a further modification to lower the ownership threshold from 80 percent to 50 percent.²⁶ Unlike the Documentation Requirements and the Per Se Rules, the Part Stock Rule applies to EGIs that are issued between members of the same MEG, not the same EG.²⁷ In the Preamble, Treasury and the Service acknowledged that the Part Stock Rule deviates in this respect from the other rules in the Proposed Regulations, but justified this departure on two grounds.²⁸ First, Treasury and the Service believed that a taxpayer's U.S. federal income tax liability can be reduced or eliminated through the introduction of excessive indebtedness without "special cooperation" among the related parties, presumably meaning that merely entering into a loan does not require high levels of control over the other party. Second, Treasury and the Service determined that a 50-percent threshold was consistent with other Code provisions that identify a level of control or ownership "that can warrant different federal tax consequences than those for less-related parties," such as under section 304.²⁹

The Part Stock Rule is prospective and generally applies to any applicable instrument issued or deemed issued on or after the date the Proposed Regulations are finalized.³⁰

3. Analysis.

As a threshold matter, it is not clear why the Service (or even Congress for that matter) felt compelled to issue the Part Stock Rule and whether it actually adds a new arrow to the Service's quiver. The Service was always free to argue for a bifurcation approach when addressing the proper characterization of an instrument, and, under *Farley Realty*, the Service already had ample case law to do so. While other courts may not have broadly adopted the bifurcation approach of *Farley Realty*, they may have done so not out of any kind of principled opposition to bifurcation *per se* but rather due to the practical difficulties in doing so outside of the straightforward *Farley Realty* fact pattern.³¹ The addition of the Part Stock Rule certainly lends both Congressional imprimatur and the force of a regulation to the bifurcation approach, but the Service and courts are ultimately left in the *exact same position* that they were in before the promulgation of the Part Stock Rule – relying on "general tax principles" to make such a determination, without any new guidance on when such bifurcation is actually warranted.

In this sense, the Part Stock Rule is analogous to Congress's codification of the economic substance doctrine as section 7701(o) in 2010.³² The codification conclusively established the conjunctive version of the test

²⁴ Prop. Treas. Reg. § 1.385-1(b)(3).

²⁵ Prop. Treas. Reg. § 1.385-1(b)(3)(i)(C); Section 1504(a)(2).

²⁶ Prop. Treas. Reg. § 1.385-1(b)(5).

²⁷ Prop. Treas. Reg. § 1.385-1(d)(2).

²⁸ 81 Fed. Reg. at 20,915.

²⁹ 81 Fed. Reg. at 20,919.

³⁰ Prop. Treas. Reg. § 1.385-1(f).

³¹ Confusingly, the Preamble explains that, due to the lack of current regulations and the "tendency" of courts to use an "all-or-nothing" approach, "the Commissioner generally is *required* to treat an interest in a corporation as either wholly indebtedness or wholly equity." 81 Fed. Reg. at 20,914 (emphasis supplied). There is no such requirement or limitation under current law on the Service's ability to argue for bifurcation or on a court to accept such an argument under the proper set of facts.

³² Health Care and Education Reconciliation Act of 2010, Pub. L. No. 111-152, § 1409(a) (2010).

(finally settling the conjunctive versus disjunctive debate among various Circuit courts)³³ and also added a new strict liability penalty for transactions that are determined to lack economic substance, both of which significantly strengthened the Service's position in applying the doctrine. Section 7701(o), however, similarly left the application of the provision entirely to the Service and the courts.³⁴ While providing some quantum of clarity to the doctrine through the articulation of the two-part test, Congress did not attempt to otherwise set forth standards on its application. Such changes, especially the strict liability penalty, potentially would have given the Service an extraordinary weapon to wield against taxpayers and could have improperly incentivized IRS auditors to raise the doctrine in every case to effectively force settlement. In the absence of any constraints from Congress, the Service, however, should be commended for imposing internal controls on such potential behavior through the issuance of a directive that sets out guidelines on the application of section 7701(o) and requires the auditor to obtain manager approval before asserting the doctrine (the "Section 7701(o) Directive").³⁵ The Part Stock Rule, given its seemingly broad application completely at the discretion of the Service, like section 7701(o), similarly raises the specter of indiscriminate and inconsistent use by IRS auditors, even in cases where the rule is not justified on the facts, to force taxpayer settlements.

The Part Stock Rule, in its current form, suffers from two main infirmities, both of which stem from the absence of guidance in the statute and in the Proposed Regulations: *when* it will be applied, and *how* it will be applied. The justification for the Part Stock Rule and the operative provision of the Part Stock Rule itself are internally inconsistent. The justification for the Part Stock Rule is that courts historically have taken an "all-or-nothing" approach to debt instruments and currently do *not* bifurcate. The operative provision of the Part Stock Rule directs the Service to perform an analysis on whether bifurcation is appropriate based on "general federal tax principles," which would presumably be found in case law and administrative guidance. If neither the courts nor the Service generally bifurcate instruments, then it follows that *no such cases or administrative guidance exist* from which to derive the necessary "general federal tax principles." The Part Stock Rule therefore relies on a faulty premise – that the Service will be able to determine whether bifurcation is appropriate based on "general federal tax principles."

The Preamble cites the confusing body of case law in the debt-equity area as the animating force behind Congress's enactment of section 385 and thus as justification for the Proposed Regulations themselves:

Under that case law, courts apply inconsistent sets of factors to determine if an interest should be treated as stock or indebtedness, subjecting substantially similar fact patterns to differing analyses. The result has been a body of case law that perpetuates the "uncertainties and difficulties which the distinction between debt and equity has produced" and with which Congress expressed concern when enacting section 385.³⁶

³³ Under section 7701(o), a taxpayer has to establish *both* that her transaction has business purpose *and* economic substance in order for the transaction to be respected (the "conjunctive test"). See Section 7701(o)(1). Prior to the enactment of section 7701(o), certain Circuit courts had set forth a version of the doctrine under which a taxpayer only had to satisfy either prong (the "disjunctive test"). See, e.g., *Rice's Toyota World, Inc. v. Commissioner*, 752 F.2d 89, 91 (4th Cir. 1985) ("To treat a transaction as a sham, the court must find that the taxpayer was motivated by no business purposes other than obtaining tax benefits in entering the transaction, and that the transaction has no economic substance because no reasonable possibility of a profit exists.").

³⁴ H.R. REP. NO. 111-443, at 295-96 (2010) ("the provision does not change current law standards in determining when to utilize an economic substance analysis").

³⁵ IRS, *Guidance for Examiners and Managers on the Codified Economic Substance Doctrine and Related Penalties*, LB&I-4-0711-015 (July 15, 2011).

³⁶ 81 Fed. Reg. at 20,913.

The Part Stock Rule, given its specific reliance on existing case law and other authorities, does nothing to advance the policy of Congress to provide clarity in an unsettled and inconsistent area of law. Therefore, additional guidance is needed to make the Part Stock Rule technically usable in practice by the Service, as opposed to merely a 50-50 settlement tool. Treasury and the Service even acknowledged the current “absence of detailed standards” in the Part Stock Rule and were concerned that it could result in “unnecessary uncertainty” if the rule was applied to instruments between unrelated parties.³⁷ The Preamble did not explain why the lack of such standards would not result in similar uncertainty in the context of related parties.

4. Recommendations for Improvements.

a. The Part Stock Rule Should Apply for EGIs Issued Between Members of the Same EG, not MEG.

We respectfully request that Treasury and the Service have the Part Stock Rule apply to EGIs issued between members of the same EG, instead of the same MEG, as is the case for the Documentation Requirements and Per Se Rules.

First, in the Preamble, Treasury and the Service specifically requested comments on how the Proposed Regulations can be made more administrable.³⁸ Having the Part Stock Rule apply to EGIs issued between members of the same EG would result in a consistent framework of rules that would be more administrable by the Service and easier for taxpayers to comply with, as opposed to keeping track of differing control levels within the same set of rules.

Second, there is no countervailing policy reason for using a lower ownership threshold for the Part Stock Rule as opposed to the 80-percent mark for the Documentation Requirements and Per Se Rules. Congress has used the 80-percent threshold in a wide variety of Code provisions to determine “control,” while the 50-percent threshold is more of an exception for certain abusive cases.³⁹ Although there is no “magic” to the 80-percent figure, Congress has historically viewed such a threshold as representing a sufficient economic connection to trigger a wide variety of Code provisions, both taxpayer-favorable and unfavorable. Although Treasury and the Service cite the lack of “special coordination” needed in the issuance of a debt instrument between related parties as favoring a lower threshold, all three rules in the Proposed Regulations—the Part Stock Rule, Documentation Requirements, and the Per Se Rules—involve various debt issuances and any level of coordination involved would seem to be substantially the same in all three cases. Abuse potential would also not seem to be a driving factor in invoking a lower threshold in the case of the Part Stock Rule. If anything, the Part Stock Rule would appear to apply in situations which Treasury and the Service should view as *less* abusive, as the rule necessarily only covers instruments that the Service concedes are, at least in part, fully respected as indebtedness.

Finally, as a practical matter, a 50-percent threshold would bring transactions within the scope of the Part Stock Rule that have little abuse potential and are already otherwise policed. For example, at 50 percent control, debt issuances in the context of joint venture arrangements between two otherwise unrelated parties

³⁷ 81 Fed. Reg. at 20,915.

³⁸ 81 Fed. Reg. at 20,929.

³⁹ For example, Congress added section 368(a)(2)(H) to provide that the 50-percent control definition in section 304(c) should apply to D reorganizations instead of the standard 80-percent definition in section 368(c), as both provisions “operate to prevent the bail-out of earnings and profits at capital gains rates.” Staff of the Joint Committee on Taxation, *General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984*, JCS-41-84, at 192-94 (1984).

would be subject to the Part Stock Rule. The prototypical concern regarding any type of transaction in a related-party context is that the controlling party will extract certain concessions from the subservient controlled party. With respect to purported indebtedness, the controlling party borrower will be able to obtain interest deductions, while avoiding the normal strictures of a creditor relationship. In a 50-percent stock ownership situation, however, there is an equal, unrelated owner on the other side that would be expected to exert ordinary business prudence both in the decision to extend the loan and in monitoring the loan during its life. Going to the example offered in the Preamble, it defies common sense to think that an unrelated 50-percent shareholder would allow her corporation to extend a \$5 million loan to the other 50-percent shareholder if the other shareholder can only be reasonably expected to pay \$3 million of the principal amount (not to mention any possible violation of basic fiduciary duties on the part of the corporation's Board if such a loan was permitted).

b. The Service Should Issue Guidance to IRS Auditors on When the Application of the Part Stock Rule is Appropriate, Similar to the Section 7701(o) Directive.

Currently, the only guidance in the Part Stock Rule on when it can apply is based on the borrower's ability to repay. Under *Farley Realty*, the presence of a so-called "equity kicker" also resulted in bifurcation. In recent public comments, Treasury and the Service have indicated their view that the Part Stock Rule is a "substance" rule "that is in addition to existing authority" and therefore could apply in cases "where otherwise prior to its issuance you wouldn't bifurcate."⁴⁰ Aside from these two situations, however, it remains unclear to both IRS auditors and taxpayers when the Part Stock Rule would apply. For example, if a debt instrument has limited voting rights, would such an instrument be bifurcated? Such ambiguity practically ensures inconsistent application and arduous taxpayer-by-taxpayer determinations, wasting both Service and taxpayer resources. In addition, as mentioned above, given that the Service has sole discretion in applying the Part Stock Rule, there is a risk that IRS auditors would use the rule merely as a settlement method as opposed to applying it in a principled manner based on the facts of the case. For these reasons, we respectfully request that the Service issue guidance to IRS auditors, either in the regulations themselves or in separate form, setting forth guidelines and a review/approval process on the application of the Part Stock Rule. The Service can look to the Section 7701(o) Directive as a model for such guidance, which we believe added much-needed clarity and consistency—in addition to checks—to the Service's application of the similarly nebulous section 7701(o).

In addition, Treasury and the Service should work with Appeals to issue guidance that would modify existing procedures to specifically allow a taxpayer to use the fast track process to appeal an IRS auditor's determination under the Part Stock Rule.

c. The Service Should Provide Detailed Guidance on the Operation of the Part Stock Rule.

In addition to the basic question of when the Part Stock Rule is to apply, the Proposed Regulations (and even the limited case law and other authorities) do not address key questions on how bifurcation would work in practice. For example, once bifurcated, how are issue price and payments allocated between the debt and equity components? Pro rata based on fair market value would seem to be a reasonable approach,⁴¹

⁴⁰ Amy S. Elliott, *Debt-Equity Regs May Encourage Foreign Buyout of U.S. Businesses*, 151 Tax Notes 1025 (May 23, 2016).

⁴¹ Cf. *Busse v. United States*, 542 F.2d 421, 426-27 (7th Cir. 1976) ("It is more reasonable to allocate the settlement to the various claims *pro rata*. . . ."); Notice 89-35, 1989-1 C.B. 675 ("Reasonable methods of allocating debt among the assets of a

but specific guidance on these and other questions would be helpful, again for both IRS agents applying the Part Stock Rule and taxpayers attempting to comply with the rule once so applied. Therefore, we respectfully request that the Service issue detailed guidance on the operation of the Part Stock Rule, either as part of the regulations or as separate guidance.

d. The Part Stock Rule Should Provide a *De Minimis* Exception.

Based on the legislative and regulatory history, the Part Stock Rule apparently is intended to address situations where the instrument at issue has “significant debt and equity characteristics,” yet the debt characteristics are “only slightly more” than the equity characteristics. Given this purpose, we respectfully request that Treasury and the Service add a *de minimis* exception to the Part Stock Rule for instruments with only minimal equity characteristics. We propose that, if the Service concludes that at least 80 percent of the instrument by fair market value is properly characterized as debt (with the remainder as equity), the instrument should not be subject to the Part Stock Rule. Such a *de minimis* exception will conserve both Service and taxpayer resources and ensure that negligible equity features do not trigger the Per Se Rule.

B. Documentation Requirements.

1. Background.

In *Fin Hay Realty Co. v. United States*,⁴² the Court of Appeals for the Third Circuit set forth a commonly used debt-equity analysis and listed sixteen factors that should be considered, one of which is “the formal indicia of the arrangement.” Even the complete lack of documentation, however, has not historically been a controlling factor for courts. In *C.M. Gooch Lumber Sales Co. v. Commissioner*,⁴³ the Tax Court observed that “[t]he absence of a written debt instrument, security, or provision for payment of interest is not controlling; formal evidences of indebtedness are at best clues to proof of the ultimate fact.”

2. Overview.

The Proposed Regulations establish a “minimum standard” for EGIs that “large”⁴⁴ taxpayers are expected to meet.⁴⁵ After the minimum standard is met, the Service’s audit team is then expected to analyze “the documentation and information prepared and maintained, other facts and circumstances relating to the EGI, and general federal tax principles” in determining whether an instrument is debt or equity.⁴⁶ “General federal tax principles” are not defined, and no guidance is provided as to how they should be applied. For example, will an audit team look to the taxpayer’s circuit and its case law in determining which factors should be considered? Or will the audit team develop its own set of factors for analyzing the debt?

passthrough entity ordinarily include a pro-rata allocation based on the fair market value, book value, or adjusted basis of the assets. . . .”); PLR 200719017 (May 11, 2007) (allocating attorney fees pro-rata when no agreement governs allocation).

⁴² 398 F.2d 694, 696 (3d Cir. 1968).

⁴³ 49 T.C. 649, 656 (1968).

⁴⁴ Prop. Treas. Reg. § 1.385-2(a)(2)(i) (based on publicly traded status or meeting a \$100 million asset or \$50 million revenue threshold).

⁴⁵ Prop. Treas. Reg. § 1.385-2(a)(1).

⁴⁶ Prop. Treas. Reg. § 1.385-2(a)(1).

If the Documentation Requirements are not satisfied, then an EGI will be treated as stock.⁴⁷ The Documentation Requirements do not describe what type of stock the EGI will be treated as (common or preferred), and the Proposed Regulations do not otherwise provide meaningful guidance to the Service's audit team on how to make such a determination.

The required documentation must establish:

1. An unconditional and legally binding obligation to pay a sum certain,⁴⁸
2. The holder has creditors' rights to enforce the obligation,⁴⁹
3. As of the date of issuance, the issuer's financial position supported a reasonable expectation that the issuer would be able to meet its obligations,⁵⁰ and
4. Actions evidencing a debtor-creditor relationship.⁵¹

Treasury and the Service explained that these elements were distilled from the case law and represent the "essential characteristics" of indebtedness.⁵²

For the first three items, documentation must be prepared within 30 days of the relevant date and evidence of actions showing a debtor-creditor relationship must be prepared within 120 days of the relevant date.⁵³ There are special rules for revolving credit and cash pooling arrangements.⁵⁴ If a taxpayer's failure to comply with the Documentation Requirements is due to reasonable cause, "appropriate modifications may be made to the requirements of this section in determining whether the requirements of this section have been satisfied. The principles of § 301.6724-1 of this chapter apply in interpreting whether reasonable cause exists in any particular case."⁵⁵

Consistent with the Per Se Rules, the Proposed Regulations provide that taxpayers cannot affirmatively apply the Documentation Requirements.⁵⁶

The Documentation Requirements are prospective and generally apply to any applicable instrument issued or deemed issued on or after the date the Proposed Regulations are finalized.⁵⁷

3. Analysis.

⁴⁷ Prop. Treas. Reg. § 1.385-2(a)(1).

⁴⁸ Prop. Treas. Reg. § 1.385-2(b)(2)(i).

⁴⁹ Prop. Treas. Reg. § 1.385-2(b)(2)(ii).

⁵⁰ Prop. Treas. Reg. § 1.385-2(b)(2)(iii).

⁵¹ Prop. Treas. Reg. § 1.385-2(b)(2)(iv).

⁵² 81 Fed. Reg. at 20,916.

⁵³ Prop. Treas. Reg. § 1.385-2(b)(3).

⁵⁴ Prop. Treas. Reg. § 1.385-2(b)(3)(iii).

⁵⁵ Prop. Treas. Reg. § 1.385-2(c)(1).

⁵⁶ Prop. Treas. Reg. § 1.385-2(d).

⁵⁷ Prop. Treas. Reg. § 1.385-2(f).

The Preamble to the Proposed Regulations provides that the regulations “are intended to impose discipline on related parties by requiring timely documentation and financial analysis that is similar to the documentation and analysis created when indebtedness is issued to third parties.”⁵⁸ Moreover, the Preamble contends that “[t]he absence of reasonable diligence by related-party lenders can have the effect of limiting the factual record that is available for additional scrutiny and thorough evaluation.”⁵⁹

RILA disagrees with the Preamble’s assumption that the Documentation Requirements are “similar to the documentation and analysis created when indebtedness is issued to third parties.” In the experience of RILA’s members, third parties do not require this level of documentation until the loan amount reaches a certain threshold, usually in the \$20-30M range. In addition, while it is theoretically possible that a lack of diligence could limit the factual record, in *none* of the cases that Treasury and the Service cited as support for their position in the Preamble, did the courts find that the factual record was limited such that the courts were prevented from issuing a decision. Rather, it appears that Treasury and the Service have developed a standardized “checklist” of items for taxpayers to provide to the Service in the course of an audit, for the purpose of streamlining the Service’s internal operations, rather than addressing an evidentiary deficiency identified by the courts.

Taxpayers already bear the burden of proof to demonstrate that an interest denominated as debt is, in fact, debt.⁶⁰ Under current law, taxpayers can—and do—satisfy their burden of proof in a variety of different ways. The Documentation Requirements mandate how taxpayers must satisfy their general burden of proof, without sufficiently taking into account the burdens and costs the Documentation Requirements will impose on taxpayers. As discussed above in detail in Part II. on Effective Dates, if the Documentation Requirements are not revised, taxpayers will be forced to undertake significant systems reviews and upgrades and hire and train personnel to comply with these requirements.

Moreover, some of the Documentation Requirements have little relevance in the context of related parties. In suggesting that there be “evidence of actions evidencing a debtor-creditor relationship,” it is unclear what is meant when the parties are related, as a creditor, for example, would not file a lawsuit against a related-party debtor to collect an overdue interest payment. Rather, the parties would move cash in some manner so as to allow the interest payment to be made. While terms are required to be arm’s length between related parties for purposes of the transfer pricing rules applicable under section 482, enforcement of related-party obligations through lawsuits or similar actions does not occur as a practical matter.

4. Recommendations for Improvements.

a. If a Taxpayer Fails to Satisfy the Documentation Requirements, the Penalty Should Not Be to Automatically Treat the Instrument as Equity.

RILA is deeply concerned by the impact of failing to satisfy the Documentation Requirements—the cliff effect that results when debt is treated as equity (which can occur merely in the case of a foot-fault such as preparing documentation 31 days after the debt was issued), is completely out of proportion to the error that a company might make. Rather than the cliff effect, RILA proposes that failure to comply with the Documentation Requirements should result in the imposition of penalties applied to any resulting

⁵⁸ 81 Fed. Reg. at 20,916.

⁵⁹ 81 Fed. Reg. at 20,915.

⁶⁰ Section 7491.

understatement of tax. To achieve this result, the Documentation Requirements should be issued under section 6662 instead of section 385. Section 6662 generally imposes accuracy-related penalties on understatements of tax and the regulations under section 6662 and 6664 describe, among other things, when there are defenses available to those penalties (including a reasonable cause defense).

For example, under section 6662(e), a penalty is imposed for substantial valuation misstatements pertaining to section 482 transactions. Treasury Regulation section 1.6662-6(d)(2)(iii) establishes documentation requirements that taxpayers must satisfy to receive relief from valuation misstatement penalties in the event of a transfer pricing adjustment, which are conceptually similar to what Treasury and the Service appear to seek to achieve with the Documentation Requirements. The section 6662 regulations describe a list of principal documents that a taxpayer generally must prepare and maintain, and a list of background documents that provide support for the principal documents. The section 6662 regulations explicitly provide that not all of the principal documents listed in the regulation may be relevant in every case. Documents must be provided within 30 days upon the request of the Service. RILA respectfully suggests that the Documentation Requirements should be withdrawn under section 385 and re-issued under section 6662. RILA suggests that existing Treas. Reg. § 1.6662-6(d)(2)(iii) could be modified to describe documents that are relevant only to documenting debt between related parties or a new regulation could be issued under section 6662, using Treas. Reg. § 1.6662-6(d)(2)(iii) as a model. In either case, our other recommendations in the remainder of this Part 4 should be incorporated. Issuing the Documentation Requirements under section 6662 will allow the Service to reduce taxpayer penalties for understatements of tax where the Documentation Requirements are satisfied. This approach is more likely to incentivize compliance with the Documentation Requirements; in addition, a monetary penalty for non-compliance is a more appropriate penalty than treating an instrument as equity.

In the alternative, if Treasury and the Service prefer to issue the Documentation Requirements under section 385, RILA proposes that failing to satisfy the Documentation Requirements should result in a rebuttable presumption that the instrument is equity. Giving a company the opportunity to rebut the presumption and present facts to the Service demonstrating that the instrument is debt will alleviate some of the unjustified harshness of the Proposed Regulations.

b. What Qualifies As Sufficient Documentation to Satisfy the Documentation Requirements Should Be Clearly Described.

The Documentation Requirements provide a list of four items that should be documented, but provide no guidance on *how* those items should be documented. To take just one example, what does it mean to establish that a holder has creditors' rights to enforce the obligation? The Proposed Regulations provide examples of creditors' rights and state that "[t]he rights of a creditor must include a superior right to shareholders to share in the assets of the issuer in case of dissolution."⁶¹ However, even third-party loans do not explicitly provide in the loan document that the creditor has superior rights to shareholders in the event of dissolution. Instead, that right is typically found in the Uniform Commercial Code or the state corporate law governing the loan agreement. RILA is concerned that, as drafted, an exam agent might insist that the loan document itself explicitly provide that the creditor has superior rights to shareholders and, if it does not, determine that the Documentation Requirements have not been satisfied. Such an outcome would be completely at odds with the Preamble's stated intent of requiring related parties to develop the same types of documentation that can be found in third-party loans.

⁶¹ Prop. Treas. Reg. § 1.385-2(b)(2)(ii).

Another example that we and our members are concerned about is what an IRS agent will expect to see when the taxpayer documents a reasonable expectation of repayment. It is our experience that some agents do not believe there is a reasonable expectation of repayment unless there is sufficient cash flow to demonstrate that the loan will be repaid in full at maturity. This belief is inconsistent with business realities, where even third parties often refinance their debt at maturity rather than repaying it in full. If one of the goals of the Documentation Requirements is to encourage consistency between related-party debt and third-party debt, the Documentation Requirements should clarify that demonstrating a reasonable expectation of repayment does *not* require the taxpayer to show sufficient cash flow to repay the debt in full on the maturity date.

c. The Relevant Date for Preparing Required Documentation Should Be Extended.

Requiring documentation to be prepared 30 or 120 days after the event, as the case may be, is a trap for the unwary that serves no tax administration purpose. The earliest the Service would need to review a taxpayer's determination is on audit. RILA recommends that the relevant date for preparing the required documentation should be extended to the due date of the relevant tax return (including extensions) for the year in which the loan was made. This recommendation removes the trap for the unwary and decreases taxpayer burden to keep track of arbitrary deadlines, while still ensuring that the Service will have access to the documentation when the documentation is actually needed.

d. Regardless of How the Documentation Requirements Are Revised, Trade Receivables and Ordinary Course Transactions Should Be Excluded.

Trade receivables are critical in the retail sector and, if members of the retail industry were required to satisfy the Documentation Requirements for all of their trade receivables, the resulting burden would be immense. Because trade receivables are ordinary course transactions in the retail industry, RILA respectfully requests that trade receivables should be exempt from the Documentation Requirements. For purposes of this exemption, RILA proposes using the definition of "trade or service receivable" in section 864(d)(3).⁶²

e. Debt Instruments between Foreign Entities Should Be Excluded from Documentation Requirements.

Taxpayers should not be required to satisfy the Documentation Requirements for debt instruments issued between foreign entities. The debt instruments issued between a foreign issuer and a foreign lender do not raise the same earnings stripping risk, namely the reduction of the U.S. tax base, which is the target of the Proposed Regulations.

f. Treasury Should Provide a *De Minimis* Rule Exempting Small Borrowings From the Documentation Requirements.

As discussed throughout this Part, the Documentation Requirements impose burdens on both the taxpayers and the government. Treasury should seek to limit those burdens to related-party debt that presents opportunities for earnings stripping (which we understand to be the primary motivation for the Proposed

⁶² This Code provision defines "trade or service receivable" as "any account receivable or evidence of indebtedness arising out of (A) the disposition by a related person of property described in section 1221(a)(1), or (B) the performance of services by a related person."

Regulations). Because *de minimis* loans, by their very nature, present little opportunity for earnings stripping, RILA recommends that Treasury exempt *de minimis* loans from the Documentation Requirements. For these purposes, RILA believes that obligations with a *de minimis* principal amount and maturities of one year and a day or less should be treated as *de minimis*.⁶³ As many of RILA's members vary in size, assigning a *de minimis* figure based on a fixed minimum amount would not be fair and equitable to the taxpayer and impose a greater burden on larger taxpayers. As such, we suggest using a percentage of the taxpayer's book assets (e.g., 100 or 120 percent) or revenue to determine each taxpayer's documentation requirement. Therefore, the documentation burden would be proportionate to the size of the taxpayer and not intentionally discriminate against larger taxpayers.

If Treasury and the Service believe a fixed amount is nevertheless preferable, we recommend that the amount be set based on comparable market behavior given that the objective of the Documentation Requirement is to achieve parity between related and unrelated-party loans. As discussed above, third parties generally do not require a similar level of documentation until the loan amount reaches the \$20-30M range. Thus, obligations below such thresholds could be subject to the *de minimis* exception under this alternative.

g. Treasury and the Service Should Confirm That Taxpayers Will Not Need to Prepare Documentation for Each Cash Pool Draw.

The Documentation Requirements currently offer modified rules with respect to revolving credit arrangements and cash pooling. Specifically, to meet the Documentation Requirement for such arrangements, taxpayers must provide the "material documentation" governing such arrangement.⁶⁴ It is unclear, however, if this is sufficient to meet the Documentation Requirements, or if taxpayers still need to provide additional information for each cash pool draw. Various cash management systems (further discussed in Part III.C.3. below) often involve frequent (often daily) transfers among members. Requiring documentation for such transfers would be unduly burdensome and would not aid Treasury and the Service in its stated goals. In fact, some companies have 1,000 (or more) cash pooling transactions occurring on a daily basis. Given the volume of activity and ambiguity surrounding how these rules apply to cash management systems, we respectfully request that Treasury and the Service exempt cash management systems like a cash pool from the ambit of the Documentation Requirements. If that is not acceptable, Treasury should confirm that the material documentation governing the cash management systems is sufficient to meet the Documentation Requirements.

h. The Reasonable Cause Exception for Failing to Satisfy the Documentation Requirements Should Be Expanded.

The reasonable cause exception provided for in the Proposed Regulations does not go far enough and should be broadened. The Proposed Regulations refer to the reasonable cause exception described in Treas. Reg. § 301.6724-1, but this is not an appropriate analogy and there are more fitting examples of a reasonable cause test elsewhere in the Code and regulations. The reasonable cause exception in Treas. Reg. § 301.6724-1 applies to the filers of information returns, who only have reasonable cause "if the filer establishes that either— (i) There are significant mitigating factors with respect to the failure, as described

⁶³ Cf. Section 263A(f)(1)(B)(iii) (*de minimis* rule for contracts with costs of \$1 million or less and lasting 1 year or less).

⁶⁴ Prop. Treas. Reg. § 1.385-2(b)(3)(iii)(B).

in paragraph (b) of this section; or (ii) The failure arose from events beyond the filer's control ("impediment"), as described in paragraph (c) of this section."⁶⁵

It is appropriate to apply such a high standard to filers of information returns because, in that case, both the taxpayer and the Service are dependent upon the information provided on the information return to determine the correct tax liability.⁶⁶ That is not the case for related-party debt, where the taxpayer is not filing an information return that will be relied upon by third parties in calculating their own tax liability and the Service is not using the information that it receives in its computer programs that match the information on third party information returns with the liability that taxpayers report on their own returns. Instead, Treasury and the Service should look to more generally applied reasonable cause exceptions in crafting a revised reasonable cause exception here.

The general reasonable cause exception for underpayments of tax is described in Treas. Reg. § 1.6664-4, and it excuses taxpayers from an understatement penalty when a taxpayer can demonstrate that it had reasonable cause for, and acted with good faith with respect to, an understatement. In developing a reasonable cause exception for the Documentation Requirements, Treasury and the Service should refer to this general framework. If Treasury and the Service withdraw the Documentation Requirements under section 385 and reissue them under section 6662, as we suggest above, there is already a pre-existing framework for a reasonable cause exception under Treas. Reg. § 1.6662-6 that would be helpful. We believe that Treasury and the Service could apply the reasonable cause exception in Treas. Reg. § 1.6662-6 to a failure to comply with the Documentation Requirements with minimal revisions. In the alternative, a special reasonable cause defense could be drafted to permit the taxpayer to demonstrate that the instrument's characterization as debt should be respected if (1) the taxpayer did not willfully disregard the Documentation Requirements and (2) there was no substantial understatement of tax as a result of the taxpayer's failure.

Furthermore, if a taxpayer has reasonable cause for failing to satisfy the Documentation Requirements, the consequences for failing to comply with the requirements should be waived. Currently, the Proposed Regulations provide that, if there is reasonable cause, "appropriate modifications" will be made to the Documentation Requirements. This language makes no sense, will be impossible to apply fairly in practice, and is completely inconsistent with how other reasonable cause tests are applied across the Code. This approach raises several questions, including: What is an "appropriate" modification? Are the same modifications appropriate for all taxpayers, or is what's "appropriate" determined on a taxpayer-by-taxpayer basis? Once the appropriate modifications have been determined, is the taxpayer's compliance tested against the revised documentation requirements? How many times does this process occur? As far as RILA is aware, every time a reasonable cause exception is provided for elsewhere in the Code and regulations, taxpayers who demonstrate reasonable cause are excused from their non-compliance. We are not aware of any other situation in which non-compliant taxpayers with reasonable cause are instead required to satisfy lesser, potentially taxpayer-specific requirements. Treasury and the Service should revise the reasonable cause exception here and make it consistent with other reasonable cause exceptions throughout the Code and regulations: if a taxpayer has reasonable cause for failing to satisfy the Documentation Requirements, then the taxpayer's non-compliance should be excused.

C. Per Se Rules.

⁶⁵ Treas. Reg. § 301.6724-1(a)(2).

⁶⁶ Treasury and the Service rejected calls from commentators to provide a safe harbor in the preamble to the final section 6724 regulations because of "the serious impediments [a safe harbor] would present for the effectiveness of the Service's matching programs. . . . that depend on the Service's receiving the best possible information." T.D. 8386 (Dec. 30, 1991).

1. Background.

In *Fin Hay*, the court listed “the intent of the parties” as the *first* factor to be analyzed.⁶⁷ Ultimately, all of the other factors can be viewed as a court’s way to determine the intent of the parties through objective means, such as the maturity date or other relevant terms or circumstances that may argue in favor or against the taxpayer’s claimed intent.⁶⁸ Thus, if the taxpayer’s subjective intent to create a debtor-creditor relationship in fact aligns with the objective intent as expressed in the terms of the instrument and the actions of the parties, a court should respect the instrument as actual indebtedness. In the words of the Tax Court, the question in such cases is: “Was there a genuine intention to create a debt, with a reasonable expectation of repayment, and did that intention comport with the economic reality of creating a debtor-creditor relationship?”⁶⁹

Importantly, although courts have repeatedly explained that the relatedness of the parties warrants closer scrutiny than in the unrelated context, “the existence of a bona fide debt is not precluded merely because the debtor and creditor are related parties.”⁷⁰ Thus, even in the related party context, taxpayers can have the requisite intent and the ability to enter into bona fide debtor-creditor relationships that are fully respected for U.S. federal income tax purposes under both common law and administrative guidance.

2. Overview.

The Per Se Rules consist of three main sub-rules: (i) a general recharacterization rule (the “General Rule”), (ii) an anti-abuse rule that prevents circumvention of the General Rule through indirect funding transactions (the “Funding Rule”), and (iii) a broad anti-abuse rule that prevents circumvention of the Per Se Rules more generally (the “Anti-Abuse Rule”).

Under the General Rule, a debt instrument⁷¹ is generally treated as stock to the extent the instrument is issued by a corporation to a member of the corporation’s EG in one of three transactions:

- (i) in a distribution,
- (ii) in exchange for EG stock (other than in an exchange already covered by the third transaction), or

⁶⁷ See also NSAR 08513 (July 22, 1988) (“The intent of the parties is the *single most significant factor* because if the question as to whether an instrument is debt or equity is at all close, a court will most likely decide the issue on this basis.”) (emphasis supplied).

⁶⁸ See, e.g., *Bauer v. Commissioner*, 748 F.2d 1365, 1367 (9th Cir. 1984) (“We have held that the question of whether an advance to a corporation is debt or equity is ‘primarily directed at ascertaining the intent of the parties.’”) (citing *A. R. Lantz Co. v. United States*, 424 F.2d 1330, 1333 (9th Cir. 1970).)

⁶⁹ *Litton Business Systems, Inc. v. Commissioner*, 61 T.C. 367, 377 (1973). See also CCA 200849012 (Dec. 5, 2008) (“The basic formula for testing for whether an instrument is debt or equity turns on the objective intent of the parties.”).

⁷⁰ *Nestle Holdings Inc. v. Commissioner*, T.C. Memo. 1995-441.

⁷¹ For reasons that are not explained in the Preamble, the Per Se Rules rely on a different definition of a “debt instrument” than that used in the Part Stock Rule and Documentation Requirements. A “debt instrument” is defined as an interest that would, but for the application of the Per Se Rules, be treated as a debt instrument under section 1275(a) and Treas. Reg. § 1.1275-1(d). Under section 1275(a), a “debt instrument” is defined as “a bond, debenture, note, or certificate or other evidence of indebtedness.” Section 1275(a)(1)(A). The regulations elaborate on the statutory definition: “any instrument or contractual arrangement that constitutes indebtedness under general principles of Federal income tax law (including, for example, a certificate of deposit or a loan).” Treas. Reg. § 1.1275-1(d).

- (iii) in exchange for property in an asset reorganization.⁷²

In the Preamble, Treasury and the Service identified these three types of transactions between affiliates as raising “significant policy concerns” that needed to be addressed through the Proposed Regulations.⁷³

Under the Funding Rule, a debt instrument is treated as stock to the extent it is a “principal purpose instrument” (“PPI”).⁷⁴ A PPI is defined as a debt instrument that is issued by a corporation (the “funded member”) to a member of the funded member’s EG in exchange for property with a principal purpose of funding one of three transactions (which generally correspond to the three transactions covered by the General Rule):

- (i) a distribution of property by the funded member to a member of the funded member’s EG, (other than a distribution of stock pursuant to the third transaction),
- (ii) an acquisition of EG stock (other than in an exchange already covered by the third transaction), or
- (iii) an acquisition of property by the funded member in an asset reorganization.⁷⁵

Treasury and the Service drafted the Funding Rule because they felt that the three aforementioned transactions presented similar policy concerns to those of the transactions covered in the General Rule⁷⁶ and that a failure to include them would result in taxpayers avoiding the General Rule through indirect—but economically equivalent—transactions.⁷⁷

Whether a debt instrument is issued with a principal purpose of funding one of the transactions in the Funding Rule is generally determined based on all the facts and circumstances.⁷⁸ This basic rule, however, is effectively subsumed by an *irrebuttable* presumption that a debt instrument is treated as issued with a principal purpose of funding one of the three transactions if it is issued by the funded member during the period beginning 36 months before the date of the transaction, and ending 36 months after the date of the transaction (the “72-month window”).⁷⁹ In the Preamble, Treasury and the Service offered their rationale for an irrebuttable presumption as opposed to an ordinary principal purpose rule:

The Treasury Department and the IRS have determined that this non-rebuttable presumption is appropriate because money is fungible and because it is difficult for the IRS

⁷² Prop. Treas. Reg. § 1.385-3(b)(2). The term “asset reorganization” is defined as an A, C, D, F, or G reorganization. Prop. Treas. Reg. § 1.385-3(f)(1).

⁷³ 81 Fed. Reg. at 20,916. The first transaction is based on the facts of *Kraft Foods Co. v. Commissioner*, 232 F.2d 118 (2d Cir. 1956). Treasury and the Service believed that the remaining two transactions implicated “similar policy considerations.” 81 Fed. Reg. at 20,916, 20,918.

⁷⁴ Prop. Treas. Reg. § 1.385-3(b)(3)(i).

⁷⁵ Prop. Treas. Reg. § 1.385-3(b)(3)(ii).

⁷⁶ 81 Fed. Reg. at 20,916.

⁷⁷ 81 Fed. Reg. at 20,918.

⁷⁸ Prop. Treas. Reg. § 1.385-3(b)(3)(iv)(A).

⁷⁹ Prop. Treas. Reg. § 1.385-3(b)(3)(iv)(B). The Proposed Regulations refer to this presumption as the “per se rule.” As we refer to the entire set of rules in Prop. Treas. Reg. § 1.385-3 as the Per Se Rules, we have avoided use of the terminology in the Proposed Regulations.

to establish the principal purposes of internal transactions. In the absence of a per se rule, taxpayers could assert that free cash flow generated from operations funded any distributions and acquisitions, while any debt instrument was incurred to finance the capital needs of those operations. Because taxpayers would be able to document the purposes of funding transactions accordingly, it would be difficult for the IRS to establish that any particular debt instrument was incurred with a principal purpose of funding a distribution or acquisition.⁸⁰

There are two exceptions to the irrebuttable presumption. First, under an exception for certain ordinary course transactions (the “Ordinary Course Exception”), the presumption does not apply to a debt instrument that arises in the ordinary course of the issuer’s trade or business in connection with either the purchase of property or the receipt of services, to the extent that it reflects an obligation to pay an amount that is currently deductible by the issuer under section 162 or currently included in the issuer’s cost of goods sold or inventory, provided the amount of the obligation at no time exceeds the amount that would be ordinary and necessary to carry on the trade or business of the issuer if it was unrelated to the lender.⁸¹

Second, an acquisition of EG stock will not be subject to the Funding Rule if the acquisition results from a transfer of property by a funded member (the “transferor”) to an expanded group member (the “issuer”) in exchange for stock of the issuer, provided that, for the 36-month period immediately following the issuance, the transferor holds, directly or indirectly, over 50 percent of the total vote and value of the issuer’s stock (the “Funded Subsidiary Exception”).⁸² For example, ParentCo wholly owns SubCo 1 and SubCo 2. SubCo 2, in turn, wholly owns SubCo 3. SubCo 1 lends \$100 to SubCo 2 in exchange for a SubCo 2 note, and, shortly thereafter, SubCo 2 acquires additional stock in SubCo 3 for \$100. Although the SubCo 2 note would normally be treated as equity under the Funding Rule because SubCo 2 acquired stock in an EG member within the 72-month window, the SubCo 2 note falls under the Funded Subsidiary Exception as SubCo 2 wholly owns SubCo 3.⁸³

Importantly, if a debt instrument is recharacterized as equity under the Funding Rule, the funded transaction itself is respected and is not also recharacterized.⁸⁴ In other words, the Per Se Rules only seek to recharacterize either debt issued in the primary transaction (caught under the General Rule) or a transaction that funds a primary transaction (caught under the Funding Rule), but not both.⁸⁵

Under the Anti-Abuse Rule, a debt instrument is treated as stock if it is issued with a principal purpose of avoiding the application of the Per Se Rules.⁸⁶ In addition to the Anti-Abuse Rule, there is a further restriction on affirmative use by taxpayers of the Per Se Rules (the “No-Affirmative-Use Rule”). Specifically, the Per Se Rules do not apply to the extent a taxpayer enters into a transaction that would

⁸⁰ 81 Fed. Reg. at 20,923-24.

⁸¹ Prop. Treas. Reg. § 1.385-3(b)(3)(iv)(B)(2).

⁸² Prop. Treas. Reg. § 1.385-3(c)(3).

⁸³ Prop. Treas. Reg. § 1.385-3(g)(3), Ex. 12.

⁸⁴ Prop. Treas. Reg. § 1.385-3(b)(3)(vi). *See also* 81 Fed. Reg. at 20,926.

⁸⁵ *See, e.g.*, Prop. Treas. Reg. § 1.385-3(g)(3), Ex. 1 (as distribution of note is recharacterized under the General Rule, a second note from the distributing entity is not also recharacterized as equity under the Funding Rule).

⁸⁶ Prop. Treas. Reg. § 1.385-3(b)(4).

otherwise be subject to the Per Se Rules with a principal purpose of reducing the U.S. federal tax liability of any member of the EG through equity recharacterization.⁸⁷

In addition to the two exceptions to the Funding Rule, there are two exceptions to the Per Se Rules generally. First, the aggregate amount of any distributions or acquisitions covered by the three transactions in either the General Rule or the Funding Rule is reduced by an amount equal to the current year earnings and profits (“E&P”) of the member engaged in such distributions or acquisitions (the “E&P Exception”).⁸⁸ Treasury and the Service believe that the E&P Exception will “accommodate many ordinary course distributions and acquisitions” that would otherwise be subject to the Funding Rule and thus provide appropriate relief to the harshness of the 72-month window.⁸⁹

Second, a debt instrument is not recharacterized as stock if, immediately after the debt instrument is issued, the aggregate adjusted issue price of debt instruments held by members of the EG that would otherwise be subject to the Per Se Rules does not exceed \$50 million (the “Threshold Exception”).⁹⁰ This exception, however, does not serve as an exclusion of such amount in the event the total debt exceeds \$50 million. In such case, the Threshold Exception does not apply to any debt instrument.⁹¹ Treasury and the Service indicated that the intention behind the Threshold Exception is to limit the Per Se Rules to large taxpayers.⁹²

The Per Se Rules, unlike the Part Stock Rule and Documentation Requirements, are generally retroactive to April 4, 2016, the date the Proposed Regulations were released. The Per Se Rules generally apply to any debt instrument issued or deemed issued on or after April 4, 2016.⁹³ If a debt instrument would be recharacterized as stock under the Per Se Rules prior to the date the Proposed Regulations are finalized, however, the debt instrument is treated as indebtedness until 90 days after such finalization.⁹⁴

3. Analysis.

The Per Se Rules are unique (and controversial) specifically because they apply to *per se* recharacterize certain debt instruments as equity “for all federal tax purposes”⁹⁵ notwithstanding the fact that the Proposed Regulations explicitly provide that such instruments “otherwise would be treated as indebtedness for federal tax purposes” under case law and administrative guidance.⁹⁶ As a *per se* set of rules, taxpayers cannot raise any defenses or provide any evidence to the contrary to avoid such a recharacterization and can only rely on any enumerated exceptions in the Per Se Rules themselves or more broadly in the Proposed Regulations. Thus, even if a taxpayer has a genuine subjective intent to issue debt, and this intent is objectively verified through the terms of the instrument and the actions of the parties, such as through timely payments of interest on their due dates and principal at maturity, nevertheless this intent is *completely disregarded* by

⁸⁷ Prop. Treas. Reg. § 1.385-3(e).

⁸⁸ Prop. Treas. Reg. § 1.385-3(c)(1).

⁸⁹ 81 Fed. Reg. at 20,924.

⁹⁰ Prop. Treas. Reg. § 1.385-3(c)(2).

⁹¹ 81 Fed. Reg. at 20,925.

⁹² 81 Fed. Reg. at 20,919.

⁹³ Prop. Treas. Reg. § 1.385-3(h)(1).

⁹⁴ Prop. Treas. Reg. § 1.385-3(h)(3).

⁹⁵ Prop. Treas. Reg. § 1.385-3(b)(1).

⁹⁶ Prop. Treas. Reg. § 1.385-3(a).

the Per Se Rules in the situations in which they apply, and the debt is recharacterized as equity. Even more surprisingly, if instead the taxpayer truly intends to treat such an instrument as equity, the instrument may be respected as debt under the No-Affirmative-Use Rule. This results in an unwarranted application of the stated policies. Based on the Preamble, Treasury and the Service have unequivocally expressed their view that instruments issued in the transactions covered by the Per Se Rules are equity instruments in substance regardless of intent.⁹⁷ If this view is correct, then the taxpayer's subjective intent should have no bearing *whatsoever* on this determination – favorable or unfavorable. In contrast, the “heads I win, tails you lose” approach adopted in the Per Se Rules seems to reflect a mere dislike on the part of Treasury and the Service to related-party debt instruments as opposed to any true attempt to establish the “substance” of such transactions. In designing the Per Se Rules, Treasury and the Service made a significant logical leap from the case law allowing related-party debt instruments but mandating close scrutiny of the terms of such arrangements, to simply recharacterizing such instruments effectively on the basis of the related-party nature alone. Treasury and the Service explained that such related-party debt often lacks “meaningful non-tax significance,” such as introducing no new capital into the structure.⁹⁸ Yet such considerations, which seem to effectively impose a business purpose requirement on indebtedness, have not historically been important to Congress,⁹⁹ courts,¹⁰⁰ or even the Service.¹⁰¹ As a matter of course, taxpayers (through their Treasury departments) analyze and determine the appropriate capital structure for the enterprise including valid numerous non-tax considerations.

The Preamble explains that the overarching purpose of the Proposed Regulations is to address transactions that result in “excessive indebtedness” between related parties.¹⁰² Not surprisingly, Treasury and the Service seem to be focused on the offensive feature of such excessive indebtedness – the associated interest deduction, which presumably, in their view, is likewise “excessive.”¹⁰³ Yet this offensive feature is inherent

⁹⁷ Treasury and the Service acknowledge the determinative role of intent in a debt-equity analysis under the case law: “Related-party indebtedness, like indebtedness between unrelated persons, may be respected as indebtedness for federal tax purposes, but only if there is intent to create a true debtor-creditor relationship that results in bona fide indebtedness.” 81 Fed. Reg. at 20,915. Related-party instruments meeting this criterion are allowed, but “warrant a more thorough and discerning examination for tax characterization purposes.” *Id.* While disregarding intent in the Per Se Rules, Treasury and the Service continue to accept its importance in the context of the Documentation Requirements: “This requirement also serves to help demonstrate whether there was intent to create a true debtor-creditor relationship that results in bona fide indebtedness” 81 Fed. Reg. at 20,916.

⁹⁸ 81 Fed. Reg. at 20,917.

⁹⁹ H.R. REP. NO. 111-443, at 296 (2010) (the codified economic substance doctrine was not intended to alter the tax treatment of “certain basic business transactions . . . merely because the choice between meaningful economic alternatives is largely or entirely based on comparative tax advantages,” including “the choice between capitalizing a business enterprise with debt or equity”).

¹⁰⁰ In his seminal article on debt versus equity, William Plumb referred to factors such as “tax motivation and business purpose” as well as “no new capital” as factors “which are merely rhetorical expressions of a result, having no proper evidentiary weight in themselves.” William T. Plumb, Jr., *The Federal Income Tax Significance of Corporate Debt: A Critical Analysis and a Proposal*, 26 TAX L. REV. 369, 412 (1970-1971).

¹⁰¹ See, e.g., CCA 200134004 (Aug. 24, 2001) (“The proper inquiry therefore is not whether Taxpayer was trying to avoid tax but whether the Perpetual Securities that Sub 2 held constituted debt or equity.”).

¹⁰² 81 Fed. Reg. at 20,914.

¹⁰³ See, e.g., 81 Fed. Reg. at 20,914 (“Nonetheless, the Treasury Department and the IRS also have determined that the proposed regulations should not apply to issuances of interests and related transactions among members of a consolidated group because the concerns addressed in the proposed regulations generally are not present when the issuer’s deduction for interest expense and the holder’s corresponding interest income offset on the group’s consolidated federal income tax return.”); 20,917 (“For example, inverted groups and other foreign-parented groups use these types of transactions to create interest deductions that reduce U.S. source income without investing any new capital in the U.S. operations. In addition, U.S.-parented groups obtain distortive results by, for example, using these types of transactions to create interest deductions that reduce the earnings and profits

in the fact that Congress enacted section 163, which allows a deduction for interest on indebtedness, while choosing not to provide an equivalent deduction for dividends paid on equity. What constitutes “excessive”? And how can claiming a benefit intended by Congress, and not otherwise limited by section 163(j) or other provisions, be considered “excessive” at all? Taxpayers often choose intercompany loans over capital contributions not out of any desire to claim an interest deduction, but simply due to the ease of putting in place a short-term loan, especially when foreign affiliates are involved. A number of foreign jurisdictions place onerous requirements on distributions that do not apply in the case of repayments on indebtedness. In other cases, like cash pooling, taxpayers enter into such arrangements to *minimize* interest expense instead of opting for third-party loans, which may be more costly and therefore would result in a *larger* interest deduction.

Although one of the main purposes of Treasury and the Service in issuing the Proposed Regulations—and specifically the Per Se Rules—was to deny “excessive” interest deductions, the vehicle chosen to effect such a policy decision was section 385 (as opposed to, for example, section 163), which classifies an instrument as debt or equity. As a result, the Proposed Regulations certainly have the effect of denying interest deductions in the situations in which they apply and recharacterize debt as equity, but they further have much broader, correlative impacts given their interaction with other Code provisions that are keyed off the debt/equity determination. Treasury and the Service plainly recognized the wide potential reach of the Per Se Rules and, in fact, confirmed this point by explicitly including a provision that, “[t]o the extent a debt instrument is treated as stock under [the operative provisions of the Per Se Rules], it is treated as stock for all federal tax purposes.”¹⁰⁴

Leaving no ambiguity, several examples in the Per Se Rules illustrate situations where a debt instrument recharacterized as equity either no longer satisfies certain Code provisions or is subject to certain Code provisions to which it was previously not subject.¹⁰⁵ In certain situations, these correlative effects may end up not only resulting in the loss of an interest deduction, but also leading to double taxation, which is an overly punitive solution to the perceived problem of “excessive” interest. For example, if a U.S. parent company with foreign retail operations has one of its foreign subsidiaries (“ForCo 1”) lend money to another foreign subsidiary (“ForCo 2”) in exchange for a note, but ForCo 2 had innocuously made a completely unrelated distribution two years earlier, the note would be recharacterized under the Funding Rule because the distribution would have occurred within the 72-month window. Subsequent payments on the note would be treated as dividends, which normally would fall under the section 954(c)(6) exception, but it would appear that these dividends would result in a *permanent loss* of ForCo 2’s foreign taxes for purposes of the section 902 indirect foreign tax credit. This is because dividends from ForCo 2 reduce foreign taxes in ForCo 2’s foreign tax pools,¹⁰⁶ but such foreign taxes are not moved to ForCo 1’s foreign tax pool due to ForCo 1 owning less than 10 percent of the voting stock in ForCo 2.¹⁰⁷

RILA does not believe that a loss of *both* an interest deduction *and* foreign tax credits is an appropriate remedy to the policy concerns expressed by Treasury and the Service. There are many other similar

of controlled foreign corporations (CFCs) and to facilitate the repatriation of untaxed earnings without recognizing dividend income.”).

¹⁰⁴ Prop. Treas. Reg. § 1.385-3(b)(1).

¹⁰⁵ See, e.g., Prop. Treas. Reg. § 1.385-3(g)(3), Ex. 1 (distribution of note treated as distribution of stock subject to section 305 after recharacterization as equity).

¹⁰⁶ Treas. Reg. § 1.902-1(a)(8)(i).

¹⁰⁷ Section 902(b); Treas. Reg. § 1.902-1(a).

examples, and we anticipate that our members will continue to discover new situations as they analyze the impact of the Proposed Regulations to their structures and operations in more detail. The purpose of any penalty regime is to “enhance voluntary compliance.”¹⁰⁸ Penalties effectively achieve this goal when the punishment is proportionate to the transgression,¹⁰⁹ and voluntary compliance is maximized when the regulated parties see a proximate connection between culpable acts and the punishment. In this example, there is no culpable act on the part of the taxpayer deserving of punishment (as the loan and the distribution were completely unrelated), and the punishment proposed is excessive in relation to any perceived benefit sought to be obtained (an interest deduction). The Per Se Rules, specifically through the application of the 72-month window, effectively punish taxpayers for completely unrelated and unintentional acts, and the consequences of such acts may extend far beyond the mere denial of an interest deduction (and may not even be fully understood either by Treasury and the Service or taxpayers at this time). In addition, due to the difficulty in identifying when triggering events for the Per Se Rules occur, taxpayers may not realize that they are engaging in behavior that is potentially subject to a penalty. Penalizing taxpayers for behavior that they did not understand to be prohibited when taxpayers engaged in the behavior is counter-productive to encouraging voluntary compliance and violates the Service’s Policy Statement on penalties.

Treasury and the Service specifically requested in the Preamble comments on “whether special rules are warranted for cash pools, cash sweeps, and similar arrangements for managing cash of an expanded group.”¹¹⁰ Cash pooling and other cash management systems enable a company to efficiently manage its cash on a group-wide basis. Companies employ such arrangements for *business* benefits, not any *tax* benefits: “Better enterprise cash utilization means a reduced cost of capital and higher returns on otherwise idle cash.”¹¹¹ Cash is the lifeblood of a company, especially in the retail business, and cash pooling is a critical tool for ensuring that the entire group has access to liquidity when necessary, while minimizing transaction costs.

There are two main types of cash pooling arrangements, although other arrangements, such as short-term intercompany loans that are economically the same as cash pools, exist as well. With regard to cash pools, the first type is known as “physical” cash pooling. In a physical cash pooling arrangement, companies within a group enter into an agreement to transfer excess cash on a regular basis (often daily) to a designated entity referred to as the “cash pool leader.” If a cash pool participant has transferred excess cash to the cash pool leader, the transfer is treated as an intercompany loan from the participant to the leader, with the leader paying interest to the participant. Conversely, if a cash pool participant needs cash, the cash pool leader will advance cash to the participant through an intercompany loan, with the participant paying interest to the leader.

The second type is known as “notional” cash pooling. In a notional cash pooling arrangement, in contrast to physical cash pooling, there are no physical movements of cash. Instead, the cash pool participants jointly enter into an agreement with a third-party bank to operate the cash pool. Each cash pool participant maintains an account with the selected bank, and deposits and draws from the cash pool are registered

¹⁰⁸ See IRS Policy Statement 20-1 regarding penalties, reproduced in I.R.M. 1.2.20.1.1(1) (revised June 29, 2004).

¹⁰⁹ See Index All Civil Tax Penalties For Inflation in General Explanations of the Administration’s Fiscal Year 2016 Revenue Proposals (Feb. 2016) (“One of the key goals of an effective tax penalty regime is to encourage compliance, which can be achieved, in part, by setting penalty amounts at a level that serves as a meaningful economic deterrent to non-compliant behavior.”).

¹¹⁰ 81 Fed. Reg. at 20,929.

¹¹¹ Creighton R. Meland, Jr., *Addressing Legal Issues in Cross-Border Cash Pooling*, FINANCIAL EXECUTIVES INSTITUTE (June 22, 2015), at <http://daily.financialexecutives.org/addressing-legal-issues-in-cross-border-cash-pooling/> (last accessed June 21, 2016).

merely as “notional” credits and debits, respectively, without any actual transfers of funds from or to the account. As the bank is now serving the role of the cash pool header, participants receive or pay interest directly to the bank, and there are no intercompany loans created as in a physical cash pool. The cash pooling arrangement is generally cross-collateralized by the accounts of all of the participants (in addition to guarantees from each participant), and the bank generally has the right to set off any credit balances with amounts available in accounts with excess funds. As a further cap on the bank’s exposure, the cash pooling agreement generally limits the aggregate borrowed amounts to the total deposited cash. There are a number of advantages to using a notional cash pooling arrangement over a physical cash pooling arrangement, including the ability to deposit and borrow in multiple currencies, shifting the currency exposure to the bank, and lowering financing costs as the bank is usually willing to offer reduced interest rates given the economies of scale.

In addition to technical cash pooling arrangements, many companies simply loan money from one subsidiary to another on a short-term (one year or less) basis to fund operating expenses efficiently. These arrangements are no different than technical cash pooling arrangements, and should not be treated any differently. It is also typical to use longer-term financing instruments to fund the significant capital expenditures necessary in the retail industry.

The Per Se Rules, as currently drafted, would present acute problems in the context of the ordinary cash pooling, short-term, and longer-term capital financing arrangements discussed above. For example, assume U.S. parent wholly owns three foreign subsidiaries, ForCo 1, ForCo 2, and ForPoolCo. ForCo 1 and ForCo 2 are operating companies, and ForPoolCo is a financing company. All three subsidiaries have entered into a physical cash pooling arrangement. ForCo 1 has \$100 of excess cash and deposits such funds with ForPoolCo. ForCo 2 has a cash shortfall of \$100 and therefore borrows such cash from ForPoolCo in lieu of more expensive third-party financing. ForCo 2, in an unrelated restructuring transaction two years prior to the borrowing, acquired stock of another affiliate. Under the Funding Rule, ForCo 2’s loan from ForPoolCo would be recharacterized as equity as the acquisition would have occurred within the 72-month window. ForCo 2’s payments on such loan, as described earlier, would be treated as distributions. Such distributions, in turn, would themselves fall under the Funding Rule as distributions of property to an affiliate, resulting in further equity recharacterizations. Extrapolating from this simple example, RILA members with cash management systems each have hundreds, *if not thousands*, of transactions effected through such systems *on a daily basis*, which would lead to potentially catastrophic consequences from the application of the Per Se Rules in such circumstances.

The Per Se Rules, especially in the cash pool and intercompany lending context, raise serious concerns among RILA members on meeting internal control standards for financial reporting purposes, given that completely unrelated transactions spread years apart can lead to equity recharacterization, with severe correlative consequences, including breakdowns of accounting controls and possibly even financial restatements if the error is large enough. Even assuming *perfect* internal procedures, which are simply not possible, such recharacterizations can still occur from unexpected subsequent events such as transfer pricing adjustments or recalculations of E&P.

4. Recommendations for Improvements.

a. The Current Exceptions to the Per Se Rules Should be Expanded.

RILA appreciates Treasury and Service’s acknowledgement of some of the adverse effects of the Per Se Rules and their attempts to partially mitigate them through enumerated exceptions to the rules, namely the E&P Exception, the Threshold Exception, and the Ordinary Course Exception. Unfortunately, the Per Se

Rules remain overly broad and the exceptions are too narrow, and therefore the Per Se Rules necessarily continue to capture transactions that clearly cannot raise policy concerns, either due to the nature of the transaction, the size of the transaction, or for other reasons.

First, we respectfully request that the E&P Exception be expanded to include accumulated E&P in addition to current E&P. In many cases, companies will be uncertain of the exact amount of current E&P until long after the close of the year-end,¹¹² and the costs of an incorrect estimate during the course of the year will have severe repercussions. Even in cases where a company may have a fairly accurate estimate of current E&P during the course of the year, in many foreign countries, local affiliates are not permitted to distribute current E&P until after year-end and the company has prepared audited local-country financial statements. In either case, the E&P Exception is severely limited if not altogether unavailable. The ability to consider accumulated E&P will alleviate both limitations.

Second, we respectfully request that the Threshold Exception be raised to \$100 million or to a proportionate amount and also serve as an actual “threshold” exception for the stated amount as opposed to having the current cliff effect. We understand the policy behind the Threshold Exception as limiting the Per Se Rules to “large companies.” Presumably, Treasury and the Service selected the \$50 million figure for both the Per Se Rules and the Documentation Requirements (in terms of revenue) based on the same considerations. We believe \$100 million is a more relevant figure to use in establishing a demarcation between small businesses and big businesses. For reference, a “middle-market” company is generally defined as a company that generates at least \$100 million in annual revenue.¹¹³ Alternatively, to provide parity amongst taxpayers, the Threshold Exception could be based on a percentage of a taxpayer’s assets or revenue so the threshold aggregate debt level is proportional to the size of the taxpayer. This would allow the Treasury and Service to capture larger transactions, but without being overly broad and focus on the targeted behavior (potential for earnings stripping) and not the taxpayer itself. Further, we believe that the usefulness of the exception is needlessly restricted through its cliff effect – a company with \$50 million in aggregate debt would qualify, while a company with \$50.1 million would not. Having the Threshold Exception serve as a complete exception for the first \$100 million (or proportionate amount) in recharacterized debt would promote efficient administration and preserve both Service and taxpayer resources, while still achieving the purpose of subjecting large companies to the Per Se Rules.

Third, we respectfully request that the Ordinary Course Exception be expanded to include other types of ordinary course expenses, including rents, royalties, and capital expenditures. Ordinary course transactions necessarily include other types of expenses than the purchase of property or receipt of services, and such other expenses similarly have no abuse potential so long as the same “ordinary and necessary” limitation on the amount applies as under the current version of the exception. In revising the exception, Treasury and the Service could look to an analogous definition in the section 956 regulations, which applies to “any obligation” that also meets the “ordinary and necessary” limitation and certain other requirements.¹¹⁴ The Ordinary Course Exception should also be expanded to include instruments issued for capital expenditures within certain limits (such as a percentage of asset book value). The retail industry is heavily capital intensive – retailers constantly need to build new stores, new distribution centers, etc. – and these

¹¹² Based on conversations with our members, typically, the period can be as long as six to nine months after year-end.

¹¹³ See, e.g., Martin Richards, *The Growth Challenges Facing Middle Market Companies*, GLOBAL TRADE (Jan. 19, 2016), at <http://www.globaltrademag.com/global-trade-daily/commentary/the-growth-challenges-facing-middle-market-companies> (last accessed June 21, 2016) (“In the U.S., we define middle market companies as having annual revenue of between \$100 million to \$1 billion.”).

¹¹⁴ Treas. Reg. § 1.956-2(b)(1)(v).

expenditures represent normal course of business transactions. Moreover, Treasury and the Service should provide guidance on debt instruments issued which may cover multiple ordinary course expenses (e.g., inventory or cost of goods sold expenses) as well as other expenses and whether support for aligning the ordinary expenses with the debt instrument is required.

b. The 72-Month Window Should be Shortened and Changed to a Rebuttable Presumption.

We believe the 72-month window is the single biggest problem with the Per Se Rules as currently drafted. Although RILA does not agree with Treasury and the Service's conclusions regarding the need for the Per Se Rules in the first instance, we believe that the 72-month window renders an otherwise reasonably workable set of rules (with some suggested modifications) into a set of rules that are completely unworkable and grossly overinclusive. The effect of the 72-month window is that unrelated transactions separated by years and that are not undertaken by the parties for the purpose of avoiding the Per Se Rules are nevertheless categorically linked together, with no recourse by the taxpayer to prove otherwise. We believe that Treasury and the Service can implement its policies while, at the same time, appropriately balance taxpayer considerations of basic fairness and practicality.

First, a six-year timeframe is an extremely lengthy period of time in today's business world. Over the course of six years, a company may have acquired another company, merged into another company, or switched business lines. It is also inconsistent with analogous periods of time established elsewhere in the Code and regulations which serve as presumptions that two transactions are linked. For example, in section 355(e), if a controlling interest is acquired in either the distributing or controlling company within two years of the distribution, gain or loss may be recognized. Similarly, in the context of disguised sales in the partnership context, a transfer from a partner to a partnership made within two years of a partnership's transfer of money or other consideration to the partner, is presumed to be a sale.¹¹⁵ There are other examples of a two-year presumption in the regulations.¹¹⁶ Therefore, we respectfully request that the 72-month window be limited to a maximum 24-month window.

Second, having the 72-month window as an irrebuttable presumption is inequitable and unnecessary. Treasury and the Service drafted the Funding Rule as requiring a "principal purpose" of funding one of the three enumerated transactions. Yet, taxpayers are denied the ability to demonstrate that they lacked any such purpose, even with the best, unassailable evidence. In our legal system, such presumptions are reserved for extreme cases, such as presuming that children below a certain age cannot be held legally responsible for their actions and therefore cannot be convicted of committing a criminal offense. Clearly, their use is limited to cases where significant policy considerations are implicated, and should not be used simply for ease of tax administration. Moreover, such an irrebuttable presumption is wholly unneeded – the taxpayer already bears the burden of proof and a rebuttable presumption would, in most cases, reach the same result. The Code and regulations are replete with "principal purpose" tests, which are generally rebuttable, and they are fully effective in achieving their desired objectives and deterring the unwanted activities. As just one example, section 956 also has a "funding" rule in Temp. Treas. Reg. § 1.956-

¹¹⁵ Treas. Reg. § 1.707-3(c)(1).

¹¹⁶ See Treas. Reg. § 1.183-1 (a taxpayer is presumed to be engaged in an activity for profit if he is engaged in the activity for two consecutive years of the last five years); Treas. Reg. § 1.367(a)-3(d)(2)(vi)(D) (transaction is deemed to have a principal tax avoidance purpose if a foreign acquiring corporation disposes of any stock of the domestic controlled corporation within two years of the transfer); Temp. Treas. Reg. § 1.897-6T(c)(2)(i)(C) (where property is transferred within two years of the original transfer to the domestic corporation and the property transferred is sold at a loss, then it will be presumed that the purpose for transferring the loss property was the avoidance of taxation on the disposition of U.S. real property interests).

1T(b)(4)(i), which similarly is triggered when a corporation is created, organized, or funded for a principal purpose of avoiding the application of section 956. Any abuse potential in the section 385 context cannot be any more severe than that in the section 956 context that a different presumption is required. Thus, it makes little sense to have the 72-month window as an irrebuttable presumption. For these reasons, we respectfully request that the 72-month window be shortened and changed to a rebuttable presumption.

c. Ordinary Cash Management Systems Should be Exempt From the Per Se Rules.

As described above, the Per Se Rules, which are already extraordinarily challenging to apply in the run-of-the-mill intercompany lending context, are entirely unworkable and unwarranted when applied to ordinary cash management systems, such as cash pooling, short-term loans, and loans to fund capital improvements. In order to avoid the possibility of inadvertently triggering the Funding Rule, taxpayers with cash management systems would need to track and monitor each member's transactions meeting the requirements of the Funding Rule and then limit such member's transactions with the cash pool for a *6-year period*. Such limitations would ultimately result in many RILA members simply abandoning such cash management tools altogether or stopping all distributions of cash from borrowing companies, given the complexity and prohibitive cost of complying with the Per Se Rules in such arrangements, coupled with the diminished usefulness of the tools. Instead, RILA members would be forced to seek out more costly financing arrangements, depressing already narrow margins and necessarily limiting funds available for other purposes such as hiring and capital investments, both of which are critical for the U.S. economy.

For these reasons, we respectfully request that Treasury and the Service exempt ordinary cash management arrangements such as cash pooling and economically similar intercompany lending to fund operations entirely from the Per Se Rules. Given the often daily sweeps of cash, cash pooling and similar cash management systems are readily distinguishable from the type of cross-border intercompany loans that raise the same policy concerns that led to the Proposed Regulations. RILA members use cash pooling, among other reasons, to provide short-term funding for acquisitions of inventory and paying employees. In addition, our members also use cash arrangements that are longer term in nature to fund capital expenditures. Thus, excluding cash management systems from the Per Se Rules would be consistent with Treasury's and the Service's attempts to exclude ordinary course transactions from the Funding Rule. Efficient cash management is merely a prudent business practice, not a tax-planning technique. If the treasury departments of RILA's members did not efficiently manage their company's cash, the companies would fail as going concerns. We believe that the Anti-Abuse Rule already serves as an effective deterrent for taxpayers that would attempt to side-step the Per Se Rules through such cash management systems, but Treasury and the Service could further draft a more targeted anti-abuse rule specifically for such arrangements to assuage any residual concerns.

d. Foreign-to-Foreign Instruments Should be Exempt From the Per Se Rules.

Consistent with our request in Part III.B.4.e., above, to exclude foreign-to-foreign instruments from the Documentation Requirements, we respectfully request that such instruments also be excluded from the Per Se Rules for the same reason – the lack of any earnings-stripping potential.

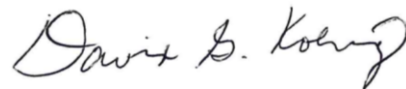
IV. State and Local Tax Implications.

The U.S. retail industry pays billions in state and local taxes annually. The Proposed Regulations could add complexity to an already complicated state tax system and may result in additional state tax costs and

compliance burdens for taxpayers. At the state level, the classification of a transaction as debt or equity can have broad implications, impacting, among other things, the determination of the corporate income tax base, allocation and apportionment, nexus, and the capital (or net worth) tax base. Thus, the Proposed Regulations may lead to increased state tax liabilities for affected companies to the extent that states conform to the Proposed Regulations. In addition, due to differences between federal and state filing methodologies (e.g., separate filings, combined group filings, and/or consolidated group filings), the Proposed Regulations could apply to a broader range of transactions at the state level than at the federal level. For example, if a conforming state applies the consolidated group exception based on the composition of the state filing group rather than the federal consolidated group, transactions could be subject to the Proposed Regulation's onerous documentation and other requirements even though the same transactions are not subject to those requirements for U.S. federal income tax purposes. This could further increase compliance burdens and tax costs for taxpayers. This concern could be mitigated in states that adhere to the literal language of the Proposed Regulations by clarifying Prop. Treas. Reg. § 1.385-1(e) to provide that "all members of a consolidated group (as defined in §1.1502-1(h)) *that file (or that are required to file) consolidated U.S. federal income tax returns* are treated as one corporation." Therefore, RILA recommends that this language be modified accordingly.

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RILA appreciates the opportunity to provide comments on the Proposed Regulations, and we hope that the above comments will be taken into account in revising the Proposed Regulations. In addition, RILA requests an opportunity to speak at the July 14, 2016 hearing on the Proposed Regulations and, simultaneously with this letter, will submit an outline of topics to be discussed at the hearing. We look forward to the prospect of commenting on further developments under section 385. If you would like to discuss any of the recommendations in this letter or the impact of the Proposed Regulations on the retail industry, please contact David G. Koenig, at telephone number (703) 600-2051 or e-mail david.koenig@rila.org.



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