Proposed Debt-Equity Regulations: What Problem Are We Solving?

by Peter B. Marrs


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In this report, Marrs explains how the per se stock rule in the proposed section 385 regulations would broadly apply to many ordinary course transactions, and he recommends ways for Treasury to narrow the scope of the regulations while more effectively addressing its concerns about U.S. earnings stripping and untaxed foreign repatriations.

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Conventional business wisdom suggests that the best strategy for creating value and achieving success is to identify a problem that should be solved, focus on solving it, and not do more.

Much has been written about the recently proposed regulations under section 385,[1] particularly prop. reg. section 1.385-3, which automatically recharacterizes specified intercompany debt transactions as stock. One overarching problem with prop. reg. section 1.385-3 is that the strategy noted above was not followed in its development.

Based on Treasury documents leading up to the release of the regulations, it appears that Treasury started off with the objective of solving a specific problem: excessive U.S. leverage (earnings stripping) by inverted U.S. companies, or more broadly, by foreign-parented companies. The preamble to the regulations also identifies a second concern: transactions undertaken by U.S.-parented companies to distribute cash from controlled foreign corporations[2] without repatriating CFC earnings. The scope of the regulations, however, is not defined by the identified concerns. The regulations apply much more broadly, with the stated goals of (1) applying general principles of economic substance to distinguish debt from equity, and (2) subjecting similar transactions to the same tax treatment.

The result is a set of regulations that applies well beyond the apparent original objective of preventing U.S. earnings stripping and the additional goal of limiting untaxed foreign repatriations, extending instead to many ordinary course transactions. The

[1]REG-108060-15 (prop. reg. sections 1.385-1 to -4).

[2]Under section 957(a), a CFC is any foreign corporation if more than 50 percent of the vote or value of the stock of that corporation is owned (or considered owned under the constructive ownership rules of section 958(b)) by U.S. shareholders on any day of the tax year of the foreign corporation.

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regulations in many respects are a proposed solution in search of a problem.

A fundamental problem with prop. reg. section 1.385-3 is that it contains provisions that might be appropriate in a narrowly targeted set of antiabuse rules but that are out of place in a set of regulations that broadly applies to ordinary course transactions. Those provisions include (1) an irrebuttable presumption that transactions undertaken within a 72-month period have been undertaken for an impermissible purpose, and (2) a prohibition on affirmative use of the rules by taxpayers.

The broad reach of the regulations to ordinary course transactions creates significant collateral damage. The recast of debt to equity can produce multiple adverse tax consequences. It creates traps for the unwary and will result in a substantial compliance burden on taxpayers as they try to steer clear of prop. reg. section 1.385-3. The regulations, at the same time, are not particularly effective at addressing either U.S. earnings stripping or untaxed foreign repatriations. Prop. reg. section 1.385-3 is both overbroad and under-inclusive and appears ill-suited for addressing the identified policy concerns.

As discussed further below, one set of circumstances in which loans between affiliates do not appear to raise the tax policy concerns underlying prop. reg. section 1.385-3, but where instead the regulations have a broad reach with significant collateral damage, involves transactions between CFCs. Applying the regulations in these circumstances does not appear to produce any material tax policy benefit, but it does create substantial costs.

To address this problem, transactions between CFCs should be carved out from the scope of the regulations. This report also provides other recommendations for narrowing the scope and reducing unintended consequences of the regulations.

I. Summary of Regulations

There are three parts to the regulations: the bifurcation rule, the documentation requirement, and the per se stock rule.

A. Bifurcation Rule

Prop. reg. section 1.385-1(d) authorizes the IRS to treat a debt instrument as part equity and part debt, as opposed to characterizing an instrument as 100 percent debt or 100 percent equity (the bifurcation rule). Prop. reg. section 1.385-1(d) would apply to debt instruments issued on or after the date the regulations are finalized.

Additional guidance under the bifurcation rule would be helpful — in particular, guidance on the circumstances in which it would apply. The bifurcation rule, however, is not the focus of this report. Section 385(a) expressly authorizes the issuance of regulations treating an instrument as part stock and part debt.

B. Documentation Requirement

Prop. reg. section 1.385-2 establishes documentation requirements that must be met for a related-party debt transaction to be respected as debt for U.S. tax purposes (the documentation requirement). The regulations require that when a debt transaction is entered into, and throughout the term of an instrument, a taxpayer have written documentation establishing that:

1. the instrument creates an unconditional and legally binding obligation to pay a sum certain on demand or on one or more fixed dates;

2. the holder has typical creditor rights to enforce the obligation;

3. there is a reasonable expectation that the issuer intends to, and has the financial ability to, meet its obligations under the instrument; and

4. the issuer makes payments of interest and principal when due under the instrument, or if the issuer defaults on its obligations, the holder reasonably exercises the diligence and judgment of a creditor.

Written documentation regarding the first three elements must be prepared within 30 days after the date the instrument is issued. Written documentation regarding the fourth element must be prepared within 120 days after the payment due date or the default, as applicable.

The documentation requirement, like the bifurcation rule, would apply to debt instruments issued on or after the date the regulations are finalized.

A few comments regarding the required documentation:

- The level and type of documentation required under the regulations should be proportional to the transaction giving rise to the indebtedness. The level of documentation should generally be no greater than the level one would expect in a transaction between unrelated parties. Not every debt obligation would be expected to have the same level and type of documentation. Often, for example, debt obligations are governed by a master agreement covering multiple transactions.
- In assessing whether the documentation requirement has been satisfied for the debtor's financial condition and creditworthiness, the question of whether the affiliated group has the requisite level of documentation should be distinguished from an assessment of the quality and reasonableness of the analysis reflected

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in the documentation. Although the distinction may be somewhat difficult to draw, the focus of the documentation requirement should be on whether the affiliated group has the requisite level of documentation. The quality and reasonableness of the analysis reflected in the documentation is relevant to the underlying substantive assessment of whether the instrument is appropriately treated as debt. That distinction is important, given that a failure to satisfy the documentation requirement causes debt to automatically be recast as stock.

- In some respects, the legal rights of related parties to enforce debt obligations may differ from the rights of unrelated parties (for example, under the laws of fraudulent conveyance or equitable subordination). That should be reflected in the type of actions expected to be taken by the lender in reasonably exercising the diligence and judgment of a creditor.
- The compliance burden of the regulations can be reduced to the extent that systems maintained by the affiliated group for nontax purposes (for example, accounting) can be leveraged to satisfy the documentation requirement.

It would be helpful for the regulations to address these points and illustrate the application of the regulations with examples.

The documentation requirement under prop. reg. section 1.385-2 is, in some respects, similar to the contemporaneous documentation requirements under section 482.[3] The section 385 documentation requirement, however, differs from the section 482 documentation requirement in that a failure to satisfy the section 385 requirement causes the debt instrument to automatically be recast as stock. The taxpayer has no ability to prevent a recast by producing evidence that the instrument is appropriately treated as debt. This puts substantial pressure on the finer points of interpreting the documentation requirement, unrelated to the merits of the underlying transaction. In contrast, failing to satisfy the section 482 documentation requirement does not itself give rise to a penalty; it merely removes a defense against a penalty that would apply because the taxpayer has understated its income as a result of incorrect transfer pricing.

Because recast of the debt instrument to stock is automatic, the reasonable cause exception in prop. reg. section 1.385-2(c) is a key provision. For many taxpayers, one of the challenges to satisfying the documentation requirement is the volume of transactions. It would be helpful if the regulations provided guidance confirming that an inadvertent, insubstantial failure to satisfy the documentation requirement falls within the reasonable cause exception when the taxpayer has made a good-faith, reasonable effort to comply with the regulations.

Moreover, consideration should be given to modifying the time limits for satisfying the documentation requirement. For many ordinary course transactions, companies that prepare and reconcile intercompany accounts quarterly may not have good documentation until quarter-close. Similarly, for high-volume transactions, it would be efficient to have a periodic compliance process documenting the financial condition of affiliates. The section 482 contemporaneous documentation requirement must be satisfied at the time of filing the U.S. tax return. It's unclear why a similar time requirement isn't appropriate under prop. reg. section 1.385-2.

Consideration should also be given to deferring or phasing in the effective date of the documentation requirement.[4] Many taxpayers will have to develop new compliance processes and adapt or create new computer systems, which will take time. Similarly, when a U.S. company acquires a foreign group that has never been subject to the documentation requirement, it will typically take time to transition the foreign group to the new compliance system.

The prop. reg. section 1.385-2 documentation requirement, however, is not the focus of this report. In general, the documentation requirement seems to effectuate the legislative intent of section 385. As discussed, the requirement is analogous to the contemporaneous documentation requirement under section 482.

C. Per Se Stock Rule

Under prop. reg. section 1.385-3, certain debt transactions between members of an affiliated group[5] are automatically recharacterized as stock (the per se stock rule). The rule applies regardless of

[3]Reg. section 1.6662-6(d)(2)(iii).

[4]*See* Notice 2014-33, 2014-21 IRB 1033 (providing transition period for compliance with the Foreign Account Tax Compliance Act).

[5]The proposed section 385 regulations apply to an expanded group. Prop. reg. section 1.385-1(b)(3). An expanded group is an affiliated group defined by reference to section 1504(a), with some modifications: (1) it applies to corporations connected by ownership of 80 percent vote or value (rather than vote and value); (2) it includes corporations held directly or indirectly (applying the constructive ownership rules of section 318, as modified by section 304(c)(3)); and (3) it includes foreign corporations, tax-exempt corporations, insurance companies, S corporations, and other entities that are excluded under section 1504(b).

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whether the debt instrument has any equity-like features. The instrument is treated as stock for all purposes of the code.

There are two parts to the per se stock rule: a general rule and a funding rule.

1. General rule. Under prop. reg. section 1.385-3(b)(2), debt issued to an affiliate is recharacterized as stock in the following transactions:

- debt issued in a corporate distribution;
- debt issued in exchange for stock of an affiliate (other than an exempt exchange);[6] and
- debt issued as consideration (boot) in specified asset reorganizations.

2. Funding rule. Under prop. reg. section 1.385-3(b)(3), debt issued to an affiliate is recharacterized as stock when the debt is incurred for a principal purpose of funding:

- a distribution of cash or other property;
- an acquisition of stock of an affiliate (other than an exempt exchange); or
- an acquisition of assets of an affiliate in specified asset reorganizations that involve the receipt of boot.

Importantly, under prop. reg. section 1.385-3(b)(3)(iv)(B), debt is irrebuttably presumed to be issued for such a principal purpose if the distribution or acquisition occurs within 36 months before or after the date of the loan.[7]

3. Exceptions. Under prop. reg. section 1.385-3(c), the per se stock rule is subject to a few exceptions:

- *Current E&P exception.* The aggregate amount of any distributions or acquisitions described in prop. reg. section 1.385-3(b)(2) or (3) is reduced by an amount equal to the funded member's current-year earnings and profits, as determined under section 316(a)(2).
- *Threshold exception.* A debt instrument is not recast as stock if the aggregate amount of debt within the affiliated group that would be subject to recharacterization under prop. reg. section 1.385-3 does not exceed $50 million. Once the threshold is exceeded, the exception will not apply to any debt instrument issued within the group, so long as any debt instrument covered by the exception remains outstanding.
- *Exception for issuance of subsidiary stock.* For purposes of the funding rule, acquiring affiliate stock will not cause a debt instrument to be recast as stock if the acquisition involves a transfer of property by the borrower to an affiliate in exchange for stock of the affiliate provided that for the 36-month period immediately following the issuance, the borrower directly or indirectly holds more than 50 percent of the total voting power and 50 percent of the total value of the affiliate's stock.

4. No affirmative use. Under prop. reg. section 1.385-3(e), the per se stock rule does not apply if an affiliated group member enters into a transaction that would otherwise be subject to the rules with a principal purpose of reducing the U.S. tax liability of any member of the group by disregarding the treatment of the debt instrument that would apply without regard to the regulations.

5. Effective date. The per se stock rule would become effective 90 days after the regulations have been issued in final form, at which point the regulations would apply to debt instruments issued after April 4, 2016.

II. Purpose of the Per Se Stock Rule

Treasury, in its press announcements, stated that the purpose of the proposed section 385 regulations is to limit U.S. earnings stripping.[8] Treasury made consistent statements in prior notices issued to address inversion transactions. Notice 2014-52 stated:

> The Treasury Department and the IRS expect to issue additional guidance to further limit inversion transactions that are contrary to the purposes of section 7874 and the benefits of post-inversion tax avoidance transactions. In particular, the Treasury Department and the IRS are considering guidance to address strategies that avoid U.S. tax on U.S. operations by

[6]An exempt exchange is a stock acquisition in which the transferor and transferee are parties to an asset reorganization and either (1) section 361(a) or (b) applies to the transferor of the stock and the stock is not transferred by issuance, or (2) section 1032 or reg. section 1.1032-2 applies to the transferor and the stock is distributed by the transferee under a plan of reorganization. Prop. reg. section 1.385-3(f)(5)(i)-(ii).

[7]The presumption under prop. reg. section 1.385-3(b)(3)(iv)(B) does not apply to debt that arises in the ordinary course of the issuer's trade or business for the purchase of property or 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, if the amount of the obligation outstanding at no time exceeds the amount that would be ordinary and necessary to carry on the trade or business of the issuer if it were unrelated to the lender.

[8]*See* Treasury, "Fact Sheet: Treasury Issues Inversion Regulations and Proposed Earnings Stripping Regulations" (Apr. 4, 2016) (stating that the section 385 regulations "address earnings stripping . . . [and] make it more difficult for foreign-parented groups to quickly load up their U.S. subsidiaries with related-party debt following an inversion or foreign takeover").

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shifting or "stripping" U.S.-source earnings to lower-tax jurisdictions, including through intercompany debt.[9]

Earnings stripping is generally understood to mean the reduction of the U.S. tax base through excessive interest expense. The term is associated with section 163(j), which restricts the deductibility of interest paid to related parties that is not subject to U.S. tax.

The preamble to the regulations expresses a concern about inverted groups and other foreign-parented groups creating interest deductions to reduce the U.S. tax base. The preamble states that the regulations "are motivated in part by the enhanced incentives for related parties to engage in transactions that result in excess indebtedness in the cross-border context."[10]

The preamble also expresses concern about specific transactions undertaken by U.S.-parented groups to distribute cash from CFCs without repatriating CFC earnings. The preamble describes such a transaction:

> An example of the latter type of transaction could involve the distribution of a note from a first-tier CFC to its United States shareholder in a taxable year when the distributing CFC has no earnings and profits (although lower-tier CFCs may) and the United States shareholder has basis in the CFC stock. In a later taxable year, when the distributing CFC had untaxed earnings and profits (such as by reason of intervening distributions from lower-tier CFCs), the CFC could use cash attributable to the earnings and profits to repay the note owed to its United States shareholder.[11]

However, instead of focusing on U.S. earnings stripping or untaxed foreign repatriations, the per se stock rule focuses more generally on the transactions described in prop. reg. section 1.385-3(b). The paradigmatic case targeted in the regulations, listed in prop. reg. section 1.385-3(b)(2)(i), is the distribution of a debt instrument by a corporation to its shareholder.

The tax treatment of a distribution of a debt instrument was litigated in the context of a domestic subsidiary and parent in *Kraft Food Co. v. Commissioner*.[12] As discussed in the preamble to the regulations, the Second Circuit in *Kraft* held that the instrument "should be respected as indebtedness because the debentures were unambiguously denominated as debt, were issued by and to real taxable entities, and created real legal rights and duties between the parties."[13]

Starting from the paradigmatic case of a distribution of a debt instrument, the regulations go down the following path:

1. Subject to limited exceptions, the regulations treat as stock any debt instrument issued in a corporate distribution, on the grounds that the instrument lacks economic substance. The preamble states that a distribution of a debt instrument should categorically be treated as the distribution of stock because the transaction does not involve the acquisition of new capital and typically lacks a substantial nontax business purpose.[14]

2. The regulations categorically treat as stock any debt instrument issued in the other transactions described in prop. reg. section 1.385-3(b). The preamble states that those intercompany transactions, like a distribution of a debt instrument, lack economic substance in that the transactions (1) do not involve the introduction of new operating capital into the affiliates (in the case of a stock acquisition) or into the affiliated group (in the case of an asset reorganization); (2) do not alter the ultimate ownership of the affiliates; and (3) have limited nontax significance. Moreover, if the regulations did not apply to the transactions, taxpayers could circumvent the regulations by entering into them.[15]

3. The regulations apply to all such transactions entered into by any affiliated group, including U.S.-parented groups.

The result is a set of regulations that does not target the two specific tax policy concerns identified in the preamble: U.S. earnings stripping and untaxed foreign repatriations. The regulations apply more broadly. Indeed, the regulations apply with astonishing breadth to ordinary course transactions.

So the question arises: What tax policy considerations underlie the per se stock rule? What tax problems is it solving? What are the costs?

III. Affiliated Groups Subject to the Regulations

What policy considerations underlie the application of prop. reg. section 1.385-3 to transactions between all members of any affiliated group, regardless of tax status (except for members of a

[9]Notice 2014-52, 2014-42 IRB 712, 729. *See also* Notice 2015-79, 2015-49 IRB 775, 784 (repeating the statement in Notice 2014-52).

[10]Prop. reg. section 1.385-1 to -4.

[11]81 F.R. at 20917.

[12]232 F.2d 118 (2d Cir. 1956).

[13]81 F.R. at 20916.

[14]*Id.* at 20917-20918.

[15]*Id.* at 20916-20917.

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consolidated group) — for example, U.S. versus foreign persons? Is the broad reach of the regulations driven by a concern that limiting them based on the tax status of the holder and issuer of the instrument would be inconsistent with the legislative intent of section 385?

Section 385(a) authorizes "necessary or appropriate" regulations for determining whether an instrument is treated as debt or stock for U.S. tax purposes. The statutory language implies that there may be appropriate circumstances in which to take account of the tax status of members of an affiliated group in the application of the regulations. Prop. reg. section 1.385-1(e) does that by treating all members of a consolidated group as one corporation for purposes of the regulations. Intercompany debt within a consolidated group is an obvious case in which taking into account the tax status of the holder and issuer of the instrument is appropriate because the group members have the same tax status and the group's U.S. tax liability would not be affected by application of the regulations.[16] Generalizing this principle, it would seem appropriate to exclude from the application of the regulations other circumstances in which the issuer and holder have the same tax status because the costs of complying with the regulations outweigh any benefits. As discussed below, one circumstance in particular is when the issuer and holder are CFCs within the same U.S. group.

Alternatively, is the broad reach of the regulations driven by concerns that limiting their application based on the tax status of the holder and issuer of the instrument may violate the nondiscrimination provisions of U.S. tax treaties with other countries? Is the scope of the regulations driven by a concern that there may be less authority to bump up against treaty nondiscrimination provisions by regulation, as compared with legislation?[17]

U.S. tax treaties with other countries generally have a nondiscrimination article designed to prevent one of the treaty countries from applying domestic tax laws or regulations to payments to residents of the other treaty country in a way that is discriminatory (that is, less favorable) than the application to residents of the first treaty country.[18]

Treaty nondiscrimination was a major issue during the enactment of section 163(j). Congress determined that section 163(j) does not violate the nondiscrimination clauses of treaties.[19] However, the treaty impact of section 163(j) has been controversial.[20] If the section 385 regulations were to treat payments by a U.S.-resident issuer to a foreign-resident holder less favorably than payments to a U.S.-resident holder, the treaty issues would likewise be complicated. An analysis of that issue is beyond the scope of this report.

However, modifying the regulations to exclude transactions between CFCs would not appear to raise treaty nondiscrimination issues for payments by a U.S.-resident issuer to a foreign-resident holder. This is because the CFC transactions do not involve a U.S. resident.[21]

IV. Transactions Subject to the Regulations

The per se stock rule must be considered together with the prop. reg. section 1.385-2 documentation requirement. The preamble to the regulations states that the documentation requirement reflects "four essential characteristics of indebtedness [that] are a necessary factor in the characterization of a covered interest as indebtedness for federal tax purposes."[22] The preamble further states that the documentation requirement reflects "the general case law view of the importance of these essential characteristics of indebtedness."[23]

So the documentation requirement reflects a view consistent with general case law that, to qualify as indebtedness, an instrument must create specific legal obligations, provide particular legal rights, and have certain economic characteristics.

The per se stock rule goes further and sets out additional requirements to qualify as debt for U.S.

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[16]In some respects, the regulations also take account of the tax consequences of particular transactions in delineating the type of transactions subject to the per se stock rule. In describing why the regulations apply to asset reorganizations, the preamble notes that any built-in gain on the transferred assets is not subject to tax in the reorganizations. *See* 81 F.R. at 20918.

[17]For a discussion of the ability to override a treaty by a regulation, see John D. McDonald, Stewart R. Lipeles, and Katie Fung, "Treaties vs. Regulations: What Happens When Sourcing Provisions Conflict," 94 *Taxes* 5 (Apr. 2, 2016); and Richard L. Doernberg, "Treaty Override by Administrative Regulation: The Multiparty Financing Regulations," 2 *Fla. Tax Rev.* 521, 532 (1995).

[18]*See, e.g.*, U.S. Model Income Tax Treaty, art. 24(1), (4), (5).

[19]H.R. Rep. No. 101-386, at 564-570 (1989).

[20]*See, e.g.*, Philip G. Cohen, "Testing for Thin Capitalization Under Section 163(j): A Flawed Safe Harbor," 67 *Tax Law.* 67 (2013) (Section 163(j) "has been criticized because . . . it was alleged to discriminate against our treaty partners in violation of such treaties."); Lee A. Sheppard, "Tax Officials Discuss Ebb and Flow of Corporate, Foreign Tax Laws at NYSBA Conference in Bermuda," *Tax Notes*, Oct. 2, 1989, p. 20 ("Treasury will strongly oppose the reconciliation bill's provisions . . . to deny deductions for interest paid to a related party that pays no U.S. tax . . . on the ground that [it] arguably violate[s] the nondiscrimination clause in U.S. tax treaties.").

[21]It is assumed that the CFCs do not engage in a U.S. trade or business.

[22]81 F.R. at 20916.

[23]*Id.*

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tax purposes. The factors identified for distinguishing debt from equity do not depend on the characteristics of the instrument. It is irrelevant whether an instrument has the most debt-like characteristics identified by courts. Instead, the debt-equity characterization depends entirely on the type of transaction in which the instrument is issued or on the type of other transactions entered into by the group members.

This approach, whereby an instrument is automatically treated as stock if the affiliated group members engage in broad categories of transactions, without regard to other relevant facts, goes beyond the analysis generally applied by courts. The preamble to the regulations cites legislative history to section 385 indicating that regulations issued thereunder need not be limited to the factors in the statute.[24] However, is the approach applied under the per se stock rule one that was contemplated by Congress in enacting section 385?

The paradigmatic transaction under the regulations, a corporate distribution of a debt instrument, would seem to be an appropriate factor in distinguishing debt from equity, though a case can be made that this depends on the facts. The transaction has been the subject of dispute under existing case law.[25] The other transactions described in prop. reg. section 1.385-3(b) are different. Those transactions are included on the premise that they are substantially similar to a corporate distribution of a note. However, the similarity depends highly on the facts.

The other transactions described in prop. reg. section 1.385-3(b) would be similar to a corporate distribution of a note when there is a circularity of cash or other property such that under established principles of economic substance, the transactions are appropriately viewed as substantially equivalent. In other circumstances, the similarity of the transactions is less clear.

> **Example 1:** P is the U.S. parent of an affiliated group that includes CFC1, CFC2, and CFC3. CFC1 and CFC2 are tax resident in Country X, and CFC3 is tax resident in Country Y. In year 1, CFC1 purchases for cash the stock of CFC2 from CFC3, allowing CFC1 and CFC2 to consolidate income and losses for Country X tax purposes. CFC3 uses the cash in part to repay third-party debt and in part to invest in business operations. In year 3, P makes a loan to CFC1 for use in expanding CFC1's business through an acquisition of assets from an unrelated party. Over the period of these transactions, CFC3 does not make any distributions to P (that is, there is no circular cash flow). Is the economic substance of the transactions a distribution of a debt instrument to P?

The approach taken in the regulations, as applied to transactions that are not substantially equivalent under established principles of economic substance, proves too much. As noted above, the preamble states that the regulations apply to acquisitions of stock of affiliates and specified asset reorganizations among affiliates because (1) the transactions do not alter the ultimate ownership of the affiliates, and (2) the transactions do not involve an introduction of new operating capital into the affiliated group (in asset reorganizations) or into the affiliates (in stock acquisitions). These criteria call into question the recognition of intercompany transactions more generally. All intercompany transactions have the common attributes of (1) not involving the acquisition of new assets from outside the group, and (2) not affecting the ultimate ownership of the group's assets. Moreover, the regulations draw a line between acquisitions of stock of an affiliate and acquisitions of assets of an affiliate (outside a reorganization) that is difficult to follow. Each transaction involves the acquisition of new assets by the acquiring entity. However, under the regulations, the issuance of debt to acquire affiliate stock is bad, but the issuance of debt to acquire affiliate assets is not.

Recharacterizing intercompany transactions based on these attributes would be contrary to long-standing U.S. tax principles. For many years a guiding principle of U.S. taxation has been to respect related-party contractual arrangements structured on an arm's-length basis in accordance with the economic substance of the transaction (that is, in accordance with the actions of unrelated parties).[26]

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[24]*Id.* at 20913 (citing S. Rep. No. 91-552, at 138 (1969)) ("The provision also specifies certain factors which may be taken into account in these [regulatory] guidelines. It is not intended that only these factors be included in the guidelines or that, with respect to a particular situation, any of these factors must be included in the guidelines, or that any of the factors which are included by statute must necessarily be given any more weight than other factors added by regulations.").

[25]*E.g., Kraft*, 232 F.2d 118.

[26]In related-party insurance arrangements, for example, the IRS has not succeeded in disregarding arm's-length transactions involving a reallocation of economic risk. In Rev. Rul. 77-316, 1977-2 C.B. 53, the IRS disallowed a deduction for insurance premiums paid by a domestic corporation to its wholly owned foreign subsidiary under the theory that the parties, while "separate corporate entities, represent one economic family." That theory found limited success in litigation. Although courts have disallowed deductions in captive insurance transactions, see, *e.g., Carnation Co. v. Commissioner*, 640 F.2d 1010 (9th Cir. 1981), "no judge of the Tax Court has ever embraced the IRS's

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Recently, under actions 8 through 10 of the base erosion and profit-shifting project, the OECD examined the appropriate tax treatment of intercompany transactions that contractually allocate capital and risk among affiliates. Many countries sought to loosen existing tax standards for when it is appropriate to recharacterize intercompany transactions. Treasury officials pushed back strongly, affirming the principle of respecting separate legal entities and contractual arrangements as long as the substance follows the form.[27]

It is understandable for the government to be focused on applying regulations consistently to similar transactions. Applying the same tax treatment to similar transactions is an important guide for achieving a tax policy objective and avoiding circumvention through tax structuring. As noted above, one benchmark for similarity is whether transactions are substantially similar under established principles of economic substance. Beyond that, it would seem that the similarity of transactions should be measured by reference to the specific tax policy objective. Do the transactions produce the same tax result? For example, if the objective of a regulation is to prevent the erosion of the U.S. tax base through earnings stripping, one can assess alternative transactions to determine whether they similarly result in earnings stripping.

So, returning to the question: What policy considerations drive the approach taken in the per se stock rule? One possibility is that Treasury had concerns that recharacterizing debt as equity only in cases giving rise to U.S. earnings stripping or untaxed foreign repatriations would be inconsistent with the legislative intent of section 385 and could create treaty issues. Perhaps a determination was made that to best fit within the scope of section 385 and avoid treaty issues, the regulations should employ tax principles that apply neutrally across fact patterns, regardless of the tax effect. At the same time, Treasury may have wanted the neutral principles to be broadly framed to have the greatest impact in addressing U.S. earnings stripping and untaxed foreign repatriations. The problem with this approach is that it produces a set of broad, bright-line rules that extend well beyond established principles for distinguishing debt from equity and greatly affect many ordinary course transactions that present no U.S. tax policy concerns.

V. Effectiveness in Addressing Policy Concerns

As a measure to prevent earnings stripping, the per se stock rule has a relatively circumscribed impact. The regulations, for example, do not limit the amount by which a foreign-parented group may leverage a U.S. subsidiary with debt when the subsidiary is initially capitalized. In this respect, the per se stock rule may provide an incentive for foreign-parented groups to front-load the debt funding of U.S. subsidiaries — accelerating U.S. earnings stripping.

As previously noted, the preamble to the regulations states that the application to U.S.-parented groups is driven, at least in part, by concerns about specific transactions undertaken by U.S.-parented groups to distribute cash from CFCs without repatriating CFC earnings. The per se stock rule has a limited impact in preventing these transactions, as well. For example, such a distribution can be achieved through third-party borrowing. Moreover, when a distribution by a CFC to a U.S. parent is funded by a borrowing from another CFC, the CFC-to-CFC loan is recharacterized as stock, but the distribution to the U.S. parent is not recharacterized. So it is questionable whether the per se stock rule is effective in addressing this tax policy concern either.

VI. Overbreadth — Transactions Between CFCs

The overbreadth of the per se stock rule is illustrated by its application to debt transactions between CFCs. Returning to the fundamental question: What tax policy problem is solved by applying the per se stock rule to CFC-to-CFC transactions?

For transactions between CFCs, there appears to be no material risk of U.S. earnings stripping. The transactions are between two foreign entities that are not directly taxable in the United States.[28] Likewise, transactions solely between CFCs do not produce an untaxed repatriation to a U.S. affiliate.

'economic family' approach, which is hard to reconcile with the doctrine that tax law respects corporate forms." *Sears, Roebuck & Co. v. Commissioner*, 972 F.2d 858, 861 (7th Cir. 1992). Instead, courts have focused on whether the parties have interacted on an arm's-length basis in pricing and risk distribution. *See, e.g., Humana Inc. v. Commissioner*, 881 F.2d 247 (6th Cir. 1989) (rejecting "economic family" theory and focusing on the presence of economic "risk shifting and risk distribution"); *Amerco Inc. v. Commissioner*, 979 F.2d 162 (9th Cir. 1992) (upholding deduction in light of sufficient risk pooling); and *Malone & Hyde Inc. v. Commissioner*, 62 F.3d 835 (6th Cir. 1995) (noting that deductions will be disallowed when the primary insurer is undercapitalized or indemnified by the taxpayer). Acknowledging these adverse precedents, the IRS announced in Rev. Rul. 2001-31, 2001-1 C.B. 1348, that it would "no longer invoke the economic family theory with respect to captive insurance transactions."

[27]Ryan Finley, "Treasury Official: View Transfer Pricing Guidance Holistically," *Tax Notes*, Mar. 21, 2016, p. 1377.

[28]As noted previously, it is assumed that the CFCs are not engaged in a U.S. trade or business.

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More broadly, in transactions between CFCs, respecting an instrument as debt for U.S. tax purposes generally does not produce a benefit compared to equity treatment. Both intercompany interest and intercompany dividends qualify for tax deferral under section 954(c)(6). The principal attributes of CFCs for U.S. tax purposes are the amount and location of E&P and foreign tax credits. A transaction treated as stock has a greater impact than debt on the location of E&P and FTCs among affiliates. In particular, distributions of E&P, including distributions under section 302(d), can have a much larger impact than interest on the location of E&P and FTCs.

Example 2:

Case 1. CFC1 makes a $100 five-year loan to CFC2 at a 3 percent interest rate. CFC2 is engaged in an active business outside the United States, and none of CFC2's income is taxable under subpart F or is income effectively connected with a U.S. trade or business. Under section 954(c)(6), therefore, CFC1's interest income is not taxable under subpart F.

CFC2's interest payments to CFC1 in no way reduce the U.S. tax base. The loan shifts $3 of E&P from CFC2 to CFC1 each year. For U.S. FTC purposes, the foreign taxes accrued by CFC2 do not move with the E&P to CFC1; they remain in CFC2's tax pool.

Case 2. CFC1 invests $100 in CFC2 in exchange for preferred stock that accrues 3 percent dividends annually and carries a 25 percent voting interest in CFC2. After a period of years, CFC2 redeems the stock for $100. CFC2 is engaged in an active business outside the United States, and none of CFC2's income is taxable under subpart F or is income effectively connected with a U.S. trade or business. Therefore, under section 954(c)(6), CFC1's dividend income is not taxable under subpart F. Moreover, under section 302(d), the redemption of the stock is treated as a section 301 distribution of E&P, and under section 954(c)(6), that distribution to CFC1 is not taxable under subpart F.

In this case, the annual payment of dividends moves $3 of E&P from CFC2 to CFC1, and the distribution in redemption of the stock moves $100 of E&P from CFC2 to CFC1. Also, a proportionate amount of the foreign taxes in CFC2's tax pool moves with the earnings to CFC1's tax pool. Moreover, under reg. section 1.302-2(c), as a result of the redemption, CFC1's basis in the stock shifts to other shares in CFC2 held by CFC1 or affiliates.

So a CFC's investment in the stock of an affiliated CFC potentially has a much larger impact on the location of U.S. tax attributes than does a loan. One might say that the government's interest is protected because the regulations prevent taxpayers from affirmatively recasting debt as equity under the regulations for the principal purpose of producing a benefit to the taxpayer. However, this puts taxpayers in an untenable position. Because a recast of a CFC-to-CFC transaction might have no U.S. tax consequences for years, taxpayers will not know whether the recast has a favorable result. Moreover, it is unclear how a taxpayer would prove the absence of a principal purpose to recast the transaction to obtain a tax benefit. Does this represent good tax policy — broadly mandating a recast that has no immediate U.S. tax consequences but substantially shakes up CFC tax attributes, while at the same time preventing taxpayers from affirmatively applying the regulations?

While the application of the per se stock rule to transactions between CFCs does not appear to advance a specific U.S. tax policy objective, it can create substantial collateral damage.

A. Ordinary Course Treasury Funding

One example of collateral damage is in the application of the per se stock rule to ordinary course treasury funding. It is common for companies to fund the banking needs of affiliates through a centralized treasury center. The treasury center functions as an internal bank. One or more treasury entities make loans to affiliates, take deposits from affiliates, and enter into foreign currency or interest rate hedging transactions with affiliates. The treasury center then enters into similar transactions with third-party banks for the entire affiliated group.

The treasury center often does not have responsibility for the equity funding of affiliates. It is common for companies to have separate treasury entities for domestic and foreign funding,[29] as well as separate treasury entities for different currencies, regions, or countries.

Companies establish centralized treasury centers because this achieves nontax efficiencies compared with the alternative of having each affiliate enter into separate financial transactions with third-party banks. For example, because affiliates commonly have offsetting positions (for example, excess cash

[29]If the foreign and domestic funding were not provided by separate treasury entities, there would be a risk of foreign-to-U.S. loans, giving rise to taxable subpart F inclusions under section 956.

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in one affiliate and cash needs in another), transacting through a centralized hedging center reduces a group's bank credit exposure and transaction fees and costs.

A company's treasury operations may include funding of affiliates under a cash pool. Under a typical cash pool, an affiliate funds its daily cash needs by making draws from the treasury entity. Unused cash held by affiliates is automatically swept to the treasury entity as deposits on a periodic basis (for example, daily).

The ordinary course debt funding provided by a company's treasury center, however, is not limited to cash pools. For example, a treasury entity may enter into a three- or five-year revolving loan facility under which the affiliate may draw funds up to a maximum amount, repay the amounts, and redraw funds throughout the period of the facility.

A company's treasury center may also provide longer-term debt funding in the ordinary course. For example, a treasury entity may provide longer-term debt to match-fund an affiliate's long-term assets.

A treasury entity may provide debt funding to an affiliate to address country-specific economic, legal, or political risks. Issues might arise in withdrawing cash from an entity or country in the case of an equity investment that do not arise for debt. Or, for regulatory reasons, a company may debt-fund affiliates at levels proportionate to the company's external debt funding.

The following example illustrates the application of the per se stock rule to such ordinary course treasury funding.

> **Example 3:** Centralized Treasury Co, a CFC, enters into a three-year cash pool facility with CFC OpCos 1 through 6. Centralized Treasury Co also enters into three-year revolving loan facilities with CFC OpCo 1 and CFC OpCo 2. Two years after making a cash draw under the revolving loan facility, CFC OpCo 1 distributes cash to CFC HoldCo reflecting accumulated (prior-year) E&P. At the time of CFC OpCo 1's cash distribution, CFC OpCos 4 through 6 have deposits with the cash pool.
>
> Upon CFC OpCo 1's cash distribution, Centralized Treasury Co's loan to CFC OpCo 1 is recharacterized as stock under the regulations. This has a cascading effect: Upon Centralized Treasury Co's deemed acquisition of the stock of CFC OpCo 1, the cash pool deposits of CFC OpCos 4 through 6 are all recharacterized as investments in the stock of Centralized Treasury Co. (See "Ordinary Course Treasury Funding" diagram.)

Treasury has indicated that it is open to providing an exception to the per se stock rule for cash pool transactions. Treasury officials, however, have said that in providing such an exception, they are looking to distinguish debt incurred to fund short-term liquidity needs (which would qualify for the exception) from longer-term funding (which would not). This raises several questions: How is short-term liquidity funding defined? If, as is often the case, an affiliate's short-term liquidity funding is followed by other short-term liquidity funding, under what circumstances will this qualify for the exception? For transactions between CFCs, the funding is between two foreign entities, with accounting, tax, legal, and potentially regulatory consequences in their countries of residence. So the requirements to satisfy an exception from the regulations may have implications in those foreign jurisdictions.

In thinking through the boundaries of a short-term liquidity exception, it's easy to get lost in the distinctions being drawn: cash-pool versus non-cash-pool funding; loans less than six months versus loans for a longer duration. This may be a point at which to ask: What problem is being solved with an exception based on these distinctions? It may be that the exception provides a complex solution to only a piece of a much larger problem.

B. Post-Acquisition Integration

Another example of when the per se stock rule might interfere with ordinary course transactions is in post-acquisition business integration. Post-acquisition restructuring often involves intercompany debt funding, but it is not short-term liquidity funding.

When one company (Acquiring Group) makes an acquisition of another company (Target Group), almost invariably the ownership structure of affiliates within Target Group will differ from the ownership structure within Acquiring Group. So Acquiring Group will want to move Target Group's affiliates to the appropriate position within Acquiring Group's organizational structure. For example, affiliates may be grouped together by country or functional currency, for regulatory reasons, or along business lines.

It is common for companies to undertake such organizational restructuring following the acquisition, rather than purchase the affiliates directly from Target Group in multiple transactions. This may be done, for example, to simplify the acquisition for the seller in a competitive bid or to facilitate regulatory approval. Moreover, in some circumstances, separate acquisitions of affiliates may not be possible, as in an acquisition of a publicly held company.

Acquiring Group will commonly engage in intercompany sales of stock of affiliates to achieve post-acquisition integration. This is particularly

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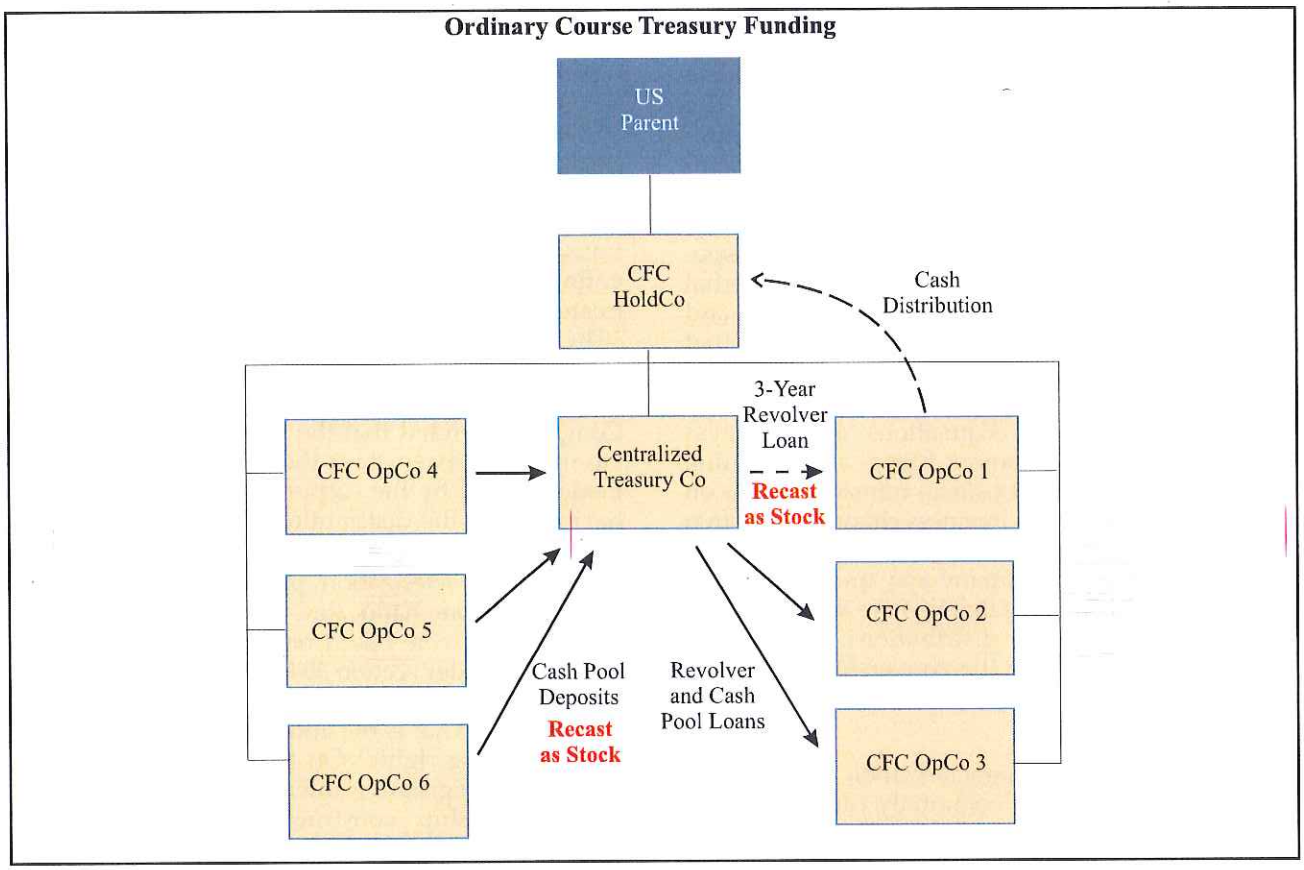

true if the affiliates must be transferred cross-chain. Transferring the companies in exchange for stock is counterproductive because it creates cross-ownership, which undercuts the objective of moving the affiliate into the appropriate separate group.

The intercompany sales of affiliates will often involve intercompany debt for reasons unrelated to U.S. tax. For example, Acquiring Group may have used its available cash in the acquisition. Or the purchasing affiliate may not have available cash and will need to borrow funds from the group's centralized treasury center.

> **Example 4:** P is the U.S. parent of an affiliated group that includes CFC1, a subsidiary resident in Country X, and CFC2, a subsidiary resident in Country Y. CFC1 acquires the shares of Target, a corporation resident in Country X, for $1,000 from an unrelated party. Target owns Target Sub, a corporation resident in Country Y that has a value of $200.
>
> P wishes to integrate Target Sub into its existing Country Y group. So CFC2 borrows $200 under a five-year loan from CFC3, the group's foreign treasury center, and uses the proceeds to purchase the stock of Target Sub.
>
> The group, as a result, is able to achieve financial accounting efficiencies in that CFC2 and Target Sub each have the Y currency as their functional currency. Moreover, CFC2 and Target Sub are able to file a consolidated tax return in Country Y.

The per se stock rule would not apply if, as part of an acquisition, affiliates of Acquiring Group borrowed intercompany to separately purchase each of the target subsidiaries that need to be integrated into different parts of Acquiring Group. Why, then, should the per se stock rule apply if instead Acquiring Group purchases Target Group from an unrelated party and then undertakes intercompany loans to transfer Target Group subsidiaries to the appropriate parts of Acquiring Group? The preamble to the regulations acknowledges that intercompany loans and purchases occur in post-acquisition integration: "The change in the direct ownership of the affiliate's stock may have some non-tax significance in certain circumstances, such as the harmonization of a group's corporate structure following an acquisition."[30] The per se stock rule nevertheless applies to the transactions.

[30]81 F.R. at 20917.

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C. Predisposition Consolidation

Similar issues arise in the intercompany consolidation of affiliates and assets in preparation for a group's disposition of all or part of a business. The consolidation is often achieved through stock acquisitions or asset reorganizations funded by intercompany loans.

The intercompany loans might be repaid at the time of the business sale. However, business dispositions typically don't occur overnight. The internal consolidations may occur over a period of time, and during that period, transactions may occur that cause the intercompany debt to be converted to stock, with adverse consequences.

Moreover, business acquisitions and business dispositions are two points along a continuum. Companies go through business transformations on an ongoing basis. These business changes will often lead to acquisitions and dispositions, but before those transactions, a company may undertake organizational restructurings that involve intercompany loans, acquisitions, and distributions. This should not be the occasion for the conversion of debt to stock.

D. Foreign Tax Credits

The debt-equity recharacterization under prop. reg. section 1.385-3 will commonly cause a permanent loss of FTCs because the lender typically will not meet the stock ownership requirements for claiming credits under section 902.

> **Example 5:** CFC1 makes a $100 five-year loan to CFC2. Within 36 months of the loan, CFC2 makes a distribution. The CFC2 distribution causes a deemed exchange of the loan for CFC2 stock. In year 5, CFC2 repays $100 to CFC1 in retirement of the instrument. Under section 302(d), this is treated as a $100 E&P distribution from CFC2 to CFC1.
>
> CFC2 has $500 of post-1986 E&P and $100 of post-1986 foreign taxes in its section 902 E&P and tax pools when the instrument is repaid. As a result of the distribution to CFC1, $100 of E&P and $20 of foreign taxes are removed from CFC2's post-1986 E&P and tax pools. Section 902 requires that CFC1 own 10 percent or more of the voting stock of CFC2 for the $20 of foreign taxes to move to CFC1's post-1986 tax pool. Consequently, it appears that as a result of the debt-equity recharacterization, the affiliated group will lose $20 of FTCs, giving rise to the prospect of double taxation of the associated earnings.

A similar FTC issue arose historically under section 304. Under section 304, a related-party sale of stock is treated as a contribution of the stock by the seller to the purchaser in exchange for deemed shares, followed by a redemption of the deemed shares. Under section 302(d), this is treated as a section 301 distribution to the seller. Often, the section 304 transaction is a cross-chain sale of shares and the seller does not own 10 percent of the voting stock of the purchaser. In Rev. Rul. 91-5[31] and Rev. Rul. 92-86,[32] however, the IRS ruled that for purposes of section 902, the seller in a section 304 transaction will be treated as directly owning the voting stock held by related parties that the seller is treated as constructively owning under section 304(c).

In reaching this result, the IRS found support in a 1984 amendment to section 304 indicating that Congress intended that the seller be allowed FTCs "to the same extent as if the distribution had been made directly by the corporation that is treated as having made the distribution."[33]

A loss of FTCs is a harsh consequence of debt-equity recharacterization under the per se stock rule. On the one hand, Rev. Rul. 91-5 and Rev. Rul. 92-86, which were based on indications of legislative intent under section 304, frame the challenge of reaching a similar result under the section 385 regulations: What is the authority for attributing 10 percent voting rights? On the other hand, the expression of legislative intent regarding an analogous ownership construct raises the question whether a loss of FTCs under the broad reach of the per se stock rule is consistent with the intent of section 385.

It is not an answer to say that taxpayers can engage in self-help to create the requisite 10 percent voting interest by, for example, including voting rights in loan agreements, creating separate "golden shares" with voting rights, or exchanging instruments recast as equity for actual voting stock. The transactions involve interests in foreign entities. Therefore, creating voting rights is a matter of foreign law, which would need to be examined in each country in which the issue arises. Moreover, the FTC issue is a consequence of regulations that extend beyond established principles for distinguishing debt from equity and apply broadly to ordinary course transactions. At minimum, the loss of FTCs is a trap for the unwary — potentially a very costly one. This is not a burden that should be shouldered by taxpayers.

The regulations should be clarified to provide that if debt is recharacterized as stock, the holder of the instrument is deemed to own a 10 percent

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[31]1991-1 C.B. 114.

[32]1992-2 C.B. 199.

[33]*See* Rev. Rul. 92-86, 1992-2 C.B. 199, 200 (quoting H.R. Rep. No. 98-861 (1984)).

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voting interest in the issuer. In this respect, it is worth noting that under prop. reg. section 1.385-1(b)(3), an expanded group is determined in part based on the constructive ownership rules of section 304(c). As noted above, in Rev. Rul. 91-5 and Rev. Rul. 92-86, the IRS looked to section 304(c) as the basis for attributing 10 percent voting rights for purposes of section 304.

E. Hedging Transactions

The recharacterization of debt as equity will collaterally affect the tax treatment of transactions entered into to hedge foreign exchange or interest rate exposure on the intercompany debt. The U.S. tax rules include provisions designed to align the tax treatment of debt instruments and transactions undertaken to hedge the debt, including regulations under sections 954, 988, 1221, and 1275. Those provisions don't apply to stock.

> **Example 6:** CFC1 is the foreign centralized treasury center for an affiliated group. CFC1 makes a loan to CFC2, denominated in CFC2's functional currency, P. CFC1's functional currency is U. To hedge its foreign currency risk, CFC1 enters into a P-U currency swap with an unrelated bank. CFC1 elects to integrate the swap and loan under reg. section 1.988-5, so that the transactions are treated as a single U-denominated loan. As a result, the foreign currency gain or loss on the swap, as an integrated component of a U-denominated loan, qualifies for U.S. tax deferral under section 954(c)(6).
>
> CFC1's loan is recast as stock under prop. reg. section 1.385-3. As a result, the swap no longer qualifies for integration treatment under reg. section 1.988-5 because section 988 does not apply to hedges of stock. Consequently, the foreign currency gain or loss under the swap is taxable under section 954(c)(1)(D).

F. Tax-Free Transfers and Reorganizations

Debt recast as stock under the per se stock rule will typically represent nonvoting preferred stock. This recast could affect whether the stock ownership or control tests under various provisions of the code are satisfied. Of particular importance is the control test under section 368(c). As a result of the nonvoting preferred stock, transactions may not satisfy the section 368(c) control test for tax-free treatment under section 351 or the reorganization provisions.

> **Example 7:** P, the U.S. parent of an affiliated group, owns two subsidiaries, S1 and S2. S1 makes a loan to S2 that is recharacterized as stock. The stock represents nonqualified preferred stock (NQPS) under section 351(g)(4). In an unrelated transaction, P transfers appreciated property to S2. Because of the NQPS, P's transfer of appreciated property does not qualify for tax-free treatment under section 351(a) because P does not control S2 within the meaning of section 368(c). P does not own 80 percent of all classes of nonvoting stock, together with 80 percent of all voting stock.

G. Burden of Regulations

As discussed, the per se stock rule can create widespread, adverse consequences for transactions between CFCs. Intercompany treasury funding is undertaken by companies as a substitute for multiple third-party banking transactions in order to achieve nontax efficiencies. This includes cash pools or similar short-term liquidity funding. But ordinary course intercompany funding extends beyond short-term liquidity funding. Intercompany funding among CFCs presents none of the tax policy concerns identified in the preamble as a rationale for the regulations: U.S. earnings stripping and untaxed foreign repatriations. In an attempt to limit exposure to the risks and costs resulting from the per se stock rule, companies will need to establish substantial compliance processes.

The preamble to the regulations states that the Office of Management and Budget has estimated that the paperwork burden associated with the regulations is 35 hours per respondent.[34] This greatly underestimates the cost of complying with the regulations. In addition to the compliance processes that companies will need to establish to attempt to avoid the complexities and adverse consequences of the per se stock rule, companies will have the costs of complying with the prop. reg. section 1.385-2 documentation requirement. Companies will likely need to adapt or create new computer systems, and may have to hire additional staff, in order to comply with the regulations. That will involve not just the tax department but also the treasury and accounting departments.[35]

To avoid these tax risks and costs of compliance, taxpayers may choose to replace intercompany funding through a centralized treasury center with third-party debt financing. That would be unfortunate because companies would lose the nontax efficiencies of centralized treasury centers. So the question is: What U.S. tax policy objective is served by applying the per se stock rule to transactions between CFCs? Does it justify the tax risks and compliance costs that would induce taxpayers to

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[34]81 F.R. at 20917.

[35]*See* letter from the U.S. Council for International Business to OMB (June 7, 2016).

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forgo the nontax efficiencies of centralized intercompany funding of affiliates?

The application of the per se stock rule to transactions between CFCs places a substantial burden on U.S.-headquartered companies as they operate in other countries, without meaningfully advancing an identified U.S. tax policy objective.

For these reasons, transactions between CFCs should be excluded from the scope of the per se stock rule.[36] As discussed below, this exclusion would not apply if the CFC-to-CFC transaction is part of an overall set of transactions that together constitute a distribution of a debt instrument to a U.S. affiliate or a substantially equivalent transaction.

For similar reasons, consideration should also be given to excluding CFC-to-CFC transactions from the prop. reg. section 1.385-2 documentation requirement.

VII. Consistency With Other Policy Objectives

Separate from the section 385 regulations, Treasury has proposed more general limitations on the amount of interest expense a U.S. group may deduct. In connection with the administration's fiscal 2017 budget, Treasury issued two legislative proposals: one directed at foreign-parented groups and another directed at U.S.-parented groups.[37]

In contrast to section 163(j), each of the administration's proposals would apply to both unrelated and related-party debt. Under the proposal directed at foreign-parented groups, the U.S. affiliated subgroup may not deduct interest expense to the extent that the ratio of the U.S. subgroup's net interest expense (the excess of interest expense over interest income) to U.S. earnings before interest, taxes, depreciation, and amortization exceeds the worldwide group's ratio of net interest expense to EBITDA. An exception is provided if the U.S. subgroup's net interest expense does not exceed 10 percent of U.S. EBITDA. Under the administration's proposal directed at U.S.-parented groups, the U.S. group's gross interest expense is allocated between U.S. assets and foreign assets. The amount of interest expense allocated to CFCs is nondeductible to the extent that the earnings of the CFCs are not subject to current U.S. tax (taking into account the administration's minimum tax on CFC earnings).

The OECD, in action 4 of the BEPS project, also made recommendations for a general limitation on interest deductions.[38] The administration's proposal applicable to foreign-parented groups is a variation of the OECD's proposal. Also, in action 2 of the BEPS project, the OECD made recommendations for limitations on cross-border hybrid arrangements involving hybrid instruments or hybrid entities.[39]

The question arises whether the per se stock rule is consistent with these other tax policy proposals. Interestingly, a Treasury official recently said that if the United States adopted a limitation on interest deductibility in accordance with the OECD's proposal, such as the administration's proposal directed at foreign-parented groups, the section 385 regulations may no longer be necessary.[40] This suggests that the regulations are directed at U.S. earnings stripping, serving as a limitation on excessive U.S. interest deductions until broader limitations can be enacted. As discussed, intercompany loans between CFCs do not present a risk of U.S. earnings stripping. Moreover, for loans between a U.S. corporation and a related CFC, it is difficult to see how the regulations advance the tax policy objective of limiting excessive U.S. interest deductions.

A tax policy objective of the administration's and OECD's proposed interest limitations is, within limits, for companies generally to allocate debt and associated interest deductions proportionately among jurisdictions in which affiliates are tax resident. Given the inefficiencies and impracticalities of having each affiliate within a group borrow from unrelated banks, intercompany funding is the primary way for debt and interest deductions to be spread throughout a group.[41]

Example 8: P is the U.S. parent of an affiliated group that includes CFC1, CFC2, CFC3, and CFC4. P incurs $1,000 of debt from unrelated parties in the capital markets. Approximately

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[36]An exception potentially could be provided for a CFC engaged in a U.S. trade or business if Treasury perceives that intercompany debt presents tax policy concerns. Interest allocation under reg. section 1.882-5 might limit opportunities to deduct excess interest.

[37]Treasury, "General Explanations of the Administration's Fiscal Year 2017 Revenue Proposals," at 2 (Feb. 1, 2016).

[38]OECD, "Limiting Base Erosion Involving Interest Deductions and Other Financial Payments, Action 4 — 2015 Final Report" (Oct. 5, 2015).

[39]OECD, "Neutralising the Effects of Hybrid Mismatch Arrangements, Action 2 — 2015 Final Report" (Oct. 5, 2015).

[40]Alexander Lewis, "Group Ratio Rule Could Make U.S. Debt-Equity Regs Unnecessary," *Tax Notes*, June 13, 2016, p. 1429.

[41]OECD, action 4 final report, *supra* note 38, at 12 ("An important feature of the fixed ratio rule is that it only limits an entity's net interest deductions (i.e. interest expense in excess of interest income). The rule does not restrict the ability of multinational groups to raise third party debt centrally in the country and entity which is most efficient taking into account non-tax factors such as credit rating, currency and access to capital markets, and then on-lend the borrowed funds within the group to where it is used to fund the group's economic activities.").

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10 percent of the group's worldwide EBITDA is earned by CFC1, 15 percent is earned by CFC2, 20 percent is earned by CFC3, and 25 percent is earned by CFC4. P lends approximately $100 to CFC1, $150 to CFC2, $200 to CFC3, and $250 to CFC4. The interest expense on the intercompany loans is deductible in the countries in which the CFCs are resident, and the interest income from the intercompany loans offsets the interest deductions on the $1,000 of third-party debt. The intercompany funding achieves a proportionate allocation of net interest expense across the countries in which the affiliates are resident.

Because of the expansive application of the per se stock rule, the section 385 regulations may cause an intercompany loan from a U.S. affiliate to a CFC to be recast as equity. This will create a hybrid instrument: The instrument is treated as equity for U.S. tax purposes and, at least initially, is respected as debt in the country in which the CFC is tax resident.

The OECD's recommendations under BEPS action 2 require the CFC's jurisdiction to potentially disallow deductions on the hybrid instrument. One of the circumstances in which deductions are disallowed is when the payments on the instrument are not subject to tax because of tax credits. Under section 902, a distribution of earnings to a 10 percent U.S. shareholder will carry FTCs for a proportionate amount of the foreign taxes paid by the distributing CFC. So if the section 385 regulations are modified to allow for FTCs on debt recast as equity, the CFC's jurisdiction may deny deductions on the instrument. And if the section 385 regulations are not so modified, the result will be a loss of FTCs and potential double taxation.

How does this result advance the underlying objectives of the administration's or the OECD's other proposals on interest expense? The rules would appear to impair the ability of U.S.-parented companies to allocate a portion of the group's third-party interest expense to other countries in which the group operates, in order to reduce the tax burden in those jurisdictions.

VIII. 'Don't Go There' Regulations

The per se stock rule has provisions appropriate for a narrowly targeted antiabuse rule. Those include the 72-month irrebuttable funding presumption and the prohibition on affirmative use of the rule by taxpayers.

In this respect, the per se stock rule is a "don't go there" rule; that is, a rule with a draconian impact that is best avoided by taxpayers. The adverse consequences under the rule include (1) loss of FTCs, (2) loss of qualification for tax-free reorganizations and transfers, and (3) loss of consistent tax treatment of hedges and the underlying hedged instrument.[42]

Implicit in such a rule is that a taxpayer can avoid transactions that would cause it to be subject to the rule. The problem is that the per se stock rule applies so broadly to ordinary course transactions. As a result, it is difficult, if not impossible, for taxpayers to not "go there" and be subject to the rule.

A. 72-Month Irrebuttable Funding Presumption

Much of the overbreadth of the per se stock rule derives from the 72-month funding presumption, which is part of the funding rule in prop. reg. section 1.385-3(b)(3). The funding rule is a "principal purpose" provision. Under the rule, a debt instrument is recharacterized as stock if the instrument is issued with a principal purpose of funding a distribution or acquisition described in prop. reg. section 1.385-3(b). A debt instrument is irrebuttably presumed to fund a distribution or acquisition if it is issued within 36 months before or after the transaction.

Implicit in a principal purpose rule is that the provision applies if a transaction is undertaken principally for the stated purpose. An irrebuttable presumption that a transaction is undertaken for such a principal purpose is inconsistent with the basic premise of a principal purpose test; a taxpayer has no ability to prove that a transaction was not undertaken for that principal purpose — no matter how compelling the facts are. The 72-month presumption under the funding rule is particularly harsh given that the transactions described in prop. reg. section 1.385-3(b) are very common in an affiliated group.

The preamble to the regulations states that the irrebuttable presumption is appropriate because "money is fungible and because it is difficult for the IRS to establish the principal purposes of internal transactions."[43] The irrebuttable presumption, however, does not operate in a way consistent with the premise that money is fungible. The principle of fungibility would suggest that all intercompany debt incurred by the issuer be allocated ratably across all of the issuer's uses of cash during the 72-month period, including any distribution or acquisition by the issuer described in prop. reg. section 1.385-3. Instead, the rule automatically

[42]The recast of debt as equity under the per se stock rule can have other adverse, collateral consequences — *e.g.*, qualification for benefits under a U.S. tax treaty, and qualification for the dividends received deduction under section 246. A discussion of all the collateral consequences is beyond the scope of this report.

[43]81 F.R. at 20923.

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matches the intercompany loan solely with the distribution or acquisition.[44]

Because of the widespread, draconian impact of the 72-month irrebuttable presumption, as described below, the provision should be replaced with a rebuttable presumption, as part of a more targeted focus of prop. reg. section 1.385-3.

B. Prohibition on Affirmative Use by Taxpayers

Under prop. reg. section 1.385-3(e), the per se stock rule does not apply to the extent that an affiliated group member enters into a transaction otherwise subject to the rule with a principal purpose of reducing the U.S. tax liability of any member of the group by disregarding the treatment of the debt instrument that would apply without regard to the regulations.

This provision creates significant uncertainty for taxpayers. In what circumstances is the prohibition intended to apply?

Typically, a taxpayer group will enter into an intercompany loan with the intent that the transaction be treated as debt for U.S. tax purposes. Then, if another transaction occurs that causes the debt instrument to be recast as stock under the regulations, the taxpayer will want to report the transaction in compliance with the regulations. But how does the taxpayer do that?

For transactions between CFCs, it would not be unusual for a recast of debt as stock under the per se stock rule to produce a favorable tax result for a taxpayer. As discussed above, both interest and dividends generally qualify for deferral of U.S. taxation under section 954(c)(6). The primary effect of a recast under the regulations is to move E&P among CFCs, together with FTCs if the credits are not lost as a result of the recast. An investment in stock typically will have a much greater impact than an investment in debt in moving earnings and FTCs because, under section 302(d), the repayment of stock will be treated as a distribution of earnings.[45]

Still, it may be years before a taxpayer can determine whether reporting the transaction as stock produces a more favorable U.S. tax result than reporting the transaction as debt. The U.S. tax impact of the recast will depend on how earnings are repatriated, and it may turn out that the recast has a negative impact on the U.S. tax liability in one year and a positive impact in a subsequent year, or vice versa.

If it turns out that characterizing the transaction as stock produces a better U.S. tax result than characterizing the transaction as debt, how does the taxpayer prove that the transaction was not entered into with a principal purpose of having the transaction be recast under the regulations to achieve that result?

One approach to interpreting this provision is that if, from the outset, the taxpayer group could have structured the transaction as stock instead of debt, the taxpayer may treat the transaction as stock when reporting its income. That is, the absence of a principal purpose to achieve a recast under the regulations is established by the fact that the transaction could have been structured as stock — there is no legal, regulatory, or other impediment that would have prevented the transaction from being structured as stock.

If this is an appropriate interpretation of the provision, it would be helpful for the final regulations to confirm that. Moreover, it would be helpful for the final regulations to include an example of the type of transaction that would run afoul of the prohibition.[46]

IX. Conclusion

Returning to the core question: What tax policy problem is solved by the per se stock rule?

The preamble to the regulations identifies two tax policy concerns: U.S. earnings stripping and untaxed foreign repatriations. As a measure to address those concerns, the per se stock rule is both underinclusive and greatly overinclusive. The rule

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[44]Even though, under the funding rule, intercompany loans are automatically matched with distributions and acquisitions over a 72-month period, equity infusions into the issuer during that period are not taken into account. It would seem appropriate for the amount of debt otherwise recharacterized under prop. reg. section 1.385-3 to be reduced by the amount of equity capital received by the issuer over the 72-month period.

[45]Debt recast as stock under section 385 regulations could potentially be fast-pay stock under reg. section 1.7701(l)-3. Fast-pay stock is generally defined as stock structured so that dividends on the stock are economically, in whole or part, a return of the holder's investment (rather than only a return on the holder's investment). If the IRS determines that a principal purpose of the fast-pay arrangement is to avoid U.S. tax, the fast-pay stock is recast as a financing instrument (often as debt) between the holder of the fast-pay stock and other holders of stock of the corporation. As discussed above, a redemption of a

(Footnote continued in next column.)

debt instrument recharacterized as stock under the section 385 regulations often will be treated as a section 301 distribution rather than as a return of the investment. As a result, the stock could be viewed as fast-pay stock. Under Notice 2000-15, 2000-1 C.B. 826, a transaction involving fast-pay stock is a listed transaction. So it's important to clarify the application of the fast-pay rules to debt recast as stock under the section 385 regulations.

[46]One such fact pattern might be hook stock (*i.e.*, an investment by a subsidiary in stock of its parent). In a number of countries, an investment in hook stock is not permitted under corporate law. A group that is unable to structure an investment in hook stock under the laws of a jurisdiction might intentionally structure intercompany debt to run afoul of prop. reg. section 1.385-3 to create hook stock for U.S. tax purposes.

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is underinclusive in that it is only partially effective in limiting U.S. earnings stripping, and it is even less effective in limiting untaxed foreign repatriations. The rule is overinclusive in its extraordinarily broad application to ordinary course transactions that do not create meaningful risks of U.S. earnings stripping or untaxed foreign repatriations.

The per se stock rule applies beyond established tax principles for recharacterizing debt as equity, creating a risk of substantial collateral damage, including loss of FTCs, loss of qualification for tax-free reorganizations and transfers, and loss of consistent tax treatment of hedges and the underlying hedged instrument. To avoid these consequences, taxpayers are forced to undertake substantial compliance costs, affecting not only the tax function but also the treasury, accounting, and legal functions.

For these reasons, the per se stock rule does not appear to be the appropriate solution to the tax concerns identified in the preamble. If, however, Treasury proceeds with finalizing the regulations with the rule, the following changes should be made to narrow its scope.

A. Exclusion of CFC-to-CFC Transactions

The per se stock rule should be modified to exclude transactions between CFCs.[47] As discussed below, the exclusion would not apply if the CFC-to-CFC transaction is part of an overall set of transactions that together constitute a distribution of a debt instrument to a U.S. affiliate or a substantially equivalent transaction.

Consideration likewise should be given to a carveout of CFCs from the prop. reg. section 1.385-2 documentation rule.[48]

If CFC-to-CFC transactions are not fully excluded from the per se stock rule, consideration should be given to reserving on them in the regulations. On this point, it is worth noting that the proposed regulations issued under section 385 in 1982 reserved on the application of the regulations to any debt instrument issued by or to a non-U.S. person.[49] This is not to suggest that the current regulations should exclude all instruments issued by or to a non-U.S. person. Rather, the previously proposed regulations are noteworthy in that Treasury reserved on transactions involving a non-U.S. person because of the perceived complexities and issues, pending further analysis.

U.S. tax reform hopefully is on the horizon. The U.S. taxation of foreign operations is out of step with the international tax rules of other major countries. Although there may be differences of views on the best way to fix the U.S. system, there appears to be general agreement that the U.S. tax deferral system is broken and should be fixed.

Under the regulations, taxpayers must immediately establish costly compliance programs to minimize exposure under the per se stock rule, as well as compliance programs for the documentation rule. It would be unfortunate if taxpayers have to incur the cost of establishing those programs only to have the taxation of CFC-to-CFC transactions be modified substantially in tax reform, reducing the need for the compliance.

B. Limit to Note Distributions or Equivalents

As discussed, the paradigmatic transaction targeted by the per se stock rule is a corporate distribution of a debt instrument. This type of transaction has been the subject of dispute under existing case law. Prop. reg. section 1.385-3 should be limited to corporate distributions of a debt instrument and other transactions that are substantially equivalent. Substantially equivalent transactions would include transactions in which there is circular cash flow.

> **Example 9:** P, the U.S. parent of an affiliated group, owns two subsidiaries, S1 and S2. P makes a $100 loan to S1, which in turn makes a $100 distribution to P. Alternatively, S2 makes a $100 loan to S1, which makes a $100 distribution to P, with P providing $100 of funding to S2 for its loan.

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[47] *See supra* note 36, discussing a possible exception if the CFC is engaged in a U.S. trade or business. Apart from transactions between CFCs, there may be other circumstances in which it is appropriate to exclude from prop. reg. section 1.385-3 transactions between foreign affiliates. Consider, for example, an investment by a U.S. company in a foreign joint venture. Assume that the U.S. company owns a 40 percent interest in the joint venture. If the joint venture enters into debt transactions that are recast as equity under prop. reg. section 1.385-3, collateral damage could result similar to that arising for CFCs, *e.g.*, loss of FTCs.

[48] Because CFC-to-CFC transactions generally do not have a current U.S. tax impact, a case can be made that the compliance costs outweigh the benefits of the documentation requirement. If, however, Treasury determines that the policies underlying the documentation requirement are such that the provision should continue to apply to CFC-to-CFC transactions, it should consider streamlining the documentation requirement for CFC-to-CFC transactions.

[49] Treasury initially published regulations under section 385 on March 24, 1980. *See* prop. reg. section 1.385-1 to -12, 45 F.R. 18957 (1980). The regulations were revised and issued in final form on December 31, 1980. *See* 45 F.R. 86438 (1980). In response to numerous comments, proposed amendments were made to the regulations on January 5, 1982, including a carveout for "international transactions," pending further study. *See* prop. reg. section 1.385-0 to -8, 47 F.R. 147, 163, 171 (1982). The regulations were ultimately withdrawn, effective August 5, 1983. *See* 48 F.R. 31053 (1983).

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The question arises whether the acquisition of affiliate stock in exchange for a debt instrument is substantially equivalent to a corporate distribution of a debt instrument. This can be debated. In the acquisition, the equity capital of the issuer is not reduced in connection with the issuance of debt. Instead, the issuer acquires new assets (the stock of the affiliate) in exchange for the issuance of a debt instrument. In what respects is that different from an acquisition of other assets in exchange for a debt instrument?

Does the analysis differ between a case in which a parent sells stock of one subsidiary to another in exchange for debt and a case in which one subsidiary sells shares of a second subsidiary to a third subsidiary in exchange for debt? The cross-chain sale does not result in a debt push-down by a controlling shareholder.

Despite the differences between an acquisition of affiliate stock and a corporate distribution of a debt instrument, under section 304, the purchase of affiliate stock is generally treated as a distribution. This may be an appropriate basis for treating the stock acquisition as substantially equivalent to the issuance of a debt instrument.[50]

An upstream sale of stock of an affiliate in exchange for a debt instrument, however, may be distinguishable. Section 304 doesn't apply to this transaction, and the transaction seems more dissimilar to a distribution of a debt instrument than do the section 304 examples.

> **Example 10:** P, the U.S. parent of an affiliated group, owns a subsidiary, S1, which in turn owns a second subsidiary, S2. S1 sells the shares of S2 to P in exchange for a note.

It is also questionable whether an upstream loan from a lower-tier affiliate to a second-tier affiliate to fund a distribution to an upper-tier affiliate should be viewed as substantially equivalent to a distribution of a debt instrument.

> **Example 11:** P, the U.S. parent of an affiliated group, owns a subsidiary, S1. S1 owns all the shares of a second subsidiary, S2, which in turn owns all the shares of a third subsidiary, S3. S3 makes a $100 loan to S2, which makes a $100 distribution to S1.

[50]It may be appropriate to apply prop. reg. section 1.385-3 to acquisitions of hook stock regardless of whether the transaction could be viewed as substantially equivalent to a corporate distribution. The preamble to the regulations expresses concern about hook stock, noting that it "typically possess[es] almost no non-tax significance." 81 F.R. at 20918.

C. Replace Irrebuttable Presumption

The 72-month irrebuttable presumption under prop. reg. section 1.385-3(b)(3) should be replaced with a rebuttable presumption. The modification would dovetail with the change described earlier under which prop. reg. section 1.385-3(b) would apply to corporate distributions of debt instruments and substantially equivalent transactions. A debt instrument issued within one or two years before or after a distribution or acquisition would be presumed to be substantially equivalent to a distribution of a debt instrument, subject to the taxpayer's right to show the absence of substantial equivalence.

These modifications to the scope of prop. reg. section 1.385-3 are important to the scope of the recommended carveout of CFC-to-CFC transactions. The carveout would generally apply to transactions between CFCs but would not apply to a CFC transaction that is part of an overall set of transactions that together constitute a distribution of a debt instrument to a U.S. affiliate or a substantially equivalent transaction. If the scope of prop. reg. section 1.385-3 is not limited to those transactions and if the 72-month irrebuttable presumption is not replaced with a rebuttable presumption, consideration should be given to extending the CFC carveout to any CFC transaction.

> **Example 12:**
>
> **Case 1.** P, the U.S. parent of an affiliated group, owns two subsidiaries, CFC1 and CFC2. In year 1, CFC1 makes a $100 loan to CFC2. P does not directly or indirectly fund that loan. CFC2 uses the proceeds of the loan to invest in its business. In year 3, CFC2 makes a $100 distribution to P. The transactions should not be viewed as substantially equivalent to a corporate distribution of a debt instrument by CFC2 to P.
>
> **Case 2.** The underlying facts are the same as in Case 1. In year 1, P makes a $100 loan to CFC1. CFC1 in turn makes a $100 loan to CFC2, which makes a $100 distribution to P. Absent other facts to the contrary, this set of transactions should be considered substantially equivalent to a corporate distribution of a debt instrument by CFC2 to P.

D. Affirmative Use of Regulations by Taxpayers

It would be helpful for the regulations to provide additional guidance on how the prohibition on affirmative use of the regulations by taxpayers is intended to be applied. For example, it would be helpful for the regulations to provide that a taxpayer may report a transaction recast under the regulations as stock if the taxpayer could have

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structured the transaction as stock from the outset — that is, there are no legal, regulatory, or other impediments that would have precluded an investment in stock. It would also be helpful if the regulations provided an example of the type of transaction that runs afoul of the provision.[51]

E. Foreign Tax Credits

The final regulations should provide that if a loan to a foreign corporation is recast as stock under the regulations, the stock will be considered to carry 10 percent voting rights for purposes of section 902 if, applying the constructive ownership rules of section 304(c), the holder of the instrument would be deemed to own at least 10 percent voting rights in the issuer.

F. Tax-Free Transfers and Reorganizations

Consideration should be given to treating debt recast under the per se stock rule not as stock for purposes of the ownership and control tests under the code, including section 368(c). One commentator has suggested section 351(g)(4) as authority for this. Section 351(g)(4) authorizes regulations for the treatment of NQPS for purposes of section 351 and other provisions of the code.[52] ■

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[51]*See supra* note 46.

[52]*See* letter of James M. Peaslee to the IRS (May 18, 2016). Section 351(g)(4) may provide authority for other changes to limit the adverse consequences of the section 385 regulations.

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