Treasury Proposes Overhaul of Intercompany Debt Rules

April 11, 2016

Executive Summary

The Internal Revenue Service (the "**IRS**") and the Treasury Department ("**Treasury**") on April 4, 2016 released proposed regulations under Section 385 of the Internal Revenue Code that, if and when finalized, will fundamentally rewrite the U.S. tax rules relating to intercompany debt. While the proposed regulations would in many respects curb the much publicized "earnings stripping" technique that has played a prominent role in "inversion" transactions, they are much broader in scope and would affect many multinational corporate groups (both U.S. and non-U.S.) in a myriad of ways. Most importantly, we believe that these regulations, if and when finalized, may result in increased cash taxes for many U.S. and non-U.S. corporations with material amounts of intercompany debt and potentially negatively impact their effective tax rates.

Very generally, the proposed regulations would do three things:

- Require as a necessary (but not a sufficient) condition to treatment as debt for U.S. federal income tax purposes that intercompany debt be accompanied by extensive contemporaneous documentation, including with respect to the debtor's ability to service the debt (the "**Documentation Rule**");
- Treat intercompany debt as equity for U.S. federal income tax purposes to the extent that it is issued (i) in one of three types of transactions (specifically, a distribution, an acquisition of stock of a group member or as a distribution of boot in an intercompany asset reorganization) (a "**Specified Transaction**") or (ii) with a principal purpose of funding any such transaction, with debt issued during the six-year period surrounding the relevant transaction (the "**Window Period**") generally being treated as issued with such a principal purpose (the "**Per Se Stock Rule**"); and
- Authorize the IRS to treat intercompany debt as in part debt and in part equity for U.S. federal income tax purposes (the "**Part Stock Rule**").

The Per Se Stock Rule is by far the most complex and far-reaching of the proposals, and has implications for both existing and future intercompany debt. Very generally, if the Per Se Stock Rule is finalized substantially in its present form:

- Intercompany debt arrangements in existence on or before April 4, 2016 will not be affected by the Per Se Stock Rule unless the debt is significantly modified;
- Intercompany debt issued after April 4, 2016 to refinance existing intercompany debt will not be treated as stock for U.S. federal income tax purposes under the Per Se Stock Rule solely by reason of being issued in the refinancing, but may be treated as stock under the Per Se Stock Rule if the issuer of the debt separately engages in a Specified Transaction during the Window Period;
- Incremental intercompany debt issued after April 4, 2016 will be subject to recharacterization as stock for U.S. federal income tax purposes under the Per Se Stock Rule if it is issued as part of, or to provide funding for, a Specified Transaction; and
- Incremental intercompany debt issued after April 4, 2016, even if it is not issued as part of, or to provide funding for, a Specified Transaction (*e.g.*, if it is issued to provide funds for a

business expansion or acquisition of an unrelated target company by the issuer of the debt), may be treated as stock if the issuer of the debt separately engages in a Specified Transaction during the Window Period.

Although there are certain exceptions to the Per Se Stock Rule, these exceptions are extremely limited, and will not apply to intercompany debt that is created or acquired in many ordinary course business transactions.

There is a growing expectation in the market that the IRS and Treasury will move quickly to finalize these regulations.[1] Multinational groups will need to consider several key features of the regulations, some of which are relevant as of April 5, 2016. The proposed regulations:

- Require extensive record creation and retention (and presumably the development of the related infrastructure), including with respect to Specified Transactions and intercompany debt issuances on or after April 5, 2016, as those may be relevant to whether intercompany debt in place 90 days after finalization of the regulations is recast as stock;
- Apply to both "inbound" and "outbound" debt instruments, with many possible attendant consequences, including loss of interest deductions and ability to effect debt repatriations; withholding on interest and principal payments; recognition of currency gains as debt is deemed exchanged for equity under the regime; possible effects on the tax status of tax-free reorganizations, property contributions, liquidations and other intragroup transactions; and possible consequences under various jurisdictions' "hybrid instrument" regimes, currently being implemented in response to OECD proposals; and
- Do not adequately address the complexity of common group cash management operations, treasury centers, market-making entities, intragroup hedging activities and many other "ordinary" intragroup operations, creating a variety of risks relating to the treatment of debt issued in these contexts and imposing material compliance costs on these and similar arrangements.

Some of the more significant aspects of the proposed regulations are summarized below. If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed at the end of this memorandum or your regular Davis Polk contact.

* * *

Part 1 discusses the Documentation Rule, Part 2 discusses the Per Se Stock Rule and provides several examples illustrating its application, and Part 3 discusses the Part Stock Rule. Part 4 summarizes rules relating to retesting and the timing of recharacterization for purposes of both the Documentation Rule and the Per Se Stock Rule, and Part 5 discusses the application of the proposed regulations to consolidated groups. Part 6 describes the groups of affiliated entities to which the proposed regulations would apply, as well as the proposed effective dates for the new rules. Finally, Part 7 highlights certain issues with respect to which Treasury has requested comments.

1. Documentation Rule (Proposed Regulations Section 1.385-2)

The Documentation Rule requires members of Expanded Groups (generally, corporations affiliated by 80% of vote or value and 80%-owned partnerships) to prepare and maintain contemporaneous

[1] Treasury and the IRS indicated in the preamble that they were motivated to issue these regulations in part because of taxpayer victories in large dollar controversies involving related party financings, citing, for example, the taxpayer's approximately $363 million victory in PepsiCo Puerto Rico, Inc. v. Commissioner.

documentation relating to any instrument between group members that is in form a debt obligation (any such instrument, an "**EGI**"). **Failure to satisfy any element of these requirements will result in the EGI's being treated as stock for U.S. federal income tax purposes.** Satisfaction of the documentation requirements does not ensure debt treatment, however, and the IRS may nonetheless challenge characterization of a "well documented" EGI on other grounds.

For purposes of determining the type of stock that the recharacterized EGI would constitute under the Documentation Rule, the terms of the EGI remain relevant. For example, a straightforward debt instrument that is recharacterized as stock would typically constitute preferred stock (and thus could be treated as "non-qualified preferred stock," "section 306 stock," or "fast pay stock," with all of the potentially adverse attendant consequences that come with each designation).

The Documentation Rule requires contemporaneous written documentation both at the time of issuance and at the time the issuer of the EGI either makes a payment or fails to make a payment.

- *Documentation Required at the Time of Issuance*: No later than 30 days after the issuance of an EGI, the parties to the EGI must prepare written documentation establishing that:
  - *Binding Obligation to Repay*: the issuer has entered into an unconditional and legally binding obligation to pay a sum certain;
  - *Creditor's Rights to Enforce Terms*: the holder has the rights of a creditor to enforce the obligation, including rights to cause or trigger an event of default or acceleration for non-payment of interest or principal when due and a right to share in assets upon the issuer's dissolution that is superior to the rights of shareholders; and
  - *Reasonable Expectation of Repayment*: there is a reasonable expectation of repayment.
    - Documents establishing a reasonable expectation of repayment may include, for example, cash flow projections, financial statements, business forecasts, asset appraisals and determination of debt-to-equity. Any such documents must also be prepared no later than 30 days after the deemed reissuance of an existing debt instrument upon a "significant modification," as determined under the applicable Treasury regulations.
- *Documentation Required Post-Issuance:* The parties to the EGI must prepare during the term of the applicable debt instrument the following written documentation establishing a genuine debtor-creditor relationship:
  - Within 120 days after each date on which a payment of interest or principal is due, written evidence of such payment (*e.g.*, a wire transfer record or a bank statement reflecting the payment).
    - It is not clear whether book entries recorded with respect to instruments that do not involve actual transfers of cash (*e.g.*, daily cash sweeps effected by journal entries among affiliated entities or the establishment of accounts receivable/payable) would satisfy this requirement.
  - Within 120 days after the date of any default, failure to pay, acceleration or similar event, written evidence of the holder's reasonable exercise of the diligence and judgment of a creditor.
    - It is not clear how compliance with this rule would interact with other legal doctrines, such as the fiduciary duties potentially owed to other creditors.

The Documentation Rule includes special requirements for documentation establishing an unconditional obligation to pay a sum certain in the case of revolving credit facilities and cash pooling arrangements:

- For revolving credit facilities, the written documentation need not include a separate note or other similar document, but must include "all relevant enabling documents," such as board of directors' resolutions, credit agreements, omnibus agreements and security agreements.
- For cash pooling arrangements or internal banking services (*e.g.*, account sweeps), the written documentation must include the material documentation governing the ongoing operations of the arrangement, including any agreements with entities that are not members of the Expanded Group.
  - *Observation*: The proposed regulations provide no guidance as to the kind of written documentation that will satisfy the requirements. For example, would one comprehensive agreement that governs all of the operations of a cash pooling arrangement to which group members are parties be sufficient? Will the parties need to examine standalone creditworthiness on a daily basis in order to establish a "reasonable expectation of repayment" each time an amount is drawn down?

Taxpayers must maintain the required documentation for all taxable years for which the EGI is outstanding and until the period of limitations expires for any return with respect to which the federal tax treatment of the EGI is relevant. The documentation must include complete and (if relevant) executed copies of all agreements and other documents. **The failure to provide such documentation to the IRS upon request will result in the EGI's being treated as stock for U.S. federal income tax purposes.**

There are limited exceptions to the Documentation Rule for certain small, non-public Expanded Groups and for certain situations in which a failure to satisfy a requirement of the Documentation Rule is due to reasonable cause.

The Documentation Rule may not be used affirmatively to treat an instrument that is in form debt as equity (*e.g.,* by intentionally failing to document the requisite factors) with a principal purpose of reducing a group member's tax liability. The proposed regulations also provide an anti-avoidance provision in respect of the Documentation Rule.

2. Per Se Stock Rule (Proposed Regulations Section 1.385-3)

The Per Se Stock Rule is directed at debt issuances that are effected in connection with certain transactions that Treasury has determined are likely to have limited non-tax significance. However, the rule is not narrowly tailored to tax avoidance transactions. For this reason, it is a virtual certainty that taxpayers will inadvertently trigger recharacterization under these rules, and the collateral consequences are potentially significant.

> While debt issued on or before April 4 is grandfathered, any debt issued thereafter will be subject to the Per Se Stock Rule if it remains outstanding 90 days after final regulations are issued.

The Per Se Stock Rule applies to debt issued in specified (but very common) situations by one corporation (the "**Issuing Corporation**") to another corporation (the "**Recipient Corporation**") in the same Expanded Group (generally, corporations affiliated by 80% of vote or value). Like the other provisions of the proposed regulations, the Per Se Stock Rule does not apply to debt issuances between members of a corporate group that files a U.S. consolidated return. Accordingly, the main application of the rules will be debt issuances (i) between non-U.S. related corporations (*e.g.*, two "controlled foreign corporations") and (ii) between a U.S. corporation and a related non-U.S. corporation (*e.g.*, a U.S. corporation and its non-U.S. subsidiary).

Transactions Subject to Recharacterization

The Per Se Stock Rule consists of a general rule that targets three fact patterns, as well as a "funding rule" intended to backstop the general rule. **Pursuant to the general rule, debt issued by the Issuing Corporation to a member of the Expanded Group will be treated as stock when it is issued**:

- in a distribution;
- in exchange for the stock of a member of the Expanded Group (generally, other than stock acquired pursuant to a tax-free asset reorganization); or
- in exchange for property in an asset reorganization, but only to the extent that, pursuant to the plan of reorganization, a member of the Expanded Group immediately before the reorganization receives the debt instrument with respect to its stock in the target corporation.

The "funding rule" focuses on preventing Issuing Corporations from doing indirectly what the general rule would prevent them from doing directly. Specifically, pursuant to the "funding rule," debt issued by the Issuing Corporation (called the "funded member" by the regulations in this context) to a member of the Expanded Group in exchange for property (including cash) will be treated as stock to the extent that it was issued with a "principal purpose" (defined below) of funding one of the transactions covered by the general rule, defined for purposes of the funding rule as follows:

- A distribution of property by the Issuing Corporation to a member of its Expanded Group, other than a tax-free distribution of stock in connection with an asset reorganization (whether acquisitive or divisive);
  - A distribution by an Issuing Corporation of the stock of a subsidiary in a spin-off without a prior transfer of assets to the subsidiary in an asset reorganization is a distribution of property for purposes of this rule.
- An acquisition by the Issuing Corporation (generally, other than stock acquired pursuant to a tax-free asset reorganization) of stock of an Expanded Group member in exchange for non-stock property (a "**Funded Stock Acquisition**"); or
- An acquisition by the Issuing Corporation in an asset reorganization to the extent that, pursuant to the plan of reorganization, a member of the Expanded Group immediately before the reorganization receives boot with respect to its stock in the target corporation.

The "principal purpose" test is subject to a broad "non-rebuttable presumption" under which a debt instrument will be treated as stock if it is issued by the Issuing Corporation during the Window Period. The breadth of this rule will almost certainly interfere with common business practices. Whether a debt instrument issued outside the Window Period will be treated as issued with a "principal purpose" of funding one of the Specified Transactions will be determined on the basis of all the facts and circumstances.

The "non-rebuttable presumption" otherwise applicable to debt issued during the Window Period does not apply to a debt instrument that arises in the ordinary course of the Issuing Corporation's trade or business. This exception is not applicable to intercompany financings or treasury center activities.

The Per Se Stock Rule applies only to instruments that would otherwise be treated as debt for U.S. federal income tax purposes after application of both the Documentation Rule and a traditional debt-equity analysis. Under the Per Se Stock Rule, a debt instrument will be treated as stock "to the extent that" it is issued in, or with a principal purpose of funding, a Specified Transaction, and therefore may be treated as stock either in whole or in part. If any portion of an instrument is treated as equity under the Per Se Stock Rule, it is so treated for all U.S. federal income tax purposes.

As under the Documentation Rule, the terms of an instrument that is recharacterized as equity under the Per Se Stock Rule remain relevant for purposes of determining the type of stock that the instrument constitutes.

If a debt instrument is only partly recharacterized as stock under the Per Se Stock Rule, it is unclear how prepayments on the instrument would be allocated between the part treated as debt and the part treated as equity, and, similarly, in the case of a sale of a portion of the instrument, it is unclear which part will be treated as sold first (or whether *pro rata* treatment would apply).

Application to Partnerships

For purposes of the Per Se Stock Rule, each Expanded Group member that is or becomes a partner in the partnership is treated as owning or acquiring its proportionate share of the partnership's assets (including any Expanded Group stock acquired by the partnership) and issuing its proportionate share of any debt instrument issued by the partnership. For these purposes, a partner's proportionate share in the partnership is determined in accordance with the partner's share of partnership profits. To the extent a debt instrument issued by a controlled partnership is recharacterized as stock under these rules, the holder of that instrument is treated as holding stock issued by the partners of the partnership that are members of the Expanded Group, and the partnership and its partners must make appropriate conforming adjustments to reflect this treatment. Such conforming adjustments must be consistent with the purposes of the Per Se Stock Rule and must be made in a manner that avoids the creation of, or increase in, a disparity between the partnership's aggregate basis in its assets and the aggregate bases of the partners' respective interests in the partnership. Recharacterization of partnership debt as equity of the corporate partners may have significant collateral consequences.

Exceptions

The Per Se Stock Rule provides for three exceptions.

- Current earnings and profits. The aggregate amount of an Issuing Corporation's distributions or acquisitions that could otherwise trigger recharacterization is reduced by an amount equal to the Issuing Corporation's current year earnings and profits.
  - *Observation*: Because the funding rule as currently drafted applies only to debt that is issued in exchange for property, it does not appear to apply to debt issued by the Issuing Corporation that is exempt under the general rule because of the current year earnings and profits exception. As a general matter, this will incentivize an Issuing Corporation with cash to "clear out" current year earnings and profits by distributing debt, while saving the cash for distributions in years in which it does not have current earnings and profits (if it does the reverse, distributing cash in years in which it has current earnings and profits and debt in years in which it does not have current earnings and profits, the debt will be treated as stock under the general rule).
- Funded acquisition of subsidiary stock. A Funded Stock Acquisition will not result in recharacterization if (i) the stock was acquired as a result of the transfer of property by the Issuing Corporation to another Expanded Group member in exchange for stock of the other member and (ii) for the 36-month period following the acquisition, the Issuing Corporation holds, directly or indirectly, more than 50% of the total combined voting power and value of the other member.
- Threshold exception. A debt instrument will not be treated as stock under the Per Se Stock Rule if, immediately after the debt instrument is issued, the aggregate adjusted issue price of all debt instruments held by members of the Expanded Group that would otherwise be recharacterized does not exceed $50 million.

Successors

The "funding rule" is applicable to a "successor" of the Issuing Corporation as if the "successor" were the Issuing Corporation. For this purpose, a "successor" is:

- a corporation that acquires the assets of the Issuing Corporation in a transaction in which the acquiring corporation succeeds to the Issuing Corporation's tax attributes (*e.g.*, a liquidation of the Issuing Corporation into its wholly owned parent or the acquisition of the Issuing Corporation's assets in an asset reorganization); or
- somewhat surprisingly, a corporation that acquires some of the assets of the Issuing Corporation in an asset reorganization in connection with a spin-off transaction.

No Affirmative Use / Anti-Abuse Rule

The Per Se Stock Rule cannot be applied affirmatively by taxpayers to generate a tax advantage from recharacterization of debt as stock under the rule. Specifically, the regulations expressly deny application of the rule in any transaction entered into with a principal purpose of reducing tax liability by disregarding the treatment of the instrument that would have applied but for the rule. The Per Se Stock Rule also includes a broad anti-abuse rule that treats as stock a debt instrument issued with a principal purpose of avoiding the application of the rule.

Observations

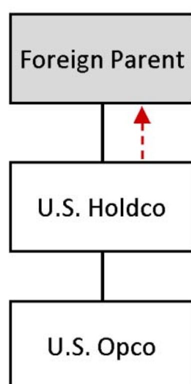
- Transaction Costs Toll Charge. The Per Se Stock Rule's focus on related party debt, rather than overall leverage, leaves taxpayers free to achieve the same leverage as they would have absent the rules, so long as they are willing to relocate their third-party borrowings. The upshot would appear to be the loss of the efficiency that results from centralizing third-party transactions in a treasury center and thus the imposition of what is effectively a capital transfer toll charge. It might be possible to mitigate this inefficiency to some extent through the use of credit support arrangements among, for example, the non-U.S. members of an Expanded Group. Such arrangements could help ease any credit concerns of third-party lenders and generally would be permissible under the proposed regulations if each direct obligor were creditworthy under traditional tax principles.
- Internal Inconsistencies. The Per Se Stock Rule treats economically similar transactions dissimilarly. For example, assume that the Issuing Corporation and the "Target Corporation" are each 100% owned by the "Parent Corporation." Under current law, an acquisition by the Issuing Corporation of Target Corporation stock generally would be treated as if the Issuing Corporation received the Target Corporation stock for its own stock and then redeemed that stock for the property or cash delivered to the Parent Corporation (a "**Section 304 Transaction**") regardless of whether the stock is acquired for cash or Issuing Corporation debt. Under the Per Se Stock Rule, a cash acquisition would continue to be treated as a Section 304 Transaction (although if the Issuing Corporation separately borrowed from the Parent Corporation, the funding rule would apply to treat that separate debt issuance as stock). An acquisition of Target Corporation stock for debt, however, would be recharacterized as an acquisition for stock and thus would in many cases be treated as a taxable disposition of the Target Corporation stock in exchange for Issuing Corporation stock. This is entirely inconsistent with the purpose of Section 304 and not at all similar to the treatment of a cash acquisition with debt funding.
- Longer-Term Debt. Because related party debt is generally susceptible to recharacterization as stock under the "funding rule" only during the Window Period, companies will have an incentive to minimize the number of times they issue related party debt, and thus maximize the periods during which they can engage in a Specified Transaction without causing related party debt

to be recharacterized under the funding rule. As a result, companies should consider (i) extending the maturity of existing related party debt that may otherwise mature in the near future (in order to begin the running of the portion of the Window Period after the deemed reissuance of the debt, assuming the extension of maturity results in a deemed reissuance of the debt for U.S. federal income tax purposes), and (ii) otherwise issuing related party debt with a tenor that is as long as commercially practicable, consistent with the treatment of the debt as debt for U.S. federal income tax purposes.

Examples

The examples below illustrate the application and consequences of the Per Se Stock Rule. The first two examples are transactions the IRS has targeted with the Per Se Stock Rule: (i) non-U.S. headed multinationals engaged in "earnings stripping"; and (ii) U.S. headed multinationals engaged in tax-free repatriation. The third example illustrates the breadth of the rule as applied to a non-U.S. treasury center.

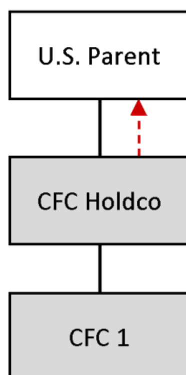
Example 1 – Earnings Stripping



U.S. Holdco distributes a U.S. Holdco note to Foreign Parent

- *Assume U.S. Holdco is not subject to limitation under Section 163(j)*
- *Consequences if debt issued on April 4*
  - Depending on treaty, possible U.S. withholding on distribution
  - No inclusion on repayment
  - Payments in respect of the note deductible by U.S. Holdco (at U.S. corporate rate) and includable by Foreign Parent (at local country rate)
- *Consequences if debt issued on April 5*
  - No withholding on stock distribution
  - Payments in respect of the note treated as dividends and thus not deductible by U.S. Holdco
  - Withholding as a dividend on payments on the note, including the principal amount at repayment (possibly subject to reduction under a treaty)

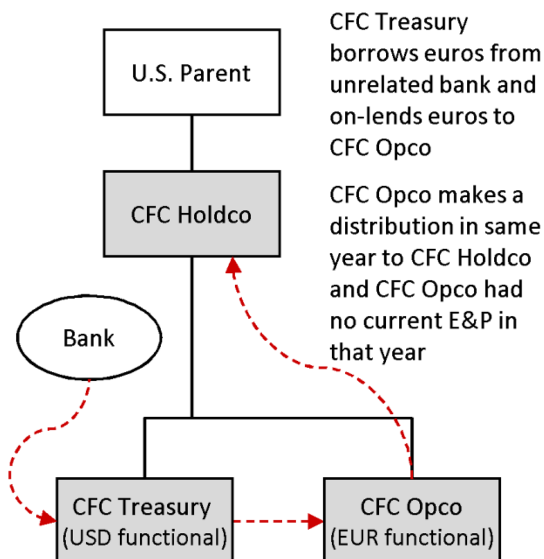
Example 2 – Repatriation



CFC Holdco distributes a CFC Holdco note to U.S. Parent

- *Assume: At the time of the distribution, CFC Holdco has no earnings and profits and U.S. Parent has basis in CFC Holdco in excess of the value of the distributed note.*
- *Consequences if debt issued on April 4*
  - No inclusion at time of distribution
  - No inclusion at time of repayment, even if CFC Holdco has earnings and profits at that time
  - Interest payments in respect of the note includable as interest by U.S. Parent
- *Consequences if debt issued on April 5*
  - Inclusion at time of distribution determined under rules applicable to stock
  - If CFC Holdco has earnings and profits at time of repayment, repayment treated as taxable dividend in the United States.
  - Interest payments in respect of the note includable as dividends by U.S. Parent

Example 3 – Non-U.S. Treasury Center



- *Consequences if loan to CFC Opco made on April 5*
  - CFC Opco distribution would trigger application of funding rule.
  - Loan between CFC Treasury and CFC Opco would be treated as stock.
  - Because the distribution was in the same year as the intercompany loan, the intercompany loan is treated as stock on the date of issuance and, as a result, there is no foreign currency gain or loss.
  - Foreign currency gain or loss is recognized on repayment of the bank loan. As a result of the recharacterization, this foreign currency gain or loss is not offset by any foreign currency gain or loss on the intercompany loan.

3. Part Stock Rule

In a fundamental departure from settled practice, the proposed regulations would permit the IRS to bifurcate instruments into part debt and part stock under certain circumstances.

- This rule applies in certain circumstances where the issuer of a purported debt instrument and the holder of that instrument are members of a "**Modified Expanded Group**," which very generally consists of a group of corporations each member of which is linked by the ownership, directly or indirectly, of at least 50% of the vote or value of its shares, partnerships if at least 50% of their capital or profits interests are owned directly or indirectly by one or more members of the modified expanded group, and individuals or entities that own or are treated as owning at least 50% of another member of the modified expanded group.
- If a purported debt instrument is within the scope of this rule, the proposed regulations authorize the IRS to treat the instrument as part debt and part stock, based on an analysis of the relevant facts and circumstances as of the date the instrument is issued under general federal tax principles.
- The proposed regulations contemplate that this authority may be used, for example, in a case where the IRS's analysis supports a reasonable expectation that, as of the issuance of an instrument, only a portion of the principal amount of the instrument will be repaid.
- As is the case with the Per Se Stock Rule, if a debt instrument is only partly recharacterized as stock under the Part Stock Rule, it is unclear how prepayments on the instrument would be allocated between the part treated as debt and the part treated as equity, and, similarly, in the case of a sale of a portion of the instrument, it is unclear which part will be treated as sold first (or whether *pro rata* treatment would apply).
- This rule will apply to debt between Modified Expanded Group members issued or deemed issued on or after the regulations are finalized.

Observation

- Settlement value and tranching of intercompany debt. This rule appears to create leverage for the IRS in settlement and may result in a greater number of nuisance settlements. We expect that taxpayers will mitigate the effect of this rule by tranching intercompany loans such that at least some of the tranches would likely not be subject to challenge.

4. Retesting and Timing of Stock Treatment

Retesting

A debt instrument that is treated as stock as a result of the Documentation Rule or the Per Se Stock Rule is no longer treated as stock when (i) the debt instrument is transferred to a person that is not a member of the same Expanded Group as the Issuing Corporation or (ii) either the Issuing Corporation or the holder of the debt instrument cease to be members of the same Expanded Group. In this event, immediately before the transaction that causes the debt instrument to cease to be treated as stock, the Issuing Corporation is deemed to issue a new debt instrument to the holder in exchange for the debt instrument that was treated as stock. In addition, for purposes of the Per Se Stock Rule, where the original stock recharacterization resulted from the "funding rule," each of the other debt instruments of the Issuing Corporation not treated as stock under the Per Se Stock Rule at such time must be "re-tested" to determine whether it is treated as funding the distribution or acquisition that previously was treated as funded by the instrument that is no longer treated as stock.

Timing of stock treatment

The Documentation Rule and Per Se Stock Rule include detailed guidance with respect to the time at which a debt instrument issued by the Issuing Corporation will be treated as stock. Generally, the recharacterization will occur as of the date the debt instrument is issued if the triggering event occurs in the same taxable year as the issuance and otherwise the recharacterization will occur at the time of the triggering event.

Deemed Exchange Rule

The holder and issuer of the relevant debt instrument generally will not realize gain or loss upon any deemed exchange of the debt instrument for stock that occurs pursuant to the provisions of the proposed regulations (regardless of which element of the regulations triggers the recharacterization). The holder and issuer generally will, however, recognize any foreign currency gain or loss with respect to the exchange.

5. Consolidated Groups

The Documentation and Per Se Stock Rules do not apply to a debt instrument held by member of a U.S. consolidated tax group of which the issuer is also a member.

- Importantly, as a result of treating all members of a U.S. consolidated group as one corporation, an instrument issued to or by a member of a U.S. consolidated group is effectively treated as issued to or by *all members* of the group for purposes of the proposed regulations. Thus, for example, a debt instrument issued by one member of a U.S. consolidated group to a non-U.S. member of its Expanded Group may be treated as funding a distribution or acquisition by another member of the U.S. consolidated group (and accordingly may be treated as stock under the funding rule), even though the latter member of the U.S. consolidated group was not funded directly.

6. Group Definitions and Effective Dates

The Documentation Rule and Per Se Stock Rule apply to entities that are members of an "**Expanded Group**," other than members of a U.S. consolidated group. Corporations will be members of an Expanded Group if they meet, directly or indirectly, an 80% affiliation threshold by vote or value. The Part Stock Rule applies to a Modified Expanded Group, which applies a broader standard that includes individual owners and a lower 50% affiliation threshold. The proposed regulations apply to Expanded Groups and Modified Expanded Groups regardless of whether the ultimate corporate parent is domestic or foreign and regardless of whether the group has undergone an inversion transaction.

For purposes of the Documentation Rule and the Part Stock Rule, the relevant groups include partnerships, with the affiliation test relating to ownership of capital or profits interests by other group members. By contrast, as discussed above, the Per Se Stock Rule adopts an aggregate approach to any "controlled partnership" (that is, a partnership at least 80% of the capital or profits interests in which are owned, directly or indirectly, by one or more corporate group members), under which partnership debt may be recharacterized as stock of one or more corporate partners.

If a debt instrument issued by a "disregarded entity" (that is, a wholly owned entity that is disregarded as separate from its owner for U.S. federal income tax purposes) is treated as equity under the Documentation Rule (or, presumably, the Part Stock Rule), the former disregarded entity will thereafter be treated as a partnership that is a member of the relevant Expanded Group. If a debt instrument issued by a disregarded entity is treated as equity under the Per Se Stock Rule, however, the instrument will be treated as stock of the entity's sole owner and the entity will continue to be treated as a disregarded entity.

The proposed regulations do not address the treatment of a debt instrument between a U.S. or non-U.S. branch (that is not a disregarded entity) of a multinational corporation and a related entity. The consequences to a U.S. branch under the Per Se Stock Rule would appear to be limited, because the only effect of recasting its nominal debt as stock of its parent would be to reduce its "U.S.-booked liabilities" under Section 1.882-5; its interest deductions would be largely unaffected, because they are principally a function of the amount of its "U.S.-connected assets," which would be unaffected by the proposed regulations. If, however, the branch were recast as a partnership, the U.S. tax consequences could be far more significant.

The Documentation and Part Stock Rules would generally apply to instruments issued after finalization of the regulations. By contrast, the Per Se Stock Rule would apply to instruments issued after April 4, 2016 that continue to be held by a group member 90 days after finalization, if certain other conditions are met. For purposes of the Documentation and Part Stock Rules, the proposed regulation clarifies that an issuance includes a deemed issuance (e.g., as a consequence of an amendment that is treated under general tax principles as an exchange of an old instrument for a new instrument). The proposed regulations do not state that an issuance includes a deemed issuance for purposes of the Per Se Stock Rule, but the significance of this difference is unclear. Specified Transactions that occurred on or before April 4, 2016 would not be taken into account for purposes of the Per Se Stock Rule, but any subsequent Specified Transaction would be taken into account. A retroactive "check-the-box" election made after April 4, 2016 cannot be used to bring a debt instrument or a Specified Transaction under the grandfathering rule. The issuance date of a debt instrument may not be clear in all cases. For example, it is not uncommon for intragroup debt to be issued as a "demand" loan, and it is not clear whether such debt, if in place on or after April 5, 2016 and before finalization, would be viewed as "grandfathered" under the Per Se Stock Rule.

7. Request for Comments

In addition to requesting comments on the scope and application of the proposed regulations, Treasury specifically requested comments with regard to a number of matters not currently covered. For example, Treasury requested guidance regarding the use of indebtedness by investment partnerships, including

through "leveraged blockers." In addition, Treasury requested comments regarding appropriate documentation for intragroup instruments that are not in the form of debt.

* * *

If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your regular Davis Polk contact.

Neil Barr	**212 450 4125**	neil.barr@davispolk.com
Mary Conway	**212 450 4959**	mary.conway@davispolk.com
Michael Farber	**212 450 4704**	michael.farber@davispolk.com
Lucy W. Farr	**212 450 4026**	lucy.farr@davispolk.com
Kathleen L. Ferrell	**212 450 4009**	kathleen.ferrell@davispolk.com
Rachel D. Kleinberg	**650 752 2054**	rachel.kleinberg@davispolk.com
Michael Mollerus	**212 450 4471**	michael.mollerus@davispolk.com
David H. Schnabel	**212 450 4910**	david.schnabel@davispolk.com
Avishai Shachar	**212 450 4638**	avishai.shachar@davispolk.com
Po Sit	**212 450 4571**	po.sit@davispolk.com

© 2016 Davis Polk & Wardwell LLP | 450 Lexington Avenue | New York, NY 10017

This communication, which we believe may be of interest to our clients and friends of the firm, is for general information only. It is not a full analysis of the matters presented and should not be relied upon as legal advice. This may be considered attorney advertising in some jurisdictions. Please refer to the firm's privacy policy for further details.