American Institute of CPAs
1455 Pennsylvania Avenue, NW
Washington, DC 20004-1081

July 7, 2016

The Honorable Jacob Lew
Secretary
Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, DC 20220

The Honorable John Koskinen
Commissioner
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20224

The Honorable Mark Mazur
Assistant Secretary for Tax Policy
Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, DC 20220

The Honorable William Wilkins
Chief Counsel
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20224

RE: Proposed Regulations Regarding the Treatment of Certain Interests in Corporations as Stock or Indebtedness (REG-108060-15)

Dear Messrs. Lew, Koskinen, Mazur and Wilkins:

The American Institute of CPAs (AICPA) offers the following comments on the proposed regulations under section 385[1] of the Internal Revenue Code (IRC or "Code") related to the treatment of certain interests in corporations as stock or debt.

The AICPA appreciates the time and effort which the United States Department of the Treasury ("Treasury") and the Internal Revenue Service (IRS or "Service") devoted to the development of the proposed regulations. However, there are many concerns among taxpayers and tax practitioners as the proposed regulations, if finalized in substantially the same format, would have a significant and disruptive impact on normal and critical operations of a large number of United States (U.S.) business entities. The proposed regulations would also dramatically impact U.S. corporate tax planning and compliance.

Our comments in this letter focus on the technical aspects of the proposed regulations. We are not currently addressing whether Treasury has exceeded its authority in issuing the regulations, in whole or in part, in order to establish specific rules for determining whether an instrument is treated as stock or indebtedness.[2]

[1] All section references in this letter are to the Internal Revenue Code of 1986, as amended, or the Treasury regulations promulgated thereunder.
[2] However, the AICPA plans to submit a separate letter on whether or not Treasury has exceeded its authority in applying the proposed regulations to partnerships.

Additionally, our comments are limited to the most important technical issues that the AICPA has identified. The proposed regulations also affect other areas that we have not addressed in this letter due to the limited comment period. The additional items include, but are not limited to:

- Conditions considered by IRS audit teams before proposing to recast an instrument as equity;
- If an instrument is recast as equity, whether the recast of the yield is also necessary and whether the safe-harbors under transfer pricing rules (such as, the applicable federal rate) would apply;
- The allocation of a partial repayment of an instrument between the debt and equity components, if the instrument is partially recast as equity;
- Issues related to state and local taxes; and
- Issues related to the taxation of exempt organizations.

BACKGROUND

Currently, in determining if an interest in a corporation is considered debt or equity for U.S. federal income tax purposes, all relevant facts and circumstances are considered. The proposed regulations would, under certain circumstances, recharacterize debt instruments as equity when issued between affiliated parties. Additionally, the proposed regulations would impose new documentation requirements that must be satisfied to treat the related party debt as debt for U.S. federal income tax purposes.

According to Treasury's press release on April 4, 2016, the proposed regulations are intended "to further reduce the benefits of and limit the number of corporate tax inversions." The AICPA believes that the proposed regulations have a much broader application and would apply to routine and ordinary business transactions, including those transactions with U.S. persons and their foreign subsidiaries, transactions with a very short-term nature, and other ordinary, non-abusive transactions for which concerns about either corporate tax inversions or earnings stripping (via debt to a foreign parent of a U.S. subsidiary) would not apply.

SUMMARY OF RECOMMENDATIONS

The AICPA provides the following recommendations for Treasury and the IRS to consider as the proposed regulations are finalized:[3]

Modify the Effective Date of the Proposed Regulations

- Revise the effective date provisions in Prop. Reg. §§ 1.385-2, -3 and -4 to provide that Prop. Reg. §§ 1.385-2, -3 and -4 apply to any expanded group instrument (EGI) issued in

[3]The AICPA has also suggested certain alternatives to the proposed changes. For purposes of simplicity, however, only the primary recommendations are listed in this section.

taxable years beginning one year after the first day of the first taxable year following the date of publication of a Treasury decision adopting Prop. Reg. §§ 1.385-2, -3 and -4 as final regulations in the Federal Register.

Cash Management Practices

- Provide definitions for the terms "cash pool," "working capital," "netting center," "payment master," and "notional cash pooling" in Prop. Reg. § 1.385-1(b).

- Cash Pool Exceptions:
    - Provide a *per se* rule that deposits to a cash pool are not subject to recharacterization under the proposed regulations.

    - Provide a rule that EGIs issued to cash pools are not subject to recharacterization under the proposed regulations provided that the aggregate principal amounts of an issuing member's EGIs with cash pools, at any point during the taxable year, do not exceed the greater of: (i) 10 percent of the capitalization of the issuing member; or (ii) the total book value of the issuing member's current assets based on its balance sheet as of its prior year end.

- Conduit Exceptions:
    - Provide an exception that cash pools are not treated as conduits for purposes of applying the proposed regulations.

    - Provide an exception that the use of a financing entity that is not a member of the expanded group in notional cash pooling arrangements will not result in the treatment of a financing entity as a conduit for purposes of applying the proposed regulations.

- Provide a *per se* rule that EGIs are not subject to the regulations if they are: (i) sourced through a netting center or payment master; and (ii) settled within 30 days following the date on which the receivable or payable is processed with the netting center or payment master.

- Expand the ordinary course exception in Prop. Reg. § 1.385-3(b)(3)(iv)(B)(2) to include obligations between an expanded group member and payment master if the payment master is utilized to satisfy an obligation that would otherwise qualify for the ordinary course exception had the obligation not been sourced through a payment master.

- Provide a rule that specifies that the repayment of a debt instrument recharacterized as equity under the proposed regulations that results in a dividend-equivalent redemption is not treated as a distribution within the meaning of Prop. Reg. § 1.385-3(b)(3)(ii)(A). In addition, provide a rule that specifies that the acquisition of a debt instrument that is recharacterized as equity under the proposed regulations is not treated as an acquisition by the cash pool of expanded group stock within the meaning of Prop. Reg. § 1.385-3(b)(3)(ii)(B).

- Provide a rule that specifies that, to the extent the cash pool exceptions do not apply, the "funding rule" can only apply to recharacterize an expanded group member's debt to the extent the expanded group member is a "net" borrower (*i.e.*, borrowing from the cash pool exceeds lending to the cash pool) on the last day of its taxable year.

- Permit companies that utilize cash pools to document each expanded group member's wherewithal to meet its obligations under the cash pooling arrangement at the time the cash pooling arrangement is entered into and on an annual basis thereafter.

<u>Rules Regarding an Entity not Originally Considered a U.S. Entity/Person but Subsequently Becomes One</u>

- Provide for an exclusion from the rules for any instrument that is outstanding between an entity and a member of its expanded group in a situation where at the time the instrument was issued the issuing entity was not a U.S. person, not required to file a U.S. tax return, and not a controlled foreign corporation (CFC) or a controlled foreign partnership, but subsequently became one of the foregoing.

- Provide for an exclusion from the rules for existing debt between an entity and members of an expanded group if at the time the debt was issued the entity was not a U.S. person, not required to file a U.S. tax return, and not a CFC or a controlled foreign partnership even though it subsequently becomes one of the foregoing.

- Respect any existing debt between an entity and members of the expanded group under Prop. Reg. § 1.385-3 such that the only instruments subject to the rules are new debt incurred after the event which causes the issuing entity to become a U.S. person required to file a tax return, or become a CFC or a controlled foreign partnership.

<u>Guidance under Section 909</u>

- Exempt from section 909, any splitter arrangement attributable to a U.S. equity hybrid instrument created solely as a result of the recasting of a taxpayer's debt instrument in whole or part as equity under the final regulations.

<u>Clarification of the Meaning of "In Form"</u>

- Clarify the definition of the term "in form."

Section 318(a)(4) Option Attribution to Determine an Expanded Group and a Modified Expanded Group

- Provide an exclusion from Section 318(a)(4) in determining an expanded group and a modified expanded group.

Partnerships

- Clarify whether section 304(c)(3)(B) applies for purposes of determining indirect ownership of a partnership interest. Section 304(c)(3)(B) should apply to modify the ownership requirements in sections 318(a)(2)(C) and 318(a)(3)(C), but should not extend to other sections of 318(a), such as section 318(a)(2)(A).

- Clarify that the "5 percent" rule applies only to sections 318(a)(2)(C) and 318(a)(3)(C), but not extend the minimum threshold ownership requirement to attributions to and from partnerships.

- Provide guidance on how "proportionately" is determined for purposes of sections 318(a)(2)(A) and 318(a)(3)(A).

- Provide a safe harbor for purposes of determining "proportionately." An appropriate safe harbor for "value" for these purposes is the liquidation value of a partner's interest.

- Clarify that the Commissioner of the Internal Revenue Service ("Commissioner") may treat an applicable instrument issued by a partnership or a disregarded entity (DRE) as in part indebtedness and in part equity in the issuing entity to the extent that such applicable instrument is properly treated as in part indebtedness and in part equity under general federal tax principles.

- Clarify that any applicable instrument issued or held by a partnership that is wholly owned by members of the same consolidated group ("consolidated group partnership") is treated as issued or held by one corporation for purposes of Prop. Reg. § 1.385-2.

- Clarify that borrowing and lending transactions between a consolidated group partnership and the consolidated group of its partners are not subject to the reporting requirements under Prop. Reg. § 1.385-2.

- Provide for an exception for the application of Prop. Reg. § 1.385-3 to the distribution of a partnership's note to its partners.

- Clarify that if a debt instrument of a DRE is treated as stock under Prop. Reg. § 1.385-3, such debt instrument is treated as stock in the first "regarded" owner. However, if the first regarded owner is a partnership, then such debt instrument is treated as stock in the corporate partners of the partnership under the principles of Prop. Reg. § 1.385-3(d)(5) (treatment of partnerships).

- Provide guidance on the method and timing for determining a partner's share of partnership profits for purposes of allocating the partner's share of a debt instrument.

- Permit use of an alternate "tracing approach" in certain situations where a distribution of borrowed funds to partners occurs on a non-pro rata basis.

- Provide a safe harbor for purposes of determining a partner's share of profits.

- Specify the time for determining the expanded group partner's proportionate share of profits. Specifically, we suggest that the share of profits is determined immediately after the controlled partnership issues a debt instrument to or receives a debt instrument from a member of the expanded group.

- Provide that a subsequent reduction in a partner's share of profits is taken into account if, at the time of the issuance or receipt of the debt instrument, the partner's reduction in share of profits is anticipated (i.e., provide that, if a partner's share of profits is reduced within one year of the issuance or receipt of a debt instrument, the reduction is presumed to have been anticipated, unless the facts and circumstances clearly establish that the decrease in the partner's share of profits was not anticipated).

- Provide a rule that a reduction in a partner's share of profits is taken into account if it is part of a plan that has as one of its principal purposes the avoidance of the regulations under section 385.

- Provide an alternative approach to determine a partner's proportionate share of a partnership's debt instrument that is subject to the recharacterization rules of Prop. Reg. § 1.385-3(b)(3).

<u>S corporations</u>

- Provide exceptions to ensure that S corporations do not inadvertently terminate their status when debt is reclassified as equity.
- Clarify whether it is possible that recharacterization of a debt instrument, issued by XYZ to A (see Example 1 in Section VIII "Effect of the Proposed Regulations on S

Corporations" below), as part debt and part stock can occur under general federal tax principles.

- Clarify whether any part debt, part stock recharacterization (see Example 1 in Section VIII "Effect of the Proposed Regulations on S corporations" below), creates a preferred stock and a second class of stock such that XYZ's S corporation status terminates.

- Clarify if the recharacterization of debt to equity is covered under any of the safe harbors found in the section 1361 single class of stock regulations (*e.g.,* under the "no principal purpose to circumvent the single class of stock" requirement of Treas. Reg. § 1.1361-1(1)(2)(i), or as a proportionately held obligation under Treas. Reg. §1.1361-1(1)(4)(ii)(B)(2)), and not treated as a second class of stock.

SPECIFIC COMMENTS

I. Modify the Effective Date

Recommendation

Given the pervasive and novel effect of Prop. Reg. §§ 1.385-2, -3 and -4 (the "Provisions"), the AICPA recommends that Treasury and the Service adopt a deferred effective date similar to the one set forth in Prop. Reg. § 1.987-11(a). Specifically, the effective date provision could provide that the Provisions shall apply to any EGI issued in taxable years beginning one year after the first day of the first taxable year following the date of publication of a Treasury decision adopting the Provisions as final regulations in the Federal Register. A deferred effective date after finalization of the proposed regulations is necessary to allow companies adequate time to modify their internal controls to comply with the new rules.

Background

Proposed Reg. § 1.385-2 applies to debt instruments issued or deemed issued on or after the date the proposed regulations are finalized and the debt instruments issued prior to the finalization date as a result of an entity classification election made under Treas. Reg. § 301.7701-3 on or after that date.[4] Proposed Reg. § 1.385-3 and Prop. Reg. § 1.385-4 apply to any debt instrument issued on or after April 4, 2016.[5]

[4] Prop. Reg. § 1.385-2(f).
[5] Prop. Reg. § 1.385-3(h)(1); Prop. Reg. § 1.385-4(e)(1).

II. Effect of the Proposed Regulations on Cash Management Practices

The finalization of the proposed regulations, as currently drafted, would have a significant impact on the day-to-day internal cash management practices of multinationals. The AICPA suggests the following modifications to the proposed regulations to address these issues and prevent the potentially significant and detrimental impact of the proposed regulations on these practices.

Background

Treasury Departments & Cash Management

a. Cash Pooling

Companies typically establish separate corporate treasury departments to manage a variety of functions related to managing the liquidity of the corporate group.[6] While the role of the treasury department may change based on the nature of a company, a common and vital function of the typical corporate treasury department is cash management. A key tool in cash management practices is "cash pooling," which involves the use of an affiliate as an internal bank (the "cash pool"), or a third-party bank that nets the bank accounts of the company's affiliates and then charges or pays interest based on the company's net cash position.

The purpose of cash pooling is to efficiently use surplus funds of affiliates by redeploying those funds to any affiliates that require working capital or short-term funding. For example, in internal cash pooling arrangements, the cash pool effectively accepts deposits from affiliates, and lends those same funds to other affiliates.[7] This technique provides companies both temporary and working capital funding mechanisms that minimize the external financing costs associated with separate borrowings from a third-party bank.

Generally, there are two methods of cash pooling arrangements employed by companies, which are:

[6] In addition to cash management, corporate treasury departments manage corporate finance matters, currency, interest rates, commodity risks, compliance matters, and obtain financing.
[7] Treasury regulations define treasury center activities as "[m]anaging the working capital of the expanded affiliated group (or any member thereof) such as by pooling the cash balances of affiliates (including both positive and deficit cash balances) or by investing or trading in financial assets solely for the account and risk of such entity or any members of its expanded affiliated group." Treas. Reg. § 1.1471-5T(e)(5)(i)(D)(1)(iv). This method is similar to short-term cash pooling.

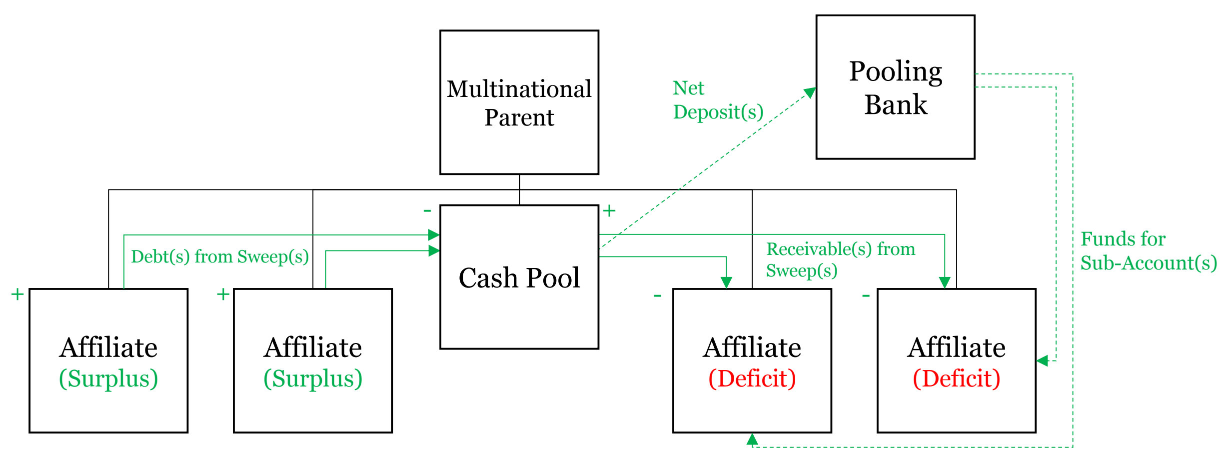
1. Zero-Balance Cash Pooling

Zero-balance cash pooling is the most common form of cash pooling, which is also referred to as "sweeping." Affiliates maintain separate bank accounts with a "pooling bank" that are generally sub-accounts of the cash pool's primary account. On a daily basis, affiliates conduct their business operations, and either deposit their surplus funds or overdraw on their account to meet operating needs. At the end of each day, any positive balances of affiliates are swept into the primary bank account of the cash pool, and all overdrafts are covered by automatic transfers from the cash pool's account. Positive cash amounts transferred from an affiliate's account are generally recorded as a loan to the cash pool,[8] and transfers from the cash pool's account to cover the overdraft of an affiliate is recorded as an intercompany loan to the affiliate. If the net amount of the cash pool's main account is positive, those funds are generally invested.

This arrangement is referred to as "zero-balance cash pooling" because each affiliate has a closing daily balance of zero. This centralized cash management technique reduces financing costs and transaction fees (because the affiliates generally use the same bank). However, unlike notional cash pooling, the company does create internal credit risk due to the creation of intra-group loans.

Zero-balance cash pooling is illustrated as follows:

Zero-Balance Cash Pooling



[8] Note, that cash transfers are alternatively recorded as debt repayment if the affiliate is a net borrower.

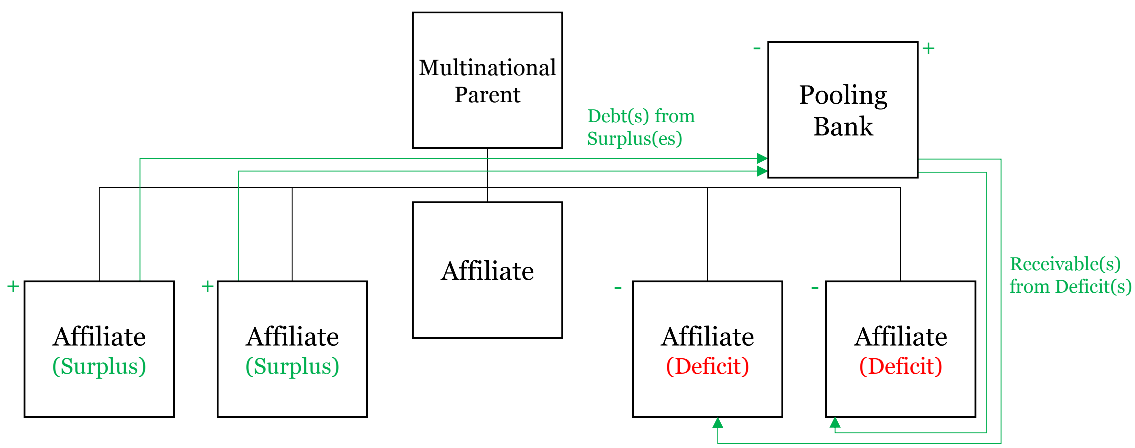
2. Notional Cash Pooling:

   Notional cash pooling is a method of external cash pooling that is conducted entirely through a third-party bank. Similar to zero-balance cash pooling, affiliates of a company deposit surplus funds with a third-party bank and affiliates that require funding borrow from the same third-party bank. The bank then nets the affiliates' accounts and either charges interest or pays interest based on the net cash position of the company.

   This arrangement reduces financing costs (as borrowers receive favorable interest rates) and reduces internal credit risk because no intercompany loans are created. Further, this method allows the company to manage foreign currency exposure (if relevant) as each affiliate deposits or borrows money in its own functional currency.

   Notional cash pooling is illustrated as follows:

<u>Notional Cash Pooling</u>



These arrangements help accomplish a treasury department's primary objective of managing the group's liquidity, by effectively using the group's excess cash to fund its operating subsidiaries, when necessary. While it is possible to circulate excess cash through the group via a series of distributions and contributions, this method is more expensive and time-consuming than pooling arrangements. There are considerations of legal steps of declaring and distributing dividends (which are possibly prohibited under local law and/or subject to withholding tax) and cash contributions throughout the corporate structure, in comparison to the direct issuance of a debt instrument by an affiliate in exchange for cash from another affiliate. Further, notwithstanding the simplicity of the illustrations above, these centralized cash management arrangements can become increasingly complex, as sweeps occur daily, and multinationals may have hundreds of affiliates creating intercompany debt on a regular basis. For example, large multinational companies sometimes establish tiered cash pools, where funds flow from a local country cash pool, to a regional cash pool, and then to a global cash pool.

b. Netting Centers and Payment Masters

Other cash management practices common among multinationals, and relevant to the proposed regulations, are the use of netting centers and payment masters. A netting center is an intragroup clearing house that is established in order to simplify the settlement of intercompany obligations. As a centralized payment system for the group, the netting center consolidates intercompany obligations by determining the net lenders and net borrowers among the participating affiliates. The net borrowers make payments to the netting center, which uses the funds received to repay net lenders. The intercompany receivables and payables are typically settled on a monthly basis, such that the netting center has a zero balance at the end of each month. This process standardizes intercompany liability repayment through a simplified process, allowing the group to reduce: (i) potential intercompany transactions; (ii) intercompany balances; and (iii) costs (*e.g.*, foreign currency costs).

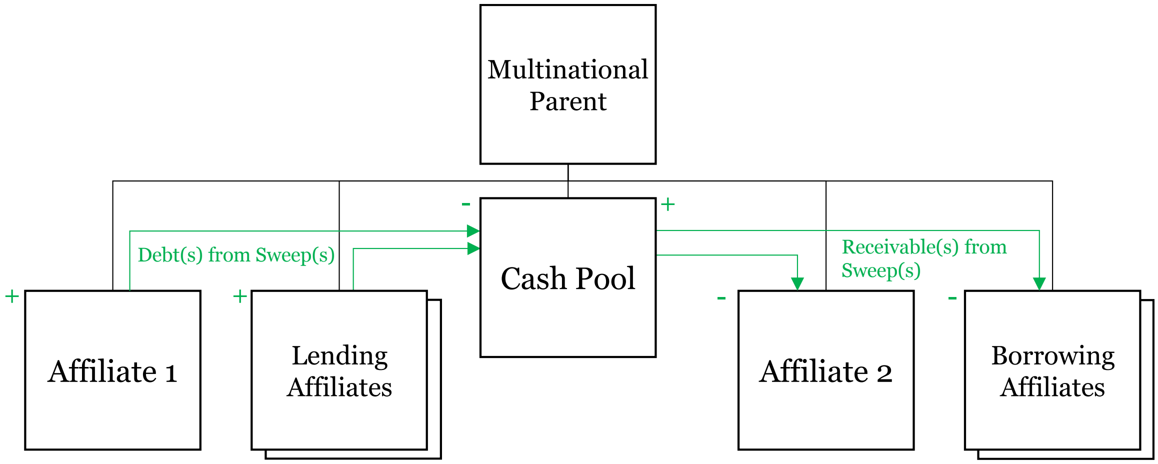
A payment master (or payment factory) is also an entity that functions as a centralized payment system for participating affiliates; however, the payment factory is typically used to repay third-party creditors rather than consolidate intercompany debt. Operating affiliates that incur debt process their invoices through the payment factory which, in turn, settles the debt with the third-party creditor. The intercompany balances arising as a result of the payment master extending credit to affiliates are typically settled on a monthly basis. The centralization of debt payments through a payment master allows the group to reduce costs by aggregating payments, standardizing the repayment process, and maintaining visibility and control over external debt repayments.

<u>Consequences of the Proposed Regulations on Cash Management Practices</u>

Interplay between Cash Pooling and the Funding Rule

The application of the proposed regulations to the typical treasury function of internal cash management will have a significant and detrimental impact on these arrangements. As illustrated below, when an affiliate's intercompany debt is recharacterized as equity, the repayment is generally a dividend-equivalent redemption, which causes the recharacterization of future borrowings as if they funded the dividend-equivalent redemption. Also, the recharacterization can result in the cash pool being treated as acquiring equity in the affiliate (an expanded group member), thus any deposits held by the cash pool are also recharacterized because they are treated as funding the acquisition of expanded group stock.

To illustrate, consider a simplified depiction of zero-balance cash pooling:



Because zero-balance cash pooling is a daily process, the amount affiliates are currently borrowing from (or lending to) the cash pool is constantly fluctuating. For example, assume Affiliate 2's balance with the cash pool fluctuates as follows (following the finalization of the proposed regulations):

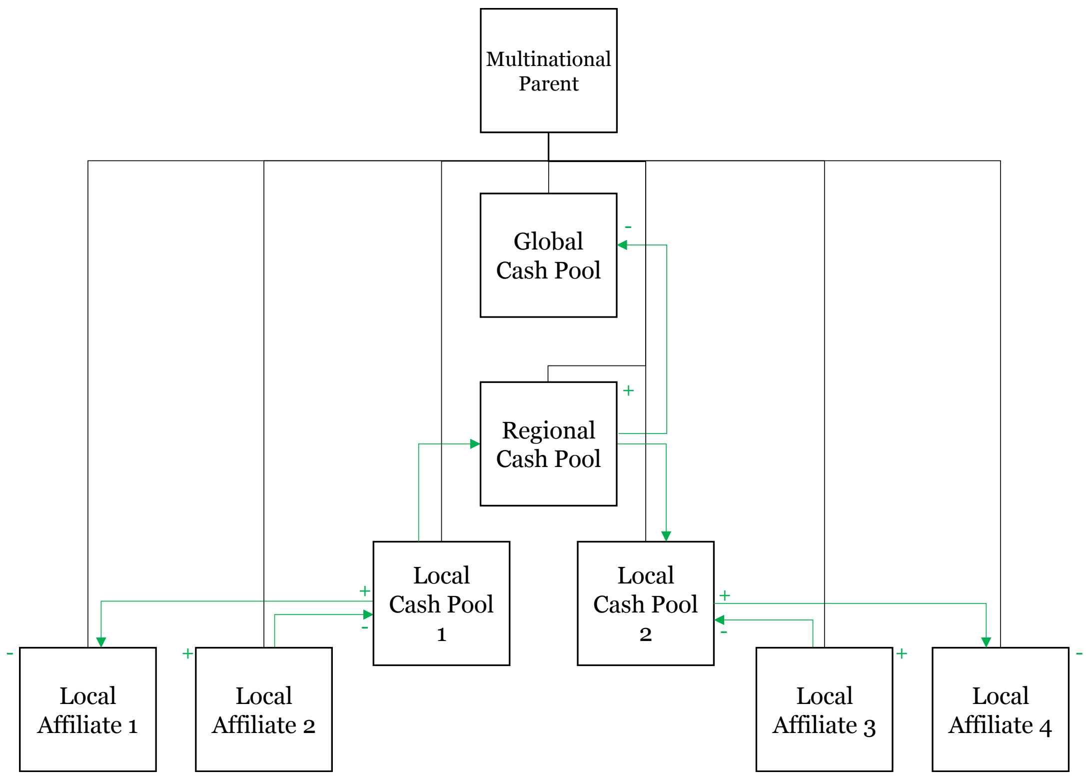
- Day 1 – ($100)
- Day 2 – $0
- Day 3 – ($100)
- Day 4 – $0

As a result, the proposed regulations treat Affiliate 2 as a funded member, such that if it were to enter into a prohibited transaction in the amount of $100 (as described in Prop. Reg. § 1.385-3(b)(3) (the "Funding Rule")) within 3 years of the borrowings listed above, the debt issued on Day 1 is treated as if Affiliate 2 issued $100 of stock to the cash pool (assuming the prohibited transaction does not qualify for an exception). Affiliate 2 is treated as: (i) redeeming $100 worth of its stock on Day 2 in a dividend-equivalent redemption under sections 302(d) and 301; (ii) issuing $100 of its stock to the cash pool on Day 3 (because it is treated as funding the prior redemption); and (iii) redeeming $100 worth of its stock on Day 4 in a dividend-equivalent redemption under sections 302(d) and 301. Due to a single prohibited transaction tainting Affiliate 2's transactions with the cash pool, these deemed stock issuances and dividend-equivalent redemptions can replicate indefinitely.

Further, due to the recharacterizations of Affiliate 2's balances with the cash pool, the cash pool is now subject to the proposed regulations because it is a funded member as a result of the loans from Affiliate 1 and the Lending Affiliates. Because Affiliate 2's debt is treated as stock, the cash pool is treated as acquiring expanded group member stock, thus the cash pool has engaged in a prohibited transaction under Prop. Reg. § 1.385-3(b)(3). Accordingly, the intercompany debts the cash pool owes to Affiliate 1 and the Lending Affiliates is treated as stock issuances by the cash pool. The repayment of these amounts are then treated as dividend-equivalent redemptions under sections 302(d) and 301. Because it is possible that Affiliate 1 and the Lending Affiliates are indebted to the cash pool in the future, or another expanded group member, these rules could apply indefinitely. This perpetual application of the Funding Rule could taint the entirety of the cash pooling system because, when considering that these intercompany balances fluctuate on a regular basis, the proposed regulations could trigger virtually countless deemed stock issuances and dividend-equivalent redemptions during a company's taxable year, solely due to its regular cash management functions.

This problem of systemic recharacterizations is further exacerbated as the company increases in size. As described above, many multinationals have tiered cash pools beginning with a local country cash pool based on the locations of operating subsidiaries (which reduces local tax costs), which feeds into a regional cash pool, that feeds into a centralized global cash pool. Thus, a local country cash pool that is tainted by an affiliate that engaged in a prohibited transaction (as illustrated above), could successively taint the regional cash pool, which would successively taint the global cash pool and potentially all of the affiliates engaged in the cash pooling system. The result of these successive applications of the Funding Rule, based on the current proposed regulations, turns a single recharacterization into a series of recharacterizations across the entire corporate group.

For example, consider the following depiction of a tiered cash pool system:



Applying the results of the examples above, where a single recharacterization replicates into a series of recharacterizations across the group, each lending entity within this structure is ultimately treated as owning stock in each borrowing entity. This series of recharacterizations would create cross-chain stock interests and hook stock throughout the group where it had not previously existed. Because the type of stock deemed issued is determined based on the terms of each instrument, the stock interest is typically nonvoting preferred stock that may qualify as: (i) nonqualified preferred stock under section 351(g);[9] (ii) section 306 stock;[10] (iii) preferred stock under section 1504(a)(4);[11] or (iv) fast-pay stock.[12]

It appears that in order to avoid the successive application of the proposed regulations in the manners depicted above, multinationals must simply adopt internal mechanisms that ensure affiliates participating in the cash pool do not engage in prohibited transactions (*i.e.*, distributions, acquisitions of expanded group stock, or certain asset reorganizations). However, from a practical perspective, companies would likely exclude a number of affiliates from participating in the cash pool if its ability to engage in typical transactions, such as distributions, were prohibited. By virtue of these exclusions, the benefit of using a cash pool is significantly reduced or negated entirely, thereby defeating its purpose.

Further, considering the array of transactions that can result in deemed distributions and contributions for U.S. federal income tax purposes (*e.g.*, Treas. Reg. § 1.1032-3), the potential for miscalculating earnings and profits (E&P) in making current year distributions,[13] and the potential for the Service to recharacterize instruments if the documentation provided pursuant to Prop. Reg. § 1.385-2 is unsatisfactory (among other things), the risk of continuing these techniques would likely outweigh the benefits.

[9] Under section 351(g), nonqualified preferred stock generally means preferred stock if: (i) the holder of such stock has the right to require the issuer or a related person to redeem or purchase the stock; (ii) the issuer or a related person is required to redeem or repurchase such stock; (iii) the issuers or a related person has the right to redeem or purchase the stock and, as of the issue date, it is more likely than not that such right will be exercised; *or* (iv) the dividend rate on such stock varies in whole or in part (directly or indirectly) with reference to interest rates, commodity prices, or other similar indices. Section 351(g)(2)(A).

[10] In general, "section 306 stock" refers to (i) stock (other than common stock issued with respect to common stock) received in a tax-free distribution under section 305(a); (ii) stock (which is not common stock) received in a tax-free reorganization under section 368 or a tax-free distribution under section 355; (iii) stock (which is not common stock) acquired in a section 351 transaction if receipt of money (in lieu of the stock) would have been treated as a dividend to any extent; and (iv) stock the basis of which (in the hands of the shareholder selling or otherwise disposing of such stock) is determined by reference to the basis (in the hands of such shareholder or any other person) of section 306 stock. *See* section 306(c)(1) and (3).

[11] Section 1504(a)(4) provides that the term "stock" does not include stock that: (i) has no voting rights; (ii) is limited and preferred with respect to dividends and does not participate in growth of the corporation; (iii) has redemption and liquidation rights which do not exceed the issue price of such stock (except for reasonable redemption or liquidation premiums); and (iv) is not convertible to another class of stock.

[12] Generally, fast-pay stock is stock structured so that dividends paid by the corporation with respect to the stock are economically (in whole or in part) a return of the holder's investment (as opposed to only a return on the holder's investment). Treas. Reg. § 1.7701(l)-3(b)(2). Note that if the instrument is treated as fast-pay stock, the recharacterization may result in the creation of a listed transaction, subject to reporting requirements. Treas. Reg. § 1.7701(l)-3; Notice 2009-59, 2009-31 I.R.B. 170.

[13] Due to the fact that E&P is computed on a year-by-year basis. Thus, taxpayers generally will not know the current effect of a distribution until the end of the year.

The risks associated with these potential successive recharacterizations are not limited to treating repayments as dividend-equivalent redemptions. Rather, the effects of causing the issuance of hook-stock and cross-chain stock across the entire group include: (i) the inability to engage in the following types of transactions due to the lack of the requisite stock ownership required for such transactions: tax-free reorganizations, section 351 exchanges, section 355 transactions, and section 332 liquidations[14] (ii) adverse U.S. federal income tax consequences as a result of nonvoting preferred stock existing in the structure (*e.g.*, deconsolidations);[15] (iii) significant complexity in determining the U.S. federal income tax consequences of transactions undertaken by affiliates with respect to their stock (*e.g.*, distributions); (iv) a U.S. federal income tax structure that is completely different from the corporate structure for reporting purposes (*e.g.*, financial reporting); and (v) the loss of foreign tax credits.[16]

Impact of the Existing Conduit Authorities

The application of certain authorities may result in disregarding the separate existence of a cash pool, such that all intercompany transactions with the cash pool are treated as occurring directly between the participating affiliates. For example, courts have applied common law conduit principles to ignore intermediaries in three-party transactions, in order to find a single transaction

[14] Under Prop. Reg. § 1.385-3(b)(3), debt instruments that are treated as stock under (b)(2), (3), or (4), are treated as stock for all U.S. federal income tax purposes. Under section 368(c), "control" requires ownership of 80 percent of the voting power of all voting stock of a corporation and at least 80 percent of the total number of shares of all other classes of stock of a corporation. Under section 332, "control" requires ownership of at least 80 percent of the voting power of all voting stock of a corporation and at least 80 percent of the total value of the stock of a corporation. Because the stock deemed issued pursuant to these regulations is typically non-voting stock, section 368(c) control issues arise if an expanded group member has issued debt subject to the recharacterization rules of Prop. Reg. § 1.385-3. Further, section 332 control issues arise where a liquidating subsidiary has issued an EGI that exceeds 20 percent of its value.

[15] Under section 1504(a), a common domestic corporation must own at least 80 percent of the total voting power and value of a subsidiary in order for the consolidated group to include the subsidiary as a member. Thus, if a member of a consolidated group has issued debt to a nonmember that is subject to the recharacterization rules of Prop. Reg. § 1.385-3, a deconsolidation could result if any of the section 1504(a)(4) requirements are not satisfied and the size of the EGI exceeds 20 percent of the value of the member.

[16] Section 902(b)(1) permits the computation of foreign taxes deemed paid where a foreign corporation owns at least ten percent of the voting stock in a distributing foreign corporation. Because stock deemed issued pursuant to these regulations is generally non-voting stock, a controlled foreign corporation's repayment of a loan subject to the recharacterization rules of Prop. Reg. § 1.385-3, would not entitle the recipient controlled foreign corporation to the foreign tax credits associated with the repayment. However, the foreign taxes in the payor's tax pools are reduced. Treas. Reg. § 1.902-1(a)(8).

undertaken between the two non-intermediaries.[17] In *Aiken Industries, Inc. v. Comm'r*,[18] a domestic corporation ("U.S. Co") issued a note (the "U.S. Note") to a related Bahamian corporation ("Bahamas Co") which, in turn, assigned the note to a newly formed Honduran corporation ("Honduras Co") in exchange for notes of Honduras Co that matched the terms of the U.S. Note. Generally, interest payments on a note are subject to 30 percent withholding tax. However, as a result of the assignment and the U.S.-Honduras tax treaty, there was no withholding tax on the payments from U.S. Co to Honduras Co. The Tax Court held that because the sole purpose for using Honduras Co was to obtain the benefits of the U.S.-Honduras treaty, there was no valid economic or business purpose to the transaction. Accordingly, Honduras Co was treated as a conduit, and the payments on the U.S. Note were treated as being made from U.S. Co to Bahamas Co.[19]

Also, for purposes of sections 956 and 881, the anti-conduit regulations under Treas. Reg. § 1.881-3 treat certain borrowings from a bank as related party borrowing if the bank would not have made the loan on the same terms but for the related party's deposit with the bank.[20] Further, in situation three of Rev. Rul. 87-89,[21] a foreign parent corporation (FP) organized in a non-treaty country deposited funds in a bank that was a resident in a treaty country and the bank lent to FP's U.S. subsidiary ("U.S. Sub"). The difference between the interest rate on FP's deposit and the loan to U.S. Sub was less than one percent. Moreover, the interest rate charged by the foreign bank on the loan to U.S. Sub would have differed absent the deposit by the foreign parent

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[17] See, Gaw v. Comm'r, T.C. Memo. 1995-531 (disregarding an intermediary where there was no proof the loans at issue had been structured for any nontax business reason), aff'd, 111 F.3d 962 (D.C. Cir. 1997); *Del Commercial Properties, Inc. v. Comm'r*, T.C. Memo. 1999-411, aff'd, 251 F.3d 210 (D.C. Cir. 2001) (applying conduit treatment where the taxpayer lacked a nontax business purpose for the loan structure and did not respect the form of its transaction), cert. denied, 534 U.S. 1104 (2002).

[18] 56 T.C. 925 (1971).

[19] *See also, Schering-Plough Corp. v. United States,* 651 F.Supp.2d 219 (D.N.J. 2009) (applying a substance-over-form analysis to recharacterize a U.S. corporation's assignment of future interest payments to its foreign subsidiaries (sourced from interest rate swaps with a third-party Dutch bank) in exchange for cash from the subsidiaries, as a loan from the foreign subsidiaries to the U.S. parent). The Tax Court has upheld the form of back-to-back license agreements where there was a close relationship between the parties, however, there were non-transitory corporate entities and license agreements with distinct terms. *SDI Netherlands B.V. v. Comm'r*, 107 T.C. 161, 175 (1996). Further, the Tax Court has respected the form of back-to-back loans even where the structure was adopted for the U.S. federal income tax purposes where there also was a business purpose (*i.e.*, providing working capital for the corporation) for the loans. *Gleason v. Comm'r*, T.C. Memo 2006-191.

[20] Generally, the anti-conduit regulations only treat an intermediate entity as a conduit if: (i) the participation of the intermediate entity (or entities) in the financing arrangement reduces the tax imposed by section 881; (ii) the participation of the intermediate entity in the financing arrangement is pursuant to a tax avoidance plan; and (iii) either; (a) the intermediate entity is related to the financing entity or the financed entity; or (b) the intermediate entity would not have participated in the financing arrangement on substantially the same terms but for the fact that the financing entity engaged in the financing transaction with the intermediate entity. The common law principles in place prior to the adoption of the anti-conduit regulations were not preempted, thus, they remain relevant to the anti-conduit analysis.

[21] The issuance of the anti-conduit regulations obsoleted certain Service guidance expanding the principles of *Aiken*. Rev. Rul. 84-152, 1984-2 C.B. 381; Rev. Rul. 84-153, 1984-2 C.B. 383; Rev. Rul. 85-163, 1985-2 C.B. 349; Rev. Rul. 87-89, Situations (1) and (2), 1987-2 C.B. 195. However, situation three of Rev. Rul. 87-89 was not obsoleted.

corporation. The Service held that because the terms of the loan by the foreign bank to U.S. Sub would have differed "but for" FP's deposit, the treatment of the two financing transactions was such that it was a direct loan from FP to U.S. Sub.

Since the proposed regulations do not address zero-balance cash pooling or notional cash pooling, the question arises whether these authorities could apply to disregard the existence of a cash pool or pooling bank in conjunction with the issues described in the section of the letter titled "the interplay between cash pooling and the funding rule." Due to the fact that these rules require an analysis of the facts and circumstances surrounding a transaction, the anti-conduit rules may (in some instances) apply to cash pooling arrangements. Application of these rules will create further uncertainty for taxpayers in determining the recharacterization consequences of applying the proposed regulations (*e.g.*, whether to treat a recharacterized deposit with a cash pool as stock in the cash pool, or stock in another affiliate).

Recommendations

Add Definitions Related to Cash Management Activities

The AICPA recommends that Treasury and the Service modify the proposed regulations to include specific rules related to cash management. As an initial matter, the AICPA recommends defining the terms "cash pool," "working capital," "netting center," "payment master," and "notional cash pooling" in Prop. Reg. § 1.385-1(b).

Specifically, the AICPA recommends defining the terms as follows:

Cash pool: "a special purpose entity and member of the expanded group, whose sole function is to manage the liquidity of the expanded group by: (i) borrowing from members of the expanded group; (ii) lending to members of the expanded group that require short-term funding[22] or working capital; and (iii) investing any excess cash on hand."

Working capital: "the capital available for conducting day-to-day operations, including the purchase of noncapital assets, and repayment of short-term debt and other operational expenses."

Netting center: "a special purpose entity and member of the expanded group, whose sole function is to consolidate intercompany obligations by receiving payments from expanded group members to repay other expanded group members."

[22] For purposes of this definition, "short-term funding" refers to incurring debt that is expected to be repaid within a year.

<u>Payment master</u>: "a special purpose entity and member of the expanded group, whose sole function is to extend credit to other members of the expanded group, for the purpose of repaying debt owed to creditors that are not members of the expanded group."

<u>Notional cash pooling</u>: "an arrangement with a financing entity that is not a member of the expanded group, that: (i) receives funds from expanded group members; (ii) lends funds to expanded group members; (iii) nets the accounts of expanded group members; and (iv) charges or pays interest based on the net cash position of all expanded group members participating in the arrangement."

Establish Exceptions for Cash Pools

a. Exceptions for Deposits and Borrowings

The AICPA recommends establishing, based on the significant impact of the proposed regulations on the day-to-day internal cash management practices of multinationals (as established above), a clearly defined and easily administrable exception for the use of cash pools. The AICPA recommends a bright line rule, in order to allow taxpayers and IRS auditors to determine with certainty whether a company's cash pooling arrangements have implications related to the proposed regulations. These changes would provide certainty with respect to determining ownership and a variety of tax attributes within the expanded group for U.S. federal income tax purposes (*e.g.*, E&P, tax pools, and effective tax rates).

Accordingly, the AICPA suggests that Treasury and the Service add the following rules to the proposed regulations:

> *<u>Deposits (Per Se Rule)</u>:* The AICPA recommends providing a *per se* rule that deposits to a cash pool are not subject to recharacterization under the proposed regulations.
>
> *<u>Borrowings (Safe Harbor)</u>*: The AICPA recommends providing a rule that EGIs issued to cash pools are not subject to recharacterization under the proposed regulations provided that the aggregate principal amounts of an issuing member's EGIs with cash pools, at any point during the taxable year, do not exceed the greater of:
>
> (i) 10 percent of the capitalization of the issuing member; or
>
> (ii) The total book value of the issuing member's current assets based on its balance sheet as of its prior year end.

The AICPA believes that the safe harbor for EGIs issued to a cash pool is a fair, objective measurement based on the typical working capital needs of borrowers from a cash pool. As an alternative, the AICPA suggests the adoption of a multi-year look back period with respect to a borrower's current assets, rather than a prior year-end measurement.[23]

b. Conduit Exceptions for Zero-Balance Cash Pooling and Notional Cash Pooling

The AICPA recommends that, because there is uncertainty in the proposed regulations as to whether (in some instances) a cash pool or pooling bank is treated as a conduit under current law, an exception is required in order to provide taxpayers certainty in determining the recharacterization consequences of applying the proposed regulations.

Therefore, the AICPA suggests that Treasury and the Service add the following rules to the proposed regulations:

> *Conduit Exception for Cash Pools*: The AICPA recommends that the final regulations include an exception stating that cash pools are not treated as conduits for purposes of applying the proposed regulations.
>
> *Conduit Exception for Notional Cash Pooling*: The AICPA recommends adding an exception that the use of a financing entity that is not a member of the expanded group, in notional cash pooling arrangements will not result in the financing entity being treated as a conduit for purposes of applying the proposed regulations.

These exceptions would clarify the consequences of recharacterizing debt instruments issued in connection with zero-balance or notional cash pooling arrangements. With respect to notional cash pooling arrangements, the AICPA believes that conduit treatment in these instances is not appropriate, as these are actual and substantive commercial arrangements. Also, the anti-conduit rules were adopted for the purpose of limiting the ability of taxpayers to reduce or eliminate tax on obligations by organizing a conduit entity in a favorable tax jurisdiction.[24] Thus, providing this rule in the proposed regulations will not frustrate the purposes of the proposed regulations, as rules recharacterizing these arrangements have already been adopted.[25]

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[23] As an alternative, a rule providing: "if an expanded group member has issued an EGI to a cash pool, the proposed regulations do not apply to the EGI to the extent the expanded group member waives all of its interest deductions with respect to the EGI for all U.S. federal income tax purposes." While not as broad as the exception described above, this would provide flexibility for some taxpayers to continue their current cash management arrangements.

[24] Preamble to the proposed regulations, *Conduit Arrangements Regulations,* 60 Fed. Reg. 40997-01 (Aug. 11, 1995) ("the IRS and Treasury believe that pre-section 7701(l) conduit rulings rested on a taxpayer having a tax avoidance purpose for structuring its transactions. The fact that an intermediate entity received and paid matching, or nearly matching, cash flows was evidence that the participation of the intermediate entity in the transaction did not serve a business purpose. Nevertheless, the fact that cash flows were not matched did not mean that the transaction had a business purpose.)"

[25] Preamble to the proposed regulations, *Treatment of Certain Interests in Corporations as Stock or Indebtedness*, 81 Fed. Reg. 20912-01 (Apr. 8, 2016) ("[w]hile these proposed regulations are motivated in part by the enhanced

Establish Exceptions for Netting Centers and Payment Masters

The AICPA recommends that, because the use of a netting center and payment master is within the rubric of the regular cash management practices of treasury departments, Treasury and the Service should add a safe harbor to the proposed regulations for these special purpose entities. A safe harbor would provide certainty to taxpayers that the use of these entities, within the limitations set forth below, will not adversely impact the entire corporate structure in the manner illustrated in the section of the letter titled "*Interplay Between Cash Pooling and Funding Rule.*" Therefore, the AICPA believes that the proposed regulations should provide a *per se* rule that EGIs are not subject to the regulations if they are: (i) sourced through a netting center or payment master; and (ii) settled within 30 days following the date on which the receivable or payable is processed with the netting center or payment master.

Further, the AICPA recommends expanding the ordinary course exception in Prop. Reg. § 1.385-3(b)(3)(iv)(B)(2) to include obligations between an expanded group member and payment master if the payment master is being utilized to satisfy an obligation that would otherwise qualify for the ordinary course exception had the obligation not been sourced through a payment master.

Establish Exceptions to the Funding Rule for Cash Pools

The AICPA recommends that Treasury and the IRS provide that the repayment of a debt instrument recharacterized as equity under the proposed regulations that results in a dividend-equivalent redemption is not treated as a distribution within the meaning of Prop. Reg. § 1.385-3(b)(3)(ii)(A). In addition, the AICPA recommends that Treasury and the Service craft a rule that provides that the acquisition of a debt instrument that is recharacterized as equity under the proposed regulations is not treated as an acquisition by the cash pool of expanded group stock within the meaning of Prop. Reg. § 1.385-3(b)(3)(ii)(B).

As discussed above in the section of the letter related to "*Interplay Between Cash Pooling and Funding Rule,*" Affiliate 2's $100 borrowing from the cash pool followed by it entering into a prohibited transaction in the amount of the borrowing, causes the recharacterization of the borrowing as an issuance of Affiliate 2 stock under Prop. Reg. § 1.385-3(b)(3). Thereafter, the cash pool is deemed to hold Affiliate 2 stock. On Day 2 when Affiliate 2 repays the borrowing, the transaction is characterized as a dividend-equivalent redemption and treated as a distribution under sections 302(d) and 301. This deemed dividend from Affiliate 2 to the cash pool causes the recharacterization of Affiliate 2's borrowing from the cash pool on Day 3 as another issuance of Affiliate 2 stock under Prop. Reg. § 1.385-3(b)(3) and the repayment of such borrowing on Day 4 is characterized as a dividend-equivalent redemption and treated as a distribution under sections

incentives for related parties to engage in transactions that result in excessive indebtedness in the cross-border context, federal income tax liability can also be reduced or eliminated with excessive indebtedness between domestic related parties.")

302(d) and 301. Therefore, due to a single prohibited transaction tainting Affiliate 2's transactions with the cash pool, it is possible that these deemed stock issuances and dividend-equivalent redemptions are replicated indefinitely.

Further, as mentioned above, due to the recharacterization of Affiliate 2's withdrawals from the cash pool, the cash pool becomes a funded member as a result of the loans from Affiliate 1 and the Lending Affiliates. Since Affiliate 2's debt is treated as stock, the cash pool is treated as acquiring expanded group stock in a prohibited transaction that triggers the application of the Funding Rule. Under the Funding Rule, the debts owed by the cash pool to Affiliate 1 and the Lending Affiliates are recharacterized as stock issuances by the cash pool. The repayment of these amounts by the cash pool to Affiliate 1 and the Lending Affiliates is treated as a dividend-equivalent redemption under sections 302(d) and 301. Due to the fact that Affiliate 1 and the Lending Affiliates may become indebted to the cash pool or another expanded group member in the future, these rules could continue to apply indefinitely.

Cash pools and their affiliates may enter into several hundred, even several thousand, funding transactions a day and the intercompany balances may fluctuate regularly throughout the year. An exception to the funding rule is necessary to turn off the iterative effect of the current proposed regulations with the purpose of creating an administrable rule for the Service and taxpayers alike.

Clarify the Funding Rule Only Applies to "Net" Fundings of Cash Pools

To ensure the administrability of the Funding Rule, the AICPA recommends that Treasury and the Service clarify that, to the extent the cash pool exceptions do not apply, the Funding Rule can only apply to recharacterize an expanded group member's debt to the extent the expanded group member is a "net" borrower (*i.e.*, borrowing from the cash pool exceeds lending to the cash pool) on the last day of its taxable year.

As stated above in the section related to *"Treasury Departments and Cash Management,"* on a periodic basis, an affiliate's excess cash balance is transferred from the affiliate's account to the cash pool's primary account as a loan from the affiliate to the cash pool. Its deficit cash balance is replenished with cash transferred from the cash pool's primary account as a loan from the cash pool to the affiliate. Thus, over the course of a year, an affiliate may have both deposits (*i.e.*, loans) and borrowings with the cash pool. Our recommendation will clarify that, to the extent the cash pool exceptions do not apply, the Funding Rule can only apply to recharacterize an expanded group member's debt to the extent the expanded group member is a "net" borrower on the last day of its taxable year.

Clarify the Documentation and Maintenance Rule for Cash Pools

Prior to finalizing the proposed regulations, the AICPA recommends that Treasury and the Service establish a rule permitting companies that utilize cash pools to document each expanded group member's wherewithal to meet its obligations under the cash pooling arrangement at the time the cash pooling arrangement is entered into and on an annual basis thereafter.

In order to respect an EGI issued pursuant to a cash pooling arrangement as debt for U.S. federal income tax purposes, the timely satisfaction of certain documentation and maintenance requirements is required. To satisfy the documentation and maintenance requirements in Prop. Reg. § 1.385-2(b)(2) through (4), taxpayers must document and maintain for all taxable years that the EGI is outstanding and until the period of limitations expires for any return with respect to which the treatment is relevant:

(i) Written evidence of an unconditional and legally binding obligation to pay a sum certain on demand or at one or more fixed dates, including documentation that sets forth the relevant legal rights and responsibilities of any members of the expanded group and any entities that are not members of the expanded group in conducting the operation of the cash pooling arrangement;[26]

(ii) Written evidence the holder has the rights of a creditor to enforce the obligation;[27]

(iii) Written evidence the issuer's financial position supports a reasonable expectation that the issuer intended to, and is able to, meet its obligations under the terms of the EGI;[28] and

(iv) Written evidence of timely interest and principal payments or, in the case of either a failure to make required payments or an event of default, the holder's reasonable exercise of the diligence and judgment of a creditor.[29]

The due date to prepare the documentation required by (i) through (iii) above, is no later than 30 calendar days after the date of execution of the legal documents governing the EGI and the date of any amendment that would increase the permitted maximum amount of principal.[30] The due date to prepare the documentation required by (iv), above, is generally no later than 120 calendar days after the due date of each interest or principal payment and the date of each default or acceleration event.[31]

Regarding (iii) above, it is unclear whether the proposed regulations would require written evidence of the issuer's financial wherewithal to meet its obligations with respect to each drawdown against a pooling arrangement.

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26 Prop. Treas. Reg. § 1.385-2(b)(2)(i); Prop. Treas. Reg. § 1.385-2(b)(3)(iii).
27 Prop. Treas. Reg. § 1.385-2(b)(2)(ii).
28 Prop. Treas. Reg. § 1.385-2(b)(2)(iii).
29 Prop. Treas. Reg. § 1.385-2(b)(2)(iv).
30 Prop. Treas. Reg. § 1.385-2(b)(3)(i) & (iii).
31 Prop. Treas. Reg. § 1.385-2(b)(3)(i) & (ii).

Our recommendation addresses the government's concern with ensuring sufficient documentation is available to substantiate a taxpayer's assertion that an advance is debt while ensuring that procedures adopted are administrable for both taxpayers and the Service.

III. Application of the Rules to an Entity in a Year in which the Entity is not a U.S. Person, Not Required to File a U.S. Tax Return, and is Not a CFC or Controlled Foreign Partnership, but in a Later Year Becomes One of the Foregoing

<u>Recommendations</u>

The AICPA recommends that the final regulations provide for an exclusion from the rules for any instrument that is outstanding between an entity and a member of its expanded group in a situation where at the time the instrument was issued, the issuing entity was not a U.S. person, not required to file a tax return, and not a CFC or a controlled foreign partnership, but subsequently becomes one of the foregoing.

Alternatively, the final regulations should provide for a grace period of at least one year to analyze and document an instrument after the entity's status changes to that of an entity required to file a tax return, the entity becomes a CFC or a controlled foreign partnership, or the entity otherwise becomes subject to the proposed regulations.

<u>Background and Analysis</u>

The AICPA believes it is unreasonable and inequitable to impose the proposed regulations to any instrument issued by an entity that is not controlled by U.S. persons and not otherwise subject to the rules upon date of issuance. For example, if a non-U.S. subsidiary or foreign partnership was not, respectively, a CFC or a controlled partnership or otherwise required to file a U.S. tax return when they issued the instrument, the commercial rationality testing required under the proposed regulations may not have been performed or documented as required by the regulations.

Additionally, if the instrument was issued between a U.S. person and an entity with minimal ownership by a U.S. person (*e.g.*, no U.S. tax return requirement, not a CFC or controlled foreign partnership), the entity holding the instrument could not have been controlled by the U.S. persons upon date of issuance. Therefore, the terms of the notes, including the ability to repay, may have been approved by the other / third-party equity holder(s). This third-party review and approval process confirmed that the terms of the instrument have commercial rationality upon the date of issuance and are deemed an instrument issued upon commercial terms.

Application of the Documentation Requirements of Prop. Reg. § 1.385-2

Recommendations

The AICPA recommends that the final regulations should not apply to any existing debt between an entity and members of an expanded group if at the time the debt was issued, the issuing entity was not a U.S. person, not required to file a tax return, and not a CFC or a controlled foreign partnership even though it subsequently becomes one of the foregoing. Proposed Reg. § 1.385-2 should only apply to debt instruments issued after the effective date of the regulations and after the time of the event which causes the entity to become a U.S. person, an entity that is required to file a tax return, or becomes a CFC or a controlled foreign partnership.

Alternatively, the AICPA recommends that the final regulations exclude the documentation requirements in Prop. Reg. § 1.385-2 from applying to an instrument prior to the point where the entity that is not a U.S. person, not required to file a tax return, and not a CFC or a controlled foreign partnership becomes one of the foregoing.

If this approach is adopted, the AICPA recommends that the final regulations provide a one-year period for the expanded group to meet the documentation requirements on a prospective basis.

Analysis

The one-year period for the expanded group to meet the documentation requirements on a prospective basis is important for two reasons. First, it is possible that a foreign member of an expanded group, which is unfamiliar with the new rules, may engage in a transaction that pulls the entity that is not a U.S. person, not required to file a tax return, and not a CFC or a controlled foreign partnership into the expanded group without the immediate knowledge of any U.S. entities. A one-year period ensures that by the time the expanded group is required to file its U.S. tax return, it will have all documentation necessary to meet the requirements under Prop. Reg. § 1.385-2. Second, the grace period provides the expanded group with sufficient time to identify any changes to its structure and apply the documentation requirements, while avoiding any unintended consequences.

Application of the Rules of Prop. Reg. § 1.385-3

Recommendations

The AICPA recommends at the time an entity that is not a U.S. person, not required to file a U.S. tax return, and not a CFC or a controlled foreign partnership becomes one of the foregoing, any existing debt between that entity and members of the expanded group is respected as such under the Prop. Reg. § 1.385-3 rules. The only instruments subject to these rules are new debt incurred after the event which causes the entity to become a U.S. person, required to file a tax return, or a CFC or a controlled foreign partnership.

Alternatively, the AICPA recommends that the final regulations provide a one-year grace period to allow the expanded group time to restructure its existing debt. In the event the existing debt is restructured during the one year grace period such that it is extinguished or restructured in such a way that is no longer subject to the proposed regulations, then the debt should not be subject to these regulations. In the event the foregoing does not occur, the proposed regulations should only apply to the instrument beginning on the date the entity that was not a U.S. person, not required to file a tax return, and not a CFC or controlled foreign partnership becomes one of the foregoing.

IV. Whether Guidance is Needed Under Section 909 to the Extend a United States Equity Hybrid Instrument Arises Solely by Reason of the Application of Prop. Reg. § 1.385-3

Recommendations

The AICPA recommends that the final regulations include a provision to exempt from section 909 any splitter arrangement attributable to a U.S. equity hybrid instrument created solely as a result of the recasting of a taxpayer's debt instrument, in whole or part, as equity under the final regulations.

Alternatively, the final regulations should provide taxpayers with the ability to elect that payments made with respect to the recast instrument are allocated first towards "related income" associated with the suspended foreign taxes, rather than the default pro rata approach.

Background and Analysis

Section 909 was designed to prevent taxpayers from claiming a foreign tax credit with respect to "split taxes" until the "related income" is taken into account. Under Treasury regulations,[32] the application of section 909 is limited to an exclusive list of arrangements that are treated as giving rise to foreign tax credit splitting events. One of the enumerated arrangements is a "U.S. equity hybrid instrument splitter arrangement" where an instrument is treated as debt by a foreign country and equity by the U.S.

Under the proposed regulations, the IRS will have the ability, after the fact, to recast debt instruments, in whole or in part, as equity for U.S. tax purposes. This action, if taken by the IRS, could result is the unintended creation of a U.S. equity hybrid instrument subject to the "splitter rules" of section 909. Additionally, the *per se* rules of Prop. Reg. § 1.385-3 will have the effect of creating numerous U.S. equity hybrid instruments.

[32] Treas. Reg. § 1.909-2.

To illustrate this point, assume CFC2 is owned by CFC1. CFC1 and CFC2 are both residents of a foreign country (FCX) and are members of a modified expanded group under the proposed regulations. CFC2 issues a debt instrument to CFC1 with a face value of $100 and with annual interest of $10, which is subject to FCX income tax at a 30 percent rate. CFC2 does not make any payments, but accrues annual interest expense; CFC1 accrues annual interest income.

Under the *per se* rule of Prop. Reg. § 1.385-3, the debt instrument is recharacterized as equity. The instrument is now treated as a U.S. equity hybrid instrument. CFC1 will report interest income of $10 and pay foreign tax of $3 to FCX. However, for U.S. tax purposes, CFC1 is not considered to have earned any income and the potentially creditable $3 in foreign tax is suspended until the "related income" is either paid to CFC1 or taken into account by the U.S. shareholder that owns CFC1.

A future payment from CFC2 to CFC1 of $10 is not necessarily treated as a payment of related income. Related income is taken out pro rata with other "earnings and profits" at the CFC2 level.

To avoid this situation, the AICPA recommends that (1) section 909 not apply for all debt instruments that are recast as equity by the IRS under the proposed regulations; (2) foreign taxes attributable to the stated interest income are not suspended and (3) any applicable foreign taxes are creditable (subject to the otherwise normal and applicable limitations) when paid or accrued.

As an alternative, the AICPA recommends that even if the taxes are subject to section 909, the taxpayer is allowed to make an election that if there is a subsequent payment made, such payment is sourced to the "related income" associated with the suspended taxes. The pro rata approach that generally treats distributions as from the distributor's E&P would not apply to related income that is attributable to a recast of an instrument under section 385.

V. Clarification is Needed Related to the Meaning of "In Form" for the Purposes of an Applicable Instrument as Defined in Prop. Reg. § 1.385-2(a)(4)

Recommendation

The AICPA recommends that the final regulations clarify the meaning of the term "in form", which is currently ambiguous, to promote a consistent application of the proposed regulations among taxpayers and practitioners.

Background and Analysis

The "bifurcation rule" under Prop. Reg. § 1.385-1(d) and the documentation requirement under Prop. Reg. § 1.385-2(b) both generally apply to an EGI. The definition of an EGI for these purposes under Prop. Reg. § 1.385-2(a)(4)(ii) requires an applicable instrument. The definition of an applicable instrument under Prop. Reg. § 1.385-2(a)(4)(i)(A) generally means any interest issued, or deemed issued, that is "in form" a debt instrument. The proposed regulations reserve for, and do not apply to, interests that are not in form debt. The term "in form" is not defined in the proposed regulations. Additionally, the formal arrangements of interests that are treated as debt under the tax law may vary.[33]

VI. The Use of the Section 318(a)(4) Option Attribution in Determining an Expanded Group and a Modified Expanded Group

Recommendations

The AICPA recommends that section 318(a)(4) not apply in determining an expanded group and a modified expanded group. The AICPA recommends implementing a rule related to options that is similar to Treas. Reg. § 1.1504-4.

The AICPA also recommends that the final regulations clarify if it was intended that Treas. Reg. § 1.1504-4 should not apply in determining an expanded group and a modified expanded group.

Background and Analysis

The definition of expanded group in Prop. Reg. § 1.385-1(b)(3) is determined based on the stock ownership rules of section 1504(a) as modified, *e.g.*, by the attribution rules of section 318 (through section 304(c)(3)). Each of these statutory rules has a specific rule that attribute stock to persons who hold options in the issuing corporation (Treas. Reg. § 1.1504-4 and section 318(a)(4), respectively).

Under Treas. Reg. § 1.1504-4(b)(1), an option is generally not considered stock or as exercised except as provided in Treas. Reg. § 1.1504-4(b)(2). Pursuant to Treas. Reg. § 1.1504-4(b)(2), an option is treated as exercised if, on a measurement date with respect to such option: (i) it could reasonably be anticipated that, if not for [Treas. Reg. § 1.1504-4], the issuance or transfer of the option in lieu of the issuance, redemption, or transfer of the underlying stock would result in the elimination of a substantial amount of federal income tax liability; and (ii) it is reasonably certain that the option will be exercised.

[33] *E.g.*, Section 1275 defines a debt instrument as "a bond, debenture, note, or certificate, or other evidence of indebtedness." Prop. Reg. § 1.7872-2 provides a definition for the term "loan" that is "interpreted broadly." Rev. Rul. 74-27 (197401 C.B. 24) (ruling that a certain "purchase and resale" arrangement constituted a secured loan); and Rev. Rul. 2008-1 (2008-1 C.B. 248) (ruling that a certain derivative contract in which a party prepaid its obligation and was entitled to a return based on the value of foreign currency constituted a foreign currency denominated debt); C.f. Treas. Reg. § 1.83-2(a)(2), which states "if the amount paid for the transfer of property is an indebtedness secured by the transferred property, on which there is not personal liability to pay all or a substantial part of such indebtedness, such transaction may be in substance the same as the grant of an option."

However, Treas. Reg. § 1.1504-4(a)(1) states:

> this section applies to all provisions under the Internal Revenue Code and the regulations to which affiliation within the meaning of section 1504(a) (with or without exceptions in section 1504(b)) is relevant, including those provisions that refer to section 1504(a)(2) (with or without exceptions in section 1504(b)) without referring to affiliation, *provided that the 80 percent voting power and 80 percent value requirements are not modified* therein [emphasis added].

Thus, it appears that Treas. Reg. § 1.1504-4 would not apply in determining an expanded group or a modified expanded group because each definition under the proposed regulations would "modify" the 80 percent voting power and 80 percent value requirements.

Section 318(a)(4) provides that stock is considered as owned by any person who has an option to acquire such stock regardless of whether the exercise of the option is reasonably certain. The application of section 318(a)(4) may overly broaden the meaning of an expanded group and a modified expanded group by imposing the proposed regulations on parties that meet the expanded group or modified expanded group definition solely as a result of an options that *e.g.,* neither conveys any voting rights over the issuer nor offers any meaningful economic participation (if the opinion is "in the money"). In that situation, we are unaware of any reason to impose equity treatment under the proposed regulations since it is anticipated that the parties would generally act at arm's length. Any abuse of removing option attribution is generally covered by the anti-abuse rules in the proposed regulations. Those rules generally apply if instruments are issued between non-expanded group members, with a view to avoid the application of the proposed regulations.

VII. Effect of the Proposed Regulations on Partnerships

<u>Effect of Prop. Reg. § 1.385-1 on Partnerships</u>

Definition of a Controlled Partnership

a. Clarify Reference to Section 304(c)(3)

<u>Recommendations</u>

The AICPA recommends that the final regulations clarify whether section 304(c)(3)(B) applies for purposes of determining indirect ownership of a partnership interest. We recommend that section 304(c)(3)(B) should apply to modify the ownership requirements in sections 318(a)(2)(C) and 318(a)(3)(C), but should not extend to other sections of 318(a), such as section 318(a)(2)(A).

The AICPA also recommends that the final regulations make clear that the "5 percent" rule applies only to sections 318(a)(2)(C) and 318(a)(3)(C), but not extend the minimum threshold ownership requirement to attributions to and from partnerships.

Background and Analysis

The proposed regulations provide that indirect ownership of a partnership interest is determined by applying the rules of section 304(c)(3). Section 304(c)(3)(A) states that section 318(a) applies for purposes of determining control. Section 304(c)(3)(B), however, modifies section 318(a).

Section 318(a)(2)(C) and section 318(a)(3)(C) contain rules for attributing to and from corporations, both of which require a threshold amount of ownership. Specifically, section 318(a)(2)(C) provides, "if 50 percent or more in value of the stock in a corporation is owned, directly or indirectly, by or for any person, such person shall be considered as owning the stock owned, directly or indirectly, by or for such corporation, in that proportion which the value of the stock which such person so owns bears to the value of all the stock in such corporation." Section 318(a)(3)(C) states, "If 50 percent or more in value of the stock in a corporation is owned, directly or indirectly, by or for any person, such corporation shall be considered as owning the stock owned, directly or indirectly, by or for such person."

Section 304(c)(3)(B) modifies the 50 percent rule provided for in section 318(a)(2)(C) and (a)(3)(C) by substituting "5 percent." Section 318(a), however, contains rules for attributing to and from partnerships, which contain no threshold ownership requirement. We suggest that a 5 percent threshold should not apply to partnership attribution.

b. Guidance on Proportionately

Recommendations

The AICPA recommends that the final regulations provide guidance on how "proportionately" is determined for purposes of sections 318(a)(2)(A) and 318(a)(3)(A).

The AICPA recommends that the final regulations provide a safe harbor for purposes of determining "proportionately." We recommend that an appropriate safe harbor for "value" for these purposes is the liquidation value of a partner's interest.[34]

[34] The constructive liquidation of a partnership interest is a common way to measure a partner's rights or ownership in a partnership, including the fair market value of a partnership interest issued to a creditor in satisfaction of debt under Treas. Reg. § 1.108-8(b), the determination of economic risk of loss under Treas. Reg. § 1.752-2(b)(1), the amount of the basis adjustment under section 743(b), and the presence of a capital interest under Rev. Proc. 93-27. In addition, numerous proposed regulations use liquidation value. For instance, liquidation value is used to determine the fair market value of a partnership interest that is transferred in connection with the performance service. *See* Prop.

Background and Analysis

As noted above, section 318 attribution in the corporate context is determined based on "value" of stock owned. In a partnership context, the determination of "value" of a partner's interest is not a straightforward analysis. Preferred interests, profits interests, and interests with targeted or special allocations all represent partnership interests for which the "value" may differ from the percentage of the partnership represented by those interests.

Treatment as Indebtedness in Part

Recommendation

Given that the rules under Prop. Reg. § 1.385-1 are intended to facilitate treatment of applicable instruments consistent with general federal tax principles, the AICPA recommends that the final regulations clarify that the Commissioner may treat an applicable instrument issued by a partnership or a DRE as part indebtedness and part equity in the issuing entity to the extent that such applicable instrument is properly treated as in part indebtedness and in part equity under general federal tax principles.[35]

Background and Analysis

Proposed Reg. § 1.385-1(d)(1) provides, part, that the Commissioner may treat an applicable instrument as part indebtedness and part stock to the extent that an analysis as of the issuance of the applicable instrument, of the relevant facts and circumstances concerning the applicable instrument under general federal tax principles, results in a determination that the applicable instrument is properly treated for federal tax purposes as part indebtedness and in part stock (emphasis added). In situations where an applicable instrument issued by a partnership or a DRE is treated as in part equity under general federal tax principles, it is unclear whether Treasury and the IRS intended to apply Prop. Reg. § 1.385-1(d)(1) to treat such portion of the applicable debt as stock in the corporate owner (if any) of the partnership or the DRE, or as equity in the partnership or the DRE. Therefore, the AICPA recommends that the final regulations clarify the application of Prop. Reg. § 1.385-1(d)(1) to debt instruments issued by a partnership or a DRE.

Reg. § 1.704-1(b)(4)(xii); Prop. Reg. § 1.83-3(l)(1); Notice 2005-43, 2005-1 C.B. 1221 (May 20, 2005). In addition, liquidation value is used to determine a partner's share of partnership profits for purposes of allocating excess nonrecourse liabilities under Prop. Reg. § 1.752-3(a)(3).

[35] See discussion at *Richmond, Fredericksburg & Potomac Railroad Co. v. Commissioner*, 528 F.2d 917 (4th Cir. 1975); *Farley Realty Corp. v. Commissioner*, 279 F.2d 701 (2d Cir. 1960).

Effect of Prop. Reg. § 1.385-2 on Partnerships

Partnership with All Consolidated Group Partners

Recommendations

The AICPA recommends that the final regulations clarify that any applicable instrument issued or held by a partnership that is wholly owned by members of the same consolidated group ("consolidated group partnership") is treated as issued or held by one corporation for purposes of Prop. Reg. § 1.385-2.

We also recommend that the IRS clarify that borrowing and lending transactions between a consolidated group partnership and the consolidated group of its partners are not subject to the reporting requirements under Prop. Reg. § 1.385-2.

Background and Analysis

Proposed Reg. § 1.385-1(b)(1) defines a controlled partnership as a partnership with respect to which at least 80 percent of the interest in partnership capital or profits are owned, directly or indirectly, by one or more members of an expanded group. Proposed Reg. § 1.385-1(e) provides that for purposes of section 385, all members of a consolidated group are treated as one corporation. These rules, taken together, imply that a consolidated group partnership is treated as owned by one corporation, thus causing the consolidated group partnership to become disregarded for purposes of Prop. Reg. § 1.385-2, and any applicable instrument issued or held by the consolidated group partnership should treated as issued or held by one corporation.

Effect of Prop. Reg. § 1.385-3 on Partnerships

Debt Distributed to a Partner

Recommendation

The AICPA recommends that Prop. Reg. § 1.385-3 not apply to the distribution of a partnership's note to its partners.

Background and Analysis

The distribution of a note from a partnership to a partner does not pose the same problems that arise upon a distribution of a note from a corporation to its shareholder. The primary, relevant difference is, in the case of a partnership, unlike a corporation, the earnings are includable currently.

Treatment of DREs under Prop. Reg. § 1.385-3

Recommendation

The AICPA recommends that the final regulations clarify that if a debt instrument of a DRE is treated as stock under Prop. Reg. § 1.385-3, such debt instrument is treated as stock in the first "regarded" owner. However, if the first regarded owner is a partnership, then the debt instrument is treated as stock in the corporate partners of the partnership under Prop. Reg. § 1.385-3(d)(5) (treatment of partnerships).

To illustrate this point, if DRE1 is owned by DRE2, and DRE2 is owned by Partnership, which is owned by Corp1 and Corp2, a debt instrument of DRE1 treated as stock under Prop. Reg. § 1.385-3 is treated as stock in both Corp1 and Corp2.

Background and Analysis

Proposed Reg. § 1.385-3(d)(6) provides that if a debt instrument of a DRE is treated as stock under Prop. Reg. § 1.385-3, then such debt instrument is treated as stock in the entity's owner.

Proportionate Share

Recommendation

The AICPA recommends that the final regulations provide guidance on the method and timing for determining a partner's share of partnership profits for purposes of allocating the partner's share of a debt instrument.

Background and Analysis

For purposes of Prop. Reg. § 1.385-3, a controlled partnership is treated as an aggregate of its partners. Specifically, Prop. Reg. § 1.385-3(d)(5)(i) provides that an expanded group partner is treated as: (i) holding its "proportionate share" of the controlled partnership's assets and (ii) issuing its "proportionate share" of any debt instrument issued by the controlled partnership. An expanded group partner's "proportionate share is determined in accordance with its share of partnership profits."

Recommendation

The AICPA recommends the allowance of an alternate "tracing approach" in certain situations identified below where a distribution of borrowed funds to the partners takes place on a non-pro rata basis.

Background and Analysis

For purposes of determining a partner's proportionate share of a debt instrument, a partner's share of partnership profits is a reasonable proxy for the partner's share of the debt when a partnership issues a debt instrument and retains the borrowed funds because the partnership is likely to repay the debt out of partnership profits. If, instead of retaining the borrowed funds, a partnership distributes the borrowed funds to its partners pro rata based on relative profits and the partners enter into a "funding transaction" as described under Prop. Reg. § 1.385-3(b)(3) that changes the instrument's treatment from debt to stock, defining "proportionate share" based on share of partnership profits is still a reasonable approach.

Recommendation

For purposes of determining a partner's share of profits, we recommend providing a safe harbor.

Analysis

We consider liquidation value percentage, as defined in Prop. Reg. § 1.752-3(a)(3), as an appropriate safe harbor for this purpose. A partner's liquidation value percentage is the ratio (expressed as a percentage) of the "liquidation value" of the partner's interest in the partnership to the liquidation value of all of the partners' interests in the partnership. A partner's liquidation value, in turn, is the amount of cash the partner would receive with respect to the interest if, immediately after formation of the partnership or a revaluation event (as described in Treas. Reg. § 1.704-1(b)(2)(iv)(*f*)(*5*)),[36] the partnership sold,—in a fully taxable transaction,—all of its assets for cash equal to the fair market value of its property (taking section 7701(g) into account), satisfied all of its fixed liabilities and paid an unrelated third party to assume all of its contingent liabilities, and then liquidated.[37]

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[36] The regulations under section 704(b) describe five different revaluation events: (i) in connection with a contribution of money or other property (other than a *de minimis* amount) to the partnership by a new or existing partner as consideration for an interest in the partnership, or (ii) in connection with the liquidation of the partnership or a distribution of money or other property (other than a *de minimis* amount) by the partnership to a retiring or continuing partner as consideration for an interest in the partnership, or (iii) in connection with the grant of an interest in the partnership (other than a *de minimis* interest), or (iv) in connection with the issuance by the partnership of a noncompensatory option (other than an option for a *de minimis* partnership interest), or (v) under generally accepted industry accounting practices, provided substantially all of the partnership's property (excluding money) consists of stock, securities, commodities, options, warrants, futures, or similar instruments that are readily tradable on an established securities market. Treas. Reg. § 1.704-1(b)(2)(iv)(*f*)(*5*)).

[37] This type of "hypothetical sale" is used elsewhere in subchapter K. *See*, *e.g.*, Treas. Reg. §§ 1.743-1(d), 1.751-1(a)(2), and 1.755-1(b)(1)(ii).

Recommendations

In addition to providing methods for determining a partner's share of profits, the AICPA recommends that the final regulations specify the time for determining the expanded group partner's proportionate share of profits. Specifically, we suggest that the share of profits is determined immediately after the controlled partnership issues a debt instrument to or receives a debt instrument from a member of the expanded group.

To avoid manipulation of profit share, we recommend that the final regulations provide that a subsequent reduction in a partner's share of profits is taken into account if, at the time of the issuance or receipt of the debt instrument, the partner's reduction in share of profits is anticipated. We recommend that Treasury and the IRS provide that, if a partner's share of profits is reduced within one year of the issuance or receipt of a debt instrument, the reduction is presumed to have been anticipated, unless the facts and circumstances clearly establish that the decrease in the partner's share of profits was not anticipated.

In addition, we recommend that the final regulations should provide a rule that a reduction in a partner's share of profits is taken into account if it is part of a plan that has as one of its principal purposes the avoidance of the regulations under section 385.[38]

If the borrowed funds are distributed non-pro rata to its partners, determining a partner's proportionate share in accordance with that partner's share of partnership profits may not represent an appropriate measure. To better account for the economics of such situations, we recommend an alternative approach to determining a partner's proportionate share of a partnership's debt instrument that is subject to the recharacterization rules of Prop. Reg. § 1.385-3(b)(3). This alternative approach is similar to the tracing rule in Treas. Reg. § 1.707-5(b)(2)(i) for determining a partner's allocable share of a partnership liability ("tracing approach"). The rule would provide that a partner's proportionate share of a debt instrument that is subject to the recharacterization rules of Prop. Reg. § 1.385-3(b)(3) is the sum of (A) the amount of the debt proceeds that is

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[38] These suggestions are very similar to the anticipated reduction rule under Prop. Reg. § 1.707-5(b)(2)(iii). Specifically, Prop. Reg. § 1.707-5(b)(2)(iii)(A) provides that for purposes of Treas. Reg. § 1.707-5(b)(2), a partner's share of a liability immediately after a partnership incurs the liability is determined by taking into account a subsequent reduction in the partner's share if (1) At the time that the partnership incurs the liability, it is anticipated that the partner's share of the liability that is allocable to a transfer of money or other consideration to the partner will be reduced subsequent to the transfer; (2) The anticipated reduction is not subject to the entrepreneurial risks of partnership operations; and (3) The reduction of the partner's share of the liability is part of a plan that has as one of its principal purposes minimizing the extent to which the partnership's distribution of the proceeds of the borrowing is treated as part of a sale. Prop. Reg. § 1.707-5(b)(2)(iii)(B) further provides that if within two years of the partnership incurring the liability, a partner's share of the liability is reduced due to a decrease in the net value of the partner or a related person for purposes of § 1.752-2(k), the reduction is presumed to be anticipated, unless the facts and circumstances clearly establish that the decrease in the net value was not anticipated. Disclosed in accordance with Prop. Reg. § 1.707-8 is required for any such reduction.

allocable under Treas. Reg. § 1.163-8T to the money transferred to the partner, and (B) the partner's proportionate share of the debt proceeds not transferred to any partners of the partnership.

The operation of the tracing approach is illustrated by the following example:

FP owns 100 percent of CFC and foreign subsidiary (FS). CFC and FS are equal partners in Partnership ("PRS"). On Date A in Year 1, FP lends $100x to PRS in exchange for PRS Note. On Date B in Year 1, PRS distributes $90x to CFC and $10x to FS. Also on Date B in Year 1, CFC and FS distribute $90x and $10x to FP, respectively.

Under Prop. Reg. § 1.385-3(d)(5)(i), CFC and FS are each treated as issuing $50x of PRS Note, which represents their proportionate share of PRS Note based on their share of partnership profits. Under Prop. Reg. § 1.385-3(b)(3)(iv)(B)(1), PRS Note is treated as issued with a principal purpose of funding the distributions to CFC and FS. Accordingly, under Prop. Reg. § 1.385-3(b)(3)(ii)(A) and Prop. Reg. § 1.385-3(d)(1)(i), CFC is treated as issuing $50x of stock (presumably limited to its share of PRS Note) to FP while FS is treated as issuing $10 of stock (presumably limited to the amount of FS' distribution to FP).

The rules under the proposed regulations do not provide treatment for the $40 that the CFC received in excess of its proportionate share of the PRS Note. Under our recommended tracing approach, however, CFC and FS's share of PRS Note that is subject to the recharacterization rules of Prop. Reg. § 1.385-3(b)(3) is $90x and $10x, respectively. Under Prop. Reg. § 1.385-3(b)(3)(iv)(B)(1), PRS Note is treated as issued with a principal purpose of funding the distributions to CFC and FS. Therefore, CFC and FP are treated as issuing $90x and $10x of their stock to FP, respectively.

VIII. Effect of the Proposed Regulations on S corporations

Recommendation

The AICPA recommends that the final regulations provide exceptions to ensure that S corporations do not inadvertently terminate their status when debt is reclassified as equity.

Background and Analysis

One of the principal purposes of the Subchapter S Revision Act of 1982[39] was to eliminate potential scenarios where an S corporation and their shareholders could inadvertently terminate their S corporation status. Since then, Congress has modified Subchapter S, and the IRS has issued related regulatory guidance, to simplify the Subchapter S rules in order to make it more difficult for inadvertent termination of S corporation status. However, the proposed regulations create

[39] P.L. 97-354, Oct. 19, 1982.

numerous new opportunities for S corporations and their shareholders to inadvertently terminate S corporation status.

The proposed regulations raise significant questions for S corporations and their shareholders and complicate the use of S corporations. To restore the stability of S corporation status, the AICPA recommends providing specific exceptions in the final regulations to ensure that S corporation status will not be terminated if an EGI debt instrument is recharacterized as equity.

Expanded Group Related Corporations

The wide range of entities considered related parties under the proposed regulations expands the pool of debt subject to possible recharacterization as equity. Therefore, it is highly likely that under the proposed regulations, if debt is reclassified as equity in the case of an S corporation, the S corporation's status can become disqualified.

The rules define "relatedness" very broadly by creating new related party groups referred to as an "expanded group" and a "modified expanded group." To define expanded group, the proposed regulations begin with the definition of an affiliated group in section 1504(a). The affiliated group definition is modified by not excluding the excludible corporations listed in section 1504(b)(1)(8). In addition, the direct ownership requirement in section 1504(a)(1)(B)(i) is modified to include direct or indirect ownership. Finally, the attribution rules of section 304(c)(3) are applied in order to determine indirect stock ownership.

The IRS has indicated that the modification to the attribution rules was intended to relate to two corporations commonly controlled by an individual as members of the same expanded group. However, it has also acknowledged that the addition of the word "indirect" only to section 1504(a)(1)(B)(i) is not sufficient to achieve that objective and therefore, section 1504(a)(1)(B)(ii) may need similar modifications.

The definition of a modified expanded group is broader than that of an expanded group. In applying the section 1504 affiliated group rules, a 50 percent threshold is used instead of an 80 percent threshold. In addition, if a person (including an individual) is treated as owning at least 50 percent of the value of the stock of a modified expanded group member under the section 318 rules, the person is treated as a member of the modified expanded group.

S Corporation Modified Expanded Groups

Recommendations

The AICPA recommends that the final regulations clarify whether recharacterization of a debt instrument, issued by XYZ to A (as in the example below) as part debt and part stock can occur under general federal tax principles.

The AICPA recommends that the final regulations clarify whether any part debt, part stock recharacterization (as in the example below) creates a preferred stock and a second class of stock such that XYZ's S corporation status terminates.

The AICPA recommends that the final regulations clarify whether the recharacterization of debt to equity is covered under any of the safe harbors found in the section 1361 single class of stock regulations (*e.g.,* under the "no principal purpose to circumvent the single class of stock" requirement under Treas. Reg. § 1.1361-1(1)(2), or the "proportionately held obligations" exception under Treas. Reg. § 1.1361-1(l)(4)(ii)(B)(2) and not treated as a second class of stock).

Background and Analysis

Under Prop. Reg. § 1.385-1(d), the IRS treats an EGI as part debt and part stock based on general federal income tax principles, which results in a determination that the EGI is properly treated as part debt and part stock. This rule applies if a member of a modified expanded group issues debt to a holder that is another member of the same modified expanded group.

To illustrate this point, consider the following example:

A, an individual, owns 100 percent of XYZ, which is an S corporation, and XYZ owns 100 percent of MNO, a wholly owned domestic C corporation subsidiary. A, XYZ and MNO are members of a modified expanded group. A lends to XYZ under the section 1361(c)(5) straight debt safe harbor. The loan is evidenced by a written note, with an unconditional promise to pay on demand a sum certain in money with a stated interest rate and payment dates with no convertibility into stock.

It is unclear in the proposed regulations if it is possible that recharacterization of the debt instrument, issued by XYZ to A, as part debt and part stock can occur under general federal tax principles. If it is possible, it is unclear in the proposed regulations if the stock is considered preferred stock and a second class of stock such that XYZ's S corporation status terminates.

Under section 1361(c)(5), straight debt is not treated as a second class of stock. Based on these facts, it would appear that the IRS is reluctant to bifurcate and recharacterize a portion of the XYZ debt instrument, as section 1361(c)(5) directly prescribes a result consistent with general federal income tax principles, which is the governing principle for recharacterization under Prop. Reg. § 1.385-1. However, even if the instrument is treated as equity under the proposed regulations, it meets the definition of straight debt under section 1361(c)(5)(B) and should not create a second class of stock.

It is unclear in the proposed regulations if the straight debt safe harbor applies. It is also unclear if the debt instrument provides a convertibility feature. It is possible that the IRS could challenge a portion of the debt instrument's character as stock under general federal tax principles. If found as part equity, it would likely create a second, preferred class of stock, thus terminating XYZ's S corporation status.

The final regulations should clarify if the recharacterization is covered under any of the safe harbors found in the section 1361 single class of stock regulations. The final regulations should clarify if it is possible that the recharacterization is covered under the "no principal purpose to circumvent the single class of stock" requirement under Treas. Reg. § 1.1361-1(1)(2). Alternatively, the final regulations should clarify that the debt instrument recharacterized as equity is a proportionately held obligation under Treas. Reg. § 1.1361-1(l)(4)(ii)(B)(2) and not treated as a second class of stock.

In order to illustrate this point, consider the following example:

A, an individual, owns 100 percent of two brother sister S corporations, MNO and XYZ. This example assumes that the final regulations establish A, MNO and XYZ as a modified expanded group. XYZ makes an intercompany loan to MNO. The debt issued by MNO is partly recharacterized by the IRS as stock held by XYZ in MNO.

The final regulations should clarify if MNO's S corporation status terminates because XYZ is now an ineligible shareholder of MNO. Additionally, the final regulations should clarify if the taxpayer can assert there was no principal purpose to create a second class of stock. The identical ownership of MNO and XYZ may support such an assertion.

S corporation groups such as the one described in the above example are common and may have intercompany loans between group members. Under the modified expanded group rules, intercompany loans easily recharacterize from debt to equity under general federal tax principles, depending on the characteristics of the debt instrument. Therefore, the proposed regulations could threaten the status of many S corporations.

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We appreciate your consideration of these comments and welcome the opportunity to discuss these issues further. Please feel free to contact me at (801) 523-1051 or tlewis@sisna.com; or Kristin Esposito, Senior Technical Manager – AICPA Tax Policy & Advocacy, at (202) 434-9241 or kesposito@aicpa.org.

Respectfully submitted,

Troy K. Lewis, CPA, CGMA
Chair, AICPA Tax Executive Committee

cc: Mr. Robert Stack, Deputy Secretary for International Tax Affairs, Department of the Treasury
Mr. Thomas West, Office of Tax Legislative Counsel, Department of the Treasury
Ms. Ossie Borosh, Senior Counsel, Office of Tax Legislative Counsel, Department of the Treasury
Ms. Brenda Zent, Special Advisor, Office of International Tax Counsel, Department of the Treasury
Ms. Danielle Rolfes, Office of International Tax Counsel, Department of the Treasury
Mr. Eric Brauer, Office of Associate Chief Counsel, Internal Revenue Service
Mr. Mark Erwin, Branch Chief, Office of Associate Chief Counsel, International, Internal Revenue Service
Mr. Raymond Stahl, Office of Associate Chief Counsel, International, Internal Revenue Service