TAX EXECUTIVES INSTITUTE, INC.

comments on

REG-108060-15

Proposed Rule on

Treatment of Certain Interests in Corporations as Stock or Indebtedness

submitted to

The Department of the Treasury and Internal Revenue Service

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1. Introduction

On April 4, 2016, the Treasury Department and IRS issued proposed regulations pursuant to § 385 of the Internal Revenue Code to be promulgated at §§ 1.385-1 through 1.385-4 of Title 26 of the Code of Federal Regulations. These proposed regulations authorize the IRS to recharacterize a taxpayer's intercompany debt as equity and require taxpayers to prepare and maintain documents and information substantiating certain intercompany debt transactions as such. Under a new "per se" rule, the proposed regulations mandate the recharacterization of debt instruments to equity if the debt is issued by a corporation to a related company (1) in a distribution, (2) in exchange for expanded group stock, (3) in exchange for property in an asset reorganization, or (4) in transactions funding these first three transactions.

TEI acknowledges the government's base-erosion concerns surrounding use of related-party debt to achieve excessive interest deductions, particularly in the context of corporate inversions. The proposed regulations, however, are overly broad, covering routine and non-tax motivated financing transactions, and appear intended to force multinational businesses to resort to third-party lending in almost all cases. Businesses use intercompany financing for a wide variety of non-tax business purposes, including, to name a few, increasing speed and efficiency of funding activities, reducing external lending fees, improving administration, minimizing harm to company credit ratings, improving consolidated balance sheets, and increasing return on invested capital. We discuss below several adverse macroeconomic impacts of the proposed regulations. Thereafter, we examine specific technical complexities the regulations would create – complexities without clear solutions that merit a thorough vetting process before adoption of final regulations. Further, we urge Treasury and the IRS to consider the following changes to the proposed regulations:

(1) harmonize the deemed-issuer rules,

(2) establish a 25% safe-harbor floor below which debt will not be recharacterized to equity,

(3) exempt non-interest bearing obligations and ordinary-course loans from documentation requirements,

(4) clarify the documentation requirements,

(5) make the per se rule of Prop. Treas. Reg. § 1.385-3 a rebuttable presumption and shorten its 72-month time period,

(6) expand the exception for distributions to encompass all earnings and profits, current and accumulated, and also exclude distributions of previously taxed income,

(7) expand the ordinary-course exception to cover all tangible personal property used in the ordinary course of business,

(8) except employee stock compensation from the documentation and recharacterization requirements, and

(9) except cash pooling arrangements from the documentation and recharacterization requirements.

Finally, we discuss our position that Treasury lacks the statutory authority to recharacterize certain debt instruments as equity on a per se basis.

Tax Executives Institute

TEI is the preeminent association of in-house tax professionals worldwide. Our approximately 7,000 members represent more than 2,800 of the leading corporations in North and South America, Europe, and Asia. TEI represents a cross-section of the business community and is dedicated to developing and effectively implementing sound tax policy, promoting the uniform and equitable enforcement of the tax laws, and reducing the cost and burden of tax administration and compliance to the benefit of taxpayers and governments alike. TEI is firmly committed to maintaining a tax system that works – one that is administrable and with which taxpayers can comply in a cost-efficient and predictable manner.

TEI, as a professional association of in-house tax executives, offers a unique perspective. Members of TEI manage the tax affairs of their companies and must contend daily with provisions of the tax law impacting business enterprises throughout the world, including transactions directly affected by these proposed regulations. Our members work for companies involved in a wide variety of industries, and their collective perspectives are broad-based. The diversity, background, and professional training of TEI's members place the organization in a uniquely qualified position from which to comment on these issues.

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2. Macroeconomic Effects

The proposed regulations create new rules in three areas. First, they authorize the IRS to recharacterize and treat a debt instrument as part debt and part equity. Second, they require documentation supporting a debt instrument for it to be treated as debt for U.S. federal income tax purposes. Third, they create a per se rule that recharacterizes and treats certain related-party debt instruments (referred to as Expanded Group Instruments or "EGIs") as stock if issued: (1) in connection with a distribution to a related shareholder, (2) in exchange for an affiliate's stock, (3) in an internal asset acquisition, or (4) in exchange for property with a principal purpose of funding one of these three transactions. The per se rule carries an irrebuttable presumption of equity characterization if an instrument is issued within 36 months before or after one of these targeted transactions.

All laws create unintended consequences, and the proposed regulations are no exception. TEI takes no position on the government's efforts to prevent inversion activity and tax-motivated earnings stripping. We believe, however, the proposed regulations could actually have a negative impact – or at least a countervailing impact eroding the objectives the government seeks to achieve – on the U.S. fisc for the simple reason they would stifle U.S. corporations from making outbound loans to their related foreign entities. If a U.S. parent seeks to fund its outbound investment with third-party lending to a foreign related company, the foreign company would likely pay a higher interest cost, reducing the U.S. parent company's taxable income as compared to making intercompany loans to international affiliates, thus reducing interest income to the parent.[1] In this circumstance, the foreign related company would likely see its foreign profits and tax burden decrease due to higher interest costs.

Equity financing may be thought of as an alternative to third-party lending. Issuing equity, however, is generally more expensive, complex, and time-consuming than issuing debt. Thus, multinationals have historically relied on related-party debt to manage cash flows and fund routine business operations around the globe. In addition, if a U.S. parent were to fund related foreign companies with equity, the U.S. parent's taxable income would also decrease compared to funding related foreign companies with debt, because of reduced interest income to the parent. The foreign related company would likely see its foreign tax burden increase in light of reduced interest payments to the U.S. parent, rather than deductible interest payments to the U.S. parent, which in turn would increase the availability of indirect foreign tax credits to the U.S. parent. Essentially,

[1] Such a disparity between the interest cost on a related-party loan and a third-party loan would be permissible under I.R.C. § 482 by way of the safe-haven provision of Treas. Reg. § 1.482-2(a)(2)(iii)(B).

to the extent the proposed regulations might stifle transactions resulting in outbound interest payments, otherwise reducing federal tax revenue, the regulations would also stifle loans by U.S. companies to foreign related entities, which would otherwise increase federal tax revenue.

Similarly, the proposed regulations are likely to have a negative impact on the U.S. fisc because of their impact on foreign-owned U.S. companies. The proposed regulations would steer companies to third-party lenders or to parent-company equity financing. This would negatively affect foreign-owned U.S. subsidiaries wishing to invest in expansion facilities and large equipment purchases. Both U.S.-parented and foreign-parented companies use intercompany debt because it is more efficient than having multinational affiliates maintain independent, third-party banking relationships. Further, equity financing is usually more expensive than debt financing because most tax treaties have lower withholding rates on interest than they do on dividends. Multinational companies will inevitably take these factors into account when deciding whether to invest capital in an affiliate in the United States or in another jurisdiction. Increasing the cost of capital for U.S. investment will result in higher internal hurdle rates, *i.e.*, required rates of return that new business investments must clear to obtain management approval. Thus, the proposed regulations risk stifling capital flowing into the United States, hindering job creation and economic growth. Put another way, less investment means less growth, and less growth means lower future wages and earnings.

Furthermore, the proposed regulations produce unintended and inappropriate restrictions on I.R.C. § 304 transactions. Congress enacted I.R.C. § 304 in keeping with its preferred tax policy that, in the case of related-party corporate ownership, cash from the related corporations, received either as a distribution or as a related-party sale transaction, be treated first as a distribution of earnings and profits before being treated as return of capital or capital gain from the sale of stock of one corporation to a related corporation. These transactions often use intercompany debt for common business reasons.

For example, an I.R.C. § 304 transaction could use intercompany debt to purchase stock of a related foreign company, thereby allowing a U.S. parent to restructure foreign corporations while meeting local tax and legal requirements. Foreign restructurings also use debt to allow corporations to return future cash accumulations through interest and principal payments as opposed to dividends subject to foreign withholding taxes and non-tax legal restrictions on equity distributions. Absent the ability to use related-party debt in such situations, U.S. parent companies may resort to third-party debt or additional equity investments to accomplish the restructurings, both of which would result in additional foreign withholding taxes on payments on such instruments. These foreign withholding taxes imposed on dividend payments would result in an overall decrease in U.S. tax revenue because they would qualify for either the direct or indirect U.S. foreign tax credit.

Regarding implementation costs, we anticipate large business taxpayers will be compelled to incur substantial costs to develop databases and accounting processes to track and account for the thousands of routine intercompany transfers and obligations that would factor into the per se calculations of Prop. Treas. Reg. § 1.385-3. Such databases and accounting work would take months or even years to complete. Complying with the proposed regulations as of April 4, 2016 is a practical impossibility.

Finally, and perhaps most ominously, to the extent the final regulations require greater reliance on third-party lending for liquidity needs, the regulations could very well amplify the negative effects of a future financial crisis. Multinational corporations forced to rely on external borrowing to meet possible liquidity needs, as opposed to global cash pooling, would necessarily be more exposed to financial shocks from third-party lenders suffering those shocks because of issues unrelated to the multinationals. For example, during the 2008 financial crisis, the commercial paper market – a common funding mechanism for short-term liquidity needs – ceased to function as it had in the past because lenders refused to roll over commercial paper balances with corporate borrowers, and other lenders were unwilling to lend on similar terms. A multinational relying on global cash pooling for its short-term liquidity needs would be much less vulnerable to a similar crisis because it would be less reliant on the financial markets for liquidity. If adopted, however, the proposed regulations would drive companies toward third-party debt, including (and perhaps especially) short-term commercial paper. All of this could compound the consequences of a future financial crisis.

If adopted in their current form, the proposed regulations would undoubtedly impose a significant cost on multinational taxpayers doing business in the United States, whether U.S.- or foreign-parented, due to significant increases in the cost of funding economic activity in the United States. The inevitable consequence of increased costs is a further eroding of the competitiveness of the United States. We therefore encourage Treasury and IRS to carefully reconsider whether the anticipated benefits of these proposed regulations outweigh their costs and economic consequences.

3. Technical Complexities Caused by the Regulations

Apart from the macroeconomic effects, the proposed regulations would also create problematic technical issues to which solutions are not readily obvious. We respectfully encourage Treasury and IRS to consider and address these issues before adopting final regulations. In particular, the rules under Prop. Treas. Reg. § 1.385-2 regarding the treatment of certain interests between members of an expanded group and Prop. Treas. Reg. § 1.385-3 regarding certain distributions of debt instruments and similar transactions, present a myriad of cascading and cliff-like effects in other areas of the Code and regulations. These points are discussed below.

Preliminarily, it is important to highlight the overall administrative burden and complexity of the proposed regulations. The proposed regulations report the estimated average annual reporting burden to be 35 hours and the estimated number of respondents to be 21,000. In TEI's view, these grossly underestimate the actual burden as they only appear to address the reporting burden of the documentation requirements of Prop. Treas. Reg. § 1.385-2(b)(2). The estimates fail to account for the additional burden of tracking and accounting for the transactions potentially subject to Prop. Treas. Reg. § 1.385-3. The burden estimate also appears to disregard the substantial systems work that will be necessary for multinationals to track all of their intercompany debts in light of the rules under Treas. Reg. § 1.385-3, particularly the 72-month rule. For large multinationals, effectively tracking intercompany debt will likely require multimillion-dollar expenditures related to up-front systems costs that may take six to 24 months to complete. The internal systems work required to properly track and comply with the proposed regulations is on par with the work financial institutions were required to undertake to comply with the regulations implementing the Foreign Account Tax Compliance Act, the effective date of which was delayed for several years in large part to accommodate the time needed to make systems changes. Here, in stark contrast, the proposed regulations contemplate a retroactive adoption of final rules. This is simply impracticable.

As part of this tracking process, multinationals would be required to maintain two separate organizational charts – one reflecting underlying legal and commercial realities that treats debt instruments in form and substance as debt for all but U.S. federal income tax purposes, and another solely for U.S. tax purposes reflecting debt "deemed" as equity under the proposed regulations.

The latter chart would require constant, real-time revision as short-term "equity" instruments are issued and "redeemed" as cash is moved around the group.

This points to a further complexity resulting from the rules: hybrid instruments. This is ironic, because the OECD recently completed its BEPS project, which included a final report of over 450 pages setting forth options to reduce or eliminate multinational corporate tax planning through the use of hybrid instruments and entities. The United States was a substantial participant in the OECD project. The proposed regulations, however, run counter to the OECD's aim to combat the use of hybrids by having the direct – even intended – result of creating more hybrid instruments. Thus, multinationals will not only have to maintain separate organizational charts and track the collateral effects of recharacterizations of debt to equity, but they will also need to assess the application of various and highly complex hybrid-instrument rules implemented by countries around the world in response to BEPS, at times retroactively.

It is thus an open question whether large multinationals will be able to effectively comply with the proposed regulations under I.R.C. § 385 despite their best efforts to do so, especially considering the April 2016 effective date. TEI therefore recommends the effective date of the final regulations be extended to at least six months after they are published in the Federal Register. We now turn to more specific technical difficulties raised by the proposed regulations.

First, Prop. Treas. Reg. § 1.385-2(b) states, "If a disregarded entity is the issuer of an EGI and that EGI is treated as equity under this section, the EGI is treated as an equity interest in the disregarded entity rather than stock in the disregarded entity's owner." This proposed rule creates significant and unintended difficulties in a variety of situations.

For example, if an EGI is treated as an equity interest in a disregarded entity that is a single member LLC and that interest is held by someone other than the disregarded entity's sole owner, then the entity would lose its disregarded status, triggering the rules governing the movement of entities from disregarded to regarded status. In addition, if the EGI is issued and repaid in a short period of time or issued and repaid repeatedly, the proposed rules would create month-to-month springing partnerships, along with all the attendant difficulties associated with partnerships springing into existence, only to become disregarded a short time later. This is in contrast to the treatment in Prop. Treas. Reg. § 1.385-3, which treats the shareholder as the issuer.

Second, tracking the owner's basis under the so-called *Johnson* regulations[2] in the EGI and previously issued ownership interests would be extremely difficult, if not impossible. Prop. Treas. Reg. § 1.358-2 creates a basis-tracing regime for allocating basis in exchanges to which I.R.C. §§ 354, 355, or 356 applies (*i.e.*, the rules governing recognition of gain in corporate reorganizations and spinoffs). Any such exchange is deemed to create shares of stock with a basis derived solely from that exchange. Thus, a 100% shareholder would be treated as having several blocks of stock, each with a different basis per share. Any sale of stock or distribution under I.R.C. § 301 must therefore be calculated separately against those different blocks of stock.

> This complexity is illustrated by Treas. Reg. § 1.358-2(c), Example 16:
>
> (i) Facts. Each of Corporation X and Corporation Y has a single class of stock outstanding, all of which is owned by Corporation P. Corporation T has a single class of stock outstanding, all of which is owned by Corporation X. The corporations do not join in the filing of a consolidated return. Corporation X purchased 100 shares of Corporation T stock on Date 1 for $1.50 each, resulting in Corporation X having an aggregate basis in the stock of Corporation T of $150. On Date 2, Corporation Y acquires the assets of Corporation T for $100 of cash, their fair market value, in a transaction described in §1.368-2(l). Pursuant to the terms of the exchange, Corporation T does not receive any Corporation Y stock. Corporation T distributes the $100 of cash to Corporation X and retains no assets.
>
> (ii) Analysis. Pursuant to §1.368-2(l), Corporation Y will be deemed to issue a nominal share of Corporation Y stock to Corporation T in addition to the $100 of cash actually exchanged for the Corporation T assets. Corporation T will be deemed to distribute the

[2] For a listing of proposed regulations generally referred to as the *Johnson* regulations in recognition of the Circuit Court's decision in *Johnson v. United States*, 435 F.2d 1257 (4th Cir. 1971), *see* REG-143686-07, Notice of Proposed Rulemaking, The Allocation of Consideration and Allocation and Recovery of Basis in Transactions Involving Corporate Stock or Securities (Feb. 23, 2009).

> nominal share of Corporation Y stock to Corporation X in addition to the $100 of cash actually distributed. Corporation X will have a basis of $50 in the nominal share of Corporation Y stock under section 358(a). However, Corporation X is not an actual shareholder of Corporation Y, the issuing corporation. Therefore, Corporation X cannot designate any share of Corporation Y stock under paragraph (a)(2)(iii)(B) of this section to which the basis of the nominal share of Corporation Y stock will attach and Corporation X will be deemed to distribute the nominal share of Corporation Y stock to Corporation P as required by §1.368-2(l). Corporation X does not recognize the loss on the deemed distribution of the nominal share to Corporation P under section 311(a). Corporation P's basis in the nominal share it receives is zero, its fair market value, under section 301(d). Under paragraph (a)(2)(iii)(B) of this section, Corporation P must designate a share of Corporation Y stock to which the nominal share's zero basis will attach.

In this example, P now has two blocks of stock in Y, one block with a zero basis and the other with its original basis. If Y makes a distribution to P, the distribution comes from both blocks of stock and creates difficulty in determining I.R.C. § 301 consequences, namely whether the distribution is a dividend, a return of basis, or a capital gain.

This example appears to run afoul of the proposed regulations because there is an acquisition of expanded group stock and a deemed distribution by both T and X. Any related-party debt issued within the 72-month time frame by either T or X would be treated as equity under the per se funding rule, creating yet more blocks of stock with different bases that must be taken into account for I.R.C. § 301 purposes.

Third, if a group wishes to treat an EGI as debt, the proposed regulations require certain documentation with respect to creditors' rights, including documentation of actions taken by the creditor upon an event of default. This raises the question of whether a lending subsidiary must declare a borrowing subsidiary in default to be considered to have exercised its rights as a creditor under the proposed regulations. Declaring a borrower in default may have unintended and potentially catastrophic collateral consequences, such as triggering cross-default clauses in other related or unrelated party-group borrowings. It is unclear whether this is intended by the proposed regulations, particularly for routine group lending transactions.

Fourth, the proposed regulations fail to specify how a recharacterized EGI is treated upon satisfaction of the debt (or, upon redemption of the stock). Because of the various ways in which the EGI can be recharacterized, whether as common stock or preferred stock or stock under I.R.C. § 306, a debtor's satisfaction of a related-party debt instrument could be treated as essentially equivalent to a dividend, depending on the debtor's earnings and profits as well as its equity profile. Thus, a distribution that might otherwise satisfy an EGI might be regarded as a redemption of stock or as a dividend payment on that stock. We recommend that final regulations contain examples of the consequences of debt satisfaction in this regard.

Fifth, if a group wishes to borrow from an unrelated lender and the lender demands the group subordinate its intercompany debt to the lender's debt, accepting this demand may raise questions under the proposed regulations as to whether the intercompany debt should be treated as equity. Assume, for example, CFC1 lends to CFC2, and Parent borrows from an unrelated lender that requires subordination of all debts to its rights. Arguably, if CFC1 were an unrelated lender, it would not agree to subordinate its claim against CFC2 to the claims of the unrelated lender. Nevertheless, if CFC1 subordinates its claims, then the government may argue this is evidence that CFC1 is not acting as an unrelated lender, but rather as an equity owner, and reclassify the loan to CFC2 as equity. This situation may cause the group to forgo third-party borrowing.

Sixth, foreign tax credits would not be available to less-than-10% shareholders with respect to repayments of EGIs the group had intended to be treated as debt but were instead treated as equity under the proposed regulations. An example of this situation is a purported debt repayment that is converted to an I.R.C. § 302 distribution on the deemed equity interest (perhaps treated as nonvoting preferred stock) to a less-than-10% shareholder (*i.e.*, the entity that the group thought was the lender), which is then precluded from claiming a deemed-paid foreign tax credit because of its small ownership interest. This underlying income would be subject to double taxation, contrary to the general policy of granting a foreign tax credit for income taxes imposed by other countries on non-U.S. earnings.

Seventh, treating EGI as equity may cause a transaction to fail nonrecognition treatment under I.R.C. § 351 because the contributing party may fall below the 80% ownership threshold after the EGI is treated as equity. Characterizing an EGI as equity could also cause other tax-free reorganizations and non-recognition transactions to fail to qualify for such treatment, potentially retroactively.

Eighth, the proposed regulations may result in foreign tax credit "splitter" transactions under I.R.C. § 909. Tracking these transactions and matching foreign taxes with the related income, while at the same time tracking deemed equity interests and other issues, would impose a substantial compliance burden. To illustrate, refer to the example provided under Treas. Reg. § 1.909-2(b)(3)(i)(E), which is reproduced below. Assume the instrument issued by CFC2 (described in the third sentence) is considered equity for U.S. federal income tax purposes under the proposed regulations. The proposed regulations themselves create the splitter event.

> *Example.*
>
> (i) Facts. USP, a domestic corporation, wholly owns CFC1, which wholly owns CFC2. Both CFC1 and CFC2 are corporations organized in country A. CFC2 issues an instrument to CFC1 that is treated as indebtedness for country A tax purposes but equity for U.S. Federal income tax purposes. Under country A's income tax laws, the instrument accrues interest at the end of each month, which results in a deduction for CFC2 and an income inclusion and tax liability for CFC1 in country A. The accrual of interest does not result in an inclusion of income for CFC1 for U.S. Federal income tax purposes. Pursuant to the terms of the instrument, CFC2 makes a distribution at the end of the year equal to the amounts of interest that have accrued during the year, and such payment is treated as a

> dividend that is included in the income of CFC1 for U.S. Federal income tax purposes.
>
> (ii) Result. Pursuant to §1.909-2(b)(3)(i)(D), because the instrument is treated as equity for U.S. Federal income tax purposes but is treated as indebtedness for country A tax purposes, it is a U.S. equity hybrid instrument. Pursuant to §1.909-2(b)(3)(i)(A)(3), because the accrual of interest under foreign law does not result in an inclusion of income of CFC1 for U.S. Federal income tax purposes, there is a splitter arrangement. The fact that the payment of the accrued amount at the end of the year pursuant to the terms of the instrument gives rise to a dividend that is included in income of CFC1 for U.S. Federal income tax purposes does not change the result because it is the accrual of interest and not the payment that gives rise to income or deductions under foreign law. The payments will be treated as a distribution of related income to the extent provided by §1.909-3 and §1.909-6(d).

Ninth, transforming debt into equity may have unintended consequences under Treas. Reg. § 1.861-12T(f), namely debt reclassified as equity changes character under these rules, with collateral consequences. Treas. Reg. § 1.861-12T applies to taxpayers apportioning expenses under an asset allocation method to determine foreign tax credit implications under I.R.C. § 904. Treas. Reg. § 1.861-12T(f) provides that asset values are reduced, thus changing the allocation, for any asset with respect to which interest expense is disallowed under any provision of the Internal Revenue Code. Any recharacterization under the proposed regulations from debt to equity results in a disallowance of interest expense. Taxpayers may therefore have to reduce the value of assets in the apportionment calculation by the amount of recharacterized indebtedness. This is not entirely clear, however, because Treas. Reg. § 1.861-12T(f) can be interpreted as requiring an instrument to be classified as indebtedness when any interest expense is disallowed, which would not be the case under the proposed regulations.

Tenth, the proposed regulations create uncertainties with longstanding IRS procedures. For example, under Rev. Proc. 99-32, if a taxpayer voluntarily makes or is required to make a transfer-pricing adjustment, an intercompany interest-bearing receivable or payable, such as an intercompany loan, is deemed to be created on the last day of the tax year in which the transfer-pricing adjustment is made. The proposed regulations do not address whether they apply to these deemed receivables and payables.

Eleventh, reclassification of debt as equity may create conflicts under U.S. income tax treaties. A treaty partner, for example, may disagree with the U.S. characterization of an EGI as equity, and the relevant treaty may have different withholding rates for interest payments than for dividends. The resulting disputes may generate increased mutual agreement procedure cases. Similarly, the OECD's BEPS project included a final report of over 450 pages on options to reduce or eliminate multinational corporate tax planning achieved through hybrid instruments and entities (*e.g.*, an instrument treated as debt in one jurisdiction but equity in another or an entity that is treated as transparent in one jurisdiction but taxable in another). The proposed regulations run counter to the objectives of the BEPS project, in which the Treasury and IRS substantially participated, by creating a new category of hybrid instruments.

Twelfth, the reclassification of part or all of a hedged instrument may result in invalidating the hedge, thus triggering timing and character consequences as well as consequences under I.R.C. § 988 when debt is exchanged for stock.

Thirteenth, there are also many complexities regarding the treatment of previously taxed income ("PTI") resulting from recharacterizing debt to equity. As payments of interest and principal are recharacterized as payments of dividends and dividend-equivalent redemptions, respectively, the intended lender would presumably receive PTI. If the U.S. shareholder of that entity is not the same U.S. shareholder of the borrowing entity, that PTI would effectively be lost under some IRS rulings. The proposed regulations also implicate the PTI basis adjustment rules, which may not operate as intended. Moreover, a distribution of PTI recasting a loan to the distributing CFC into equity is contrary to the general policy of ensuring that PTI distributions are tax-neutral.

Fourteenth, in addition to the technical and administrative complexities the proposed regulations introduce into the already complex U.S. federal income tax regime, the proposed regulations would also have far-reaching effects on state tax law. For example, they would affect the deductibility of related-party interest expenses in states that require separate company reporting. They would also require multinational companies operating in multiple states to create and maintain state-specific procedures and organizational charts, tracking the impacts of the proposed regulations on their state returns. The state impacts could vary wildly depending on whether and to what extent states choose to adopt or reject the new federal rules.

Finally, the CFC look-through rule of I.R.C. § 954(c)(6) expires at the end of 2019. Payments of interest and principal recharacterized as dividends would give rise to subpart F income in the hands of the payee CFC (if not eligible for another subpart F exception), creating yet another category of payments and transactions that must be tracked and accounted for under the proposed regulations.

The foregoing list is not exhaustive. However, it serves to highlight the array of technical complexities presented in the proposed regulations and the effects they would have on legitimate transactions and ordinary business processes. Accordingly, before the proposed regulations are finalized, TEI respectfully requests Treasury and IRS assess and resolve these complexities.

4. Harmonizing the Deemed-Issuer Rules

As discussed above, the proposed regulations sometimes treat a disregarded entity as the issuer of an instrument and sometimes treat the disregarded entity's sole owners as the issuer. For example, Prop. Treas. Reg. § 1.385-2(c)(5) states, "If a disregarded entity is the issuer of an EGI and that EGI is treated as equity under this section [§ 1.385-2], the EGI is treated as an equity interest in the disregarded entity rather than stock in the disregarded entity's owner." On the other hand, Prop. Treas. Reg. § 1.385-3(d)(6) states, "If a debt instrument of a disregarded entity is treated as stock under this section [§ 1.385-3], such debt instrument is treated as stock in the entity's owner rather than as an equity interest in the entity." In both cases, the disregarded entity is the issuer of an instrument and the instrument is treated as equity under the proposed regulations. Only in the former case, however, is the equity instrument deemed to be an interest in the disregarded entity; and only in the former case is the equity instrument deemed to be an interest in the disregarded entity's owner. It is not clear why the proposed regulations require two different treatments for the same result – that is, an instrument issued by a disregarded entity treated as equity. TEI recommends that these two treatments be harmonized so the issuer of the instrument in each case will only be the shareholder of the disregarded entity. This would simplify the application of the proposed regulations, make them more administrable, and ease the compliance burden.

5. 25% Floor for Recharacterizing Debt to Equity

Congress amended I.R.C. § 385 in 1989 "to allow the Treasury Department to characterize an instrument having *significant* debt and equity characteristics as part debt and part equity."[3] Under this grant of limited rulemaking authority, an instrument with *insignificant* equity

[3] H.R. REP. NO. 101-386, at 562 (1989) (Conf. Rep.) (emphasis added).

characteristics should not be subject to recharacterization. The proposed regulations, however, offer no such safeguard. An examiner is free to bifurcate a taxpayer's EGI into 99% debt and 1% equity. Such an adjustment would likely result in immaterial tax adjustments, but the technical implications arising from that recharacterization – from basis tracing to springing partnerships – would be enormous.

We encourage Treasury and the IRS to establish a safe harbor under which no recharacterization is permitted absent a determination that 25% or more of an instrument is properly treated as equity under the proposed regulations. Such a safe harbor would benefit the IRS and taxpayers by promoting efficient enforcement efforts by IRS personnel and avoiding controversies that result in immaterial tax adjustments.

6. Documentation Requirements

Prop. Treas. Reg. § 1.385-2(b) requires taxpayers to prepare certain documentation for EGIs. If taxpayers fail to do so, the debt will be treated as stock for U.S. federal income tax purposes. This documentation must establish (1) an issuer's obligation to pay a sum certain, (2) creditor's rights, (3) a reasonable expectation of an issuer's ability to repay the EGI, and (4) documentation of payments or actions in the event of a default. First, Treasury should entirely except from this documentation requirement non-interest bearing trade payables and receivables, as well as certain routine, daily lending transactions that offer little opportunity for abusive earnings-stripping activity. Second, Treasury should clarify in final regulations how taxpayers can satisfy these documentation requirements.

a. Exceptions from Documentation Requirements

The underlying purpose of the debt-equity analysis is to prevent a purported debtor-creditor relationship from substantively facilitating inappropriate earnings stripping, among other policy concerns. The documentation requirement, in turn, enables an analysis of whether a debt instrument is appropriately treated as stock or indebtedness. The documentation requirements are unnecessary for and would create tremendous inefficiencies if applied to debt arising in day-to-day, ordinary-course business transactions. Specifically, non-interest bearing trade payables and receivables; cash pooling arrangements; and advances used to pay for inventory, related tangible property, and common deductible expenses should be exempt from the final regulations' documentation requirements. These day-to-day funding needs have a fundamentally different nature than long-term funding efforts and little or no ability to facilitate targeted earnings stripping. Thus, the costs of assembling and maintaining the required documentation would outweigh enforcement related benefits associated with it.

b. Clarifying the Documentation Requirements

The proposed regulations contain relatively clear explanations for satisfying certain of the documentation requirements. Taxpayers, however, need significantly more guidance on how to meet the third documentation requirement, namely establishing that the debt issuer's financial position supports a reasonable expectation that it intended to and would be able to meet its debt obligations under the instrument. Under the proposed regulations, this documentation is left to the taxpayer to decide but may include, "cash flow projections, financial statements, business forecasts, asset appraisals, determination of debt-to-equity and other relevant financial ratios of the issuer relative to industry averages, and other information regarding the sources of funds enabling the issuer to meet its obligations pursuant to the terms of the applicable instrument."[4] The IRS, of course, has the discretion to later decide if a taxpayer's documentation efforts in this regard are insufficient, as the documentation requirements are not a safe harbor, but rather, a minimum floor that must be met for an EGI to be treated as debt.

[4] Prop. Treas. Reg. § 1.385-2(b)(2)(iii).

Treasury and the IRS could prevent unnecessary disputes surrounding what is or is not sufficient to satisfy the third documentation requirement of Prop. Treas. Reg. § 1.385-2(b)(2)(iii) by providing a safe-harbor list of documentation, the existence of which would satisfy the requirements. The required documentation should reflect business realities. The documentation should be practical (*e.g.*, consistent with ordinary business practice given the magnitude of the instrument) and affordable to prepare. In TEI's view, the regulations should make clear that master lending agreements and annual credit checks satisfy the documentation safe-harbor, while also permitting other documentation to satisfy the regulatory requirements, even if not on the safe-harbor list. We also recommend adding a safe-harbor provision in the form of projected cash flows used for internal purposes or benchmarked debt-to-equity ratios for documenting a debtor's ability to pay. Documentation safe harbors would give taxpayers comfort that, if they properly complete the list, they will be protected from a subsequent recharacterization due to a documentation failure, while also giving taxpayers flexibility to produce documentation in another, potentially more efficient manner and still satisfy the regulations, albeit without the protection of a safe harbor.

Furthermore, we recommend the final regulations make clear that documentation regarding a reasonable expectation of an issuer's ability to repay the EGI may include documentation substantiating the issuer's ability to refinance that EGI with third-party debt. We recommend modifying Prop. Treas. Reg. § 1.385-2(b)(2)(iii) to include the following language (additions in **bold**):

> …The documentation may include cash flow projections, financial statements, business forecasts, asset appraisals, determination of debt-to-equity and other relevant financial ratios of the issuer in relation to industry averages, and other information regarding the sources of funds enabling the issuer to meet its obligations pursuant to the terms of the applicable instrument. **Documentation supporting a reasonable expectation that an EGI may be repaid with the proceeds of third-party debt obligations may also be relevant. Such documentation includes, but is not limited to, information about the issuer's available committed bank**

> **facilities, its history of bank loans or bond issuances, and its corporate credit ratings. Absence of such documentation does not undermine other types of evidence.** If any member of an expanded group relied on any report or analysis prepared by a third party in analyzing whether the issuer would be able to meet its obligations pursuant to the terms of the EGI, the documentation must include the report or analysis….

In addition, if the final regulations do not exempt cash pooling arrangements from the documentation requirements, we recommend they clarify that separate documentation for multiple drawdowns under an intercompany debt facility during a taxable year are not required. Requiring taxpayers to document monthly, or more frequent drawdowns under a cash pooling arrangement or other intercompany debt facility would be unduly burdensome and duplicative.

The proposed regulations allow a revolving-credit EGI lender to document an issuer's obligation to pay a sum certain with properly maintained enabling documents. This practical and common-sense allowance prevents creditors from having to re-document a debtor's obligation to pay back the debt with each drawdown. We appreciate this allowance and believe it should also extend to documentation regarding creditor's rights, as no practical reason exists not to extend such an allowance. We recommend modifying Prop. Treas. Reg. § 1.385-2(b)(3)(iii)(A) to include the following language (additions in **bold**):

> Revolving credit agreements and similar agreements. Notwithstanding paragraph**s** (b)(2)(i) **and (b)(2)(ii)** of this section, if an EGI is not evidenced by a separate note or other writing executed with respect to the initial principal balance or any increase in principal balance (for example, an EGI documented as a revolving credit agreement or an omnibus agreement that governs open account obligations)**, or any material changes to a creditor's rights**, the EGI satisfies the requirements of paragraph**s** (b)(2)(i) **and (b)(2)(ii)** of this section only if the material documentation associated with the EGI, including all relevant enabling documents, is prepared, maintained, and provided in accordance with the requirements of this section.

Finally, TEI also recommends that taxpayers have until the filing of their relevant tax returns to complete such documentation rather than within 30 days of issuing the EGI. This timeframe is more realistic given the breadth of required documentation and would significantly ease the administrative burden of the proposed regulations. There does not appear to be a policy reason to restrict the time to document a transaction to such a short window, as it is unclear how a failure to document an EGI more than 30 days after its issuance would facilitate earnings stripping, so long as the documentation is prepared by the time the taxpayer files its return. Moreover, as long as the documentation is in fact prepared by the return-filing deadline, it should be readily available for transmission to the IRS upon audit.

7. Non-Rebuttable Presumption and 72-Month Period of Prop. Treas. Reg. § 1.385-3

The non-rebuttable presumption of equity treatment required by Prop. Treas. Reg. § 1.385-3 is unreasonable and does not reflect the realities of possible business transactions. Although described as a "principal purpose" test, that section's funding rule includes a non-rebuttable presumption that a debt instrument is issued with a principal purpose of funding an applicable distribution or acquisition if the instrument is issued by the funding member during the period beginning 36 months before and ending 36 months after the applicable distribution or acquisition.

Although a similar per se rule has been included to address inversions and other outbound transfer issues under the I.R.C. §§ 7874 and 367 regulations, we believe this approach is not appropriate here. The proposed regulations cast a broad net, implicating a wide variety of routine non-tax motivated commercial activities and producing significant U.S. federal income tax complications. For example, if the funding rule applies, it can result in eliminating foreign tax credits, creating uncertainty in calculating earnings and profits ("E&P") and locating it within a group, shifting basis between debt instruments within a group, causing mismatches in the timing and character of income as between borrowings from third parties and intercompany loans recharacterized as stock, changing tax ownership of the borrower, and potentially resulting in fast-pay stock and listed transactions.

We recommend that the proposed regulations be modified to follow the approach taken in the conduit rules under Treas. Reg. §§ 1.881-3, I.R.C. § 956, and the disguised sale rules of I.R.C. § 707. Namely, the final regulations should treat the funding rules as anti-abuse rules serving to backstop the rules in Prop. Treas. Reg. § 1.385-3(b)(2), and the treatment as equity should be a rebuttable presumption. Thus, the funding rule should apply only in cases where a taxpayer makes a loan as part of a plan or arrangement that includes a distribution or acquisition described in Prop. Treas. Reg. § 1.385-3(b)(2) by the funded member and has a principal purpose of achieving substantially the same economic effect as a distribution of a debt instrument or use of a debt instrument to buy related-party stock. Accordingly, when borrowed funds are invested in working capital or other business investments, taxpayers should be permitted to demonstrate that the funds are used for capital investment. Taxpayers should also be permitted to demonstrate through tracing back-to-back borrowings, for example, if a foreign parent borrows and re-lends to a U.S. subsidiary within reasonable parameters.

In justifying the non-rebuttable presumption, the preamble of the proposed regulations states, "The Treasury Department and the IRS have determined that this non-rebuttable presumption is appropriate because money is fungible and because it is difficult for the IRS to establish the principal purposes of internal transactions."[5] We suggest that if a taxpayer can demonstrate a transaction has a principal purpose of creating bona fide debt, then the transaction should be treated as debt. If the rule remains a non-rebuttable presumption, it will unnecessarily complicate and increase the cost of a variety of legitimate business transactions.

[5] Notice of Proposed Rulemaking, 81 Fed. Reg. 20912, 20923 (April 8, 2016) (to be codified at 26 C.F.R. pt. 1).

In that regard, we also recommend shortening the 72-month period provided in Prop. Treas. Reg. § 1.385-3. This six-year window is unnecessarily long. Not only will taxpayers be unable to characterize their intercompany debt instruments with certainty at the time of execution, but the character of an instrument will remain uncertain for three years after that. If the government finalizes this rule, TEI recommends shortening the look-back and look-forward windows to 24 months simply to increase administrability and certainty.

8. Exception to the Extent of Earnings and Profits

Prop. Treas. Reg. § 1.385-3(c)(1) creates an exception to the per se rule by reducing the extent of the aggregate amount of any distributions or acquisitions described in Prop. Treas. Reg. §§ 1.385-3(b)(2) or (b)(3)(ii) by an amount equal to the member's current-year E&P. TEI commends Treasury and the IRS for including this exception. We suggest below two proposals that will make the exception more practical for taxpayers.

a. Earnings and Profits

Taxpayers should be free to make distributions of accumulated earnings without creating per se equity transactions, and, in this context, there is no principled distinction between current and accumulated E&P. Restricting the distribution of E&P is an unwarranted burden on business-motivated cash management decisions, which are based on a variety of commercial factors, including cash needs, projections, and currency considerations. Furthermore, limiting distributions to current E&P can be difficult for many reasons, including, for example, differences between U.S. GAAP and statutory accounting, statutory restrictions on the payment of interim dividends in many jurisdictions (*i.e.*, dividends paid in the same year that the earnings are generated), and the inability to accurately forecast current E&P as a result of unpredictable business changes. Because companies often cannot ascertain the true amount of their current E&P

until after their tax returns are filed, under the proposed rules these businesses must choose between risking a distribution in excess of current E&P, or making a smaller distribution. The latter may result in a portion of current E&P each year being converted to accumulated E&P that cannot subsequently be distributed without implicating the proposed regulations. Thus, we recommend modifying the E&P exception from the per se rule to include both current and accumulated E&P.

Alternatively, if an exception for total accumulated E&P is untenable, we recommend the E&P exception include current E&P as well as accumulated E&P from the previous two years, determined on a rolling basis. This two-year look-back period would ensure taxpayers have final undistributed earnings information for evaluating the amount of distributions they can make in a particular year without running afoul of the regulations and without permanently converting current earnings into earnings that cannot be distributed without implicating the regulations because of timing considerations. The suggested look-back rule would apply upon finalization regardless of whether the E&P were generated prior or subsequent to the regulations' effective date. Under the rule, any E&P not distributed by the end of the second taxable year after it is earned would become accumulated for purposes of applying the regulations, and distributing such long-term accumulated amounts would result in a transaction that could be covered by the per se rule.

b. Previously Taxed Income

We also recommend that previously taxed income ("PTI") be freely distributable without being subject to the proposed regulations. Taxpayers should not be penalized for distributing cash when such distributed earnings have already been taxed in the United States and there had never been a receipt of such cash. Subjecting these distributions to the per se rule would be fundamentally unfair. Accordingly final regulations should disregard distributions of PTI when calculating the amount of distributions in applying the regulations. Moreover, recharacterizing a loan to a distributing CFC into equity because of a PTI distribution is contrary to the general policy of ensuring that PTI distributions are tax-neutral, as PTI should not cause adverse tax consequences to the taxpayer (such as the aforementioned "lost" PTI).

9. Tangible Personal Property and Prop. Treas. Reg. § 1.385-3

The non-rebuttable presumption in the per se rule includes an exception for debt instruments issued in connection with certain ordinary-course intercompany purchases of currently deductible or inventory property, and provisions of services. We propose a further exception for all debt instruments issued in exchange for tangible personal property transferred in the ordinary course of business, provided the amount of the obligation outstanding at no time exceeds the amount that would be ordinary and necessary to carry on the trade or business of the issuer if it were unrelated to the lender. Tangible personal property used in the ordinary course of a business is routinely purchased on credit between related companies in ways offering little to no opportunity for aggressive tax planning, but the proposed regulations would likely extend to such transactions. For example, if Retailer A in Country A expected to have excess inventory in the coming quarter and sold that inventory to its sibling Retailer B in Country B, Retailer A might also sell its excess shelving on credit to Retailer B. While the inventory sold on credit would be excepted from the proposed regulations, the shelving sold on credit would fall under the proposed regulations. Both transactions are undertaken and meaningfully linked for business purposes, but the sale of the shelving might no longer be possible, practically speaking, under the proposed regulations. Costs and complexities associated with tracking such small-scale transactions solely for purposes of complying with the proposed regulations may be reason enough to discontinue or dramatically curtail such transactions. Furthermore, interest is frequently not charged on routine ordinary-course credit transactions. This is permissable under the safe harbor interest-rate rules in the I.R.C. § 482 regulations, and such non-interest credit transactions should be excepted from the proposed regulations as well.

10. Employee Stock Compensation

TEI recommends that bona fide employee stock compensation plans be excepted from the proposed regulations' documentation and recharacterization requirements. Many companies provide stock compensation to both management and non-management employees. Stock compensation typically takes the form of stock options or restricted stock units, which employees may exercise if and when they wish. Thus, stock-based transactions can take place as frequently as a daily basis and are under the control of the compensated employees. Parent companies have various ways of providing their stock as compensation to the employees of the parent's subsidiaries. Typically these transactions are structured in one of three different ways, each of which can be problematic under Prop. Treas. Reg. § 1.385-3(b)(2): (1) the subsidiary can purchase parent stock directly for cash, (2) the subsidiary can purchase parent stock for a deferred payment obligation, or (3) the parent company can provide the stock directly to the subsidiary employee. In the third payment method, I.R.C. § 1032 regulations treat the parent stock provided to a subsidiary for employee compensation as purchased by the subsidiary. As the proposed regulations are currently drafted, each of these methods would result in an acquisition of expanded group stock, and any related-party debt owed by the subsidiary would be treated as equity. Employee stock compensation, however, does not raise the earnings stripping concerns targeted by the proposed regulations. Thus, deemed or actual related-party payments for stock used to satisfy employee stock-compensation programs should be excepted from the scope of the final regulations.

11. Cash Pooling

One of the most significant challenges in the proposed regulations relates to the treatment of cash pooling. Cash pooling is a business process by which related entities cost-efficiently share and access cash for short-term liquidity needs. This section discusses how cash pooling works and why it is critical for ordinary, non-tax business purposes, as well as how the regulations should define and apply to cash pooling. We interpret Treasury's recent public statements as indicating any exceptions from the regulations for cash-pooling should not be so broad as to apply to virtually any intercompany debt financing. We also appreciate that cash is fungible and that tracing any particular dollar in debt funding is both difficult and of limited value. With these considerations in mind, we recommend the following changes to the proposed regulations.

a. Definition of a Cash Pool

We propose to define a "cash-pooling arrangement" as:

> *Any mechanism used among members of an affiliated group of companies to aggregate and offset cash balances in order to meet members' short-term cash needs and access short-term cash surpluses.*

For example, consider an affiliated group of companies with profitable operations in multiple countries and among multiple legal entities. Despite each companies' respective profitability, on any given day, the amount of cash on hand may be greater or less than the companies' cash requirements, whether because of the timing of converting current assets such as accounts receivable and inventory, into cash, or paying current liabilities. Even profitable companies need a mechanism to borrow and deposit funds on a short-term basis. While this need could be satisfied through third-party borrowing, this is an expensive and inefficient way to fund liquidity needs and is the primary reason companies pool their cash.

b. The Mechanics of Cash Pooling

Cash pooling that does not use a third-party lender, often referred to as "zero balancing," involves the physical movement of cash from one account to a header account (referred to as a master account) held by the cash-pool head. All cash balances in participating accounts are physically transferred to the header account. There are a number of ways to engage in physical cash pooling:

- *Automated sweep*. At a specified time toward the end of the business day, balances are automatically swept from participating accounts to the header account. The size of the transferred balance can vary. The simplest form of sweep is a zero-balancing pool. This reduces all balances on participating accounts to zero. When an account runs a deficit, the transfer takes the form of a payment from the header account.
- *Compulsory participation in an in-house bank*. Companies sometimes require group entities to participate in an in-house bank, which results in a de facto physical cash pool. In this form, cash is concentrated at the in-house bank, as group entities are required to hold bank accounts with the in-house bank rather than with an external bank.
- *Discretionary participation on periodic basis*. In this form, balances are pooled when cash surpluses reach a certain level, or they are regularly pooled on a weekly, monthly, or quarterly basis, at the discretion of an authorized individual.

c. Economic Rationale for Cash Pooling

Financial professionals who serve in the treasury function of businesses are under constant pressure to manage cash efficiently while at the same time minimizing risks to their organizations. For those in international businesses, the challenges involved in managing cash are multiplied by, among other things, the complex nature of international regulations and varying global banking practices.

The core challenge for all treasury professionals is to ensure visibility of their group's cash positions globally. Having clear knowledge of each operating entity's cash position can help ensure the entity is funded as economically as possible and that any surplus cash is invested safely. In addition, complete and accurate visibility of cash positions helps the group treasury function identify risk exposure and develop strategies to manage them. The greater the number of group bank accounts and the number of currencies in which they are denominated, the more difficult it is for the group treasury to monitor and manage account balances.

Mobilizing cash on a global basis with cash pools helps the group treasury operate more efficiently. These structures allow balances on the various bank accounts to be aggregated, typically by currency, so the group can more easily identify accounts with cash surpluses and shortfalls requiring funding. Where cash is pooled on a cross-border basis, intercompany transactions are part of the structure, allowing automatic funding for entities with a cash requirement. At the same time, these structures help the group treasury understand its foreign exchange positions and ensure they are hedged appropriately.

It is much less expensive for companies to deploy their excess cash within the group rather than borrow locally from commercial banks.[6] For example, assume an affiliated group forms four

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[6] Rate disparities between cash pooling and third-party lending are permissible under I.R.C. § 482 by way of the safe-haven provision of Treas. Reg. § 1.482-2(a)(2)(iii)(B).

new companies that start operations on the first day of the tax year with the following anticipated next-day cash flows at the end of their first three days of operations:

Example 1: Affiliated Group Commences New Operations through Companies 1-4

Day 1	Company 1	Company 2	Company 3	Company 4	Totals
Anticipated Day 2 Cash Inflows	10	4	7	5	26
Anticipated Day 2 Cash Outflows	-5	-12	-6	-2	-25
Cumulative Cash Flow	5	-8	1	3	1
Day 2					
Anticipated Day 3 Cash Inflows	8	9	2	5	24
Anticipated Day 3 Cash Outflows	-6	-3	-5	-2	-16
Cumulative Cash Flow	7	-2	-2	6	9
Day 3					
Anticipated Day 4 Cash Inflows	5	3	7	5	20
Anticipated Day 4 Cash Outflows	-8	-4	-9	-5	-26
Cumulative Cash Flow	4	-3	-4	6	3

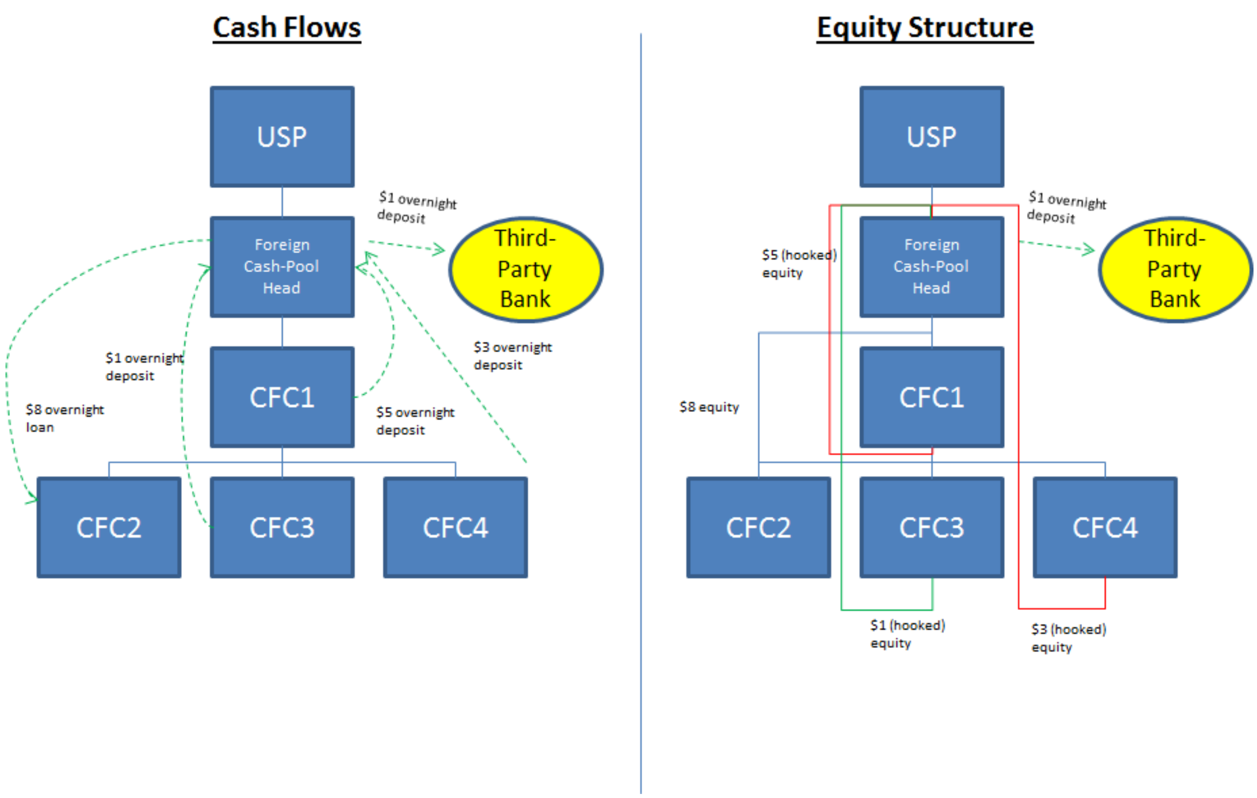
To meet their Day 2 cash flow needs, Companies 1, 3, and 4 could individually deposit their excess cash with a local, third-party bank, and Company 2 could borrow $8 from its local bank. Alternatively, however, the Companies could enter into a cash-pooling arrangement permitting the four participants to meet their short-term cash requirements and deposit excess cash on a short-term basis. Company 3 may be a depositor on Day 1 but a net borrower on Days 2 and 3. A cash-pooling arrangement allows it to adjust its local cash balances without requiring daily determinations by the cash-pool head of each borrower's ability to repay and by each depositor of the cash-pool head's ability to repay the former's deposit.

d. Why Exceptions for Cash Pooling Are Warranted

Companies engage in cash pooling to ensure sufficient liquidity at the lowest possible cost to the group. An affiliate in a cash pool may be a borrower one day but a depositor the next. By this very nature, companies would suffer a material burden of their cash-pooling arrangements if they had to meet the documentation requirements of Prop. Treas. Reg. § 1.385-2. Cash balances subject to pooling can and often do fluctuate significantly. For example, compare payroll dates requiring cash outflows to receivable settlement dates resulting in cash inflows. Applying documentation requirements of the proposed regulations to standard cash-pooling arrangements would be exceedingly difficult for taxpayers to satisfy – and for the IRS to audit: Absent relaxation of the existing documentation requirements for cash pooling, each daily change in balance might be viewed as a discrete debt issuance subject to the new rules. If this were the case, the ownership structure of a typical multinational would change daily. Using the data provided in Example 1, Group ownership structure would change as follows (assuming the Group commences operations on Day 1, and deposits and borrows in accordance with next-day cash requirements):

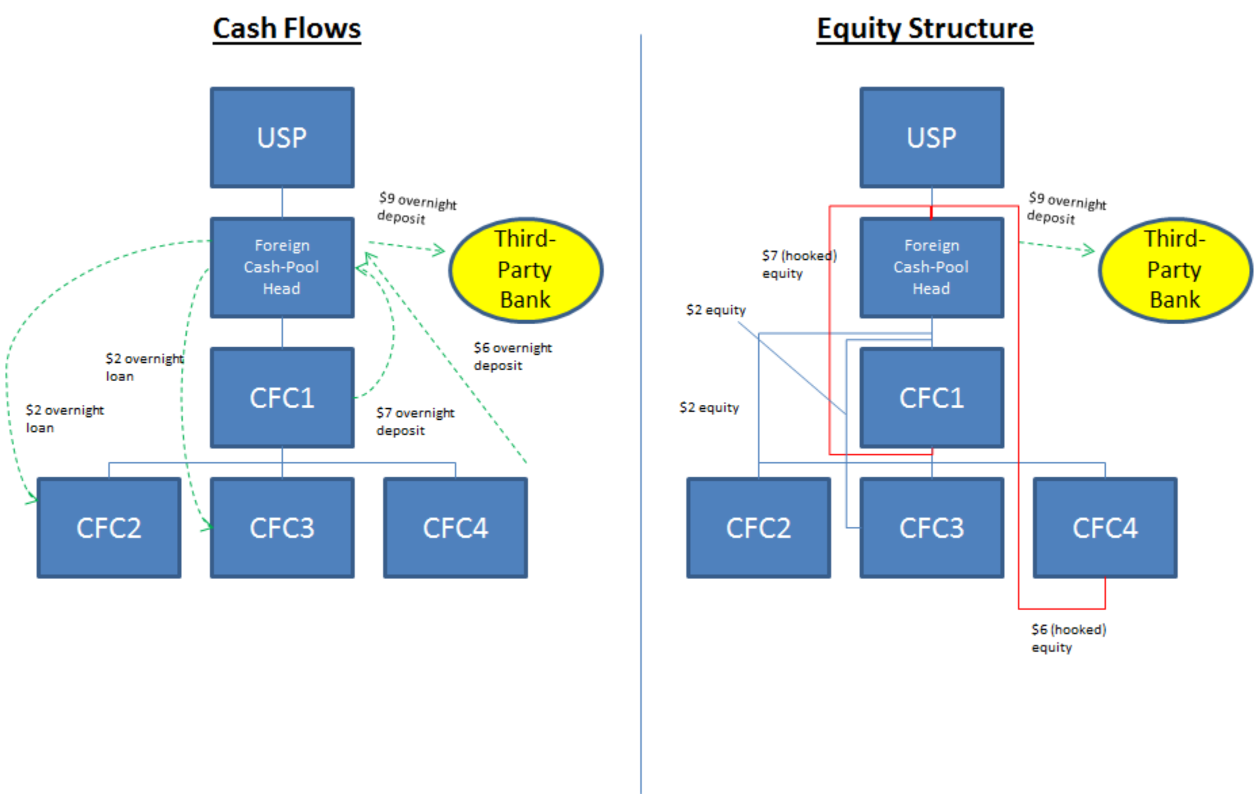
Example 2: Daily Change in Equity Structure from Cash Pooling

<u>Day 1 Cash Pooling</u>



Under this scenario, in a normal cash-pooling arrangement, CFC1, CFC3, and CFC4's Day 1 deposits in the cash-pool head would be immediately recharacterized as "hooked" stock in the head by virtue of failing to document its ability to repay their deposits as required under the four-prong documentation requirement. For the same failure, the cash-pool head would hold an $8 equity interest in CFC2.

<u>Day 2 Cash Pooling – Cumulative Balances</u>

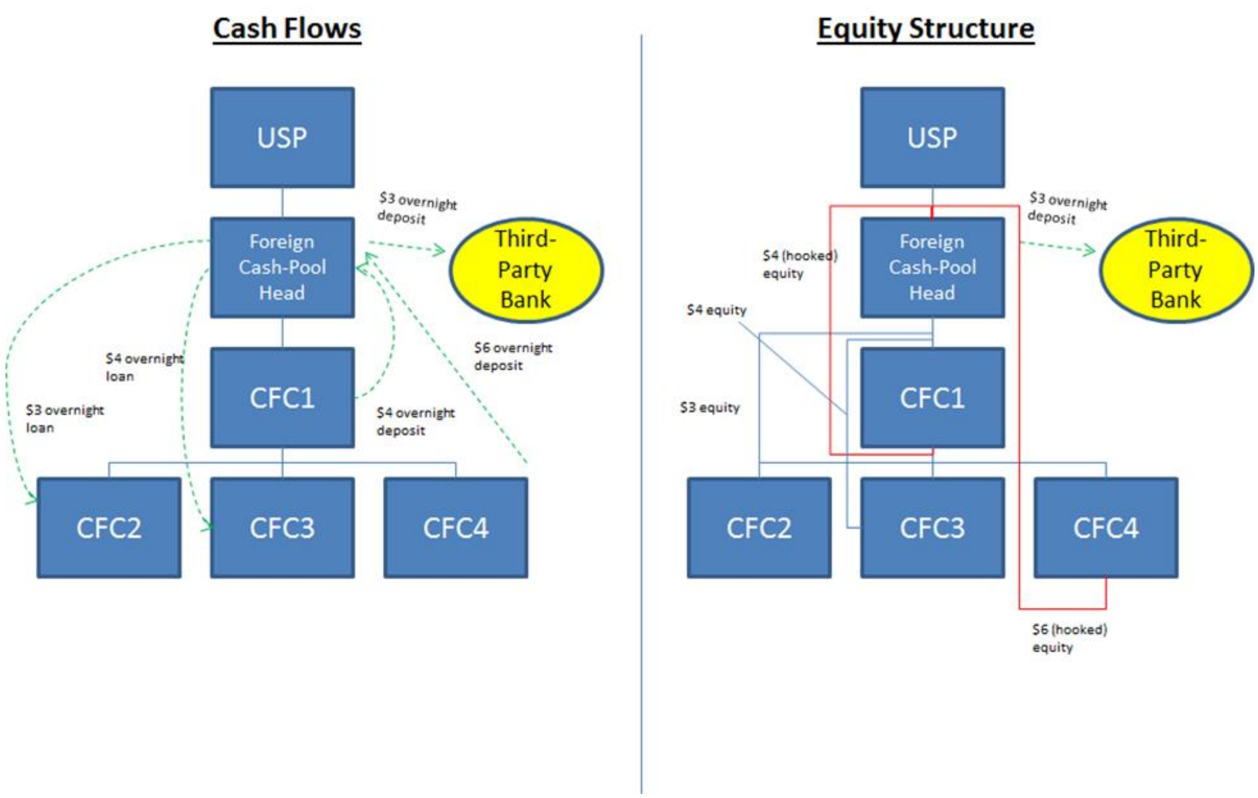


From Day 1 to Day 2, the cash-pool head's loan balance to CFC2 has gone from $8 to $2. Under the proposed regulations, this would reflect an equity redemption by the head in its recharacterized (Day 1) equity interest in CFC2, with a corresponding transfer of earnings E&P (as well as foreign tax credits, unlikely to be creditable due to a lack of voting rights) from CFC2 to the head. CFC2's E&P would not be determined before the end of the tax year, so CFC2 would not know at the time of this redemption whether it is a dividend or a return of basis.

CFC3, in turn, has gone from being a depositor to a borrower due to its change in cash balance, representing its Day 2 redemption of the $1 hooked stock in the cash-pool head issued on Day 1 and a recharacterized equity investment by the head to CFC3 at the end of Day 2.

CFC1 has increased its equity interest in the parent on Day 2 from $5 to $7, and in CFC4 from $3 to $6.

<u>Day 3 Cash Pooling – Cumulative Balances</u>



At the end of Day 3, CFC1's deposit has dropped from $7 to $4, representing a $3 Day 3 redemption of a portion of its $7 Day 2 equity in the cash-pool head with a corresponding E&P (and non-creditable foreign income tax) transfer from the head to CFC1.

While the practical consequences of the proposed rules are hard to know until the last day of the tax year, including how to order the E&P inclusions (Does the cash-pool head first include its Day 2 deemed redemption of CFC2 shares before CFC1 determines how much E&P it receives in its Day 3 redemption of its equity in the cash-pool head?), the group is only into the third day of the year.

e. Proposed Exceptions for Cash Pooling

Commensurate with the definition of cash pooling stated above, we propose that cash-pooling arrangements be excepted from the documentation and recharacterization requirements of Prop. Treas. Regs. §§ 1.385-2 and 1.385-3. Cash pooling arrangements merely facilitate the netting of affiliated entities' trade receivables and payables arising in the ordinary course of business. Our proposed exception is similar to that provided in Treas. Reg. § 1.881-3(b)(3)(ii)(b)(3) (and illustrated in Treas. Reg. § 1.881-3(e), Example 22), which provides an exception to the application of those regulations' conduit rules for intercompany cash management systems involving the operation of a sweep account to net ordinary course payables and receivables of affiliates. An exception is warranted in the current context because cash pooling related to ordinary-course trade receivables and payables gives little opportunity for inappropriate earnings stripping, which is at the heart of the proposed regulations.

Separately, due to the widespread use of cash pooling prior to issuance of the proposed regulations, many taxpayers have cash-pool balances at either affiliates or heads that are properly treated as debt for U.S. federal income tax purposes under preexisting rules. We believe the proposed regulations intend to leave prior debt financing in place and thus exclude debt issued prior to April 4, 2016 from the documentation requirements of Prop. Treas. Reg. § 1.385-2 and from recharacterization under the funding rule of Prop. Treas. Reg. § 1.385-3. Based on this general intent, we assume, but request confirmation that, debt balances in place on April 3, 2016 pursuant to a cash-pooling arrangements are grandfathered and therefore would not be subject to Prop. Treas. Regs. §§ 1.385-2 or 1.385-3, and that taxpayers will be permitted to remove such pre-

April 4th debt balances from their cash-pooling arrangements and place them into different debt programs (such as into a long-term debt financing).

12. Validity of Prop. Treas. Reg. § 1.385-3

TEI is also concerned that the proposed regulations exceed Treasury's administrative authority to issue regulations under I.R.C. § 385.

The preamble to the proposed regulations states they are issued under authority granted by I.R.C. § 385. Although I.R.C. § 385 clearly grants regulatory authority, it also constrains that authority. I.R.C. § 385(b) states, "The regulations prescribed under this section shall set forth factors which are to be taken into account in determining with respect to a particular factual situation whether a debtor-creditor relationship exists or a corporation-shareholder relationship exists." That section then provides five factors that may, among other factors, be used to determine administratively whether the IRS should recharacterize debt as equity. The proposed regulations' preamble states that the legislative history explains that regulations promulgated under I.R.C. § 385 need not rely on the five listed factors set forth in I.R.C. § 385(b), which is true. However, neither the legislative history nor the statute itself authorizes the adoption of regulations allowing the IRS to make per se determinations as to when debt is equity for tax purposes. The plain language of the statute – "factors which are to be taken into account in determining with respect to a particular factual situation whether a debtor-creditor relationship exists" – contemplates a debt-to-equity recharacterization occuring on a case-by-case basis, based on the particular instrument's characteristics. Prop. Treas. Reg. § 1.385-3 does just the opposite, however, determining that certain debt transactions in certain circumstances must be recharacterized as equity without regard to the subject debt instruments' characteristics. Indeed, the proposed regulations require equity characterization even if the instrument is characterized as debt under existing case law and IRS administrative pronouncements.

Under the law, courts

> must accept an agency's authoritative interpretation of an ambiguous statutory provision if the agency's interpretation is reasonable. In determining whether a statute is ambiguous and in ultimately determining whether the agency's interpretation is permissible or instead is foreclosed by the statute, we must employ all the tools of statutory interpretation, including text, structure, purpose, and legislative history. No matter how it is framed, the question a court faces when confronted with an agency's interpretation of a statute it administers is always, simply, whether the agency has stayed within the bounds of its statutory authority.[7]

The plain language of I.R.C. § 385(b) does not explicitly or implicitly provide for per se debt-to-equity recharacterizations. As a result of the per se rule, two debt instruments that are identical in all other terms could be subject to opposite characterizations simply because one is issued to a third-party bank and the other to an affiliated lender. This inappropriately elevates form over substance and exceeds the rulemaking authority granted by Congress. There is no indication Congress intended I.R.C. § 385 to be a mechanism for curtailing disfavored distributions between corporations and their shareholders. The types of transactions contemplated by Prop. Treas. Reg. § 1.385-3 might raise policy concerns, but we respectfully assert Treasury and the IRS do not have the regulatory authority to recharacterize them as equity transactions on a wholesale, per se basis.

* * *

[7] *Loving v. Internal Revenue Serv.*, 742 F.3d 1013, 1016 (D.C. Cir. 2014) (internal citations omitted).

Tax Executives Institute appreciates this opportunity to present its views on the proposed regulations in REG-108060-15. If you have any questions about these comments, please contact Mark Pollard, chair of TEI's U.S. International Tax Committee, at (920) 721-4325 or Mark.Pollard@kcc.com or John L. Schoenecker, Tax Counsel at TEI, at (202) 470-3600 or jschoenecker@tei.org.

Respectfully submitted,

TAX EXECUTIVES INSTITUTE, INC.

C.N. Macfarlane

C.N. (Sandy) Macfarlane
International President