INTERNAL REVENUE
BULLETIN

IRS

HIGHLIGHTS OF THIS ISSUE

Bulletin No. 2016–17
April 25, 2016

These synopses are intended only as aids to the reader in identifying the subject matter covered. They may not be relied upon as authoritative interpretations.

INCOME TAX

REG–108060–15, page 636.

This document contains proposed regulations under section 385 of the Internal Revenue Code (Code) that would authorize the Commissioner to treat certain related party interests in a corporation as indebtedness in part and stock in part for federal tax purposes, and establish threshold documentation requirements that must be satisfied in order for certain related party interests in a corporation to be treated as indebtedness for federal tax purposes. The proposed regulations also would treat as stock certain related party interests that otherwise would be treated as indebtedness for federal tax purposes. The proposed regulations generally affect corporations that issue purported indebtedness to related corporations or partnerships.

Rev. Proc. 2016–18, page 635.

This revenue procedure provides an updated list of countries with which the IRS and Treasury have determined that it is appropriate to have an automatic exchange relationship with respect to the bank deposit interest information collected under Sections 1.6049–4(b)(5) and 1.6049–8 of the Income Tax Regulations. This revenue procedure is a March 2016 supplement to Rev. Proc. 2014–64, 2014–53 I.R.B. 1022, which was last supplemented by Rev. Proc. 2015–50, 2015–42 I.R.B 583 in September 2015.

EXEMPT ORGANIZATIONS

Announcement 2016–15, page 636.

Revocation of IRC 501(c)(3) Organizations for failure to meet the code section requirements. Contributions made to the organizations by individual donors are no longer deductible under IRC 170(b)(1)(A).

Finding Lists begin on page ii.

The IRS Mission

Provide America's taxpayers top-quality service by helping them understand and meet their tax responsibilities and enforce the law with integrity and fairness to all.

Introduction

The Internal Revenue Bulletin is the authoritative instrument of the Commissioner of Internal Revenue for announcing official rulings and procedures of the Internal Revenue Service and for publishing Treasury Decisions, Executive Orders, Tax Conventions, legislation, court decisions, and other items of general interest. It is published weekly.

It is the policy of the Service to publish in the Bulletin all substantive rulings necessary to promote a uniform application of the tax laws, including all rulings that supersede, revoke, modify, or amend any of those previously published in the Bulletin. All published rulings apply retroactively unless otherwise indicated. Procedures relating solely to matters of internal management are not published; however, statements of internal practices and procedures that affect the rights and duties of taxpayers are published.

Revenue rulings represent the conclusions of the Service on the application of the law to the pivotal facts stated in the revenue ruling. In those based on positions taken in rulings to taxpayers or technical advice to Service field offices, identifying details and information of a confidential nature are deleted to prevent unwarranted invasions of privacy and to comply with statutory requirements.

Rulings and procedures reported in the Bulletin do not have the force and effect of Treasury Department Regulations, but they may be used as precedents. Unpublished rulings will not be relied on, used, or cited as precedents by Service personnel in the disposition of other cases. In applying published rulings and procedures, the effect of subsequent legislation, regulations, court decisions, rulings, and procedures must be considered, and Service personnel and others concerned are cautioned against reaching the same conclusions in other cases unless the facts and circumstances are substantially the same.

The Bulletin is divided into four parts as follows:

Part I.—1986 Code.
This part includes rulings and decisions based on provisions of the Internal Revenue Code of 1986.

Part II.—Treaties and Tax Legislation.
This part is divided into two subparts as follows: Subpart A, Tax Conventions and Other Related Items, and Subpart B, Legislation and Related Committee Reports.

Part III.—Administrative, Procedural, and Miscellaneous.
To the extent practicable, pertinent cross references to these subjects are contained in the other Parts and Subparts. Also included in this part are Bank Secrecy Act Administrative Rulings. Bank Secrecy Act Administrative Rulings are issued by the Department of the Treasury's Office of the Assistant Secretary (Enforcement).

Part IV.—Items of General Interest.
This part includes notices of proposed rulemakings, disbarment and suspension lists, and announcements.

The last Bulletin for each month includes a cumulative index for the matters published during the preceding months. These monthly indexes are cumulated on a semiannual basis, and are published in the last Bulletin of each semiannual period.

Part III. Administrative, Procedural, and Miscellaneous

26 CFR 1.6049.00–00: Returns Relating to Payments of Interest
(Also: 1.3406.07–00 Exceptions to Backup Withholding)

Rev. Proc. 2016–18

SECTION 1. PURPOSE

This revenue procedure supplements the listing in Revenue Procedure 2014–64, 2014–53 I.R.B. 1022, as previously supplemented by Rev. Proc. 2015–50, 2015–42 I.R.B. 583, of the countries with which the Department of the Treasury (Treasury Department) and the Internal Revenue Service (IRS) have determined that it is appropriate to have an automatic exchange relationship with respect to the information collected under §§ 1.6049–4(b)(5) and 1.6049–8 of the Income Tax Regulations.

SECTION 2. BACKGROUND

Sections 1.6049–4(b)(5) and 1.6049–8(a), as revised by TD 9584, require the reporting of certain deposit interest paid to nonresident alien individuals on or after January 1, 2013. Rev. Proc. 2012–24, 2012–20 I.R.B. 913, was published contemporaneously with the publication of TD 9584. Section 4 of that revenue procedure identified the countries with which the Treasury Department and the IRS had determined that it was appropriate to have an automatic exchange relationship with respect to the information collected under §§ 1.6049–4(b)(5) and 1.6049–8. Rev. Proc. 2012–24 was updated and superseded by Rev. Proc. 2014–64, Section 4 of which contained an updated list of countries with which an automatic exchange relationship had been determined appropriate. Rev. Proc. 2014–64 was supplemented by Rev. Proc. 2015–50, which added 16 countries to that list. This revenue procedure further supplements Rev. Proc. 2014–64 by adding three countries (Azerbaijan, Jamaica, and the Slovak Republic) to the list of countries in Section 4 of Rev. Proc. 2014–64.

SECTION 3. SUPPLEMENT TO REV. PROC. 2014–64

Section 4 of Rev. Proc. 2014–64, as supplemented by Rev. Proc. 2015–50, is further supplemented to read as follows:

The following list identifies the countries with which the automatic exchange of the information collected under §§ 1.6049–4(b)(5) and 1.6049–8 has been determined by the Treasury Department and the IRS to be appropriate:

Australia
Azerbaijan
Brazil
Canada
Czech Republic
Denmark
Estonia
Finland
France
Germany
Gibraltar
Guernsey
Hungary
Iceland
India
Ireland
Isle of Man
Italy
Jamaica
Jersey
Latvia
Liechtenstein
Lithuania
Luxembourg
Malta
Mauritius
Mexico
Netherlands
New Zealand
Norway
Poland
Slovak Republic
Slovenia
South Africa
Spain
Sweden
United Kingdom

SECTION 4. EFFECT ON OTHER DOCUMENTS

Rev. Proc. 2014–64, as supplemented by Rev. Proc. 2015–50, is further supplemented.

SECTION 5. DRAFTING INFORMATION

The principal author of this revenue procedure is Jackie Bennett Manasterli of the Office of Associate Chief Counsel (International). For further information regarding this revenue procedure contact Ms. Manasterli at (202) 317-5218 (not a toll-free number).

Part IV. Items of General Interest

Deletions From Cumulative List of Organizations, Contributions to Which are Deductible Under Section 170 of the Code

Announcement 2016–15

Table of Contents

The Internal Revenue Service has revoked its determination that the organizations listed below qualify as organizations described in sections 501(c)(3) and 170(c)(2) of the Internal Revenue Code of 1986.

Generally, the IRS will not disallow deductions for contributions made to a listed organization on or before the date of announcement in the Internal Revenue Bulletin that an organization no longer qualifies. However, the IRS is not precluded from disallowing a deduction for any contributions made after an organization ceases to qualify under section 170(c)(2) if the organization has not timely filed a suit for declaratory judgment under section 7428 and if the contributor (1) had knowledge of the revocation of the ruling or determination letter, (2) was aware that such revocation was imminent, or (3) was in part responsible for or was aware of the activities or omissions of the organization that brought about this revocation.

If on the other hand a suit for declaratory judgment has been timely filed, contributions from individuals and organizations described in section 170(c)(2) that are otherwise allowable will continue to be deductible. Protection under section 7428(c) would begin on April 25, 2016 and would end on the date the court first determines the organization is not described in section 170(c)(2) as more particularly set for in section 7428(c)(1). For individual contributors, the maximum deduction protected is $1,000, with a husband and wife treated as one contributor. This benefit is not extended to any individual, in whole or in part, for the acts or omissions of the organization that were the basis for revocation.

NAME OF ORGANIZATION	Effective Date of Revocation	LOCATION
Cloverfield 180, Inc.	January 1, 2013	Van Wert, Ohio
Texas Cave Conservancy	January 1, 2012	Cedar Park, TX

Notice of Proposed Rulemaking Treatment of Certain Interests in Corporations as Stock or Indebtedness

REG–108060–15

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking.

SUMMARY: This document contains proposed regulations under section 385 of the Internal Revenue Code (Code) that would authorize the Commissioner to treat certain related-party interests in a corporation as indebtedness in part and stock in part for federal tax purposes, and establish threshold documentation requirements that must be satisfied in order for certain related-party interests in a corporation to be treated as indebtedness for federal tax purposes. The proposed regulations also would treat as stock certain related-party interests that otherwise would be treated as indebtedness for federal tax purposes. The proposed regulations generally affect corporations that issue purported indebtedness to related corporations or partnerships.

DATES: Written or electronic comments and requests for a public hearing must be received by July 7, 2016.

ADDRESSES: Send submissions to: CC: PA:LPD:PR (REG–108060–15), room 5203, Internal Revenue Service, P.O. Box 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand-delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to CC:PA:LPD:PR (REG–108060–15), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue NW, Washington, DC 20224 or sent electronically via the Federal eRulemaking Portal at *http://www.regulations.gov* (IRS REG–108060–15).

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations under §§ 1.385–1 and 1.385–2, Eric D. Brauer, (202) 317-5348; concerning the proposed regulations under §§ 1.385–3 and 1.385–4, Raymond J. Stahl, (202) 317-6938; concerning submissions of comments or requests for a public hearing, Regina Johnson, (202) 317-5177 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collection of information contained in this notice of proposed rulemaking has been submitted to the Office of Management and Budget in accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3507(d)). Comments on the collection of information should be sent to the Office of Management and Budget, Attn: Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503, with copies to the Internal Revenue Service, Attn: IRS Reports Clearance Officer, SE:W:CAR:MP:T:T:SP, Washington, DC 20224. Comments on the collection of information should be received by June 7, 2016. Comments are specifically requested concerning:

Whether the proposed collection of information is necessary for the proper per-

formance of the functions of the IRS, including whether the information will have practical utility;

The accuracy of the estimated burden associated with the proposed collection of information;

How the quality, utility, and clarity of the information to be collected may be enhanced;

How the burden of complying with the proposed collection of information may be minimized, including through the application of automated collection techniques or other forms of information technology; and

Estimates of capital or start-up costs and costs of operation, maintenance, and purchase of services to provide information.

The collection of information in this proposed regulation is in *§ 1.385–2(b)(2)*. This collection of information is necessary to determine whether certain interests between members of an expanded affiliated group are to be treated as stock or indebtedness for federal tax purposes. The likely respondents are entities that are affiliates of publicly traded entities or meet certain thresholds on their financial statements.

Estimated total annual reporting burden: 735,000 hours.

Estimated average annual burden per respondent: 35 hours.

Estimated number of respondents: 21,000.

Estimated frequency of responses: Monthly.

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a valid control number assigned by the Office of Management and Budget.

Background

As described further in this preamble, courts historically have analyzed whether an interest in a corporation should be treated as stock or indebtedness for federal tax purposes by applying various sets of factors to the facts of a particular case. In 1969, Congress enacted section 385 to authorize the Secretary of the Treasury (Secretary) to prescribe such regulations as may be necessary or appropriate to determine whether an interest in a corporation is to be treated as stock or indebtedness for purposes of the Code. Because no regulations are currently in effect under section 385, the case law that developed before the enactment of section 385 has continued to evolve and to control the characterization of an interest in a corporation as debt or equity.

I. *Section 385 Statute and Legislative History*

A. *Original Enactment of Section 385*

Section 385(a), as originally enacted as part of the Tax Reform Act of 1969 (Pub. L. No. 91–172, 83 Stat. 487), authorizes the Secretary to prescribe such regulations as may be necessary or appropriate to determine whether an interest in a corporation is treated as stock or indebtedness for purposes of the Code.

Section 385(b) provides that the regulations prescribed under section 385 shall set forth factors that are to be taken into account in determining in a particular factual situation whether a debtor-creditor relationship exists or a corporation-shareholder relationship exists. Under section 385(b), those factors may include, among other factors, the following: (1) whether there is a written unconditional promise to pay on demand or on a specified date a sum certain in money in return for an adequate consideration in money or money's worth, and to pay a fixed rate of interest; (2) whether there is subordination to or preference over any indebtedness of the corporation; (3) the ratio of debt to equity of the corporation; (4) whether there is convertibility into the stock of the corporation; and (5) the relationship between holdings of stock in the corporation and holdings of the interest in question.

In enacting section 385(a) and (b), Congress authorized the Secretary to prescribe targeted rules to address particular factual situations, stating:

> In view of the uncertainties and difficulties which the distinction between debt and equity has produced in numerous situations . . . the committee further believes that it would be desirable to provide rules for distinguishing debt from equity in the variety of contexts in which this problem can arise. The differing circumstances which characterize these situations, however, would make it difficult for the committee to provide comprehensive and specific statutory rules of universal and equal applicability. In view of this, the committee believes it is appropriate to specifically authorize the Secretary of the Treasury to prescribe the appropriate rules for distinguishing debt from equity in these different situations.

S. Rep. No. 91–552, at 138 (1969). The legislative history further explains that regulations applicable to a particular factual situation need not rely on the factors set forth in section 385(b):

> The provision also specifies certain factors which may be taken into account in these [regulatory] guidelines. It is not intended that only these factors be included in the guidelines or that, with respect to a particular situation, any of these factors must be included in the guidelines, or that any of the factors which are included by statute must necessarily be given any more weight than other factors added by regulations.

Id. Accordingly, section 385(b) provides the Secretary with discretion to establish specific rules for determining whether an interest is treated as stock or indebtedness for federal tax purposes in a particular factual situation.

B. *1989 and 1992 Amendments to Section 385*

Congress amended section 385 in 1989 and 1992. In 1989, the Omnibus Budget Reconciliation Act of 1989 (Pub. L. No. 101–239, 103 Stat. 2106) amended section 385(a) to expressly authorize the Secretary to issue regulations under which an interest in a corporation is to be treated as in part stock and in part indebtedness. This amendment also provides that any regulations so issued may apply only with respect to instruments issued after the date on which the Secretary or the Secretary's delegate provides public guidance as to the characterization of such instruments (whether by regulation, ruling, or otherwise). *See* Pub. L. No. 101–239, sec. 7208(a)(2). The legislative history to the 1989 amendment notes that, while "[t]he characterization of an investment in a corporation as debt or equity for Federal income tax purposes generally is deter-

mined by reference to numerous factors, . . . there has been a tendency by the courts to characterize an instrument entirely as debt or entirely as equity." H.R. Rep. No. 101–386, at 3165–66 (1989) (Conf. Rep.).

In 1992, Congress added section 385(c) to the Code as part of the Energy Policy Act of 1992 (Pub. L. No. 102–486, 106 Stat. 2776). Section 385(c)(1) provides that the issuer's characterization (as of the time of issuance) as to whether an interest in a corporation is stock or indebtedness shall be binding on such issuer and on all holders of such interest (but shall not be binding on the Secretary). Section 385(c)(2) provides that, except as provided in regulations, section 385(c)(1) shall not apply to any holder of an interest if such holder on his return discloses that he is treating such interest in a manner inconsistent with the initial characterization of the issuer. Section 385(c)(3) authorizes the Secretary to require such information as the Secretary determines to be necessary to carry out the provisions of section 385(c), including the information necessary for the Secretary to determine how the issuer characterized an interest as of the time of issuance.

Congress added section 385(c) in response to issuers and holders characterizing a corporate instrument inconsistently. H.R. Rep. No. 102–716, at 3 (1992). For example, a corporate issuer may designate an instrument as indebtedness for federal tax purposes and deduct as interest the amounts paid on the instrument, while a corporate holder may treat the instrument as stock for federal tax purposes and claim a dividends received deduction with respect to the amounts paid on the instrument. *See id.*

II. *Regulations*

There are no regulations currently in effect under section 385. On March 24, 1980, the Department of the Treasury (Treasury Department) and the IRS published a notice of proposed rulemaking (LR–1661) in the **Federal Register** (45 FR 18959) under section 385 relating to the treatment of certain interests in corporations as stock or indebtedness. Final regulations (TD 7747) were published in the **Federal Register** (45 FR 86438) on December 31, 1980. Subsequent revisions of the final regulations were published in the **Federal Register** on May 4, 1981, January 5, 1982, and July 2, 1982 (46 FR 24945, 47 FR 147, and 47 FR 28915, respectively). The Treasury Department and the IRS published a notice of proposed withdrawal of TD 7747 in the **Federal Register** on July 6, 1983 (48 FR 31053), and in TD 7920, published in the **Federal Register** (48 FR 50711) on November 3, 1983, the Treasury Department and the IRS withdrew TD 7747.

The Treasury Department and the IRS have not previously published any regulations regarding the 1989 amendment to section 385(a), which authorizes the Secretary to issue regulations that treat an interest in a corporation as indebtedness in part or as stock in part. In addition, no regulations have been published with respect to the 1992 addition of section 385(c) authorizing the Secretary to require information related to an issuer's initial characterization of an interest for federal tax purposes or to affect the ability of a holder to treat an interest inconsistent with the initial treatment of the issuer.

III. *Case Law*

In the absence of regulations under section 385, the pre-1969 case law has continued to evolve and control the characterization of an interest as debt or equity for federal tax purposes. Under that case law, courts apply inconsistent sets of factors to determine if an interest should be treated as stock or indebtedness, subjecting substantially similar fact patterns to differing analyses. The result has been a body of case law that perpetuates the "uncertainties and difficulties which the distinction between debt and equity has produced" and with which Congress expressed concern when enacting section 385. *See* S. Rep. No. 91–552, at 138. For example, in *Fin Hay Realty Co. v. United States*, 398 F.2d 694 (3d Cir. 1968), the U.S. Court of Appeals for the Third Circuit identified sixteen factors relevant for distinguishing between indebtedness and stock:

> (1) the intent of the parties; (2) the identity between creditors and shareholders; (3) the extent of participation in management by the holder of the instrument; (4) the ability of the corporation to obtain funds from outside sources; (5) the 'thinness' of the capital structure in relation to debt; (6) the risk involved; (7) the formal indicia of the arrangement; (8) the relative position of the obligees as to other creditors regarding the payment of interest and principal; (9) the voting power of the holder of the instrument; (10) the provision of a fixed rate of interest; (11) a contingency on the obligation to repay; (12) the source of the interest payments; (13) the presence or absence of a fixed maturity date; (14) a provision for redemption by the corporation; (15) a provision for redemption at the option of the holder; and (16) the timing of the advance with reference to the organization of the corporation.

Id. at 696. By contrast, in *Estate of Mixon v. United States*, 464 F.2d 394 (5th Cir. 1972), the U.S. Court of Appeals for the Fifth Circuit identified thirteen factors that are similar to, but not the same as, those used in *Fin Hay* to distinguish between indebtedness and stock:

> (1) the names given to the certificates evidencing the indebtedness; (2) The presence or absence of a fixed maturity date; (3) The source of payments; (4) The right to enforce payment of principal and interest; (5) participation in management flowing as a result; (6) the status of the contribution in relation to regular corporate creditors; (7) the intent of the parties; (8) 'thin' or adequate capitalization; (9) identity of interest between creditor and stockholder; (10) source of interest payments; (11) the ability of the corporation to obtain loans from outside lending institutions; (12) the extent to which the advance was used to acquire capital assets; and (13) the failure of the debtor to repay on the due date or to seek a postponement.

Id. at 402. The weight given to the various factors in a particular case also differs, and is highly dependent upon the relevant facts and circumstances. *See, e.g.*, *J.S. Biritz Construction Co. v. Commissioner*, 387 F.2d 451, 456–57 (8th Cir. 1967) (stating that the factors "have varying degrees of relevancy, depending on the particular factual situation and are

generally not all applicable to any given case").

Under this facts-and-circumstances analysis, as developed in the case law, no single fact or circumstance is sufficient to establish that an interest should be treated as stock or indebtedness. *See, e.g.*, *John Kelley Co. v. Commissioner*, 326 U.S. 521, 530 (1946) ("[N]o one characteristic . . . can be said to be decisive in the determination of whether the obligations are risk investments in the corporations or debts."); *Fin Hay*, 398 F.2d at 697 ("[N]either any single criterion nor any series of criteria can provide a conclusive answer in the kaleidoscopic circumstances which individual cases present."). It was this emphasis on particular taxpayer facts and circumstances, coupled with inconsistent analysis of the relevant factors by different courts, that led Congress to delegate to the Secretary the authority to provide regulations under section 385 for distinguishing debt from equity that could depart from the factors developed in case law or enumerated in the statute. *See* S. Rep. No. 91–552, at 138.

IV. *Other Relevant Statutory Provisions*

Section 701 provides that a partnership as such shall not be subject to federal income tax, but that persons carrying on business as partners shall be liable for federal income tax only in their separate or individual capacities.

Section 1502 provides that the Secretary shall prescribe such regulations as the Secretary deems necessary in order that the federal tax liability of any affiliated group of corporations making a consolidated return and of each corporation in the group, both during and after the period of affiliation, may be returned, determined, computed, assessed, collected, and adjusted, in such manner as clearly to reflect the federal income tax liability and the various factors necessary for the determination of such liability, and in order to prevent avoidance of such tax liability. In prescribing such regulations, section 1502 authorizes the Secretary to prescribe rules that are different from the provisions of chapter 1 of subtitle A of the Code that would apply if such corporations filed separate returns.

Section 7701(l) provides that the Secretary may prescribe regulations recharacterizing any multiple-party financing transaction as a transaction directly among any two or more of such parties where the Secretary determines that such recharacterization is appropriate to prevent avoidance of any tax imposed by the Code.

V. *Earnings Stripping Guidance Described in Notice 2014–52 and Notice 2015–79*

Notice 2014–52, 2014–42 IRB 712 (Oct. 14, 2014), and Notice 2015–79, 2015–49 IRB 775 (Dec. 7, 2015), described regulations that the Treasury Department and the IRS intend to issue with respect to corporate inversions and related transactions. Notice 2014–52 and Notice 2015–79 also provided that the Treasury Department and the IRS expect to issue additional guidance to further limit the benefits of post-inversion tax avoidance transactions. The notices stated, in particular, that the Treasury Department and the IRS are considering guidance to address strategies that avoid U.S. tax on U.S. operations by shifting or "stripping" U.S.-source earnings to lower-tax jurisdictions, including through intercompany debt.

VI. *Purpose of the Proposed Regulations*

These proposed regulations under section 385 address whether an interest in a related corporation is treated as stock or indebtedness, or as in part stock or in part indebtedness, for purposes of the Code. While these proposed regulations are motivated in part by the enhanced 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. Thus, the proposed rules apply to purported indebtedness issued to certain related parties, without regard to whether the parties are domestic or foreign. Nonetheless, the Treasury Department and the IRS also have determined that the proposed regulations should not apply to issuances of interests and related transactions among members of a consolidated group because the concerns addressed in the proposed regulations generally are not present when the issuer's deduction for interest expense and the holder's corresponding interest income offset on the group's consolidated federal income tax return.

Section A of this Part VI addresses bifurcation of interests that are indebtedness in part but not in whole. Section B of this Part VI addresses documentation requirements for related-party indebtedness. Section C of this Part VI addresses distributions of debt instruments and similar transactions.

A. *Interests that are Indebtedness in Part but Not in Whole*

As previously noted, Congress amended section 385(a) in 1989 to authorize the issuance of regulations permitting an interest in a corporation to be treated as in part indebtedness and in part stock. The legislative history to the 1989 amendment explained that "there has been a tendency by the courts to characterize an instrument entirely as debt or entirely as equity." H.R. Rep. No. 101–386, at 562 (1989) (Conf. Rep.). No regulations have been promulgated under the amendment, however, and this tendency by the courts has continued to the present day. Consequently, the Commissioner generally is required to treat an interest in a corporation as either wholly indebtedness or wholly equity.

This all-or-nothing approach is particularly problematic in cases where the facts and circumstances surrounding a purported debt instrument provide only slightly more support for characterization of the entire interest as indebtedness than for equity characterization, a situation that is increasingly common in the related-party context. The Treasury Department and the IRS have determined that the all-or-nothing approach frequently fails to reflect the economic substance of related-party interests that are in form indebtedness and gives rise to inappropriate federal tax consequences. Accordingly, the Treasury Department and the IRS have determined that the interests of tax administration would best be served if the Commissioner were able to depart from the all-or-nothing approach where

appropriate to ensure that the provisions of the Code are applied in a manner that clearly reflects the income of related taxpayers. To that end, these proposed regulations would exercise the authority granted by section 385(a) to permit the Commissioner to treat a purported debt instrument issued between related parties as in part indebtedness and in part stock for federal tax purposes. However, the proposed regulations would not permit issuers and related holders to treat such an instrument in a manner inconsistent with the issuer's initial characterization. The proposed regulations described in Part IV.B.2 of the Explanation of Provisions section of this preamble also rely in part on the authority granted under section 385(a) to treat interests as in part indebtedness and in part stock for federal tax purposes.

The proposed rule applies with respect to parties that meet a lower 50-percent threshold for relatedness than the threshold applicable with respect to other rules contained in these proposed regulations. This is because, as noted in Part VI of the Background section of this preamble, federal income tax liability can be reduced or eliminated by the introduction of excessive indebtedness between related parties, and this can be accomplished without special cooperation among the related parties and regardless of other transactions undertaken by the issuer or holder after issuance. In addition, a 50-percent relatedness threshold is consistent with other provisions used in subchapter C of the Code to identify a level of control or ownership that can warrant different federal tax consequences than those for less-related parties.

The proposed rule merely permits the Commissioner to treat a purported debt instrument as in part indebtedness and in part stock consistent with its substance. Moreover, the proposed regulations would not affect the authority of the Commissioner to disregard a purported debt instrument as indebtedness or stock, to treat a purported debt instrument as indebtedness or equity of another entity, or otherwise to treat a purported debt instrument in accordance with its substance. *See, e.g.*, *Plantation Patterns v. Commissioner*, 462 F.2d 712 (5th Cir. 1972).

The Treasury Department and the IRS recognize that authorizing the Commissioner to treat purported debt instruments issued among unrelated parties as indebtedness in part and stock in part could result in unnecessary uncertainty in the capital markets in the absence of detailed standards for the exercise of that authority. Similarly, any exercise of this authority with respect to related-party interests that are denominated as other than indebtedness would require more detailed guidance. Thus, the proposed rule does not apply in those contexts.

B. *Related-Party Indebtedness*

1. *Background*

Related-party indebtedness, like indebtedness between unrelated persons, may be respected as indebtedness for federal tax purposes, but only if there is intent to create a true debtor-creditor relationship that results in bona fide indebtedness. While still subject to the same multifactor analysis used for characterizing interests issued between third parties, "courts have consistently recognized that transactional forms between related parties are susceptible of manipulation and, accordingly, warrant a more thorough and discerning examination for tax characterization purposes." *PepsiCo Puerto Rico, Inc. v. Commissioner*, T.C. Memo 2012–269, at 51, *citing United States v. Uneco, Inc.*, 532 F.2d 1204, 1207 (8th Cir. 1976); *Cuyuna Realty Co. v. United States*, 382 F.2d 298, 301 (Ct. Cl. 1967) (stating that an advance between a parent corporation and a subsidiary or other affiliate under common control must be subject to particular scrutiny "because the control element suggests the opportunity to contrive a fictional debt, an opportunity less present in an arms-length transaction between strangers.").

This scrutiny is warranted because there is typically less economic incentive for a related-party lender to impose discipline on the legal documentation and economic analysis supporting the characterization of an interest as indebtedness for federal tax purposes. While a lender typically carefully documents a loan to a third party borrower and decides whether and how much to lend based on that documentation and objective financial criteria, a related-party lender, especially one that directly or indirectly controls the borrower, may require only simple (or even no) legal documentation and may forgo any economic analysis that would inform the lender of the amount that the borrower could reasonably be expected to repay.

The absence of reasonable diligence by related-party lenders can have the effect of limiting the factual record that is available for additional scrutiny and thorough examination. Nonetheless, courts do not always require related parties to engage in reasonable financial analysis and legal documentation similar to that which business exigencies would incent third-parties in connection with lending to unrelated borrowers. *See, e.g.*, *C.M. Gooch Lumber Sales Co. v. Commissioner*, 49 T.C. 649 (1968) at 656 (noting that in the case of related-party debt, "the absence of a written debt instrument, security, or provision for the payment of interest is not controlling; formal evidences of indebtedness are at best clues to proof of the ultimate fact"); *see also Byerlite Corp. v. Williams*, 286 F.2d 285, 290–91 (6th Cir. 1960), *citing Ewing v. Commissioner*, 5 T.C. Memo 908 (1946) ("The fact that advancements to a corporation are made without requiring any evidence of indebtedness . . . was not a controlling consideration . . .").

Historically, the absence of clear guidance regarding the documentation and information necessary to support debt characterization in the related-party context did not pose a significant obstacle, because the transactions presented by cases such as *Mixon*, *Fin Hay*, and their progeny were not factually complex. Typically, the earlier cases involved direct advances between individual U.S. taxpayers and their closely held domestic corporations. The relevant documentation was readily identifiable, available on hand, and able to be analyzed by the Commissioner in due course. Further, when the case law was developing, the dollar amounts at stake were comparatively modest. In *Fin Hay*, the shareholder advances gave rise to a total federal tax liability of $3,241; in *Mixon*, the shareholder advances gave rise to a total federal tax liability of $126,964.

Increasingly, this is no longer the case. Over time, the Treasury Department and

the IRS have observed that business practices, structures, and activities between related parties have changed considerably. The Treasury Department and the IRS acknowledge that the size, activities, and financial complexity of corporations and their group structures have grown exponentially, and understand that these groups routinely include foreign entities, sometimes from multiple foreign jurisdictions, as well as federal tax-indifferent domestic members. The scope and complexity of intragroup transactions has grown commensurately. Examples include the transactions at issue in *PepsiCo Puerto Rico, Inc. v. Commissioner* and *NA General Partnership & Subsidiaries v. Commissioner*, T.C. Memo 2012–172, both involving the global restructuring of multinational corporate groups.

As a result of these developments, it is increasingly problematic that there is a lack of guidance prescribing the information and documentation necessary to support the characterization of a purported debt instrument as indebtedness in the related-party context. The lack of such guidance, combined with the sheer volume of financial records taxpayers produce in the ordinary course of business, makes it difficult to identify the documents that will ultimately be required to support such a characterization, particularly with respect to whether a reasonable expectation of repayment is present at the time an interest is issued. The result can be either the inadvertent omission of necessary documents from disclosure to the IRS or the provision of vast amounts of irrelevant documents and material, such that forensic accounting expertise is required to isolate and evaluate relevant information. In either case, the ability of the Commissioner to administer the Code efficiently with respect to related-party interests is impeded. In addition, the absence of guidance makes it difficult for U.S. taxpayers to determine timely what steps they must take to ensure that essential records are not only prepared, but also maintained in a manner that will facilitate their being made available upon request, particularly regarding transactions with related parties whose books and records are located in foreign jurisdictions.

Finally, the dollar amounts at stake have often become increasingly significant. For example, the federal tax liability at issue in *PepsiCo* was $363,056,012; the federal tax liability at issue in *NA General Partnership* was $188,000,000. As a result, it has become increasingly important to prescribe rules that identify the types of documentation and information necessary to support the characterization of a related-party interest as indebtedness for federal tax purposes.

2. *Proposed Regulations Addressing Documentation Requirements*

To address these concerns, the Treasury Department and the IRS are proposing rules, under the authority granted in section 385(a) to prescribe regulations to determine whether an interest in a corporation is stock or indebtedness, that prescribe the nature of the documentation and information that must be prepared and maintained for a purported debt instrument issued by a corporation to a related party to be treated as indebtedness for federal tax purposes. The proposed regulations are intended to impose discipline on related parties by requiring timely documentation and financial analysis that is similar to the documentation and analysis created when indebtedness is issued to third parties. This requirement also serves to help demonstrate whether there was intent to create a true debtor-creditor relationship that results in bona fide indebtedness and also to help ensure that the documentation necessary to perform an analysis of a purported debt instrument is prepared and maintained. This approach is consistent with the long-standing view held by courts that the taxpayer has the burden of substantiating its treatment of an arrangement as indebtedness for federal tax purposes. *Hollenbeck v. Commissioner*, 422 F.2d 2, 4 (9th Cir. 1970).

In general, the Treasury Department and the IRS have determined that timely preparation of documentation and financial analysis evidencing four essential characteristics of indebtedness are a necessary factor in the characterization of a covered interest as indebtedness for federal tax purposes. Those characteristics are: a legally binding obligation to pay, creditors' rights to enforce the obligation, a reasonable expectation of repayment at the time the interest is created, and an ongoing relationship during the life of the interest consistent with arms-length relationships between unrelated debtors and creditors. These characteristics are drawn from the case law and are consistent with the text of section 385(b)(1) and (5). While the proposed regulations do not intend to alter the general case law view of the importance of these essential characteristics of indebtedness, the proposed regulations do require a degree of discipline in the creation of necessary documentation, and in the conduct of reasonable financial diligence indicative of a true debtor-creditor relationship, that exceeds what is required under current law. *See, e.g.*, *C.M. Gooch Lumber Sales Co.*, 49 T.C. 649; *Byerlite Corp.*, 286 F.2d 285.

The proposed regulations make clear that the preparation and maintenance of this documentation and information are not dispositive in establishing that a purported debt instrument is indebtedness for federal tax purposes. Rather, these requirements are necessary to the conduct of the multi-factor analysis used in the *Mixon* and *Fin Hay* line of cases to determine the nature of an interest as indebtedness for federal tax purposes.

C. *Certain Distributions of Debt Instruments and Similar Transactions*

1. *In General*

The Treasury Department and the IRS have identified three types of transactions between affiliates that raise significant policy concerns and that should be addressed under the Secretary's authority to prescribe rules for particular factual situations: (1) distributions of debt instruments by corporations to their related corporate shareholders; (2) issuances of debt instruments by corporations in exchange for stock of an affiliate (including "hook stock" issued by their related corporate shareholders); and (3) certain issuances of debt instruments as consideration in an exchange pursuant to an internal asset reorganization. Similar policy concerns arise when a related-party debt instrument is issued in a separate transaction to fund (1) a distribution of cash or other property to a related corporate shareholder; (2) an acquisition of affiliate stock from an affiliate; or (3) certain acquisitions of property

from an affiliate pursuant to an internal asset reorganization. Accordingly, the proposed regulations treat related-party debt instruments issued in any of the foregoing transactions as stock, subject to certain exceptions.

Sections C.2 through C.5 of this Part VI describe in greater detail the purposes of the proposed regulations that apply to these types of transactions. Part IV of the Explanation of Provisions section of this preamble describes in detail the proposed regulations.

2. *Debt Instrument Issued in a Distribution*

In *Kraft Foods Co. v. Commissioner*, 232 F.2d 118 (2d Cir. 1956), the U.S. Court of Appeals for Second Circuit addressed a situation in which a domestic corporate subsidiary issued indebtedness in the form of debentures to its sole shareholder, also a domestic corporation, in payment of a dividend. The parent and subsidiary were required to file separate returns under the Code in effect during the years at issue, and, before taking into account the interest income and deductions on the distributed indebtedness, the parent corporation had losses and the subsidiary was profitable.

The court considered arguments by the government that the parent-subsidiary relationship warranted additional scrutiny in determining whether a debtor-creditor relationship was established in substance. In particular, the Commissioner argued that, because the issuer subsidiary was wholly-owned, "the sole stockholder [could] deal as it please[d] with the corporate entity it control[led]" and, as a result, the transaction could have been a sham. *Id.* at 123. The Commissioner also argued that the debentures should be treated as stock because no new capital was introduced into the subsidiary in connection with the issuance of the debentures, *see id.* at 126–27, and because the taxpayer conceded that the issuance of the debentures in payment of the dividend lacked a business purpose other than tax minimization. *See id.* at 127–28.

In holding for the taxpayer, the Second Circuit determined that the debentures should be respected as indebtedness because the debentures were unambiguously denominated as debt, were issued by and to real taxable entities, and created real legal rights and duties between the parties. *See id.* at 127–28. In a dissenting opinion, Chief Judge Clark supported "test[ing] the genuineness of the intercorporate indebtedness by objective standards" that would disregard indebtedness issued in this circumstance, and warned that the majority opinion would open "a large leak . . . operable merely by denominating an intercorporate allocation of surplus a debt" and would "[s]urely . . . stimulate imitators." *Id.* at 129.

Other courts have not given the same level of deference to the form of a transaction that the Second Circuit did in *Kraft* and have treated purported indebtedness as stock in similar circumstances. For example, some courts have closely scrutinized situations in which indebtedness is owed in proportion to stock ownership to determine whether a debtor-creditor relationship exists in substance. *See, e.g.*, *Uneco, Inc. v. United States*, 532 F.2d 1204, 1207 (8th Cir. 1976) ("Advances between a parent corporation and a subsidiary or other affiliate are subject to particular scrutiny . . . ."); *Arlington Park Jockey Club, Inc. v. Sauber*, 262 F.2d 902, 906 (7th Cir. 1959) ("It has been held that [a cash advance made in proportion to stock ownership] gives rise to a strong inference that the advances represent additional capital investment and not loans." (citing *Schnitzer v. Commissioner*, 13 T.C. 43, *aff'd* 183 F.2d 70 (9th Cir. 1950))). Consistent with those decisions, section 385(b)(5) specifically authorizes the Secretary, in issuing regulations distinguishing between stock and indebtedness, to take into account "the relationship between holdings of stock in the corporation and holdings of the interest in question."

Courts also have given weight to the lack of new capital investment when a closely-held corporation issues indebtedness to a controlling shareholder but receives no new investment in exchange. *See, e.g.*, *Talbot Mills v. Commissioner*, 146 F.2d 809 (1st Cir. 1944) (emphasizing that a transaction involved no new investment, did not affect proportionate ownership, and was motivated primarily by tax benefits in holding that a closely-held corporation's participating notes should be treated as stock when each stockholder exchanged four-fifths of its existing stock for notes with a face amount equal to the par value of the stock surrendered), *aff'd sub nom*, *John Kelley Co. v. Commissioner*, 326 U.S. 521 (1946); *Sayles Finishing Plants, Inc. v. United States*, 399 F.2d 214 (Ct. Cl. 1968) (noting that a "lack of new money can be a significant factor in holding a purported indebtedness to be a capital transaction, particularly when the facts otherwise show that the purported indebtedness was merely a continuation of the stock interests allegedly converted").

In many contexts, a distribution of a debt instrument similar to the one at issue in *Kraft* lacks meaningful non-tax significance, such that respecting the distributed instrument as indebtedness for federal tax purposes produces inappropriate results. For example, inverted groups and other foreign-parented groups use these types of transactions to create interest deductions that reduce U.S. source income without investing any new capital in the U.S. operations. In addition, U.S.-parented groups obtain distortive results by, for example, using these types of transactions to create interest deductions that reduce the earnings and profits of controlled foreign corporations (CFCs) and to facilitate the repatriation of untaxed earnings without recognizing dividend income. An example of the latter type of transaction could involve the distribution of a note from a first-tier CFC to its United States shareholder in a taxable year when the distributing CFC has no earnings and profits (although lower-tier CFCs may) and the United States shareholder has basis in the CFC stock. In a later taxable year, when the distributing CFC had untaxed earnings and profits (such as by reason of intervening distributions from lower-tier CFCs), the CFC could use cash attributable to the earnings and profits to repay the note owed to its United States shareholder. The taxpayer takes the position that the note should be respected as indebtedness and, therefore, that the repayment of the note does not result in any of the untaxed earnings and profits of the CFC being taxed as a dividend to the United States shareholder.

In light of these policy concerns, the proposed regulations treat a debt instrument issued in fact patterns similar to that

in *Kraft* as stock. The factors discussed in *Kraft* and *Talbot Mills*, including the parent-subsidiary relationship, the fact that no new capital is introduced in connection with a distribution of debentures, and the typical lack of a substantial non-tax business purpose, support the conclusion that the issuance of a debt instrument in a distribution is a transaction that frequently has minimal or nonexistent non-tax effects. Moreover, although the holder of a debt instrument has different legal rights than a holder of stock, the distinction between those rights usually has limited significance when the parties are related. Subsidiaries often do not have significant amounts of debt financing from unrelated lenders (other than trade payables) and, to the extent they do, they may minimize any potential impact of related-party debt on unrelated creditors, for example, by subordinating the related-party debt instrument.

Thus, any non-tax effects of a distribution of a debt instrument to an affiliate are often minimized or eliminated, allowing the related parties to obtain significant federal tax benefits at little or no cost. Accordingly, based on these considerations, the Treasury Department and the IRS have determined that in fact patterns similar to *Kraft* it is appropriate to treat a debt instrument as stock.

3. *Debt Instrument Issued in Exchange for Affiliate Stock*

The Treasury Department and the IRS have determined that the issuance of a related-party debt instrument to acquire stock of a related person is similar in many respects to a distribution of a debt instrument and implicates similar policy considerations. Recognizing the economic similarities between purchases of affiliate stock and distributions, Congress enacted section 304 and its predecessors to prevent taxpayers from acquiring affiliate stock to convert what otherwise would be a taxable dividend into a sale or exchange transaction. *See* S. Rep. No. 83–1622 at 46 (1954) (noting that, under section 304, "where the effect of the sale [of related-party stock] is in reality the distribution of a dividend, it will be taxed as such"). Similarly, if the proposed regulations addressed only debt instruments issued in a distribution, and not acquisitions of affiliate stock that have the effect of a distribution, taxpayers would readily substitute the latter transaction for the former in order to produce the inappropriate tax result that the proposed regulations are intended to prevent.

Like distributions of debt instruments, issuances of debt instruments to acquire affiliate stock frequently have limited non-tax significance, particularly in relation to the significant federal tax benefits that are generated in the transaction. Such transactions do not change the ultimate ownership of the affiliate, and introduce no new operating capital to either affiliate. While the change in the direct ownership of the affiliate's stock may have some non-tax significance in certain circumstances, such as the harmonization of a group's corporate structure following an acquisition, other purchases of affiliate stock, including purchases of "hook stock" from a parent in exchange for a debt instrument, typically possess almost no non-tax significance.

Accordingly, the proposed regulations generally treat a debt instrument issued in exchange for affiliate stock as stock.

4. *Debt Instrument Issued Pursuant to an Internal Asset Reorganization*

The proposed regulations also address certain debt instruments issued by an acquiring corporation as consideration in an exchange pursuant to an internal asset reorganization. Internal asset reorganizations can operate in a similar manner to section 304 transactions as a device to convert what otherwise would be a distribution into a sale or exchange transaction without having any meaningful non-tax effect. Congress noted this similarity in 1984 when it harmonized the control requirement for section 368(a)(1)(D) reorganizations with the control requirement in section 304. *See* Staff of Joint Comm. on Taxation, 98th Cong., General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984 193 (Comm. Print 1984) ("The D reorganization provisions address the bail-out problem in the context of a transfer of assets by 1 corporation to another. Section 304 deals with the problem in the context of a transfer of stock by shareholders to a corporation they control.").

Consider the following example: A foreign parent corporation (Parent) owns all of the stock of two U.S. subsidiaries, S1 and S2. In a transaction qualifying as a reorganization described in section 368(a)(1)(D), Parent transfers its stock in S1 to S2 in exchange for a note issued by S2, and S1 converts to a limited liability company. For federal tax purposes, S1 is treated as selling all of its assets to S2 in exchange for a debt instrument, and under section 356, Parent is treated as receiving the S2 debt instrument from S1 in a liquidating distribution with respect to Parent's S1 stock. This transaction has a similar effect (and tax treatment) as a section 304 transaction in which S2 issues a debt instrument to Parent in exchange for S1 stock, with the only difference being that S2 acquired the assets of S1 instead of the S1 stock and that Parent received the debt instrument as a result of the liquidation of S1.

This transaction introduces no new capital into the P group, and does not affect the ultimate ownership of the assets held by S1 or S2. Furthermore, S1 generally would not be required to recognize any built-in gain on the transfer of its assets to S2. Although this transaction entails a transfer of assets from S1 to S2, the tax costs (if any) and the non-tax consequences that result from this type of transaction among related parties are typically insignificant relative to the federal tax benefits obtained through the introduction of a related-party debt instrument. Accordingly, the proposed regulations treat a debt instrument issued by an acquiring corporation as consideration in an exchange pursuant to an internal asset reorganization as stock, consistent with the treatment of a debt instrument issued in a distribution or in exchange for affiliate stock.

5. *Debt Instrument Issued with a Principal Purpose of Funding Certain Distributions and Acquisitions*

The Treasury Department and the IRS have determined that the policy concerns implicated by the transactions described in Sections C.2 through C.4 of this Part VI are also present when a corporation issues

a debt instrument with a principal purpose of funding certain related-party transactions. Specifically, the proposed regulations treat a debt instrument issued for property, including cash, as stock when the debt instrument is issued to an affiliate with a principal purpose of funding (1) a distribution of cash or other property to a related corporate shareholder, (2) an acquisition of affiliate stock from an affiliate, or (3) certain acquisitions of property from an affiliate pursuant to an internal asset reorganization.

Without these funding provisions, taxpayers that otherwise would have issued a debt instrument in a one-step transaction described in Sections C.2 through C.4 of this Part VI would be able to use multi-step transactions to avoid the application of these proposed regulations while achieving economically similar outcomes. For example, a wholly-owned subsidiary that otherwise would have distributed a debt instrument to its parent corporation in a distribution could, absent these rules, borrow cash from its parent and later distribute that cash to its parent in a transaction that is purported to be independent from the borrowing. Like the distribution of a note, this transaction, if respected, would result in an increase of related-party debt, but no new net investment in the operations of the subsidiary. The parent corporation would have effectively reshuffled its subsidiary's capital structure to obtain more favorable federal tax treatment for the subsidiary without affecting its control over the subsidiary. The similarity between these transactions indicates that they should be subject to similar tax treatment.

The Treasury Department and the IRS also have determined that a debt instrument should be subject to these funding rules regardless of whether the funding affiliate (the lender) is a party to the funded transaction. Otherwise, a corporation could, for example, borrow funds from a sister corporation and immediately distribute those funds to the common parent corporation. Issuances of debt instruments to an affiliate in order to fund a distribution of property, an acquisition of affiliate stock, or an acquisition of an affiliate's assets in a reorganization often would confer significant federal tax benefits without having a significant non-tax impact, regardless of whether the lender is also a party to the funded transaction. Accordingly, the proposed regulations treat as stock a debt instrument issued to an affiliate to fund one of the specified transactions regardless of whether the lender is a party to the funded transaction.

Explanation of Provisions

I. *Overview*

The proposed regulations provide guidance regarding substantiation of the treatment of certain interests issued between related parties as indebtedness for federal tax purposes, the treatment of certain interests in a corporation as in part indebtedness and in part stock, and the treatment of distributions of debt instruments and similar transactions that frequently have only limited non-tax effects. More specifically, the proposed regulations are set forth in four sections. First, proposed § 1.385–1 prescribes definitions and operating rules applicable to the regulations under section 385 generally, including a rule treating members of a consolidated group, as defined in § 1.1502–1(h), as one corporation. Proposed § 1.385–1(d) also provides that the Commissioner has the discretion to treat certain interests in a corporation for federal tax purposes as indebtedness in part and stock in part. Second, proposed § 1.385–2 addresses the documentation and information that taxpayers must prepare and maintain within required timeframes to substantiate the treatment of an interest issued between related parties as indebtedness for federal tax purposes. Such substantiation is necessary, but not sufficient, for a purported debt interest that is within the scope of these rules to be characterized as indebtedness; general federal income tax principles also apply in making such a determination. Third, if the application of proposed § 1.385–2 and general federal income tax principles otherwise would result in treating an interest issued to a related party as indebtedness for federal tax purposes, proposed § 1.385–3 provides additional rules that may treat the interest, in whole or in part, as stock for federal tax purposes if it is issued in a distribution or other transaction that is identified as frequently having only limited non-tax effect, or is issued to fund such a transaction. Finally, proposed § 1.385–4 provides operating rules for applying proposed § 1.385–3 to interests that cease to be between members of the same consolidated group or interests that become interests between members of the same consolidated group.

II. *Generally Applicable Definitions and Special Rules*

A. *Definition of Expanded Group*

As previously discussed, the concerns addressed by the proposed regulations arise with respect to interests issued among related parties. The scope of the proposed regulations is therefore generally limited to purported indebtedness between members of an expanded group. Proposed § 1.385–1, which sets forth definitions generally applicable to the regulations proposed under section 385, defines the term *expanded group* by reference to the term affiliated group in section 1504(a). However, the proposed regulations broaden the definition in several ways. Unlike an affiliated group, an expanded group includes foreign and tax-exempt corporations, as well as corporations held indirectly, for example, through partnerships. Further, in determining relatedness, the proposed regulations adopt the attribution rules of section 304(c)(3). The proposed regulations also modify the definition of affiliated group to treat a corporation as a member of an expanded group if 80 percent of the vote or value is owned by expanded group members (instead of 80 percent of the vote and value, as generally required under section 1504(a)).

Through this definition of an expanded group, the application of the proposed regulations is limited to transactions between highly-related parties. Other rules, discussed in Section III.A (limiting the application of proposed § 1.385–2 to large taxpayers) and Section IV.C ($50 million threshold exception for proposed § 1.385–3) of this Explanation of Provisions limit the application of the proposed regulations to large taxpayers.

B. *Treatment of Deemed Exchanges*

Proposed § 1.385–1 includes rules that prescribe the effects under the Code gen-

erally of an exchange of purported indebtedness for stock that is deemed to occur under the proposed regulations. Under those rules, on the date the indebtedness is recharacterized as stock, the indebtedness is deemed to be exchanged, in whole or in part, for stock with a value that is equal to the holder's adjusted basis in the portion of the indebtedness that is treated as equity under the regulations, and the issuer of the indebtedness is deemed to retire the same portion of the indebtedness for an amount equal to its adjusted issue price as of that date. This rule generally will prevent both the holder and issuer from realizing gain or loss from the deemed exchange other than foreign exchange gain or loss recognized by the issuer or the holder under section 988.

C. *Treatment of Certain Instruments as in Part Indebtedness and as in Part Stock*

Proposed § 1.385–1 implements the statutory authority under section 385(a) to treat an instrument as part indebtedness and part stock by authorizing the Commissioner to treat certain instruments issued between related parties in this manner. Any such treatment will occur only in the event that the substance of the instrument is regarded for federal tax purposes and the instrument has met the documentation and information requirements in proposed § 1.385–2 (described subsequently in Section III), if applicable. In addition, the Commissioner is not required to treat such an interest as indebtedness in part and stock in part. For example, under the proposed regulations, if an analysis of a related-party interest that is documented as a $5 million debt instrument demonstrates that the issuer cannot reasonably be expected to repay more than $3 million of the principal amount as of the issuance of the interest, the Commissioner may treat the interest as part indebtedness ($3 million) and part stock ($2 million). The type of stock (for example, common stock or preferred stock, section 306 stock, stock described in section 1504(a)(4)) that the instrument will be treated as for federal tax purposes is determined by taking into account the terms of the instrument (for example, voting and conversion rights and rights relating to dividends, redemption, liquidation, and other distributions).

The Treasury Department and the IRS believe that this approach will facilitate the treatment of purported debt instruments issued between related parties in a manner that is more consistent with the substance of the underlying transaction.

Pursuant to section 385(c) and the regulatory authority granted the Secretary under section 385(c)(2), the issuer of the interest, the holder of the interest, and any other person relying on the characterization of the interest as indebtedness for federal tax purposes are all required to treat the interest consistent with the issuer's initial characterization. Thus, for example, a holder may not disclose on its return under section 385(c)(2) that it is treating an EGI, as later defined in Section III.A of this Explanation of Provisions, as indebtedness in part or stock in part if the issuer of the EGI treats the EGI as indebtedness. This approach eliminates cases in which members of the same expanded group take contrary positions as to the treatment of an EGI as indebtedness, stock, or indebtedness in part and stock in part.

The proposed regulations authorize the treatment of an interest as indebtedness in part and stock in part in the case of instruments issued in the form of debt between parties that are related, but at a lesser degree of relatedness than that required to include them in an expanded group. Under the proposed regulations, treatment as indebtedness in part and stock in part can apply to purported indebtedness between members of *modified expanded groups* (which are defined in the same manner as expanded groups, but adopting a 50-percent ownership test and including certain partnerships and other persons). The 50-percent relatedness threshold contained in the definition of *modified expanded group* is consistent with other provisions used in subchapter C of the Code to identify a level of control or ownership that can warrant different federal tax consequences than those of less-related parties. For example, a similar threshold applies in determining whether (i) control exists under section 304(c), (ii) attribution to and from corporations is applicable under section 318, (iii) persons are related under section 267(b), which is incorporated into numerous provisions of the Code, (iv) a redemption is substantially disproportionate under section 302(b)(2), (v) a disqualified distribution has occurred under section 355(d), (vi) a distribution is subject to section 355(e), and (vii) corporations are under common control for purposes of section 334. The Treasury Department and the IRS request comments on whether it would be helpful or appropriate to have this rule apply more generally.

D. *Consolidated Groups*

As described in Part VI of the Background section of this preamble, many of the concerns regarding related-party indebtedness are not present in the case of indebtedness between members of a consolidated group. Accordingly, the proposed regulations under section 385 do not apply to interests between members of a consolidated group, although general federal tax principles continue to apply. Proposed § 1.385–1(e) achieves this result by treating a consolidated group as one corporation. See Section III.A and Section IV.F of this Part for additional rules affecting consolidated groups.

III. *Substantiation of Related-Party Indebtedness: Proposed § 1.385–2*

A. *In General*

Proposed § 1.385–2 reflects the importance of contemporaneous documentation in identifying the rights, obligations, and intent of the parties to an instrument that is purported to be indebtedness for federal tax purposes. Such documentation is particularly important to the analysis of instruments issued between related parties. In recognition of this importance, the Treasury Department and the IRS are exercising authority granted under section 385(a) to treat the timely preparation and maintenance of such documentation as necessary factors to be taken into account in determining whether certain interests are properly characterized as stock or indebtedness. Accordingly, the proposed regulations first prescribe the nature of the documentation necessary to substantiate the treatment of related-party instruments as indebtedness and, second, require that

such documentation be timely prepared and maintained. The proposed regulations further provide that, if the specified documentation is not provided to the Commissioner upon request, the Commissioner will treat the preparation and maintenance requirements as not satisfied and will treat the instrument as stock for federal tax purposes. The type of stock (for example, common stock or preferred stock, section 306 stock, stock described in section 1504(a)(4)) that the instrument will be treated as for federal tax purposes is determined by taking into account the terms of the instrument (for example, voting and conversion rights and rights relating to dividends, redemption, liquidation, and other distributions).

Satisfaction of the requirements of the proposed regulations does not establish that a related-party instrument is indebtedness. Rather, satisfaction of the proposed regulations acts as a threshold test for allowing the possibility of indebtedness treatment after the determination of an instrument's character is made under federal tax principles developed under applicable case law. If the requirements of the proposed regulations are not satisfied, the purported indebtedness would be recharacterized as stock. In such a case, any federal tax benefit claimed by the taxpayer with respect to the treatment of the interest as indebtedness will be disallowed.

Judicial doctrines that disregard transactions as having no substance continue to be applicable and are not affected by the proposed regulations. Accordingly, proposed § 1.385–2 applies only to interests the substance of which is potentially regarded as indebtedness for federal tax purposes. In addition, proposed § 1.385–2 does not limit the ability of the IRS to request information under any existing authorities, such as the rules under section 7602.

As discussed previously, these proposed regulations apply only to purported indebtedness issued among entities that are highly related. Several provisions of the proposed regulations combine to effect this limitation.

First, proposed § 1.385–2 provides rules only with respect to *applicable instruments*, that is, interests issued in the form of debt. Thus, these proposed regulations do not apply to any interest or arrangement that is not, in form, indebtedness. The documentation and other rules in proposed § 1.385–2(b) are tailored to arrangements that in form are traditional debt instruments and do not address other arrangements that may be treated as indebtedness under general federal tax principles. The proposed regulations under § 1.385–2 reserve with respect to documentation of interests that are not in form indebtedness. Because there are a large number of ways to document these arrangements, rules that provide sufficient information about these arrangements will need to contain specific documentation and timing requirements depending on the type of arrangement. Accordingly, the Treasury Department and the IRS request comments regarding the appropriate documentation and timing requirements for the various forms that these arrangements can take.

Second, proposed § 1.385–2 only applies to applicable interests that are issued and held by members of an expanded group (*expanded group instruments*, or *EGI*). For purposes of § 1.385–2, controlled partnerships are treated as members of the expanded group, and the term *controlled partnership* is defined as any partnership the capital or profits interest in which is 80-percent owned by members of the expanded group. Proposed § 1.385–2 provides that, solely for purposes of § 1.385–2, the term *issuer* means a person that is obligated to satisfy any material payment obligations created under the terms of an EGI. For this purpose, a disregarded entity can be treated as the issuer. A person can be an issuer if that person is expected to satisfy a material obligation under an EGI, even if that person is not the primary obligor. A guarantor, however, is not an issuer unless the guarantor is treated as the primary obligor under federal tax principles. *See, e.g.*, *Plantation Patterns, Inc. v. Commissioner*, 462 F.2d 712 (5th Cir. 1972).

Third, proposed § 1.385–2 is intended to apply only to large taxpayer groups. Accordingly, an EGI is not subject to proposed § 1.385–2 unless the stock of any member of the expanded group is publicly traded, all or any portion of the expanded group's financial results are reported on financial statements with total assets exceeding $100 million, or the expanded group's financial results are reported on financial statements that reflect annual total revenue that exceeds $50 million. The proposed regulations provide guidance regarding the financial statement or statements that are to be used for purposes of determining the expanded group's assets and liabilities. In general, this determination is made by reference to a financial statement required to be filed with the Securities and Exchange Commission, a certified audited financial statement that is accompanied by the report of an independent certified public accountant (or in the case of a foreign entity, by the report of a similarly qualified independent professional) that is used for certain purposes, or a financial statement (other than a tax return) required to be provided to the federal, state, or foreign government or any federal, state, or foreign agency. Because this list represents a set of financial statements created for other purposes for persons outside the expanded group, these financial statements are expected to be sufficiently reliable for this purpose. In addition, to prevent the use of stale financial information, only applicable financial statements prepared within the three years of the EGI becoming subject to the proposed regulations are relevant for determining whether an EGI is subject to the proposed regulations under § 1.385–2.

B. *Types of Documentation and Other Information Required*

The core of proposed § 1.385–2 is the guidance regarding the nature of the documentation and information that must be prepared and maintained to support the characterization of an EGI as indebtedness for federal tax purposes. The regulations organize the requirement into four categories, each reflecting an essential characteristic of indebtedness for federal tax purposes: a binding obligation to repay the funds advanced, creditor's rights to enforce the terms of the EGI, a reasonable expectation that the advanced funds can be repaid, and actions evidencing a genuine debtor-creditor relationship. Together these categories represent a distillation of case law principles established for determining that an instrument is genuine indebtedness for federal tax purposes.

The proposed regulations require that the prescribed documentation and information must be provided with respect to each category. Failure to provide the documentation and information upon request by the Commissioner will result in the Commissioner treating the requirements of this section as not satisfied. The four categories are more specifically described in the following four paragraphs.

1. *Binding Obligation to Repay*. The threshold requirement for indebtedness is a binding legal obligation to repay the funds advanced. The proposed regulations require evidence of such obligation in the form of timely prepared written documentation executed by the parties.

2. *Creditor's Rights to Enforce Terms*. The documents establishing the issuer's obligation to repay must also establish that the creditor/holder has the legal rights of a creditor to enforce the terms of the EGI. The proposed regulations give examples of such rights that creditor/holder typically has, including the right to trigger a default and the right to accelerate payments. The proposed regulations also give an example of one right that a creditor/holder must have, which is a superior right to shareholders to share in the assets of the issuer in the event that the issuer is dissolved or liquidated.

3. *Reasonable Expectation of Repayment*. The proposed regulations also require the taxpayer to provide timely prepared documentation evidencing a reasonable expectation that the issuer could in fact repay the amount of a purported loan. The proposed regulations give examples of such documentation, including cash flow projections, financial statements, business forecasts, asset appraisals, determination of debt-to-equity and other relevant financial ratios of the issuer (compared to industry averages). Special rules are provided to address disregarded entities that issue an EGI.

4. *Genuine Debtor-Creditor Relationship*. Finally, the taxpayer asserting indebtedness treatment must prepare and maintain timely evidence of an ongoing debtor-creditor relationship. This documentation can take two forms. In the case of an issuer that complied with the terms of the EGI, the documentation must include timely prepared documentation of any payments on which the taxpayer relies to establish such treatment under general federal tax principles. Alternatively, if the issuer failed to comply with the terms of the EGI, either by failing to make required payments or by otherwise suffering an event of default under the terms of the EGI, the documentation must include evidence of the holder's reasonable exercise of the diligence and judgment of a creditor. The proposed regulations give examples of such documentation, including evidence of the holder's efforts to enforce the terms of the EGI, as well as any efforts to renegotiate the EGI.

In general, the documentation must be prepared no later than 30 calendar days after the date of the relevant event, which is generally the later of the date that the instrument becomes an EGI or the date that an expanded group member becomes an issuer with respect to an EGI. However, in the case of documentation of the debtor-creditor relationship, the regulations allow the documentation to be prepared up to 120 calendar days after the payment or relevant event occurred. This extended period is intended to avoid inadvertent failures to comply with the regulations that may be more likely in the case of events that occur during the life of an EGI. If an applicable instrument is not an EGI when issued, no documentation is required under the proposed regulations for any date before the date the applicable instrument becomes an EGI.

The proposed regulations provide special rules for determining the timeliness of documentation preparation in the case of certain revolving credit agreements and similar arrangements and cash pooling arrangements, generally looking to the documents pursuant to which the arrangements were established.

C. *Maintenance Requirement*

Under proposed § 1.385–2, the documentation and information in the four categories previously described must be maintained for all taxable years that the EGI is outstanding and until the period of limitations expires for any return with respect to which the federal tax treatment of the EGI is relevant. The proposed regulations do not otherwise specify where or in what manner such records must be kept. The Treasury Department and the IRS intend that taxpayers have flexibility to determine the manner in which the requirements of the proposed regulations are satisfied.

D. *Timing of Application of Rule*

In general, proposed § 1.385–2 will apply to an applicable instrument at the time it becomes an EGI and thereafter. If an EGI that was characterized as stock under the rules of § 1.385–2 ceases to be an EGI, general federal tax principles will apply to determine its character at the time it ceases to be an EGI; if, under general federal tax principles, it is treated as indebtedness, the issuer is treated as issuing a new debt instrument to the holder in exchange for the EGI immediately before the transaction that causes the instrument to cease to qualify as an EGI.

If an applicable instrument is an EGI when issued, determinations under proposed § 1.385–2 are generally effective from the issuance date. If an applicable instrument was not an EGI when issued, proposed § 1.385–2 applies, and any resulting determination is generally effective, when the applicable instrument becomes an EGI. However, if an EGI originally treated as debt is later recharacterized as stock because the documentation and information cease to evidence an ongoing debtor-creditor relationship, the recharacterization will be effective as of the time that the facts and circumstances cease to evidence a debtor-creditor relationship.

E. *Consolidated Groups*

Proposed § 1.385–1(e) provides that members of a consolidated group are treated as one corporation. Proposed § 1.385–2(c)(4)(ii) further provides that if an applicable instrument ceases to be an intercompany obligation and, as a result, becomes an EGI subject to the rules of proposed § 1.385–2, the applicable instrument is treated as becoming an EGI immediately after it ceases to be an intercompany obligation.

F. *Modifications to General Operation of Proposed § 1.385–2*

The proposed regulation includes a number of provisions that modify the gen-

eral rules of § 1.385–2 in order to provide flexibility in appropriate circumstances or to prevent abuse. First, the requirements of proposed § 1.385–2 may be modified if a taxpayer's failure to comply with the requirements is attributable to reasonable cause. The principles of § 301.6724–1 (relating to waivers of penalty if failure due to reasonable cause) apply for purposes of determining whether reasonable cause exists in any particular case.

Second, to prevent abuse, proposed § 1.385–2 prohibits the affirmative use of the rules in the proposed regulations to support a particular characterization of an instrument. Thus, if a taxpayer fails to satisfy the requirements of proposed § 1.385–2 with a principal purpose of reducing the federal tax liability of any member of the expanded group, the rules of the proposed regulations do not apply.

Third, if an applicable instrument that is not an EGI is issued with a principal purpose of avoiding the purposes of proposed § 1.385–2, the applicable instrument is treated as an EGI and will be subject to the provisions of the proposed regulations. Such a situation could occur if, for example, an applicable interest was issued by an expanded group member to a trust held by members of the same expanded group.

G. *Effective Date of Proposed § 1.385–2*

The provisions of § 1.385–2 are proposed to be generally effective when the regulations are published as final regulations. Proposed § 1.385–2 would apply to any applicable instrument issued on or after that date, as well as to any applicable instrument treated as issued as a result of an entity classification election under § 301.7701–3 made on or after the date the regulations are issued as final regulations.

IV. *Certain Distributions of Debt Instruments and Similar Transactions*

A. *In General*

Proposed §§ 1.385–3 and 1.385–4 provide rules that treat as stock certain interests that otherwise would be treated as indebtedness for federal income tax purposes. Proposed § 1.385–3 applies to debt instruments that are within the meaning of section 1275(a) and § 1.1275–1(d), as determined without regard to the application of proposed § 1.385–3. Section 1275(a) and § 1.1275–1(d) generally define a debt instrument as any instrument or contractual arrangement that constitutes indebtedness under general principles of federal income tax law. Thus, the term *debt instrument* for purposes of proposed §§ 1.385–3 and 1.385–4 means an instrument that satisfies the requirements of proposed §§ 1.385–1 and 1.385–2 and that is indebtedness under general principles of federal income tax law. The Treasury Department and the IRS plan to amend § 1.1275–1(d) to coordinate § 1.1275–1(d) with the regulations under section 385 when the proposed regulations are finalized.

Specifically, proposed § 1.385–3 treats as stock certain debt instruments issued by one member of an expanded group to another member of the same group (expanded group debt instrument) in the circumstances described in Section B of this Part IV, unless an exception described in Section C of this Part IV applies. Detailed operating rules regarding the recharacterization (including with respect to partnerships) are discussed in Section D of this Part IV. A rule to prevent taxpayers from affirmatively using proposed §§ 1.385–3 and 1.385–4 is discussed in Section E of this Part IV. Section F of this Part IV discusses proposed § 1.385–4, which provides special rules to address the treatment of consolidated groups. The effective date of proposed §§ 1.385–3 and 1.385–4 is discussed in Section G of this Part IV.

To the extent proposed § 1.385–3 treats an interest as stock, the interest is treated as stock for all federal tax purposes. Consistent with the traditional case law debt-equity analysis, when a debt instrument is treated as stock under proposed § 1.385–3, the terms of the debt instrument (for example, voting rights or conversion features) are taken into account for purposes of determining the type of stock resulting from the recharacterization, including whether such stock is preferred stock or common stock.

B. *Debt Instruments Treated as Stock*

Proposed § 1.385–3 provides three rules that treat an expanded group debt instrument as stock: a general rule, a funding rule, and an anti-abuse rule.

1. *The General Rule*

The general rule treats an expanded group debt instrument as stock to the extent it is issued by a corporation to a member of the corporation's expanded group (1) in a distribution; (2) in exchange for expanded group stock, other than in an exempt exchange (as defined later in this Section 1); or (3) in exchange for property in an asset reorganization, but only to the extent that, pursuant to the plan of reorganization, a shareholder that is a member of the issuer's expanded group immediately before the reorganization receives the debt instrument with respect to its stock in the transferor corporation. All or a portion of an issuance of a debt instrument may be described in more than one prong of the general rule without changing the result that follows from being described in a single prong.

For purposes of the first prong of the general rule, the term *distribution* is broadly defined as any distribution by a corporation to a member of the corporation's expanded group with respect to the distributing corporation's stock, regardless of whether the distribution is treated as a dividend within the meaning of section 316. Thus, a debt instrument issued in exchange for stock of the issuer of the debt instrument (that is, in a redemption under corporate law) is a distribution that is covered by the first prong of the general rule and an acquisition of expanded group stock covered by the second prong of the general rule.

The second prong of the general rule – addressing debt instruments issued in exchange for expanded group stock – applies regardless of whether the expanded group stock is acquired from a shareholder of the issuer of the expanded group stock, or directly from the issuer. For an illustration of this rule in a context where stock is not formally issued because it would be a "meaningless gesture," see Example 11 in § 1.385–3(g)(3) of the proposed regulations.

For purposes of the second prong of the general rule, the term *exempt exchange* means an acquisition of expanded group stock in which the transferor and trans-

feree of the stock are parties to a reorganization that is an asset reorganization, and either (i) section 361(a) or (b) applies to the transferor of the expanded group stock and the stock is not transferred by issuance; or (ii) section 1032 or § 1.1032–2 applies to the transferor of the expanded group stock and the stock is distributed by the transferee pursuant to the plan of reorganization. As a result, the second prong of the general rule generally does not apply to a debt instrument that is issued in exchange for expanded group stock when section 361(a) or (b) applies to the transferor of such stock. This limitation has the effect of causing exchanges of expanded group stock that are part of an asset reorganization to be covered only by the third prong of the general rule, which, as discussed in the next paragraph, imposes limitations on the application of the general rule to exchanges that are part of an asset reorganization.

The third prong of the general rule applies to asset reorganizations among corporations that are members of the same expanded group. An *asset reorganization* is a reorganization within the meaning of section 368(a)(1)(A), (C), (D), (F), or (G). Specifically, the third prong of the general rule applies to a debt instrument issued in exchange for property in an asset reorganization, but only to the extent that, pursuant to the plan of reorganization, a shareholder that is a member of the issuer's expanded group immediately before the reorganization receives the debt instrument with respect to its stock in the transferor corporation. The second step receipt of the debt instrument by the expanded group shareholder could be in the form of a distribution of the debt instrument to shareholders of the distributing corporation in a divisive asset reorganization, or in redemption of the shareholder's stock in the transferor corporation in an acquisitive asset reorganization. Because the third prong of the general rule applies only to a debt instrument that is received by a shareholder with respect to its stock in the transferor corporation, that debt instrument would, absent the application of § 1.385–3, be treated as "other property" within the meaning of section 356.

The third prong of the general rule is limited to debt instruments distributed to shareholders pursuant to the reorganization, and does not apply to debt instruments exchanged for securities or other debt interests because, in that latter case, the newly issued debt instrument is exchanged for existing debt interests and thus no additional debt is incurred by the parties to the reorganization.

2. *The Funding Rule*

a. *Funded Transactions*

The funding rule treats as stock an expanded group debt instrument that is issued with a principal purpose of funding a transaction described in the general rule (principal purpose debt instrument). Specifically, a principal purpose debt instrument is a debt instrument issued by a corporation (funded member) to another member of the funded member's expanded group in exchange for property with a principal purpose of funding (1) a distribution of property by the funded member to a member of the funded member's expanded group, other than a distribution of stock pursuant to an asset reorganization that is permitted to be received without the recognition of gain or income under section 354(a)(1) or 355(a)(1) or, when section 356 applies, that is not treated as "other property" or money described in section 356; (2) an acquisition of expanded group stock, other than in an exempt exchange, by the funded member from a member of the funded member's expanded group in exchange for property other than expanded group stock; or (3) the acquisition of property by the funded member in an asset reorganization but only to the extent that, pursuant to the plan of reorganization, a shareholder that is a member of the funded member's expanded group immediately before the reorganization receives "other property" or money within the meaning of section 356 with respect to its stock in the transferor corporation.

Prongs (1) through (3) of the funding rule are referred to in this Section 2 as "distributions or acquisitions." Proposed § 1.385–3(b)(3)(iii) provides that, if all or a portion of a distribution or acquisition by a funded member is described in more than one prong of the funding rule, the funded member is treated as engaging in only a single distribution or acquisition for purposes of applying the funding rule. The funding rule addresses transactions that, when viewed together, present similar policy concerns as the transactions that are subject to the general rule.

The first prong of the funding rule – addressing a distribution by a funded member – excludes a distribution of stock permitted to be received without the recognition of gain under section 355(a)(1) when the distribution is pursuant to an asset reorganization (that is, a divisive reorganization qualifying under section 368(a)(1)(D)), but does not exclude a distribution of stock that is permitted to be received without the recognition of gain under section 355(a)(1) when the transaction qualifies under section 355 without also qualifying as a reorganization (that is, a distribution of the stock of a controlled corporation without a related transfer of property by the distributing corporation to the controlled corporation pursuant to the plan of reorganization). The reason for this distinction is that the controlled corporation in a divisive reorganization described in section 368(a)(1)(D) acquires assets of the distributing corporation and, as described in Section B.2.b.v of this Part IV, is treated as a successor of the distributing corporation (and the distributing corporation is treated as a predecessor of the controlled corporation) for purposes of the funding rule. In contrast, when a distribution transaction qualifies under section 355 without also qualifying as a reorganization, the controlled corporation does not acquire assets from the distributing corporation as part of the transaction and the corporations are not treated as predecessor and successor of each other for purposes of the funding rule. Consistent with this approach, proposed § 1.385–3 does not treat a section 355 distribution that is part of a divisive reorganization as a distribution for purposes of the funding rule because the distributing corporation and the controlled corporation are both parties to the reorganization and are both treated as funded members to the extent of any prior debt instrument issued by the distributing corporation. For a further illustration of this rule, see Example 10 in § 1.385–3(g)(3) of the proposed regulations.

b. *Determining Whether a Debt Instrument Is Issued with a Principal Purpose of Funding a Distribution or Acquisition*

The determination as to whether a debt instrument is issued with a principal purpose of funding a distribution or acquisition is based on all of the facts and circumstances. A debt instrument may be treated as issued with such a principal purpose whether it is issued before or after a distribution or acquisition.

i. *Non-Rebuttable Presumption During the 72-Month Period*

Proposed § 1.385–3 also establishes a non-rebuttable presumption that certain expanded group debt instruments are issued with a principal purpose of funding a distribution or acquisition by the funded member. Specifically, such a principal purpose is deemed to exist if the expanded group debt instrument is issued by the funded member during the period beginning 36 months before the funded member makes a distribution or acquisition and ending 36 months after the distribution or acquisition (the 72-month period). This per se rule does not create a safe harbor. Accordingly, a debt instrument issued outside the 72-month period may be treated as having a principal purpose of funding a distribution or acquisition, based on the facts and circumstances.

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. In the absence of a per se rule, taxpayers could assert that free cash flow generated from operations funded any distributions and acquisitions, while any debt instrument was incurred to finance the capital needs of those operations. Because taxpayers would be able to document the purposes of funding transactions accordingly, it would be difficult for the IRS to establish that any particular debt instrument was incurred with a principal purpose of funding a distribution or acquisition. The exception discussed in Section C of this Part IV for distributions and acquisitions that do not exceed current year earnings and profits would accommodate many ordinary course distributions and acquisitions, providing significant flexibility to avoid the application of this per se rule. The Treasury Department and the IRS have determined that this exception, together with the exception for a tainted debt instrument that does not exceed $50 million, also discussed in Section C of this Part IV, appropriately balance between preventing tax-motivated transactions among members of an expanded group and accommodating ordinary course transactions.

ii. *Exception to Non-Rebuttable Presumption for Ordinary Course Debt Instruments*

An exception to this per se rule applies to ordinary course debt instruments. Proposed § 1.385–3(b)(3)(iv)(B)(*2*) defines an ordinary course debt instrument as a debt instrument that arises in the ordinary course of the issuer's trade or business in connection with the purchase of property or the receipt of services to the extent that it reflects an obligation to pay an amount that is currently deductible by the issuer under section 162 or currently included in the issuer's cost of goods sold or inventory, provided that 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 was unrelated to the lender. This exception is intended to apply to debt instruments that arise in connection with the purchase of property or the receipt of services between members of the same expanded group in the ordinary course of the purchaser's or recipient's trade or business, and is not intended to apply to intercompany financing or treasury center activities or to capital expenditures. An ordinary course debt instrument is not subject to the per se rule; however, it may be treated as having a principal purpose of funding a distribution or acquisition by the issuer, based on the facts and circumstances.

iii. *Ordering Rules*

For purposes of applying the per se rule, proposed § 1.385–3(b)(3)(iv)(B)(*3*) includes an ordering rule that provides that, when two or more debt instruments may be treated as potentially funding the same acquisition or distribution, the debt instruments are tested based on the order in which they were issued. Thus, for example, if a company issues an expanded group debt instrument of $100x in each of years 1 and 2, and then makes a distribution of $150x in year 3, the distribution will result in a recharacterization as of the date of the distribution of $100x of the year 1 debt instrument and $50x of the year 2 debt instrument. For a further illustration of this rule, see Example 6 in § 1.385–3(g)(3) of the proposed regulations.

A second ordering rule in proposed § 1.385–3(b)(3)(iv)(B)(*4*) provides that, when a debt instrument may be treated as funding more than one distribution or acquisition, the earliest distribution or acquisition is treated as the first distribution or acquisition that was funded.

An exception to these ordering rules applies when an acquisition of expanded group stock by issuance ceases to qualify for the exception from the funding rule described in Section C.3 of this Part IV. In that case, the acquisition of expanded group stock is treated as an acquisition that is subject to the funding rule on the date that the acquisition actually occurred, but debt instruments issued, and other distributions and acquisitions that occurred, prior to the date that the acquirer ceases to qualify for the exception are ordered without regard to the acquisition of expanded group stock that previously was excepted from the funding rule.

iv. *Transition Rule*

For a rule preventing the funding rule from treating a debt instrument issued on or after April 4, 2016 from being treated as funding a distribution or acquisition that occurred before April 4, 2016, see Section G of this Part IV.

v. *Predecessor and Successor Rules*

Finally, the funding rule provides that references in the funding rule to the funded member include any predecessor or successor of such member. A *predecessor* is defined to include the distributor or transferor corporation in a transaction described in section 381(a) in which a member of the expanded group is the acquiring corporation, but also includes the trans-

feror corporation in a divisive reorganization described in section 368(a)(1)(D) or (G). The term predecessor does not include, with respect to a controlled corporation, a distributing corporation that distributed the stock of the controlled corporation pursuant to section 355(c). Similarly, a *successor* is defined to include the acquiring corporation in a transaction described in section 381(a) in which a member of the expanded group is the distributor or transferor corporation, but also includes the acquiring corporation in a divisive reorganization described in section 368(a)(1)(D) or (G). The term successor does not include, with respect to a distributing corporation, a controlled corporation the stock of which was distributed by the distributing corporation pursuant to section 355(c). In addition, Section C.3 of this Part IV, which sets forth an exception to the funding rule for certain acquisitions of expanded group stock by issuance, provides that the funded member is treated as a predecessor of the issuer and the issuer is treated as a successor of the funded member to the extent of the value of the acquired stock. For an illustration of these rules, see Examples 9, 10, and 12 in proposed § 1.385–3(g)(3).

3. *The Anti-Abuse Rule*

Proposed § 1.385–3(b)(4) also provides that a debt instrument is treated as stock if it is issued with a principal purpose of avoiding the application of the proposed regulations. In addition, other interests that are not debt instruments for purposes of proposed §§ 1.385–3 and 1.385–4 (for example, contracts to which section 483 applies or nonperiodic swap payments) are treated as stock if issued with a principal purpose of avoiding the application of proposed §§ 1.385–3 or 1.385–4.

Proposed § 1.385–3(b)(4) includes a non-exhaustive list of examples illustrating situations where the anti-abuse rule might apply. The anti-abuse rule may apply, for example, if a debt instrument is issued to, and later acquired from, a person that is not a member of the issuer's expanded group with a principal purpose of avoiding the application of the proposed regulations. In that situation, factors that may be taken into account in determining the presence or absence of a principal purpose of avoiding the application of the proposed regulations include the time period between the issuance of the debt instrument to the non-member and the acquisition of the debt instrument by a member of the issuer's expanded group, and whether there was a significant change in circumstances during that time period. For example, a change of control of the issuer group (for example, a cash acquisition of all of the stock of the ultimate parent company of the issuer) after the issuance and before the acquisition of the debt instrument that was not foreseeable when the debt instrument was issued to the non-member could indicate that the debt instrument was not issued with a principal purpose of avoiding the application of the proposed regulations. In contrast, the issuance of a debt instrument to a non-member after discussions were underway regarding the change-of-control transaction could indicate that the debt instrument was issued with a principal purpose of avoiding the application of the proposed regulations.

Other examples of when the anti-abuse rule could apply include situations where, with a principal purpose of avoiding the application of proposed § 1.385–3: (i) a debt instrument is issued to a person that is not a member of the issuer's expanded group and that person later becomes a member of the issuer's expanded group; (ii) a debt instrument is issued to an entity that is not taxable as a corporation for federal tax purposes (for example, a trust that is beneficially owned by an expanded group member); or (iii) a member of the issuer's expanded group is substituted as a new obligor or added as a co-obligor on an existing debt instrument. The anti-abuse rule also could apply to a debt instrument that is issued or transferred in connection with a reorganization or similar transaction with a principal purpose of avoiding the application of the proposed regulations. For a further illustration of this rule, see Example 18 in § 1.385–3(g)(3) of the proposed regulations.

4. *Coordination Between General Rule and Funding Rule*

Proposed § 1.385–3(b)(5) includes a rule to address a potential overlap between the general rule and the funding rule. This coordination rule provides that, to the extent all or a portion of a debt instrument issued in an asset reorganization is treated as stock under the third prong of the general rule (relating to a debt instrument issued for property in an asset reorganization), the distribution of the deemed stock to a shareholder in the asset reorganization is not also treated as a distribution or acquisition by the transferor corporation for purposes of the funding rule. This coordination rule addresses a specific potential overlap situation where a debt instrument is distributed to a shareholder pursuant to an asset reorganization and is characterized under the third prong of the general rule as an issuance of stock. When the issuance of the debt instrument is characterized under the general rule as an issuance of stock, the stock may be treated as non-qualified preferred stock for purposes of section 356. Nonqualified preferred stock received by a shareholder in a distribution is itself treated as "other property" for purposes of section 356. This overlap rule provides that, if the shareholder is deemed to receive nonqualified preferred stock in the asset reorganization, the distribution of the nonqualified preferred stock in the asset reorganization is not treated as a distribution or acquisition for purposes of the funding rule. For an illustration of this rule, see Example 8 in § 1.385–3(g)(3) of the proposed regulations.

C. *Exceptions*

Proposed § 1.385–3(c) provides three exceptions from the application of proposed § 1.385–3(b) for transactions that otherwise could result in a debt instrument being treated as stock.

1. *Exception for Current Year Earnings and Profits*

As noted in Section B.2 of this Part IV, proposed § 1.385–3(c)(1) includes an exception pursuant to which distributions and acquisitions described in proposed § 1.385–3(b)(2) (the general rule) or proposed § 1.385–3(b)(3)(ii) (the funding rule) that do not exceed current year earnings and profits (as described in section 316(a)(2)) of the distributing or acquiring

corporation are not treated as distributions or acquisitions for purposes of the general rule or the funding rule. For this purpose, distributions and acquisitions are attributed to current year earnings and profits in the order in which they occur.

2. *Threshold Exception*

A second exception provides that an expanded group debt instrument will not be treated as stock if, when the debt instrument is issued, the aggregate issue price of all expanded group debt instruments that otherwise would be treated as stock under the proposed regulations does not exceed $50 million (the threshold exception). If the expanded group's debt instruments that otherwise would be treated as stock later exceed $50 million, then all expanded group debt instruments that, but for the threshold exception, would have been treated as stock are treated as stock, rather than only the amount that exceeds $50 million. Thus, the threshold exception is not an exemption of the first $50 million of expanded group debt instruments that otherwise would be treated as stock under the proposed regulations, but rather is only intended to provide an exception from the application of proposed § 1.385–3 for taxpayers that have not exceeded the $50 million threshold. If the $50 million threshold subsequently is exceeded, the timing of the recharacterization of the relevant debt instrument as stock depends on when the debt instrument was issued. If the debt instrument ceases to qualify for the threshold exception after the taxable year of its issuance, the recharacterization is treated as occurring on the date that the threshold exception ceases to apply. If, on the other hand, the debt instrument ceases to qualify for the threshold exception during the same taxable year that the debt instrument is issued, the debt instrument is treated as stock as of the day that the debt instrument is issued. Once the $50 million threshold is exceeded, the threshold exception will not apply to any debt instrument issued by members of the expanded group for so long as any instrument that previously was treated as indebtedness solely because of the threshold exception remains outstanding, in order to prevent the $50 million limitation from refreshing after those instruments are treated as stock.

The threshold exception is applied after applying the exception for current year earnings and profits. For an illustration of the interaction of the threshold exception and the exception for current year earnings and profits, see Example 17 in § 1.385–3(g)(3) of the proposed regulations.

3. *Exception for Funded Acquisitions of Subsidiary Stock by Issuance*

An acquisition of expanded group stock will not be treated as an acquisition described in the second prong of the funding rule if (i) the acquisition results from a transfer of property by a funded member (the transferor) to an issuer in exchange for stock of the issuer, and (ii) for the 36-month period following the issuance, the transferor holds, directly or indirectly, more than 50 percent of the total combined voting power of all classes of stock of the issuer entitled to vote and more than 50 percent of the total value of the stock of the issuer. For purposes of this exception, a transferor's indirect stock ownership is determined by applying the principles of section 958(a) without regard to whether an intermediate entity is foreign or domestic.

If the transferor ceases to meet the ownership requirement at any time during the 36-month period, the acquisition of expanded group stock will no longer qualify for the exception and will be treated as an acquisition described in the second prong of the funding rule. In this case, for purposes of applying the per se rule, the acquisition may be treated as having been funded by a debt instrument issued during the 72-month period determined with respect to the date of the acquisition (rather than the date that the exception ceased to apply (the cessation date)), but, in the case of a debt instrument issued prior to the cessation date, only to the extent that such debt instrument is treated as indebtedness as of the cessation date (that is, a debt instrument not already treated as stock).

The proposed regulations treat an issuer and a transferor as a successor and predecessor, respectively, for purposes of the funding rule to the extent of the value of the expanded group stock acquired from the issuer. However, for purposes of the per se rule, the issuer and transferor are only treated as successor and predecessor, respectively, with respect to a debt instrument issued by the transferor during the period beginning 36 months before the relevant issuance of expanded group stock and ending 36 months after such issuance. Proposed § 1.385–3(f)(11) further limits the effect of treating the issuer and transferor as successor and predecessor by providing that a distribution made by the issuer directly to the transferor is not treated as a distribution made by the transferor for purposes of applying the funding rule to a debt instrument of the transferor.

For an illustration of this exception, see Example 12 in § 1.385–3(g)(3) of the proposed regulations.

D. *Operating Rules*

Proposed § 1.385–3(d) includes operating rules for determining when a debt instrument is treated as stock and for certain deemed exchanges required under the proposed regulations.

1. *Timing of Stock Treatment*

a. *Timing under the General Rule*

A debt instrument treated as stock under the general rule is treated as stock from the time when the debt instrument is issued. In addition, and in contrast to the funding rule, the treatment of a debt instrument as stock pursuant to the general rule may affect other aspects of the tax treatment of the transaction in which the debt instrument is issued. For example, a distribution of a debt instrument is treated as a distribution of stock for all federal tax purposes and, accordingly, is subject to section 305. Similarly, a debt instrument issued in exchange for expanded group stock is treated as an acquisition of expanded group stock in exchange for stock of the issuing corporation. Because stock of the issuing corporation is not treated as "property" within the meaning of section 317, such transactions would not, for example, be described in section 304(a)(1) or be subject to § 1.367(b)–10, both of which only apply to certain acquisitions of stock for property.

b. *Timing under the Funding Rule*

When the funding rule applies, a principal purpose debt instrument also is treated as stock from the time when the debt instrument is issued, but only to the extent it is issued in the same or a subsequent taxable year as the distribution or acquisition that the debt instrument is treated as funding. To the extent that a principal purpose debt instrument is issued in a taxable year preceding the taxable year in which the distribution or acquisition that it is treated as funding occurs, the debt instrument is respected as indebtedness until the date such distribution or acquisition occurs, at which time it is deemed to be exchanged (as described in Section D.2 of this Part IV) for stock. For these purposes, the relevant taxable year is the taxable year of the funded member. See Section C.3 of this Part IV for a discussion of the timing rule when the exception for funded acquisitions of subsidiary stock by issuance ceases to apply.

In contrast to transactions that are characterized under the general rule, when the funding rule applies, the tax treatment of the distribution or acquisition that the principal purpose debt instrument is treated as funding is never recharacterized under the proposed regulations. Accordingly, in the case of a section 301 distribution that triggers the application of the funding rule, section 301 will continue to apply to the distribution without regard to the fact that the debt instrument that is treated as funding the distribution is recharacterized as stock. Similarly, the application of section 304 to a funded acquisition of expanded group stock would not be affected by the fact that the debt instrument that is treated as funding the acquisition is recharacterized as stock under the funding rule.

c. *Transitional Timing Rule*

For an additional timing rule addressing certain debt instruments issued on or after April 4, 2016 and before the date of publication in the **Federal Register** of the Treasury decision adopting proposed § 1.385–3 as a final regulation, see section G of this Part IV.

2. *Deemed Exchange*

As described in Section D.1 of this Part IV, the funding rule can apply to treat a debt instrument as stock in a taxable year that is subsequent to the taxable year in which the debt instrument is issued. In addition, as described in Section C of this Part IV, when the $50 million threshold exception ceases to apply, all debt instruments of the expanded group issued in a prior taxable year that previously was treated as indebtedness because of the threshold exception is treated as stock on the date that the threshold exception ceases to apply. In those situations the deemed exchange rule described in Section B of Part II applies. This deemed exchange rule does not apply when a debt instrument that is treated as stock under proposed § 1.385–3 leaves the expanded group, as described in Section D.3 of this Part IV.

3. *Debt Instrument that Leaves the Expanded Group*

When a debt instrument that is treated as stock under proposed § 1.385–3 is transferred to a person that is not a member of the expanded group, or when the obligor with respect to such debt instrument ceases to be a member of the expanded group that includes the issuer, the interest ceases to be treated as stock. This is because proposed § 1.385–3 generally applies only to a debt instrument that is held by a member of an expanded group. For purposes of this rule, it should be noted that a debt instrument held by a partnership is considered held by its partners, as described in Section D.4 of this Part IV.

The proposed regulations provide that, immediately before a debt instrument that is treated as stock under proposed § 1.385–3 ceases to be held by a member of the expanded group, the expanded group issuer is deemed to issue a new debt instrument to the expanded group holder in exchange for the debt instrument that was treated as stock. The proposed regulations provide that this deemed issuance of the debt instrument is not itself subject to the general rule.

When a debt instrument treated as stock pursuant to the funding rule ceases to be treated as stock because it is no longer an expanded group debt instrument, all other debt instruments of the issuer that are not currently treated as stock are re-tested to determine whether other debt instruments are treated as funding the distribution or acquisition that previously was treated as funded by the debt instrument that ceases to be treated as stock pursuant to this rule. For an illustration of this rule, see Example 7 in § 1.385–3(g)(3) of the proposed regulations.

4. *Treatment of Partnerships*

To prevent avoidance of these rules through the use of partnerships, proposed § 1.385–3(d)(5) takes an aggregate approach to controlled partnerships for purposes of the proposed regulations. The legislative history of subchapter K of chapter 1 of the Code provides that, for purposes of interpreting Code provisions outside of that subchapter, a partnership may be treated as either an entity separate from its partners or an aggregate of its partners, depending on which characterization is more appropriate to carry out the purpose of the particular section under consideration. H.R. Conf. Rep. No. 2543, 83rd Cong. 2d. Sess. 59 (1954). Thus, for example, when a member of an expanded group becomes a partner in a partnership that is a controlled partnership with respect to the expanded group, the member is treated as acquiring its proportionate share of the controlled partnership's assets. In addition, each expanded group partner in a controlled partnership is treated as (i) issuing its proportionate share of any debt instrument issued by the controlled partnership, (ii) acquiring its proportionate share of any expanded group stock acquired by the controlled partnership, and (iii) receiving its proportionate share of any "other property" received by the partnership in a transaction described in section 356. For this purpose, a partner's proportionate share is determined in accordance with the partner's share of partnership profits. A partnership is a *controlled partnership* if 80 percent or more of the interests in the capital or profits of the partnership are owned, directly or indirectly, by one or more members of an expanded group. For this pur-

pose, indirect ownership of a partnership interest is determined based on the indirect ownership rules of section 304(c)(3).

If a debt instrument issued by a controlled partnership were to be recharacterized as equity in the controlled partnership, the resulting equity could give rise to guaranteed payments that may be deductible or gross income allocations to partners that would reduce the taxable income of the other partners that did not receive such allocations. Therefore, under the authority of section 7701(l) to recharacterize multiple-party financing transactions, proposed § 1.385–3(d)(5)(ii) provides that, when a debt instrument issued by a partnership is recharacterized, in whole or in part, under proposed § 1.385–3, the holder of the recharacterized debt instrument is treated as holding stock in the expanded group partner or partners rather than as holding a partnership interest in the controlled partnership. The partnership and its partners must make appropriate conforming adjustments to reflect the expanded group partner's treatment under the proposed regulations. Any such adjustments must be consistent with the purposes of these proposed regulations and must be made in a manner that avoids the creation of, or increase in, a disparity between the controlled partnership's aggregate basis in its assets and the aggregate bases of the partners' respective interests in the partnership. For an illustration of the rules applicable to controlled partnerships, see Examples 13, 14, and 15 in § 1.385–3(g)(3) of the proposed regulations.

5. *Notification of Inconsistent Treatment Waived*

Section 385(c)(1) provides that an issuer's characterization as of the time of issuance of an interest as debt or stock is binding on the issuer and on all holders of the interest. Section 385(c)(2) provides an exception to that rule if the holder discloses on its return that the holder is treating such interest in a manner that is inconsistent with such characterization. Section 385(c)(3) provides that the Secretary is authorized to require such information as the Secretary determines to be necessary to carry out the provisions of section 385(c). Under proposed § 1.385–3, a holder may be required to treat an interest as stock even though the issuer treated it as debt when it was issued. For example, a debt instrument may first be treated as a principal purpose debt instrument in a year that follows the year in which the debt instrument was issued. In that case, absent a regulatory provision to the contrary, the holder would be subject to the reporting requirement described in section 385(c)(2).

The Treasury Department and the IRS have determined that the characterization and reporting requirements in section 385(c) were not intended to apply when regulations under section 385 require an interest to be recharacterized after the issuer's initial characterization of that interest. Accordingly, the proposed regulations provide that section 385(c)(1) does not apply to a debt instrument to the extent that it is treated as stock under the proposed regulations.

6. *Obligations of Disregarded Entities*

Proposed § 1.385–3(d)(6) provides that a debt instrument issued by a disregarded entity that is treated as stock under proposed § 1.385–3 is treated as stock in the disregarded entity's owner rather than as an equity interest in the disregarded entity. Ordinarily, when a disregarded entity becomes an entity with more than one equity owner, the disregarded entity converts to a partnership. *See, e.g.*, § 301.7701–3(f)(2); Rev. Rul. 99–5, 1999–1 C.B. 434. Under these circumstances, the Treasury Department and the IRS have determined that treating a debt instrument issued by a disregarded entity that is treated as stock under proposed § 1.385–3 as stock in its owner, rather than as an equity interest in the disregarded entity, is consistent with, and addresses similar policy concerns as, the rules applicable to a debt instrument issued by a controlled partnership, which are described in Section D.4 of this Part IV.

E. *No Affirmative Use*

Under proposed § 1.385–3(e), proposed §§ 1.385–3 and 1.385–4 do not apply to the extent a person enters into a transaction that otherwise would be subject to the proposed regulations with a principal purpose of reducing its federal tax liability or the federal tax liability of another person by disregarding the treatment of the debt instrument that would occur without regard to the proposed regulations.

F. *Treatment of Consolidated Groups*

As noted previously, the Treasury Department and the IRS have determined that a debt instrument between members of the same consolidated group does not raise the same federal tax concerns as a debt instrument between members of the same expanded (but not consolidated) group. Accordingly, proposed § 1.385–4 includes special rules, issued under the authority of section 1502, for applying § 1.385–3 to consolidated groups, including rules addressing the treatment of a debt instrument issued by one member of a consolidated group to another member of the same consolidated group (consolidated group debt instrument) and rules regarding the treatment of a debt instrument when it ceases to be a consolidated group debt instrument.

1. *Consolidated Groups Treated as One Corporation*

For purposes of proposed § 1.385–3, all members of a consolidated group are treated as one corporation. Accordingly, proposed § 1.385–3 does not apply to a consolidated group debt instrument. Thus, for example, the proposed regulations do not treat as stock a debt instrument that is issued by one member of a consolidated group to another member of the consolidated group in a distribution. The proposed regulations define a consolidated group in the same manner as the consolidated return regulations. *See* § 1.1502–1(h).

As a result of treating all members of a consolidated group as one corporation for purposes of applying proposed § 1.385–3, a debt instrument issued to or by one member of a consolidated group generally is treated as issued to or by all members of the same consolidated group. Thus, a debt instrument issued by one consolidated group member to a member of its expanded group that is not a member of its consolidated group may be treated under the funding rule as funding a distribution or acquisition by another member of that consolidated group, even though that other consolidated group member was not

the issuer and thus was not funded directly. Similarly, a debt instrument issued by one consolidated group member to another consolidated group member is treated as stock under the general rule when the debt instrument is distributed by the holder to a member of the expanded group that is not a member of the same consolidated group, regardless of whether the issuer itself distributed the debt instrument. For an illustration of this rule, see Example 1 in proposed § 1.385–4(d)(3).

2. *Debt Instrument that Ceases to Be a Consolidated Group Debt Instrument but Continues to Be an Expanded Group Debt Instrument*

Proposed § 1.385–4 includes rules addressing debt held or issued by a consolidated group member that leaves a consolidated group, but continues to be a member of the expanded group (such corporation, a *departing member*).

Generally, any consolidated group debt instrument that is issued or held by the departing member and that is not treated as stock solely by reason of the rule treating all members of a consolidated group as one corporation (exempt consolidated group debt instrument) is deemed to be exchanged for stock immediately after the departing member leaves the group. Any consolidated group debt instrument issued or held by a departing member that is not an exempt consolidated group debt instrument (non-exempt consolidated group debt instrument) is treated as indebtedness unless and until the non-exempt consolidated group debt instrument is treated as a principal purpose debt instrument under proposed §§ 1.385–3(b)(3)(ii) and 1.385–3(d)(1) as a result of a distribution or acquisition described in proposed § 1.385–3(b)(3)(ii) that occurs after the departure. However, solely for purposes of applying the 72-month period under the per se funding rule, the debt instrument is treated as having been issued when it was first treated as a consolidated group debt instrument.

When a member of a consolidated group transfers a consolidated group debt instrument to an expanded group member that is not a member of the consolidated group, the debt instrument is treated as issued by the issuer of the debt instrument (which is treated as one corporation with the transferor of the debt instrument) to the transferee expanded group member on the date of the transfer. For purposes of proposed § 1.385–3, the consequences of the transfer are determined in a manner that is consistent with treating a consolidated group as one corporation. Thus, for example, the sale of a consolidated group debt instrument to an expanded group member that is not a member of the consolidated group is treated as an issuance of the debt instrument to the transferee expanded group member in exchange for property. To the extent the debt instrument is treated as stock upon being transferred, the debt instrument is deemed to be exchanged for stock immediately after the debt instrument is transferred outside of the consolidated group. For an illustration of this rule, see Examples 1 and 2 in § 1.385–4(d)(3) of the proposed regulations.

G. *Proposed Effective/Applicability Date and Transition Rules*

Sections 1.385–3 and 1.385–4 are proposed to apply to any debt instrument issued on or after April 4, 2016 and to any debt instrument issued before April 4, 2016 as a result of an entity classification election made under § 301.7701–3 that is filed on or after April 4, 2016. However, when §§ 1.385–3(b) and 1.385–3(d)(1)(i) through (d)(1)(v), or § 1.385–4 of the proposed regulations, otherwise would treat a debt instrument as stock prior to the date of publication in the **Federal Register** of the Treasury decision adopting this rule as a final regulation, the debt instrument is treated as indebtedness until the date that is 90 days after the date of publication in the **Federal Register** of the Treasury decision adopting this rule as a final regulation. To the extent that the debt instrument described in the preceding sentence is held by a member of the issuer's expanded group on the date that is 90 days after the date of publication in the **Federal Register** of the Treasury decision adopting this rule as a final regulation, the debt instrument is deemed to be exchanged for stock on the date that is 90 days after the date of publication in the **Federal Register** of the Treasury decision adopting this rule as a final regulation.

In addition, for purposes of determining whether a debt instrument is a principal purpose debt instrument described in proposed § 1.385–3(b)(3)(iv), a distribution or acquisition described in proposed § 1.385–3(b)(3)(ii) that occurs before April 4, 2016, other than a distribution or acquisition that is treated as occurring before April 4, 2016 as a result of an entity classification election made under § 301.7701–3 that is filed on or after April 4, 2016, is not taken into account.

Statement of Availability of IRS Documents

IRS Revenue Procedures, Revenue Rulings notices, and other guidance cited in this document are published in the Internal Revenue Bulletin (or Cumulative Bulletin) and are available from the Superintendent of Documents, U.S. Government Printing Office, Washington, DC 20402, or by visiting the IRS website at *http://www.irs.gov*.

Special Analyses

Executive Orders 13563 and 12866 direct agencies to assess costs and benefits of available regulatory alternatives and, if regulation is necessary, to select regulatory approaches that maximize net benefits (including potential economic, environmental, public health and safety effects, distributive impacts, and equity). Executive Order 13563 emphasizes the importance of quantifying both costs and benefits, of reducing costs, of harmonizing rules, and of promoting flexibility. This rule has been designated a "significant regulatory action" under section 3(f) of Executive Order 12866 and designated as economically significant. Accordingly, the rule has been reviewed by the Office of Management and Budget. A regulatory assessment for this proposed rule is available in the docket for this rulemaking on www.regulations.gov.

Pursuant to the Regulatory Flexibility Act (5 U.S.C. Chapter 6), it is hereby certified that the proposed regulations will not have a significant economic impact on a substantial number of small entities. Accordingly, an initial regulatory flexibility analysis is not required. The Commissioner and the courts historically have analyzed whether an interest in a corporation

should be treated as stock or indebtedness for federal tax purposes by applying various sets of factors to the facts of a particular case. Proposed § 1.385–1 provides that in connection with determining whether an interest in a corporation should be treated as stock or indebtedness for federal tax purposes, the Commissioner has the discretion to treat certain interests in a corporation for federal tax purposes as indebtedness in part and stock in part. Proposed § 1.385–1 does not require taxpayers to take any additional actions or to engage in any new procedures or documentation. Because proposed § 1.385–1 contains no such requirements, it does not have an effect on small entities.

To facilitate the federal tax analysis of an interest in a corporation, taxpayers are required to substantiate their classification of an interest as stock or indebtedness for federal tax purposes. Proposed § 1.385–2 provides documentation requirements to substantiate the treatment of certain related-party instruments as indebtedness. First, these rules apply only to debt instruments in form issued within expanded groups of corporations and other entities. Second, proposed § 1.385–2 only applies to expanded groups if the stock of a member of the expanded group is publicly traded, or financial statements of the expanded group or its members show total assets exceeding $100 million or annual total revenue exceeding $50 million. Because the rules are limited to large expanded groups, they will not affect a substantial number of small entities.

Proposed § 1.385–3 provides rules that treat as stock certain interests in a corporation that are held by a member of the corporation's expanded group and that otherwise would be treated as indebtedness for federal tax purposes. Proposed § 1.385–4 provides rules regarding the application of proposed § 1.385–3 to members of a consolidated group. Proposed § 1.385–3 includes multiple exceptions that limit its application. In particular, the threshold exception provides that an expanded group debt instrument will not be treated as stock under proposed § 1.385–3 if, when the debt instrument is issued, the aggregate issue price of all expanded group debt instruments that otherwise would be treated as stock under proposed § 1.385–3 does not exceed $50 million. The threshold exception also governs the application of proposed § 1.385–3 rules to members of a consolidated group described in proposed § 1.385–4. Although it is possible that the classification rules in proposed §§ 1.385–3 and 1.385–4 could have an effect on small entities, the threshold exception makes it unlikely that a substantial number of small entities will be affected by proposed §§ 1.385–3 and 1.385–4. Pursuant to section 7805(f) of the Code, these regulations have been submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on their impact on small business.

Comments and Public Hearing

Before the proposed regulations are adopted as final regulations, consideration will be given to any written (a signed original and eight copies) or electronic comments that are submitted timely to the IRS. The Treasury Department and the IRS request comments on all aspects of the proposed rules, including comments on the clarity of the proposed rules and how they can be made more administrable. In addition, comments are requested on: (1) other instruments that should be subject to the proposed regulations, including other types of applicable instruments that are not indebtedness in form that should be subject to proposed § 1.385–2 and the documentation requirements that should apply to such applicable instruments; (2) whether special rules are warranted for cash pools, cash sweeps, and similar arrangements for managing cash of an expanded group; (3) the rule addressing deemed exchanges of an EGI and a debt instrument; (4) the application of these rules to any entity with respect to a year in which the entity is not a U.S. person (as defined in section 7701(a)(30)), is not required to file a U.S. tax return, and is not a CFC or a controlled foreign partnership, but in a later year becomes one of the foregoing; (5) whether certain indebtedness commonly used by investment partnerships, including indebtedness issued by certain "blocker" entities, implicate similar policy concerns as those motivating the proposed regulations, such that the scope of the proposed regulations should be broadened; (6) whether guidance is needed under section 909 to the extent a U.S. equity hybrid instrument arises solely by reason of the application of proposed § 1.385–3; and (7) the treatment of controlled partnerships in proposed § 1.385–3 and the collateral consequences of the recharacterization and any corresponding adjustments, including the treatment of a partner's proportionate share of partnership assets or debt instruments, of treating a debt instrument issued by a controlled partnership as stock in its expanded group partners, including a situation in which a recharacterization results in a partnership owning stock of an expanded group partner. Specifically, the Treasury Department and the IRS request comments on how to apply proposed § 1.385–3 when expanded group partners make distributions subject to the funding rule with respect to some, but not all, partnership debt instruments; when one or more, but not all, expanded group partners make a distribution subject to the funding rule with respect to part or all of their share of the partnership debt instrument; and how to address such distributions when a controlled partnership has one or more partners that are not expanded group members. The Treasury Department and the IRS also request comments on whether the objective rules in proposed § 1.385–3(d)(5) have the potential to be manipulated, including by selectively locating debt instruments in order to achieve results that are contrary to the purposes of these regulations, and, if so, whether the anti-abuse rule in proposed § 1.385–3(b)(4) or the rule prohibiting the affirmative use of these rules by taxpayers in proposed § 1.385–3(e) are sufficient to address these concerns.

More generally, the Treasury Department and the IRS request comments on whether additional guidance is necessary regarding the manner by which issuers and holders notify the Secretary of the intended federal tax treatment of an interest in a corporation.

The Treasury Department and the IRS are aware that the issuance of preferred equity by a controlled partnership to an expanded group member may give rise to similar concerns as debt instruments of a controlled partnership issued to an expanded group member, and that controlled partnerships may, in some cases, issue preferred equity with a principal purpose

of avoiding the application of § 1.385–3 of the proposed regulations. The Treasury Department and the IRS are considering rules that would treat preferred equity in a controlled partnership as equity in the expanded group partners, based on the principles of the aggregate approach used in proposed § 1.385–3(d)(5). Comments are requested regarding the recharacterization of preferred equity in those circumstances. Until any such guidance is issued, the IRS intends to closely scrutinize, and may challenge when the regulations become effective, transactions in which a controlled partnership issues preferred equity to an expanded group member and, within the relevant 72-month period, one or more expanded group partners in the controlled partnership engage in a transaction described in § 1.385–3(b)(3)(ii) of the proposed regulations.

Finally, regarding the request for comments on whether guidance is needed under section 909 when a U.S. equity hybrid instrument arises solely by reason of the application of § 1.385–3: the application of proposed § 1.385–3 may give rise to a U.S. equity hybrid instrument splitter arrangement under § 1.909–2(b)(3)(i) (for example when indebtedness issued by one CFC to another CFC is treated as equity under proposed § 1.385–3). When this occurs, payments made pursuant to the instrument generally would result in distributions out of earnings and profits attributable pro rata to related income and other income, as described in §§ 1.909–3 and 1.909–6(d). Given that these section 385 regulations may give rise to a proliferation of U.S. hybrid equity instrument splitter arrangements, the Treasury Department and the IRS request comments on whether additional guidance is needed under section 909, including to address any uncertainty with respect to how U.S. hybrid equity instrument splitter arrangements are treated. All comments will be available for public inspection and copying at www.regulations.gov or upon request.

Drafting Information

The principal authors of these regulations are Eric D. Brauer of the Office of Associate Chief Counsel (Corporate) and Raymond J. Stahl of the Office of Associate Chief Counsel (International). However, other personnel from the Treasury Department and the IRS participated in their development.

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List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Proposed Amendment to the Regulations

Accordingly, 26 CFR part 1 is proposed to be amended as follows:

PART I—INCOME TAXES

Paragraph 1. The authority citation for part 1 is amended by adding entries in numerical order to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

Section 1.385–1 also issued under 26 U.S.C. 385.

Section 1.385–2 also issued under 26 U.S.C. 385 and 26 U.S.C. 1502.

Section 1.385–3 also issued under 26 U.S.C. 385, 26 U.S.C. 701, and 7701(l).

Section 1.385–4 also issued under 26 U.S.C. 385 and 26 U.S.C. 1502.

Par. 2. Section 1.385–1 is added to read as follows:

§ 1.385–1 General provisions.

(a) *Overview*. This section provides definitions applicable to the regulations under section 385 and operating rules regarding the treatment of certain direct and indirect interests in corporations as stock or indebtedness for federal tax purposes. Section 1.385–2 provides documentation and information requirements necessary for certain interests issued between members of an expanded group (as defined in paragraph (b)(3) of this section) to be treated as indebtedness for federal tax purposes. Section 1.385–3 provides rules that treat as stock certain interests in a corporation issued between members of an expanded group in connection with certain purported distributions of debt instruments and similar transactions. Section 1.385–4 provides special rules regarding the transactions described in § 1.385–3 as they relate to consolidated groups.

(b) *Definitions*. The definitions in this paragraph (b) apply for purposes of the regulations under section 385. For additional definitions that apply for purposes of § 1.385–2, see § 1.385–2(a)(4). For additional definitions that apply for purposes of §§ 1.385–3 and 1.385–4, see § 1.385–3(f).

(1) *Controlled partnership*. The term *controlled partnership* means a partnership with respect to which at least 80 percent of the interests in partnership capital or profits are owned, directly or indirectly, by one or more members of an expanded group. For this purpose, indirect ownership of a partnership interest is determined by applying the principles of paragraph (b)(3)(ii) of this section.

(2) *Disregarded entity*. The term *disregarded entity* means a business entity (as defined in § 301.7701–2(a) of this chapter) that is disregarded as an entity separate from its owner for federal tax purposes under §§ 301.7701–1 through 301.7701–3 of this chapter.

(3) *Expanded group*—(i) *In general*. The term *expanded group* means an affiliated group as defined in section 1504(a), determined:

(A) Without regard to paragraphs (1) through (8) of section 1504(b);

(B) By substituting "directly or indirectly" for "directly" in section 1504(a)(1)(B)(i); and

(C) By substituting "or" for "and" in section 1504(a)(2)(A).

(ii) *Indirect stock ownership*. For purposes of this paragraph (b)(3), indirect stock ownership is determined by applying the rules of section 304(c)(3).

(4) *Modified controlled partnership*. The term *modified controlled partnership* means a partnership with respect to which at least 50 percent of the interests in partnership capital or profits are owned, directly or indirectly, by one or more members of a modified expanded group. For this purpose, indirect ownership of a partnership interest is determined by applying the principles of paragraph (b)(3)(ii) of this section.

(5) *Modified expanded group*. The term *modified expanded group* means an expanded group, as defined in this section, determined by substituting "50" for "80" in sections 1504(a)(2)(A) and (B). If one or more members of a modified expanded group own, directly or indirectly, 50 percent of the interests in partnership capital or profits of a modified controlled partner-

ship, the modified controlled partnership is treated as a member of the modified expanded group. In addition, if a person (as defined in section 7701(a)(1)) is treated, under the rules of section 318, as owning at least 50 percent of the value of the stock of a modified expanded group member, the person is treated as a member of the modified expanded group.

(c) *Treatment of deemed exchange*. If a debt instrument (as defined in § 1.385–3(f)(3)) or an EGI (as defined in § 1.385–2(a)(4)(ii)) is deemed to be exchanged, in whole or in part, for stock pursuant to § 1.385–2(c)(3)(ii), § 1.385–3(d)(1)(ii), § 1.385–3(d)(1)(iii), § 1.385–3(d)(1)(iv), § 1.385–3(d)(1)(v), § 1.385–3(h)(3), or § 1.385–4(e)(3), the holder is treated as having realized an amount equal to the holder's adjusted basis in that portion of the indebtedness or EGI as of the date of the deemed exchange (and as having basis in the stock deemed to be received equal to that amount), and the issuer is treated as having retired that portion of the debt instrument or EGI for an amount equal to its adjusted issue price as of the date of the deemed exchange. In addition, neither party accounts for any accrued but unpaid qualified stated interest on the debt instrument or EGI or any foreign exchange gain or loss with respect to that accrued but unpaid qualified stated interest (if any) as of the deemed exchange. Notwithstanding the first sentence of this paragraph (c), the rules of § 1.988–2(b)(13) apply to require the holder and the issuer of a debt instrument or an EGI that is deemed to be exchanged in whole or in part for stock pursuant to § 1.385–2(c)(3)(ii), § 1.385–3(d)(1)(ii), § 1.385–3(d)(1)(iii), § 1.385–3(d)(1)(iv), § 1.385–3(d)(1)(v), § 1.385–3(h)(3), or § 1.385–4(e)(3) to recognize any exchange gain or loss, other than any exchange gain or loss with respect to accrued but unpaid qualified stated interest that is not taken into account under this paragraph (c) at the time of the deemed exchange. For purposes of this paragraph (c), in applying § 1.988–2(b)(13) the exchange gain or loss under section 988 is treated as the total gain or loss on the exchange.

(d) *Treatment as indebtedness in part*—(1) *In general*. The Commissioner may treat an EGI (as defined in § 1.385–2(a)(4)(ii) and described in paragraph (d)(2) of this section) as in part indebtedness and in part stock to the extent that an analysis, as of the issuance of the EGI, of the relevant facts and circumstances concerning the EGI (taking into account any application of § 1.385–2) under general federal tax principles results in a determination that the EGI is properly treated for federal tax purposes as indebtedness in part and stock in part. For example, if the Commissioner's analysis supports a reasonable expectation that, as of the issuance of the EGI, only a portion of the principal amount of an EGI will be repaid and the Commissioner determines that the EGI should be treated as indebtedness in part and stock in part, the EGI may be treated as indebtedness in part and stock in part in accordance with such determination, provided the requirements of § 1.385–2, if applicable, are otherwise satisfied and the application of federal tax principles supports this treatment. The issuer of an EGI, the holder of an EGI, and any other person relying on the characterization of an EGI as indebtedness for federal tax purposes are required to treat the EGI consistent with the issuer's initial characterization. Thus, for example, a holder may not disclose on its return under section 385(c)(2) that it is treating an EGI as indebtedness in part or stock in part if the issuer of the EGI treats the EGI as indebtedness.

(2) *EGI described in this paragraph (d)(2)*. An EGI is described in this paragraph (d)(2) if it is an applicable instrument (as defined in § 1.385–2(a)(4)(i)) an issuer of which is one member of a modified expanded group and the holder of which is another member of the same modified expanded group.

(e) *Treatment of consolidated groups*. For purposes of the regulations under section 385, all members of a consolidated group (as defined in § 1.1502–1(h)) are treated as one corporation.

(f) *Effective/applicability date*. This section applies to any applicable instrument issued or deemed issued on or after the date these regulations are published as final regulations in the **Federal Register**, and to any applicable instrument treated as indebtedness issued or deemed issued before the date these regulations are issued as final regulations if and to the extent it was deemed issued as a result of an entity classification election made under § 301.7701–3 of this chapter that is filed on or after the date these regulations are issued as final regulations in the **Federal Register**. For purposes of §§ 1.385–3 and 1.385–4, this section applies to any debt instrument issued on or after April 4, 2016 and to any debt instrument treated as issued before April 4, 2016 as a result of an entity classification election made under § 301.7701–3 of this chapter that is filed on or after April 4, 2016.

Par. 3. Section 1.385–2 is added to read as follows:

§ 1.385–2 Treatment of certain interests between members of an expanded group.

(a) *General*—(1) *Scope*. This section prescribes threshold requirements that must be satisfied regarding the preparation and maintenance of documentation and information with respect to an expanded group instrument (an EGI, as defined in paragraph (a)(4)(ii) of this section). The purpose of preparing and maintaining the documentation and information required by this section is to enable an analysis to be made whether an EGI is appropriately treated as stock or indebtedness for federal tax purposes. Satisfying the requirements of this section does not establish that an interest is indebtedness; such satisfaction serves as a minimum standard that enables this determination to be made under general federal tax principles. The rules of this section must be interpreted and applied in a manner that is consistent with and reasonably carries out the purposes of this section. Moreover, nothing in this section prevents the Commissioner from asserting that the substance of a transaction involving an EGI (or the EGI itself) is different from the form of the transaction (or the EGI) or disregarding the transaction (or the EGI) or treating the transaction (or the EGI) in accordance with its substance for federal tax purposes. Such an assertion may be made based on the documentation or information received pursuant to a request under this section or a request for information under section 7602. If, and only if, the requirements of this section are satisfied, the determination of the federal tax treatment of the EGI is made based on an analysis of the documentation and information pre-

pared and maintained, other facts and circumstances relating to the EGI, and general federal tax principles. If the requirements of this section are not satisfied with respect to an EGI the substance of which is regarded for federal tax purposes, the EGI will be treated as stock. This section does not otherwise affect the authority of the Commissioner under section 7602 to request and obtain documentation and information regarding transactions and instruments that purport to create an interest in a corporation. If the requirements of this section are satisfied or otherwise do not apply, see §§ 1.385–3 and 1.385–4 for additional rules for determining whether and the extent to which an interest otherwise treated as indebtedness under general federal tax principles is recharacterized as stock for federal tax purposes.

(2) *Application*—(i) *In general*. This section applies to an EGI only if—

(A) The stock of any member of the expanded group is traded on (or subject to the rules of) an established financial market within the meaning of § 1.1092(d)–1(b);

(B) On the date that an applicable instrument first becomes an EGI, total assets exceed $100 million on any applicable financial statement, or

(C) On the date that an applicable instrument first becomes an EGI, annual total revenue exceeds $50 million on any applicable financial statement.

(ii) *Non-U.S. dollar applicable financial statements*. If an applicable financial statement is denominated in a currency other than the U.S. dollar, the total assets and annual total revenue are translated into U.S. dollars at the spot rate (as defined in § 1.988–1(d)) as of the date of the applicable financial statement.

(3) *Consistency rule*. If an issuer characterizes an EGI as indebtedness, the EGI will be respected as indebtedness only if the requirements of § 1.385–2(b) are met with respect to the EGI. If the issuer of an EGI characterizes that EGI as indebtedness, the issuer, the holder, and any other person relying on the characterization of an EGI as indebtedness for federal tax purposes is required to treat the EGI as indebtedness for all federal tax purposes. The Commissioner is not bound by the issuer's characterization of an EGI.

(4) *Definitions*. The definitions in this paragraph (a)(4) apply for purposes of this section.

(i) *Applicable instrument*—(A) *In general*. The term *applicable instrument* means any interest issued or deemed issued that is in form a debt instrument. See paragraph (a)(4)(i)(B) of this section for rules regarding an interest that is not in form a debt instrument.

(B) *[Reserved]*

(ii) *Expanded group instrument*. The term *expanded group instrument* (*EGI)* means an applicable instrument an issuer of which is one member of an expanded group and the holder of which is another member of the same expanded group.

(iii) *Issuer*. Solely for purposes of this section, the term *issuer* means a person (including a disregarded entity defined in § 1.385–1(b)(2)) that is obligated to satisfy any material obligations created under the terms of an EGI. A person can be an issuer if that person is expected to satisfy a material obligation under an EGI, even if that person is not the primary obligor. A guarantor, however, is not an issuer unless the guarantor is expected to be the primary obligor.

(iv) *Applicable financial statement*. For purposes of this section, the term *applicable financial statement* means a financial statement, listed in paragraphs (a)(4)(iv)(A) through (C) of this section, that includes the assets, portion of the assets or annual total revenue of any member of the expanded group and that is prepared as of any date within 3 years prior to the date the applicable instrument at issue first becomes an EGI. A financial statement that includes the assets or annual total revenue of a member of an expanded group may be a separate company financial statement of any member of the expanded group or any consolidated financial statement that includes the assets, portion of the assets, or annual total revenue of any member of the expanded group. A financial statement includes—

(A) A financial statement required to be filed with the Securities and Exchange Commission (the Form 10–K or the Annual Report to Shareholders);

(B) A certified audited financial statement that is accompanied by the report of an independent certified public accountant (or in the case of a foreign entity, by the report of a similarly qualified independent professional) that is used for—

(*1*) Credit purposes;

(*2*) Reporting to shareholders, partners, or similar persons; or

(*3*) Any other substantial non-tax purpose; or

(C) A financial statement (other than a tax return) required to be provided to the Federal, state, or foreign government or any Federal, state, or foreign agency.

(b) *Documentation and information required to determine treatment*—(1) *Preparation and maintenance of documentation and information*—(i) *In general*. Except as otherwise provided in this section, an EGI is treated for federal tax purposes as stock if the documentation and information described in paragraph (b)(2) of this section are not prepared, or the maintenance requirements of paragraph (b)(4) of this section are not satisfied. If the requirements of this section are satisfied, general federal tax principles apply to determine whether, or the extent to which, the EGI is treated as indebtedness for federal tax purposes. This determination will take into account the documentation and information prepared, maintained, and provided in accordance with this section, as well as any additional facts and circumstances. This section applies to each EGI separately, but the same documentation and information may satisfy the requirements of this section for more than one EGI.

(ii) *Failure to provide documentation and information described in paragraph (b)(2) of this section*. If a taxpayer characterizes an EGI as indebtedness and fails to provide the documentation and information described in paragraph (b)(2) of this section upon request by the Commissioner, the Commissioner will treat the requirements of this section as not satisfied.

(2) *Documentation and other information required*. This paragraph (b)(2) describes the documentation and information that must be prepared and maintained to satisfy the requirements of this section. In each case, the documentation must include complete and (if relevant) executed copies of all instruments, agreements and other documents evidencing the material rights and obligations of the issuer and the holder relating to the EGI, and any associated rights and obligations of other par-

ties, such as guarantees and subordination agreements. Additional documentation and information may be provided to supplement, but not substitute for, the documentation and information required under this section. The documentation and information must satisfy the following requirements:

(i) *Unconditional obligation to pay a sum certain*. There must be written documentation prepared by the time required in paragraph (b)(3) of this section establishing that the issuer has entered into an unconditional and legally binding obligation to pay a sum certain on demand or at one or more fixed dates.

(ii) *Creditor's rights*. The written documentation described in paragraph (b)(2)(i) of this section must establish that the holder has the rights of a creditor to enforce the obligation. The rights of a creditor typically include, but are not limited to, the right to cause or trigger an event of default or acceleration of the EGI (when the event of default or acceleration is not automatic) for non-payment of interest or principal when due under the terms of the EGI and the right to sue the issuer to enforce payment. The rights of a creditor must include a superior right to shareholders to share in the assets of the issuer in case of dissolution.

(iii) *Reasonable expectation of ability to repay EGI*. There must be written documentation prepared containing information establishing that, as of the date of issuance of the applicable instrument and taking into account all relevant circumstances (including all other obligations incurred by the issuer as of the date of issuance of the applicable instrument or reasonably anticipated to be incurred after the date of issuance of the applicable instrument), the issuer's financial position supported a reasonable expectation that the issuer intended to, and would be able to, meet its obligations pursuant to the terms of the applicable instrument. For this purpose, if a disregarded entity is treated as the issuer of an EGI, and the owner of the disregarded entity has limited liability within the meaning of § 301.7701–3(b)(2)(ii) of this chapter, only the assets and financial position of the disregarded entity are relevant for purposes of this paragraph (b)(2)(iii). If the owner of such a disregarded entity does not have limited liability within the meaning of § 301.7701–3(b)(2)(ii), all of the assets and the financial position of the disregarded entity and the owner are relevant for purposes of this paragraph (b)(2)(iii). 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. 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. If the report or analysis is protected or privileged under law governing an inquiry or proceeding with respect to the EGI and the protection or privilege is asserted, neither the existence nor the contents of the report or analysis is taken into account in determining whether the requirements of this section are satisfied.

(iv) *Actions evidencing debtor-creditor relationship*—(A) *Payments of principal and interest*. If an issuer made any payment of interest or principal with respect to the EGI (whether in accordance with the terms and conditions of the EGI or otherwise, including prepayments), and such payment is claimed to support the treatment of the EGI as indebtedness under general federal tax principles, documentation must include written evidence of such payment that is prepared by the time required in paragraph (b)(3) of this section. Such evidence could include, for example, a wire transfer record or a bank statement reflecting the payment.

(B) *Events of default and similar events*. If the issuer did not make a payment of interest or principal that was due and payable under the terms and conditions of the EGI, or if any other event of default or similar event has occurred, there must be written documentation, prepared, by the time required in paragraph (b)(3) of this section, evidencing the holder's reasonable exercise of the diligence and judgment of a creditor. Such documentation may include evidence of the holder's efforts to assert its rights under the terms of the EGI, including the parties' efforts to renegotiate the EGI or to mitigate the breach of an obligation under the EGI, or any change in material terms and conditions of the EGI, such as maturity date, interest rate, or obligation to pay interest or principal, and any documentation detailing the holder's decision to refrain from pursuing any actions to enforce payment.

(v) *Additional information with respect to an EGI evidenced by documentation that does not in form reflect indebtedness*. This paragraph (b)(1)(v) describes additional information with respect to an EGI evidenced by documentation that does not in form reflect indebtedness.

(A)–(B) *[Reserved]*

(3) *Timely preparation requirement*—(i) *General rule*. For purposes of this section, the documentation described in paragraphs (b)(2)(i), (ii) and (iii) of this section will be treated as satisfying the timely preparation requirement of this paragraph (b)(3) if it is prepared no later than 30 calendar days after the relevant date, as defined in paragraph (b)(3)(ii) of this section. The documentation described in paragraph (b)(2)(iv) of this section will be treated as satisfying the timely preparation requirement of this paragraph (b)(3) if it is prepared no later than 120 calendar days after the relevant date, as defined in paragraph (b)(3)(ii) of this section, as applicable.

(ii) *Relevant date*. Subject to the special rules in paragraph (b)(3)(iii) of this section (relating to certain financial arrangements not evidenced by an instrument) and paragraph (c)(1) of this section (relating to modifications to certain requirements of this section), the *relevant date* is as follows:

(A) For documentation and information described in paragraphs (b)(2)(i) and (b)(2)(ii) of this section (relating to issuer's unconditional obligation to repay and establishment of holder's creditor's rights), the relevant date is the date on which a member of the expanded group becomes an issuer of a new or existing EGI, without regard to any subsequent deemed issuance of the EGI under § 1.1001–3. In the case of an applicable instrument that becomes an EGI subsequent to issuance, including an intercom-

pany obligation, as defined in § 1.1502–13(g)(2)(ii), that ceases to be an intercompany obligation, the relevant date is the day on which the applicable instrument becomes an EGI.

(B) For documentation and information described in paragraph (b)(2)(iii) of this section (relating to reasonable expectation of issuer's repayment), the relevant dates are the dates on which a member of the expanded group becomes an issuer with respect to an EGI and any later date on which an issuance is deemed to occur under § 1.1001–3 and any subsequent relevant date that occurs under the special rules in paragraph (b)(3)(iii) of this section. In the case of an applicable instrument that becomes an EGI subsequent to issuance, the relevant date is the day on which the applicable instrument becomes an EGI and any relevant date after the date that the applicable instrument becomes an EGI.

(C) For documentation and information described in paragraph (b)(2)(iv)(A) of this section (relating to payments of principal and interest), each date on which a payment of interest or principal is due, taking into account all additional time permitted under the terms of the EGI before there is (or holder can declare) an event of default for nonpayment, is a relevant date.

(D) For documentation and information described in paragraph (b)(2)(iv)(B) of this section (relating to events of default and similar events), each date on which an event of default, acceleration event or similar event occurs under the terms of the EGI is a relevant date. For example, if the terms of the EGI require the issuer to maintain certain financial ratios, any date on which the issuer fails to maintain the specified financial ratio (and such failure results in an event of default under the terms of the EGI) is a relevant date.

(E) In the case of an applicable instrument that becomes an EGI subsequent to issuance, no date before the applicable instrument becomes an EGI is a relevant date.

(iii) *Special rules for determining relevant dates with respect to certain financial arrangements*. The relevant dates with respect to the arrangements described in this paragraph (b)(3)(iii) include the date of the execution of the legal documents governing the EGI and the date of any amendment to those documents that provides for an increase in the permitted maximum amount of principal. In addition —

(A) *Revolving credit agreements and similar agreements*. Notwithstanding paragraph (b)(2)(i) 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), the EGI satisfies the requirements of paragraph (b)(2)(i) 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. Relevant enabling documents may include board of directors' resolutions, credit agreements, omnibus agreements, security agreements, or agreements prepared in connection with the execution of the legal documents governing the EGI as well as any relevant documentation executed with respect to an initial principal balance or increase in the principal balance of the EGI.

(B) *Cash pooling arrangements*. Notwithstanding paragraph (b)(2)(i) of this section, if an EGI is issued pursuant to a cash pooling arrangement or internal banking service that involves account sweeps, revolving cash advance facilities, overdraft set-off facilities, operational facilities, or similar features, the EGI satisfies the requirements of paragraph (b)(2)(i) of this section only if the material documentation governing the ongoing operations of the cash pooling arrangement or internal banking service, including any agreements with entities that are not members of the expanded group, is prepared, maintained, and provided in accordance with the requirements of this section. Such documentation must contain 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 or internal banking service.

(4) *Maintenance requirements*. The documentation and information described in paragraph (b)(2) of this section must be maintained 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 of the EGI is relevant. See section 6001 (requirement to keep books and records).

(c) *Operating rules*—(1) *Reasonable cause exception*. If the person characterizing an EGI as indebtedness for federal tax purposes establishes that a failure to satisfy the requirements of this section is due to reasonable cause, appropriate modifications may be made to the requirements of this section in determining whether the requirements of this section have been satisfied. The principles of § 301.6724–1 of this chapter apply in interpreting whether reasonable cause exists in any particular case.

(2) *General application of section to applicable instrument becoming or ceasing to be an EGI*—(i) *Applicable instrument becomes an EGI*. If an applicable instrument that is not an EGI when issued subsequently becomes an EGI, this section applies to the applicable instrument immediately after it becomes an EGI and thereafter.

(ii) *EGI treated as stock ceases to be an EGI*. When an EGI treated as stock due to the application of this section ceases to be an EGI, the applicable instrument is characterized at that time under general federal tax principles. If, under general federal tax principles, the applicable instrument is treated as indebtedness, the issuer is treated as issuing a new instrument to the holder in exchange for the EGI immediately before the transaction that causes the EGI treated as stock due to the application of this section to cease to be treated as an EGI. See § 1.385–1(c).

(3) *Effective date for treatment of EGI as stock under this section*—(i) *In general*. If an applicable instrument is an EGI when issued and is determined to be stock, in whole or in part, due to the application of this section, the applicable instrument or relevant portion thereof is treated as stock from the date it was issued. However, if an applicable instrument is issued prior to the time it becomes an EGI and is determined to be stock, at the time it becomes an EGI due to the application of this section, it is treated as stock from the date it becomes an EGI.

See § 1.385–2(c)(4) regarding intercompany obligations (deemed issued immediately after ceasing to be an intercompany obligation for purposes of this section and § 1.385–3).

(ii) *EGI recharacterized as stock based on behavior of issuer or holder after issuance*. Notwithstanding paragraph (c)(3)(i) of this section, if an EGI initially treated as indebtedness is recharacterized as stock as a result of failing to satisfy paragraph (b)(2)(iv) of this section (actions evidencing debtor-creditor relationship), the EGI will cease to be treated as indebtedness as of the time the facts and circumstances regarding the behavior of the issuer or the holder with respect to the EGI cease to evidence a debtor-creditor relationship. For purposes of determining whether an EGI originally treated as indebtedness ceases to be treated as indebtedness by reason of paragraph (b)(2)(iv) of this section, the rules of this section apply before the rules of § 1.1001–3, such that an EGI initially treated as indebtedness may be recharacterized as stock regardless of whether the indebtedness is altered or modified (as defined in § 1.1001–3(c)) and, in determining whether indebtedness is recharacterized as stock, § 1.1001–3(f)(7)(ii)(A) does not apply.

(4) *Applicable instruments issued and held by members of consolidated groups*—(i) *Consolidated group treated as one corporation*. Section 1.385–1(e) provides that members of a consolidated group are treated as one corporation. Thus, during the time that the issuer and the holder of an applicable instrument are members of the same consolidated group, the applicable instrument is treated as not outstanding for purposes of this section. As a result, this section does not apply to any applicable instrument that is an intercompany obligation as defined in § 1.1502–13(g)(2)(ii).

(ii) *Applicable instrument that ceases to be an intercompany obligation*. If an applicable instrument ceases to be an intercompany obligation and, as a result, becomes an EGI, the applicable instrument is treated as becoming an EGI immediately after it ceases to be an intercompany obligation. This paragraph (c)(4)(i) does not affect the application of the rules under § 1.1502–13(g).

(5) *Treatment of disregarded entities*. 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. See § 1.385–2(c)(6)(ii) for rules regarding the treatment of an EGI issued by a controlled partnership.

(6) *Applicable instruments issued or held by controlled partnerships*—(i) *Controlled partnerships included in expanded group*. For purposes of this section, a controlled partnership (as defined in § 1.385–1(b)(1)) is treated as a member of an expanded group if one or more members of the expanded group own, directly or indirectly, 80 percent of the interests in partnership capital or profits of the controlled partnership.

(ii) *Treatment of EGI issued by a controlled partnership that is recharacterized under this section*. If an EGI that is issued by a controlled partnership is recharacterized as stock under this section, the EGI is treated as an equity interest in the controlled partnership.

(d) *No affirmative use*. The rules of this section do not apply if there is a failure to satisfy the requirements of paragraph (b) of this section with a principal purpose of reducing the federal tax liability of any member or members of the expanded group of the issuer and holder of the EGI or any other person relying on the characterization of an EGI as indebtedness for federal tax purposes.

(e) *Anti-avoidance*. If an applicable instrument that is not an EGI is issued with a principal purpose of avoiding the purposes of this section, the applicable instrument is treated as an EGI subject to this section.

(f) *Effective/applicability date*. This section applies to any applicable instrument issued or deemed issued on or after the date these regulations are published as final regulations in the **Federal Register**, and to any applicable instrument treated as indebtedness issued or deemed issued before the date these regulations are issued as final regulations if and to the extent it was deemed issued as a result of an entity classification election made under § 301.7701–3 of this chapter that is filed on or after the date these regulations are issued as final regulations in the **Federal Register**.

Par. 4. Section 1.385–3 is added to read as follows:

§ 1.385–3 Certain distributions of debt instruments and similar transactions.

(a) *Scope*. This section provides rules that treat as stock certain interests in a corporation that are held by a member of the corporation's expanded group and that otherwise would be treated as indebtedness for federal tax purposes. Paragraph (b) of this section sets forth situations in which a debt instrument is treated as stock under this section. Paragraph (c) of this section provides three exceptions to the application of paragraph (b) of this section. Paragraph (d) of this section provides operating rules. Paragraph (e) of this section limits the affirmative use of this section. Paragraph (f) of this section provides definitions. Paragraph (g) of this section provides examples illustrating the application of the rules of this section. Paragraph (h) of this section provides dates of applicability. For rules regarding the application of this section to members of a consolidated group, see § 1.385–4.

(b) *Debt instrument treated as stock*—(1) *Effect of characterization as stock*. To the extent a debt instrument is treated as stock under paragraphs (b)(2), (3), or (4) of this section, it is treated as stock for all federal tax purposes. Any interest, or portion thereof, that is not characterized as stock under this section is treated as stock or indebtedness under applicable federal tax law, without reference to this section.

(2) *General rule*. Except as provided in paragraphs (c) and (e) of this section and in § 1.385–4, a debt instrument is treated as stock to the extent the debt instrument is issued by a corporation to a member of the corporation's expanded group as described in one or more of the following paragraphs:

(i) In a distribution;

(ii) In exchange for expanded group stock, other than in an exempt exchange; or

(iii) In exchange for property in an asset reorganization, but only to the extent that, pursuant to the plan of reorganization, a shareholder that is a member of the issuer's expanded group immediately be-

fore the reorganization receives the debt instrument with respect to its stock in the transferor corporation.

(3) *Funding rule*—(i) *In general*. Except as provided in paragraphs (c) and (e) of this section and in § 1.385–4, a debt instrument is treated as stock to the extent it is a principal purpose debt instrument.

(ii) *Principal purpose debt instrument*. For purposes of this paragraph (b)(3), a debt instrument is a principal purpose debt instrument to the extent it is issued by a corporation (funded member) to a member of the funded member's expanded group in exchange for property with a principal purpose of funding a distribution or acquisition described in one or more of the following paragraphs:

(A) A distribution of property by the funded member to a member of the funded member's expanded group, other than a distribution of stock pursuant to an asset reorganization that is permitted to be received without the recognition of gain or income under section 354(a)(1) or 355(a)(1) or, when section 356 applies, that is not treated as "other property" or money described in section 356;

(B) An acquisition of expanded group stock, other than in an exempt exchange, by the funded member from a member of the funded member's expanded group in exchange for property other than expanded group stock; or

(C) An acquisition of property by the funded member in an asset reorganization but only to the extent that, pursuant to the plan of reorganization, a shareholder that is a member of the funded member's expanded group immediately before the reorganization receives "other property" or money within the meaning of section 356 with respect to its stock in the transferor corporation.

(iii) *Transactions described in more than one paragraph*. Solely for purposes of this section, to the extent all or a portion of a distribution or acquisition by a funded member is described in more than one of paragraphs (b)(3)(ii)(A) through (C) of this section, the funded member is treated as engaging in only a single distribution or acquisition described in paragraph (b)(3)(ii) of this section.

(iv) *Principal purpose*—(A) *In general*. Subject to paragraph (b)(3)(iv)(B)(*1*) of this section, whether a debt instrument is issued with a principal purpose of funding a distribution or acquisition described in paragraph (b)(3)(ii) of this section is determined based on all the facts and circumstances. A debt instrument may be treated as issued with a principal purpose of funding a distribution or acquisition described in paragraph (b)(3)(ii) of this section regardless of whether it is issued before or after such distribution or acquisition.

(B) *Per se rule*—(*1*) *In general*. Except as provided in paragraph (b)(3)(iv)(B)(*2*) of this section, a debt instrument is treated as issued with a principal purpose of funding a distribution or acquisition described in paragraph (b)(3)(ii) of this section if it is issued by the funded member during the period beginning 36 months before the date of the distribution or acquisition, and ending 36 months after the date of the distribution or acquisition (72-month period).

(*2*) *Ordinary course exception*. Paragraph (b)(3)(iv)(B)(*1*) of this section does not apply to a debt instrument that arises in the ordinary course of the issuer's trade or business in connection with the purchase of property or the receipt of services to the extent that it reflects an obligation to pay an amount that is currently deductible by the issuer under section 162 or currently included in the issuer's cost of goods sold or inventory, provided that 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 was unrelated to the lender.

(*3*) *Multiple interests*. If, pursuant to paragraph (b)(3)(iv)(B) of this section, two or more debt instruments may be treated as a principal purpose debt instrument, the debt instruments are tested under paragraph (b)(3)(iv)(B) of this section based on the order in which they were issued, with the earliest issued debt instrument tested first. See paragraph (g)(3) of this section, *Example 6*, for an illustration of this rule.

(*4*) *Multiple distributions or acquisitions*. Except as provided in paragraph (c)(3) of this section, if, pursuant to paragraph (b)(3)(iv)(B) of this section, a debt instrument may be treated as funding more than one distribution or acquisition described in paragraph (b)(3)(ii) of this section, the debt instrument is treated as funding one or more distributions or acquisitions based on the order in which the distributions or acquisitions occurred, with the earliest distribution or acquisition treated as the first distribution or acquisition that was funded. See paragraph (g)(3) of this section, *Example 9*, for an illustration of this rule.

(v) *Predecessors and successors*. For purposes of this paragraph (b)(3), references to the funded member include references to any predecessor or successor of such member. See paragraph (g)(3) of this section, *Examples 9*, *10*, and *12*, for illustrations of this rule.

(vi) *Treatment of funded transactions*. When a debt instrument is treated as stock pursuant to paragraph (b)(3) of this section, the distribution or acquisition described in paragraph (b)(3)(ii) of this section that is treated as funded by such debt instrument is not recharacterized as a result of the treatment of the debt instrument as stock.

(4) *Anti-abuse rule*. A debt instrument is treated as stock if it is issued with a principal purpose of avoiding the application of this section or § 1.385–4. In addition, an interest that is not a debt instrument for purposes of this section and § 1.385–4 (for example, a contract to which section 483 applies or a nonperiodic swap payment) is treated as stock if issued with a principal purpose of avoiding the application of this section or § 1.385–4. This paragraph (b)(4) may apply, for example, if a debt instrument is issued to, and later acquired from, a person that is not a member of the issuer's expanded group with a principal purpose of avoiding the application of this section. Additional examples of when this paragraph (b)(4) could apply include, without limitation, situations where, with a principal purpose of avoiding the application of this section, a debt instrument is issued to a person that is not a member of the issuer's expanded group, and such person later becomes a member of the issuer's expanded group; a debt instrument is issued to an entity that is not taxable as a corporation for federal tax purposes; or a member of the issuer's expanded group is substituted as a new obligor or added as a co-obligor on an existing debt instrument. This paragraph (b)(4) also may apply to a

debt instrument that is issued or transferred in connection with a reorganization or similar transaction with a principal purpose of avoiding the application of this section or § 1.385–4. See paragraph (g)(3) of this section, *Example 18*, for an illustration of this rule.

(5) *Coordination between general rule and funding rule*. To the extent a debt instrument is treated as stock under paragraph (b)(2)(iii) of this section, the distribution of the debt instrument (which is treated as a distribution of stock as a result of the application of paragraph (b)(2)(iii) of this section) pursuant to the same reorganization that caused paragraph (b)(2)(iii) of this section to apply is not also treated as a distribution or acquisition described in paragraph (b)(3)(ii) of this section. See paragraph (g)(3) of this section, *Example 8*, for an illustration of this rule.

(c) *Exceptions*—(1) *Exception for current year earnings and profits*. For purposes of applying paragraphs (b)(2) and (b)(3) of this section to a member of an expanded group with respect to a taxable year, the aggregate amount of any distributions or acquisitions that are described in paragraphs (b)(2) or (b)(3)(ii) of this section are reduced by an amount equal to the member's current year earnings and profits described in section 316(a)(2). This reduction is applied to the transactions described in paragraphs (b)(2) and (b)(3)(ii) of this section based on the order in which the distribution or acquisition occurs. See paragraph (g)(3) of this section, *Example 17*, for an illustration of this rule.

(2) *Threshold exception*. A debt instrument is not treated as stock under this section if, immediately after the debt instrument is issued, the aggregate adjusted issue price of debt instruments held by members of the expanded group that would be subject to paragraph (b) of this section but for the application of this paragraph (c)(2) does not exceed $50 million. Once this threshold is exceeded, this paragraph (c)(2) will not apply to any debt instrument issued by members of the expanded group for so long as any debt instrument that previously was treated as indebtedness solely because of this paragraph (c)(2) remains outstanding. For purposes of this rule, any debt instrument that is not denominated in U.S. dollars is translated into U.S. dollars at the spot rate (as defined in § 1.988–1(d)) on the date that the debt instrument is issued. See paragraph (g)(3) of this section, *Example 17*, for an illustration of this rule. See paragraph (d)(1)(iii) of this section for rules regarding the treatment of a debt instrument that ceases to qualify for the exception provided in this paragraph (c)(2).

(3) *Exception for funded acquisitions of subsidiary stock by issuance*. An acquisition of expanded group stock will not be treated as described in paragraph (b)(3)(ii)(B) of this section if the acquisition results from a transfer of property by a funded member (the transferor) to an expanded group member (the issuer) in exchange for stock of the issuer, provided that, for the 36-month period immediately following the issuance, the transferor holds, directly or indirectly, more than 50 percent of the total combined voting power of all classes of stock of the issuer entitled to vote and more than 50 percent of the total value of the stock of the issuer. If the transferor ceases to meet this ownership requirement at any time during that 36-month period, then on the date that the ownership requirement ceases to be met (cessation date), this paragraph (c)(3) ceases to apply and the acquisition is treated as an acquisition described in paragraph (b)(3)(ii)(B) of this section. In this case, for purposes of applying the per se rule, the acquisition may be treated as having been funded by any debt instrument issued during the 72-month period determined with respect to the date of the acquisition (rather than with respect to the cessation date), but, in the case of a debt instrument issued prior to the cessation date, only to the extent that such debt instrument is treated as indebtedness as of the cessation date (that is, a debt instrument not already treated as stock). For purposes of this paragraph (c)(3), a transferor's indirect stock ownership is determined by applying the principles of section 958(a) without regard to whether an intermediate entity is foreign or domestic. See paragraph (d)(1)(v) of this section for rules regarding the treatment of a debt instrument that is treated as funding an acquisition to which this exception ceases to apply.

(d) *Operating rules*—(1) *Timing*. This paragraph (d)(1) provides rules for determining when a debt instrument is treated as stock under paragraph (b) of this section. For special rules regarding the treatment of a deemed exchange of a debt instrument that occurs pursuant to paragraphs (d)(1)(ii), (d)(1)(iii), (d)(1)(iv), or (d)(1)(v), see § 1.385–1(c).

(i) *General timing rule*. Except as otherwise provided in this paragraph (d)(1), when paragraph (b) of this section applies to treat a debt instrument as stock, the debt instrument is treated as stock when the debt instrument is issued. When paragraph (b)(3) of this section applies to treat a debt instrument as stock when the debt instrument is issued, see also paragraph (b)(3)(vi) of this section.

(ii) *Exception when a debt instrument is treated as funding a distribution or acquisition that occurs in a subsequent taxable year*. When paragraph (b)(3)(iv)(B) of this section applies to treat a debt instrument as funding a distribution or acquisition described in paragraph (b)(3)(ii) of this section that occurs in a taxable year subsequent to the taxable year in which the debt instrument is issued, the debt instrument is deemed to be exchanged for stock when the distribution or acquisition described in paragraph (b)(3)(ii) of this section occurs. See paragraph (g)(3) of this section, *Example 9*, for an illustration of this rule.

(iii) *Exception when a debt instrument ceases to qualify for the threshold exception*. A debt instrument that previously was treated as indebtedness pursuant to the threshold exception set forth in paragraph (c)(2) of this section is deemed to be exchanged for stock when the debt instrument ceases to qualify for the threshold exception. Notwithstanding the preceding sentence, if the debt instrument was both issued and ceases to qualify for the threshold exception during the same taxable year, the general timing rule of paragraph (d)(1)(i) of this section applies. See paragraph (g)(3) of this section, *Example 17*, for an illustration of this rule.

(iv) *Exception when a debt instrument is re-tested under paragraph (d)(2) of this section*. When paragraph (b)(3)(iv)(B) of this section applies to treat a debt instrument as funding a distribution or acquisition described in paragraph (b)(3)(ii) of

this section as a result of a re-testing described in paragraph (d)(2) of this section that occurs in a taxable year subsequent to the taxable year in which the debt instrument is issued, the debt instrument is deemed to be exchanged for stock on the date of the re-testing. See paragraph (g)(3) of this section, *Example 7*, for an illustration of this rule.

(v) *Exception when a debt instrument ceases to qualify for the exception for acquisitions of subsidiary stock by issuance*. When paragraph (b)(3)(iv)(B) and the modified ordering rule in paragraph (c)(3) of this section apply to treat a debt instrument as funding an acquisition of expanded group stock that previously qualified for the exception set forth in paragraph (c)(3) of this section, the debt instrument is deemed to be exchanged for stock on the cessation date referred to in paragraph (c)(3) of this section if the debt instrument was issued in a taxable year preceding the taxable year that includes the cessation date. For all other debt instruments that are treated as funding an acquisition of expanded group stock that previously qualified for the exception set forth in paragraph (c)(3) of this section, the general timing rule of paragraph (d)(1)(i) of this section applies.

(2) *Debt instrument treated as stock that leaves the expanded group*. Subject to paragraph (b)(4) of this section, when the holder and issuer of a debt instrument that is treated as stock under this section cease to be members of the same expanded group, either because the debt instrument is transferred to a person that is not a member of the expanded group that includes the issuer or because the holder or the issuer cease to be members of the same expanded group, the debt instrument ceases to be treated as stock under this section. For this purpose, immediately before the transaction that causes the holder and issuer of the debt instrument to cease to be members of the same expanded group, the issuer is deemed to issue a new debt instrument to the holder in exchange for the debt instrument that was treated as stock in a transaction that is disregarded for purposes of paragraphs (b)(2) and (b)(3) of this section. For purposes of paragraph (b)(3)(iv)(B) of this section, when this paragraph (d)(2) causes a debt instrument that previously was treated as stock pursuant to paragraph (b)(3) of this section to cease to be treated as stock, all other debt instruments of the issuer that are not currently treated as stock are retested to determine whether those other debt instruments are treated as funding the distribution or acquisition that previously was treated as funded by the debt instrument that ceases to be treated as stock pursuant to this paragraph (d)(2). See paragraph (g)(3) of this section, *Example 7*, for an illustration of this rule.

(3) *Inapplicability of section 385(c)(1)*. Section 385(c)(1) does not apply with respect to a debt instrument to the extent that it is treated as stock under this section.

(4) *Taxable year*. For purposes of this section, the term *taxable year* refers to the taxable year of the issuer of the debt instrument.

(5) *Treatment of partnerships*—(i) *Application of aggregate treatment*. For purposes of this section, a controlled partnership is treated as an aggregate of its partners. Thus, for example, when a corporation that is a member of an expanded group becomes a partner in a partnership that is a controlled partnership with respect to that expanded group, the corporation is treated as acquiring its proportionate share of the controlled partnership's assets. In addition, each expanded group partner in a controlled partnership is treated as issuing its proportionate share of any debt instrument issued by the controlled partnership. For this purpose, a partner's proportionate share is determined in accordance with the partner's share of partnership profits. See paragraph (g)(3) of this section, *Example 13*, for an illustration of this rule.

(ii) *Treatment of debt instruments issued by partnerships*. To the extent that the application of the aggregate approach in paragraph (d)(5)(i) of this section causes a debt instrument issued by a controlled partnership to be recharacterized under paragraph (b) of this section, then the holder of the recharacterized debt instrument is treated as holding stock in the expanded group partners. In addition, the partnership and its partners must make appropriate conforming adjustments to reflect this treatment. Any such adjustments must be consistent with the purposes of this section and must be made in a manner that avoids the creation of, or increase in, a disparity between the controlled partnership's aggregate basis in its assets and the aggregate bases of the partners' respective interests in the partnership. See paragraph (g)(3) of this section, *Examples 14* and *15*, for an illustration of this rule.

(6) *Treatment of disregarded entities*. If a debt instrument of a disregarded entity is treated as stock under this section, such debt instrument is treated as stock in the entity's owner rather than as an equity interest in the entity.

(e) *No affirmative use*. The rules of this section and § 1.385–4 do not apply to the extent a person enters into a transaction that otherwise would be subject to these rules with a principal purpose of reducing the federal tax liability of any member of the expanded group that includes the issuer and the holder of the debt instrument by disregarding the treatment of the debt instrument that would occur without regard to this section.

(f) *Definitions*. The definitions in this paragraph (f) apply for purposes of this section and for purposes of § 1.385–4.

(1) *Asset reorganization*. The term *asset reorganization* means a reorganization within the meaning of section 368(a)(1)(A), (C), (D), (F), or (G).

(2) *Controlled partnership*. The term *controlled partnership* has the meaning specified in § 1.385–1(b)(1).

(3) *Debt instrument*. The term *debt instrument* means an interest that would, but for the application of this section, be treated as a debt instrument as defined in section 1275(a) and § 1.1275–1(d).

(4) *Distribution*. The term *distribution* means any distribution made by a corporation with respect to its stock.

(5) *Exempt exchange*. The term *exempt exchange* means an acquisition of expanded group stock in which the transferor and transferee of the stock are parties to an asset reorganization, and either—

(i) Section 361(a) or (b) applies to the transferor of the expanded group stock and the stock is not transferred by issuance; or

(ii) Section 1032 or § 1.1032–2 applies to the transferor of the expanded group stock and the stock is distributed by the transferee pursuant to the plan of reorganization.

(6) *Expanded group*. The term *expanded group* has the meaning specified in § 1.385–1(b)(3).

(7) *Expanded group partner*. The term *expanded group partner* means any person that is a partner in a controlled partnership and that is a member of the expanded group whose members own, directly or indirectly, at least 80 percent of the interests in the controlled partnership's capital or profits.

(8) *Expanded group stock*. The term *expanded group stock* means, with respect to a member of an expanded group, stock of a member of the same expanded group.

(9) *Predecessor*—(i) *In general*. The term *predecessor* includes, with respect to a corporation, the distributor or transferor corporation in a transaction described in section 381(a) in which the corporation is the acquiring corporation. For purposes of the preceding sentence, the transferor corporation in a reorganization within the meaning of section 368(a)(1)(D) or (G) is treated as a transferor corporation in a transaction described in section 381(a) without regard to whether the reorganization meets the requirements of sections 354(b)(1)(A) and (B). The term predecessor does not include, with respect to a controlled corporation, a distributing corporation that distributed the stock of the controlled corporation pursuant to section 355(c).

(ii) *Special rules for funded acquisitions of subsidiary stock by issuance*. The term predecessor also includes, with respect to an issuer that issues stock to a transferor in a transaction described in paragraph (c)(3) of this section, the transferor, but, for purposes of applying the per se rule in paragraph (b)(3)(iv)(B)(*1*) of this section, only with respect to a debt instrument issued by the transferor during the 72-month period determined with respect to the transaction described in paragraph (c)(3) of this section, and only to the extent of the value of the expanded group stock acquired from the issuer in the transaction described in paragraph (c)(3) of this section.

(10) *Property*. The term *property* has the meaning specified in section 317(a).

(11) *Successor*—(i) *In general*. The term *successor* includes, with respect to a corporation, the acquiring corporation in a transaction described in section 381(a) in which the corporation is the distributor or transferor corporation. For purposes of the preceding sentence, the acquiring corporation in a reorganization within the meaning of section 368(a)(1)(D) or (G) is treated as an acquiring corporation in a transaction described in section 381(a) without regard to whether the reorganization meets the requirements of sections 354(b)(1)(A) and (B). The term successor does not include, with respect to a distributing corporation, a controlled corporation the stock of which was distributed by the distributing corporation pursuant to section 355(c).

(ii) *Special rules for funded acquisitions of subsidiary stock by issuance*. The term successor also includes, with respect to a transferor that transfers property to an issuer in exchange for stock of the issuer in a transaction described in paragraph (c)(3) of this section, the issuer, but, for purposes of applying the per se rule in paragraph (b)(3)(iv)(B)(*1*) of this section, only with respect to a debt instrument issued by the transferor during 72-month period determined with respect to the transaction described in paragraph (c)(3) of this section, and only to the extent of the value of the expanded group stock acquired from the issuer in the transaction described in paragraph (c)(3) of this section. A distribution by an issuer described in paragraph (c)(3) of this section directly to the transferor is not taken into account for purposes of applying paragraph (b)(3) of this section to a debt instrument of the transferor.

(g) *Examples*—(1) *Assumed facts*. Except as otherwise stated, the following facts are assumed for purposes of the examples in paragraph (g)(3) of this section:

(i) FP is a foreign corporation that owns 100 percent of the stock of USS1, a domestic corporation, 100 percent of the stock of USS2, a domestic corporation, and 100 percent of the stock of FS, a foreign corporation;

(ii) USS1 owns 100 percent of the stock of DS, a domestic corporation, and CFC, which is a controlled foreign corporation within the meaning of section 957;

(iii) At the beginning of Year 1, FP is the common parent of an expanded group comprised solely of FP, USS1, USS2, FS, DS, and CFC (the FP expanded group);

(iv) The FP expanded group has more than $50 million of debt instruments described in paragraph (c)(2) of this section at all times;

(v) No issuer of a debt instrument has current year earnings and profits described in section 316(a)(2);

(vi) All notes are debt instruments described in paragraph (f)(3) of this section;

(vii) No notes are eligible for the ordinary course exception described in paragraph (b)(3)(iv)(B)(2) of this section;

(viii) Each entity has as its taxable year the calendar year;

(ix) PRS is a partnership for federal income tax purposes;

(x) No corporation is a member of a consolidated group, as defined in § 1.1502–1(h);

(xi) No domestic corporation is a United States real property holding corporation within the meaning of section 897(c)(2); and

(xii) Each note is issued with adequate stated interest (as defined in section 1274(c)(2)).

(2) *No inference*. Except as provided in this section, it is assumed for purposes of the examples that the form of each transaction is respected for federal tax purposes. No inference is intended, however, as to whether any particular note would be respected as indebtedness or as to whether the form of any particular transaction described in paragraph (g)(3) of this section would be respected for federal tax purposes.

(3) *Examples*. The following examples illustrate the rules of this section.

Example 1. Distribution of a debt instrument. (i) *Facts*. On Date A in Year 1, FS lends $100x to USS1 in exchange for USS1 Note A. On Date B in Year 2, USS1 issues USS1 Note B, which is has a value of $100x, to FP in a distribution.

(ii) *Analysis*. USS1 Note B is a debt instrument that is issued by USS1 to FP, a member of USS1's expanded group, in a distribution. Accordingly, USS1 Note B is treated as stock under paragraph (b)(2)(i) of this section. Under paragraph (d)(1)(i) of this section, USS1 Note B is treated as stock when it is issued by USS1 to FP on Date B in Year 2. Accordingly, USS1 is treated as distributing USS1 stock to its shareholder FP in a distribution that is subject to section 305. Because USS1 Note B is treated as stock for federal tax purposes when it is issued by USS1, USS1 Note B is not treated as property for purposes of paragraph (b)(3)(ii)(A) of this section because it is not property within the meaning specified in section 317(a). Accordingly, USS1 Note A is not treated as funding the distribu-

tion of USS1 Note B for purposes of paragraph (b)(3)(ii)(A) of this section.

Example 2. Debt instrument issued for expanded group stock that is exchanged for stock in a corporation that is not a member of the same expanded group. (i) *Facts.* UST is a publicly traded domestic corporation. On Date A in Year 1, USS1 issues USS1 Note to FP in exchange for FP stock. On Date B of Year 1, USS1 transfers the FP stock to UST's shareholders, which are not members of the FP expanded group, in exchange for all of the stock of UST.

(ii) *Analysis.* (A) Because USS1 and FP are both members of the FP expanded group, USS1 Note is treated as stock when it is issued by USS1 to FP in exchange for FP stock on Date A in Year 1 under paragraphs (b)(2)(ii) and (d)(1)(i) of this section. This result applies even though, pursuant to the same plan, USS1 transfers the FP stock to persons that are not members of the FP expanded group. The exchange of USS1 Note for FP stock is not an exempt exchange within the meaning of paragraph (f)(5) of this section.

(B) Because USS1 Note is treated as stock for federal tax purposes when it is issued by USS1, pursuant to section § 1.367(b)–10(a)(3)(ii) (defining property for purposes of § 1.367(b)–10) there is no potential application of § 1.367(b)–10(a) to USS1's acquisition of the FP stock.

(C) Because paragraph (b)(2) of this section treats USS1 Note as stock for federal tax purposes when it is issued by USS1, USS1 Note is not treated as indebtedness for purposes of applying paragraph (b)(3) of this section.

Example 3. Issuance of a note in exchange for expanded group stock. (i) *Facts.* On Date A in Year 1, USS1 issues USS1 Note to FP in exchange for 40 percent of the FS stock owned by FP.

(ii) *Analysis.* (A) Because USS1 and FP are both members of the FP expanded group, USS1 Note is treated as stock when it is issued by USS1 to FP in exchange for FS stock on Date A in Year 1 under paragraphs (b)(2)(ii) and (d)(1)(i) of this section. The exchange of USS1 Note for FS stock is not an exempt exchange within the meaning of paragraph (f)(5) of this section because USS1 and FP are not parties to a reorganization.

(B) Because USS1 Note is treated as stock for federal tax purposes when it is issued by USS1, USS1 Note is not treated as property for purposes of section 304(a) because it is not property within the meaning specified in section 317(a). Therefore, USS1's acquisition of FS stock from FP in exchange for USS1 Note is not an acquisition described in section 304(a)(1).

(C) Because USS1 Note is treated as stock for federal tax purposes when it is issued by USS1, USS1 Note is not treated as indebtedness for purposes of applying paragraph (b)(3) of this section.

Example 4. Funding occurs in same taxable year as distribution. (i) *Facts.* On Date A in Year 1, FP lends $200x to CFC in exchange for CFC Note A. On Date B in Year 1, CFC distributes $400x of cash to USS1 in a distribution. CFC is not an expatriated foreign subsidiary as defined in § 1.7874–12T(a)(9).

(ii) *Analysis.* Under paragraph (b)(3)(iv)(B) of this section, CFC Note A is treated as issued with a principal purpose of funding the distribution by CFC to USS1 because CFC Note A is issued to a member of the FP expanded group during the 72-month period determined with respect to CFC's distribution to USS1. Accordingly, under paragraphs (b)(3)(ii)(A) and (d)(1)(i) of this section, CFC Note A is treated as stock when it is issued by CFC to FP on Date A in Year 1.

Example 5. Additional funding. (i) *Facts.* The facts are the same as in *Example 4*, except that, in addition, on Date C in Year 2, FP lends an additional $300x to CFC in exchange for CFC Note B.

(ii) *Analysis.* The analysis is the same as in *Example 4* with respect to CFC Note A. CFC Note B is also issued to a member of the FP expanded group during the 72-month period determined with respect to CFC's distribution to USS1. Under paragraph (b)(3)(iv)(B) of this section, CFC Note B is treated as issued with a principal purpose of funding the remaining portion of CFC's distribution to USS1, which is $200x. Accordingly, $200x of CFC Note B is a principal purpose debt instrument that is treated as stock under paragraph (b)(3)(ii)(A) of this section. Under paragraph (d)(1)(ii) of this section, $200x of CFC Note B is deemed to be exchanged for stock on Date C in Year 2. The remaining $100x of CFC Note B continues to be treated as indebtedness.

Example 6. Funding involving multiple interests. (i) *Facts.* On Date A in Year 1, FP lends $300x to USS1 in exchange for USS1 Note A. On Date B in Year 2, USS1 distributes $300x of cash to FP. On Date C in Year 3, FP lends another $300x to USS1 in exchange for USS1 Note B.

(ii) *Analysis.* (A) Under paragraph (b)(3)(iv)(B)(*3*) of this section, USS1 Note A is tested under paragraph (b)(3) of this section before USS1 Note B is tested. USS1 Note A is issued during the 72-month period determined with respect to USS1's $300x distribution to FP and, therefore, is treated as issued with a principal purpose of funding the distribution under paragraph (b)(3)(iv)(B)(*1*) of this section. Beginning on Date B in Year 2, USS1 Note A is a principal purpose debt instrument that is treated as stock under paragraphs (b)(3)(ii)(A) and (d)(1)(ii) of this section.

(B) Under paragraph (b)(3)(iv)(B)(*3*) of this section, USS1 Note B is tested under paragraph (b)(3) of this section after USS1 Note A is tested. Because USS1 Note A is treated as funding the entire $300x distribution by USS1 to FP, USS1 Note B will continue to be treated as indebtedness.

Example 7. Re-testing. (i) *Facts.* The facts are the same as in *Example 6*, except that on Date D in Year 4, FP sells USS1 Note A to Bank.

(ii) *Analysis.* (A) Under paragraph (d)(2) of this section, USS1 Note A ceases to be treated as stock when FP sells USS1 Note A to Bank on Date D in Year 4. Immediately before FP sells USS1 Note A to Bank, USS1 is deemed to issue a debt instrument to FP in exchange for USS1 Note A in a transaction that is disregarded for purposes of paragraphs (b)(2) and (b)(3) of this section.

(B) Under paragraph (d)(2) of this section, after USS1 Note A is deemed exchanged, USS1's other debt instruments that are not treated as stock as of Date D in Year 4 (USS1 Note B) are re-tested for purposes of paragraph (b)(3)(iv)(B) of this section to determine whether other USS1 debt instruments are treated as funding the $300x distribution by USS1 to FP on Date B in Year 2. USS1 Note B was issued by USS1 to FP within the 72-month period determined with respect to the $300x distribution. Under paragraph (b)(3)(iv)(B)(*1*) of this section, USS1 Note B is treated as issued with a principal purpose of funding the $300x distribution. Accordingly, USS1 Note B is a principal purpose debt instrument under paragraph (b)(3)(ii)(A) of this section that is deemed to be exchanged for stock on Date D in Year 4, the re-testing date, under paragraph (d)(1)(iv) of this section. See § 1.385–1(c) for rules regarding the treatment of this deemed exchange.

Example 8. Distribution of expanded group stock and debt instrument in a reorganization that qualifies under section 355. (i) *Facts.* On Date A in Year 1, FP lends $200x to USS2 in exchange for USS2 Note. In a transaction that is treated as independent from the transaction on Date A in Year 1, on Date B in Year 2, USS2 transfers a portion of its assets to DS2, a newly-formed domestic corporation, in exchange for all of the stock of DS2 and DS2 Note. Immediately afterwards, USS2 distributes all of the DS2 stock and the DS2 Note to FP with respect to FP's USS2 stock in a transaction that qualifies under section 355. USS2's transfer of a portion of its assets qualifies as a reorganization within the meaning of section 368(a)(1)(D). The DS2 stock has a value of $150x and DS2 Note has a value of $50x. The DS2 stock is not non-qualified preferred stock as defined in section 351(g)(2). Absent the application of this section, DS2 Note would be treated by FP as "other property" within the meaning of section 356.

(ii) *Analysis.* (A) The contribution and distribution transaction is a reorganization within the meaning of section 368(a)(1) involving a transfer of USS2's property described in section 361(a). Thus, DS2 Note is a debt instrument that is issued by DS2 to USS2, both members of the FP expanded group, pursuant to an asset reorganization (as defined in paragraph (f)(1) of this section), and received by FP, another FP expanded group member, with respect to FP's USS2 stock. Accordingly, DS2 Note is treated as stock when it is issued by DS2 to USS2 on Date B in Year 2 pursuant to paragraphs (b)(2)(iii) and (d)(1)(i) of this section.

(B) Because DS2 Note is treated as stock when it is issued, section 355(a)(1) rather than section 356 may apply to FP on FP's receipt of DS2 Note. Alternatively, depending on the terms of DS2 Note and other factors, DS2 Note may be treated as non-qualified preferred stock that is not treated as stock pursuant to section 355(a)(3)(D). If DS2 Note is treated as non-qualified preferred stock, such stock would continue to be treated by FP as "other property" for purposes of section 356 under section 356(e). In that case, USS2's distribution of DS2 Note would be treated as "other property" described in section 356, and thus the distribution of DS2 note preliminarily would be described in paragraph (b)(3)(ii)(A) of this section. However, under paragraph (b)(5) of this section, because DS2 Note is treated as stock under paragraph (b)(2)(iii) of this section, USS2's distribution of DS2 Note to FP pursuant to the plan of reorganization is not also treated as a distribution or acquisition described in paragraph (b)(3)(ii) of this section that could cause USS2 Note to be a principal purpose debt instrument.

(C) USS2's distribution of $150x of actual DS2 stock is a distribution of stock pursuant to an asset reorganization that is permitted to be received by FP without recognition of gain under section 355(a)(1). Accordingly, USS2's distribution of the actual DS2 stock to FP is not a distribution of property by USS2 for purposes of paragraph (b)(3)(ii)(A) of this section.

(D) USS2's transfer of assets to DS2 in exchange for DS2 stock is not an acquisition described in paragraph (b)(3)(ii)(B) of this section because USS2's acquisition of DS2 stock is an exempt exchange. USS2's acquisition of DS2 stock is an exempt exchange described in paragraph (f)(5)(ii) of this section because USS2 and DS2 are both parties to a reorganization that is an asset reorganization, section 1032 applies to DS2, the transferor of the expanded group stock, and the DS2 stock is distributed by USS2, the transferee, pursuant to the plan of reorganization. Because USS2 has not made a distribution or acquisition that is treated as a distribution or acquisition for purposes of paragraph (b)(3)(ii) of this section, USS2 Note is not a principal purpose debt instrument.

Example 9. Funding a distribution by a successor to funded member. (i) *Facts.* The facts are the same as in *Example 8*, except that on Date C in Year 3, DS2 distributes $200x of cash to FP and, subsequently, on Date D in Year 3, USS2 distributes $100x of cash to FP.

(ii) *Analysis.* (A) DS2 is a successor with respect to USS2 under paragraph (f)(11)(i) of this section because DS2 is the acquiring corporation in a reorganization within the meaning of section 368(a)(1)(D). USS2 is a predecessor with respect to DS2 under paragraph (f)(9)(i) of this section because USS2 is the transferor corporation in a reorganization within the meaning of section 368(a)(1)(D). Accordingly, under paragraph (b)(3)(v) of this section, a distribution by DS2 is treated as a distribution by USS2. Under paragraph (b)(3)(iv)(B) of this section, USS2 Note is treated as issued with a principal purpose of funding the distribution by DS2 to FP because USS2 Note was issued during the 72-month period determined with respect to DS2's $200x cash distribution. Accordingly, USS2 Note is a principal purpose debt instrument under paragraph (b)(3)(ii)(A) of this section that is deemed to be exchanged for stock on Date C in Year 3 under paragraph (d)(1)(ii) of this section. See § 1.385–1(c) for rules regarding the treatment of this deemed exchange.

(B) Because the entire amount of USS2 Note is treated as funding DS2's $200x distribution to FP, under paragraph (b)(3)(iv)(B)(*4*) of this section, USS2 Note is not treated as funding the subsequent distribution by USS2 on Date D in Year 3.

Example 10. Asset reorganization; section 354 qualified property. (i) *Facts.* On Date A in Year 1, FS lends $100x to USS2 in exchange for USS2 Note. On Date B in Year 2, in a transaction that qualifies as a reorganization within the meaning of section 368(a)(1)(D), USS2 transfers all of its assets to USS1 in exchange for stock of USS1 and the assumption by USS1 of all of the liabilities of USS2, and USS2 distributes to FP, with respect to FP's USS2 stock, all of the USS1 stock that USS2 received. FP does not recognize gain under section 354(a)(1).

(ii) *Analysis.* (A) USS1 is a successor with respect to USS2 under paragraph (f)(11)(i) of this section because USS1 is the acquiring corporation in a reorganization within the meaning of section 368(a)(1)(D). For purposes of paragraph (b)(3) of this section, USS2 and its successor, USS1, are funded members with respect to USS2 Note. Although USS2, a funded member, distributes property (USS1 stock) to its shareholder, FP, pursuant to the reorganization, the distribution of USS1 stock is not described in paragraph (b)(3)(ii)(A) of this section because the property is permitted to be received without the recognition of gain under section 354(a)(1). The distribution of USS1 stock is also not described in paragraph (b)(3)(ii)(C) of this section because FP does not receive the USS1 stock as "other property" within the meaning of section 356.

(B) USS2's exchange of assets for USS1 stock is not an acquisition described in paragraph (b)(3)(ii)(B) of this section because USS2's acquisition of USS1 stock is an exempt exchange. USS2's acquisition of USS1 stock is an exempt exchange described in paragraph (f)(5)(ii) of this section because USS1 and USS2 are both parties to a reorganization, section 1032 applies to USS1, the transferor of the expanded group stock, and the USS1 stock is distributed by USS2, the transferee, pursuant to the plan of reorganization.

(C) Because neither USS1 nor USS2 has made a distribution or acquisition described in paragraph (b)(3)(ii) of this section, USS2 Note is not a principal purpose debt instrument.

Example 11. Triangular reorganization. (i) *Facts.* USS2 owns 100 percent of the stock of DS2, a domestic corporation. On Date B in Year 1, FP issues FP stock and FP Note to USS1 as a contribution to capital. USS1 does not formally issue additional USS1 stock to FP in exchange for FP stock and FP Note, but is treated as issuing stock to FP in an exchange to which section 351 applies. Immediately afterwards, USS1 transfers the FP stock and FP Note to DS2 in exchange for all of DS2's assets, and DS2 distributes the FP stock and FP Note to USS2 with respect to USS2's DS2 stock in a liquidating distribution.

(ii) *Analysis.* FP Note is issued by FP to USS1 in exchange for stock of USS1 in an exchange that is not an exempt exchange described in paragraph (f)(5) of this section. Under paragraph (b)(2)(ii) of this section, FP Note is treated as stock beginning on Date B in Year 1.

Example 12. Funded acquisition of subsidiary stock by issuance; successor.

(i) *Facts.* On Date A in Year 1, FS lends $100x to USS1 in exchange for USS1 Note. On Date B in Year 1, USS1 transfers property that has a value of $20x to CFC in exchange for additional CFC stock that has a value of $20x. On Date C in Year 2, CFC distributes $20 cash to USS1. On Date D in Year 3, CFC acquires stock of FS from FP in exchange for $50x cash.

(ii) *Analysis.* (A) But for the exception in paragraph (c)(3) of this section, USS1 Note would be treated under paragraph (b)(3)(iv)(B) of this section as issued with a principal purpose of funding an acquisition of expanded group stock described in paragraph (b)(3)(ii)(B) of this section because USS1 Note is issued to a member of the FP expanded group during the 72-month period determined with respect to USS1's acquisition of CFC stock on Date B in Year 1. However, because USS1's acquisition of CFC stock results from a transfer of property from USS1 to CFC in exchange for CFC stock and immediately after the transaction USS1 holds 100 percent of the stock of CFC, the exception in paragraph (c)(3) of this section applies. Accordingly, USS1's acquisition of CFC stock on Date B in Year 1 is not treated as an acquisition of stock described in paragraph (b)(3)(ii)(B) of this section, and USS1 Note is not treated as stock.

(B) CFC is a successor with respect to USS1 under paragraph (f)(11)(ii) of this section. For purposes of paragraph (b)(3)(iv)(B)(*1*) of this section CFC is a successor only to the extent of the value of the expanded group stock acquired from CFC in the transaction described in paragraph (c)(3) of this section.

(C) Under paragraph (f)(11)(ii) of this section, CFC's $20x cash distribution to USS1 on Date C in Year 2 is not taken into account for purposes of applying paragraph (b)(3) of this section to USS1 Note.

(D) On Date D in Year 3, CFC continues to be a successor to USS1 for purposes of applying the per se rule in paragraph (b)(3)(iv)(B) of this section. Accordingly, USS1 Note is a principal purpose debt instrument under paragraph (b)(3)(ii)(A) of this section that is deemed to be exchanged for stock on Date D in Year 3 under paragraph (d)(1)(ii) of this section. See § 1.385–1(c) for rules regarding the treatment of this deemed exchange.

Example 13. Distribution of a debt instrument to partnership. (i) *Facts.* CFC and FS are equal partners in PRS. PRS owns 100 percent of the stock of X Corp, a domestic corporation. On Date A in Year 1, X Corp issues X Note to PRS in a distribution.

(ii) *Analysis.* (A) Under § 1.385–1(b)(3), in determining whether X Corp is a member of the expanded group that includes CFC and FS, CFC and FS are each treated as holding 50 percent of the X Corp stock held by PRS. Accordingly, 100 percent of X Corp's stock is treated as owned by CFC and FS under § 1.385–1(b)(3)(i)(B), and X Corp is a member of the FP expanded group.

(B) Together CFC and FS own 100 percent of the interests in PRS capital and profits, such that PRS is a controlled partnership described in § 1.385–1(b)(1). Under paragraph (d)(5)(i) of this section, solely for purposes of this section, when X Corp issues X Note to PRS, proportionate shares of X Note are treated as issued to CFC and FS. Accordingly, for purposes of applying paragraph (b) of this section, in Year 1, 50 percent of X Note is treated as issued to CFC in a distribution and the other 50 percent of X Note is treated as issued to FS in a distribution. Therefore, under paragraphs (b)(2)(i) and (d)(1)(i) of this section, X Note is treated as stock beginning on Date A in Year 1. Under paragraph (d)(5)(i) of this section, CFC and FS are treated as holding X Note solely for purposes of this section. For all other federal tax purposes, X Note is treated as stock in X Corp that is held by PRS, and X Corp is treated as distributing its stock

to its shareholder in a distribution that is subject to section 305.

Example 14. Loan to partnership; same-year distribution. (i) *Facts*. The facts are the same as in *Example 13*, except that X Corp does not distribute X Note to PRS; instead, on Date A in Year 1 FP lends $200x to PRS in exchange for PRS Note. On Date B in Year 1, CFC distributes $100x to USS1 and FS distributes $100x to FP. CFC is not an expatriated foreign subsidiary as defined in § 1.7874–12T(a)(9).

(ii) *Analysis*. (A) Under paragraph (d)(5)(i) of this section, solely for purposes of this section, CFC and FS are each treated as issuing $100x of PRS Note on Date A in Year 1, which represents their proportionate shares of PRS Note. CFC's and FS's shares of PRS Note are each issued to FP, a member of the same expanded group, during the 72-month periods determined with respect to the distributions by CFC and FS. Under paragraph (b)(3)(iv)(B)(*1*) of this section, PRS Note is treated as issued with a principal purpose of funding the distributions by CFC and FS. Accordingly, under paragraphs (b)(3)(ii)(A) and (d)(1)(i) of this section, PRS Note is a principal purpose debt instrument that is treated as stock when it is issued on Date A in Year 1.

(B) Under paragraph (d)(5)(ii) of this section, CFC and FS are each treated as issuing $100x of stock to FP. Appropriate conforming adjustments must be made to CFC's and FS's interests in PRS to reflect the deemed treatment of PRS Note as stock issued by CFC and FS, which must be done in a manner that avoids the creation of, or increase in, a disparity between PRS's aggregate basis in its assets and the aggregate bases of CFC's and FS's respective interests in PRS. For example, reasonable and appropriate adjustments may occur when the following steps are deemed to occur on Date A in Year 1:

(*1*) CFC issues stock to FP in exchange for $100x;

(*2*) FS issues stock to FP in exchange for $100x;

(*3*) CFC contributes $100x to PRS in exchange for a partnership interest in PRS; and

(*4*) FS contributes $100x to PRS in exchange for a partnership interest in PRS.

Example 15. Loan to partnership; distribution in later year. (i) *Facts*. The facts are the same as in *Example 14*, except that CFC and FS do not make distributions on Date B of Year 1; instead, CFC distributes $100x to USS1 and FS distributes $100x to FP on Date C of Year 2.

(ii) *Analysis*. (A) As in *Example 14*, CFC's and FS's shares of PRS Note are each issued to FP, a member of the same expanded group, during the 72-month periods determined with respect to the distributions by CFC and FS. Under paragraph (b)(3)(iv)(B)(*1*) of this section, PRS Note is treated as issued with a principal purpose of funding the distributions by CFC and FS. Accordingly, PRS Note is a principal purpose debt instrument that is treated as stock under paragraph (b)(3)(i)(A) of this section. Under paragraph (d)(1)(ii) of this section, PRS Note is treated as stock on Date C in Year 2.

(B) Under paragraph (d)(5)(ii) of this section, CFC and FS are each treated as issuing $100x of stock to FP. Appropriate conforming adjustments must be made to CFC's and FS's interests in PRS to reflect the deemed treatment of PRS Note as stock issued by CFC and FS, which must be done in a manner that avoids the creation of, or increase in, a disparity between PRS's aggregate basis in its assets and the aggregate bases of CFC's and FS's respective interests in PRS. For example, reasonable and appropriate adjustments may occur when the following steps are deemed to occur on Date C in Year 2:

(*1*) CFC assumes liability with respect to $100x of PRS Note;

(*2*) FS assumes liability with respect to $100x of PRS Note;

(*3*) CFC issues stock to FP in satisfaction of the $100x of PRS Note assumed by CFC; and

(*4*) FS issues stock to FP in satisfaction of the $100x of PRS Note assumed by FS.

Example 16. Distribution of another member's debt instrument. (i) *Facts*. On Date A in Year 1, CFC lends $100x to FS in exchange for FS Note. On Date B in Year 2, CFC distributes FS Note to USS1.

(ii) *Analysis*. Although CFC distributes FS Note, which is a debt instrument, to USS1, another member of CFC's expanded group, paragraph (b)(2)(i) of this section does not apply because CFC is not the issuer of the FS Note.

Example 17. Threshold exception and current year earnings and profits exception. (i) *Facts*. Before Date A in Year 1, the members of FP's expanded group hold no outstanding debt instruments that otherwise would be treated as stock under this section. On Date A in Year 1, CFC issues CFC Note, which has an issue price of $40 million, to USS1 in a distribution. On Date B in Year 2, USS1 issues USS1 Note, which has an issue price of $20 million, to FP in a distribution. On Date C in Year 3, FS distributes $30 million in cash to FP. On Date D in Year 3, DS lends $30 million to FS in exchange for FS Note A. On Date E in Year 3, FS issues FS Note B, which has an issue price of $19 million, to FP in a distribution. In Year 3, FS has $35 million in earnings and profits described in section 316(a)(2).

(ii) *Analysis*. (A) Because CFC does not have earnings and profits described in section 316(a)(2) in Year 1, the exception in paragraph (c)(1) of this section does not apply to CFC Note. Immediately after CFC Note is issued to USS1 on Date A in Year 1, the aggregate adjusted issue price of outstanding debt instruments issued by members of FP's expanded group that would be subject to paragraph (b) of this section but for the application paragraph (c)(2) of this section does not exceed $50 million. Accordingly, the threshold exception described in paragraph (c)(2) applies to the CFC Note.

(B) Because USS1 does not have earnings and profits described in section 316(a)(2) in Year 2, the exception in paragraph (c)(1) of this section does not apply to USS1 Note. Immediately after USS1 Note is issued to FP on Date B in Year 2, the aggregate adjusted issue price of outstanding debt instruments issued by members of the FP expanded group that would be subject to paragraph (b) of this section but for the application of paragraph (c)(2) of this section exceeds $50 million. Under paragraph (d)(1)(iii) of this section, CFC Note is deemed to be exchanged for stock on Date B in Year 2, when debt instruments of the FP expanded group cease to qualify for the threshold exception described in paragraph (c)(2) of this section. In addition, the threshold exception described in paragraph (c)(2) of this section does not apply to USS1 Note because, immediately after USS1 Note is issued, the aggregate adjusted issue price of outstanding debt instruments issued by members of the expanded group that would be subject to paragraph (b) of this section but for the application paragraph (c)(2) of this section exceeds $50 million. Accordingly, USS1 Note is treated as stock when it is issued on Date B in Year 2.

(C) Under paragraph (c)(1) of this section, for purposes of applying paragraphs (b)(2) and (b)(3) of this section to a member of an expanded group with respect to Year 3, the aggregate amount of any distributions or acquisitions by FS that are described in paragraphs (b)(2) or (b)(3)(ii) of this section are reduced by an amount equal to FS's current year earnings and profits described in section 316(a)(2) for Year 3, which is $35 million. Thus, $35 million of distributions or acquisitions by FS in Year 3 are not taken into account for purposes of applying paragraphs (b)(2) and (b)(3) of this section. The reduction is applied first against FS's $30 million cash distribution on Date C in Year 3 and second against FS's $19 million note distribution on Date E in Year 3. Accordingly, under paragraph (c)(1) of this section, FS Note A is not treated as stock under paragraph (b)(3) of this section. In addition, under paragraph (c)(1) of this section a portion of FS Note B equal to $5 million is not treated as stock under paragraph (b)(2) of this section.

(D) When FS Note B is issued in Year 3, CFC Note, which previously was treated as indebtedness solely because of paragraph (c)(2) of this section, remains outstanding. Accordingly, the threshold exception described in paragraph (c)(2) of this section does not apply to FS Note B. Accordingly, the remaining amount of FS Note B equal to $14 million after applying the exception under paragraph (c)(1) of this section is treated as stock under paragraph (b)(2) of this section.

Example 18. Distribution of a debt instrument and issuance of a debt instrument with a principal purpose of avoiding the purposes of this section. (i) *Facts*. On Date A in Year 1, USS1 issues USS1 Note A, which has a value of $100x, to FP in a distribution. On Date B in Year 1, with a principal purpose of avoiding the application of this section, FP sells USS1 Note A to Bank for $100x of cash and lends $100x to USS1 in exchange for USS1 Note B.

(ii) *Analysis*. USS1 Note A is a debt instrument that is issued by USS1 to FP, a member of USS1's expanded group, in a distribution. Accordingly, under paragraphs (b)(2)(i) and (d)(1)(i) of this section, USS1 Note A is treated as stock when it is issued by USS1 to FP on Date A in Year 1. Accordingly, USS1 is treated as distributing USS1 stock to its shareholder FP. Because USS1 Note A is treated as stock of USS1, USS1 Note A is not property as specified in section 317(a) on Date A in Year 1. Under paragraph (d)(2) of this section, USS1 Note A ceases to be treated as stock when FP sells USS1 Note A to Bank on Date B in Year 1. Immediately before FP sells USS1 Note A to Bank, USS1 is deemed to issue a debt instrument to FP in exchange for USS1 Note A in a transaction that is disregarded for purposes of paragraphs (b)(2) and (b)(3) of this section. USS1 Note B is not treated as stock under paragraph (b)(3)(ii)(A) of this section because the funded member, USS1, has not made a distribution of property.

However, because the transactions occurring on Date B of Year 1 were undertaken with a principal purpose of avoiding the purposes of this section, USS1 Note B is treated as stock on Date B of Year 1 under paragraph (b)(4) of this section.

(h) *Effective/applicability date and transition rules*—(1) *In general*. This section applies to any debt instrument issued on or after April 4, 2016, and to any debt instrument treated as issued before April 4, 2016 as a result of an entity classification election made under § 301.7701–3 of this chapter that is filed on or after April 4, 2016.

(2) *Transition rule for distributions or acquisitions occurring before April 4, 2016*. For purposes of paragraph (b)(3)(iv) of this section, a distribution or acquisition described in paragraph (b)(3)(ii) of this section that occurs before April 4, 2016, other than a distribution or acquisition that is treated as occurring before April 4, 2016 as a result of an entity classification election made under § 301.7701–3 of this chapter that is filed on or after April 4, 2016, is not taken into account.

(3) *Transition rule for debt instruments that would be treated as stock prior to the date of publication in the* ***Federal Register*** *of the Treasury decision adopting this rule as a final regulation*. When paragraphs (b) and (d)(1)(i) through (v) of this section otherwise would treat a debt instrument as stock prior to the date of publication in the **Federal Register** of the Treasury decision adopting this rule as a final regulation, the debt instrument is treated as indebtedness until the date that is 90 days after the date of publication in the **Federal Register** of the Treasury decision adopting this rule as a final regulation. To the extent that the debt instrument described in the preceding sentence is held by a member of the issuer's expanded group on the date that is 90 days after the date of publication in the **Federal Register** of the Treasury decision adopting this rule as a final regulation, the debt instrument is deemed to be exchanged for stock on the date that is 90 days after the date of publication in the **Federal Register** of the Treasury decision adopting this rule as a final regulation.

Par. 5. Section 1.385–4 is added to read as follows:

§ 1.385–4 Treatment of consolidated groups.

(a) *Scope*. Section 1.385–1(e) provides that members of a consolidated group are treated as one corporation for purposes of the regulations under section 385. This section provides rules for applying § 1.385–3 to consolidated groups when an interest ceases to be a consolidated group debt instrument or becomes a consolidated group debt instrument. For definitions applicable to this section, see § 1.385–3(f).

(b) *Debt instrument ceases to be a consolidated group debt instrument but continues to be an expanded group debt instrument*—(1) *Member leaving the group*. When a corporation ceases to be a member of the consolidated group but continues to be a member of the expanded group (such corporation, a *departing member*), a debt instrument that is issued or held by the departing member is treated as indebtedness or stock pursuant to paragraphs (b)(1)(i) or (b)(1)(ii) of this section.

(i) *Exempt consolidated group debt instrument that ceases to be consolidated group debt instrument*. Any exempt consolidated group debt instrument that is issued or held by the departing member is deemed to be exchanged for stock immediately after the departing member leaves the group. For these purposes, the term *exempt consolidated group debt instrument* means any debt instrument that was not treated as stock solely by reason of the departing member's treatment under § 1.385–1(e). See paragraph (d) of this section, *Example 3*, for an illustration of this rule.

(ii) *Non-exempt consolidated group debt instrument that ceases to be consolidated group debt instrument*—(A) *In general*. Any consolidated group debt instrument issued or held by a departing member that is not an exempt consolidated group debt instrument (*non-exempt consolidated group debt instrument*) is treated as indebtedness unless and until the non-exempt consolidated group debt instrument is treated as a principal purpose debt instrument under § 1.385–3(b)(3)(ii) and (d)(1) as a result of a distribution or acquisition described in § 1.385–3(b)(3)(ii) that occurs after the departure.

(B) *Coordination with funding rule*. Solely for purposes of applying the 72-month period under § 1.385–3(b)(3)(iv)(B) (the per se rule), a non-exempt consolidated group debt instrument is treated as having been issued when it was first treated as a consolidated group debt instrument. For all other purposes of applying § 1.385–3, including for purposes of applying § 1.385–3(d), a non-exempt consolidated group debt instrument is treated as issued by the issuer of the debt instrument immediately after the departing member leaves the group.

(2) *Consolidated group debt instrument that is transferred outside of the consolidated group*. Solely for purposes of § 1.385–3, when a member of a consolidated group that holds a consolidated group debt instrument transfers the debt instrument to an expanded group member that is not a member of the consolidated group, the debt instrument is treated as issued by the issuer of the debt instrument (which is treated as one corporation with the transferor of the debt instrument pursuant to § 1.385–1(e)) to the transferee expanded group member on the date of the transfer. For purposes of § 1.385–3, the consequences of such transfer are determined in a manner that is consistent with treating a consolidated group as one corporation. Thus, for example, the sale of a consolidated group debt instrument to an expanded group member that is not a member of the consolidated group will be treated as an issuance of the debt instrument to the transferee expanded group member in exchange for property. To the extent the debt instrument is treated as stock upon being transferred, the debt instrument is deemed to be exchanged for stock immediately after the debt instrument is transferred outside of the consolidated group. For examples illustrating this rule, see paragraph (d) of this section, *Examples 1* and *2*.

(c) *Debt instrument entering a consolidated group*. When a debt instrument that is treated as stock under § 1.385–3 becomes a consolidated group debt instrument, immediately before that debt instrument becomes a consolidated group debt instrument, the issuer is treated as issuing a new debt instrument to the holder in exchange for the debt instrument that was

treated as stock in a transaction that is disregarded for purposes of § 1.385–3(b).

(d) *Examples*—(1) *Assumed facts*. Except as otherwise stated, the following facts are assumed for purposes of the examples in paragraph (d)(3) of this section:

(i) FP is a foreign corporation that owns 100 percent of the stock of USS1, a domestic corporation, and 100 percent of the stock of FS, a foreign corporation;

(ii) USS1 owns 100 percent of the stock of DS1, a domestic corporation;

(iii) DS1 owns 100 percent of the stock of DS2, a domestic corporation;

(iv) At the beginning of Year 1, FP is the common parent of an expanded group comprised solely of FP, USS1, FS, DS1, and DS2 (the FP expanded group);

(v) USS1, DS1, and DS2 are members of a consolidated group of which USS1 is the common parent (the USS1 consolidated group);

(vi) The FP expanded group has more than $50 million of debt instruments described in § 1.385–3(c)(2) at all times;

(vii) No issuer of a debt instrument has current year earnings and profits described in section 316(a)(2);

(viii) All notes are debt instruments described in § 1.385–3(f)(3) and therefore have satisfied any requirements under § 1.385–2, if applicable, and are respected as debt instruments under general federal tax principles;

(ix) No notes are eligible for the ordinary course exception described in § 1.385–3(b)(3)(iv)(B)(*2*);

(x) Each entity has as its taxable year the calendar year;

(xi) No domestic corporation is a United States real property holding corporation within the meaning of section 897(c)(2); and

(xii) Each note is issued with adequate stated interest (as defined in section 1274(c)(2)).

(2) *No inference*. Except as provided in this section, it is assumed for purposes of the examples that the form of each transaction is respected for federal tax purposes. No inference is intended, however, as to whether any particular note would be respected as indebtedness or as to whether the form of any particular transaction described in paragraph (d)(3) of this section would be respected for federal tax purposes.

(3) *Examples*. The following examples illustrate the rules of this section.

Example 1. Distribution of consolidated group debt instrument. (i) *Facts*. On Date A in Year 1, DS1 issues DS1 Note to USS1 in a distribution. On Date B in Year 2, USS1 distributes DS1 Note to FP.

(ii) *Analysis*. Under § 1.385–1(e), the USS1 consolidated group is treated as one corporation for purposes of § 1.385–3. Accordingly, when DS1 issues DS1 Note to USS1 in a distribution, DS1 is not treated as issuing a debt instrument to another member of DS1's expanded group in a distribution for purposes of § 1.385–3, and DS1 Note is not treated as stock under § 1.385–3. Under paragraph (b)(2) of this section, when USS1 distributes DS1 Note to FP, the USS1 consolidated group is treated as issuing a debt instrument to FP in a distribution. Accordingly, DS1 Note is treated as DS1 stock under § 1.385–3(b)(2)(i). For this purpose, DS1 Note is deemed to be exchanged for stock immediately after DS1 Note is transferred outside of the USS1 consolidated group.

Example 2. Sale of consolidated group debt instrument. (i) *Facts*. On Date A in Year 1, DS1 lends $200x to USS1 in exchange for USS1 Note. On Date B in Year 2, USS1 distributes $200x to FP. On Date C in Year 2, DS1 sells USS1 Note to FS for $200x.

(ii) *Analysis*. Under § 1.385–1(e), the USS1 consolidated group is treated as one corporation for purposes of § 1.385–3. Accordingly, when USS1 issues USS1 Note to DS1 on Date A in Year 1, USS1 is not treated as a funded member, and when USS1 distributes $200x to FP on Date B in Year 2, § 1.385–2(b)(3) does not apply. Under paragraph (b)(2) of this section, when DS1 sells USS1 Note to FS, the USS1 consolidated group is treated as issuing USS1 Note to FS in exchange for $200x on Date C in Year 2. Because USS1 Note was issued by the USS1 consolidated group to FS within 36 months of the distribution by the USS1 consolidated group to FP, § 1.385–3(b)(3)(iv)(B)(*1*) treats USS1 Note as issued with a principal purpose of funding that distribution. Accordingly, USS1 Note is a principal purpose debt instrument that is treated as USS1 stock under § 1.385–3(b)(3)(ii)(A). Under paragraph (b)(2) of this section, immediately after USS1 Note is transferred outside of the USS1 consolidated group, USS1 Note is deemed to be exchanged for stock.

Example 3. Treatment of exempt consolidated group debt instrument when a consolidated group member leaves the consolidated group. (i) *Facts*. On Date A in Year 1, DS1 issues DS1 Note A to USS1 in a distribution. On Date B in Year 2, USS1 lends $100x to DS1 in exchange for DS1 Note B. On Date C in Year 4, FP purchases 25 percent of DS1's stock from USS1, resulting in DS1 ceasing to be a member of the USS1 consolidated group.

(ii) *Analysis*. (A) Under § 1.385–1(e), the USS1 consolidated group is treated as one corporation for purposes of § 1.385–3 until Date C in Year 4. Accordingly, when DS1 issues DS1 Note to USS1 in a distribution on Date A in Year 1, DS1 is not treated as issuing a debt instrument to a member of DS's expanded group in a distribution for purposes of § 1.385–3(b)(2), and DS1 Note A is not treated as stock under § 1.385–3 on Date A in Year 1. DS1 Note A is an exempt consolidated group debt instrument because DS1 Note A is not treated as stock on Date A in Year 1 solely by reason of § 1.385–1(e). Under paragraph (b)(1)(i) of this section, immediately after DS1 leaves the USS1 consolidated group, DS1 Note A is deemed to be exchanged for stock.

(B) DS1 Note B is a non-exempt consolidated group debt instrument because DS1 Note B, which is issued in exchange for cash, would not be treated as stock even absent the application of § 1.385–1(e) because there have been no transactions described in § 1.385–3(b)(3)(ii) that would have been treated as funded by DS1 Note B in the absence of the application of § 1.385–1(e). Accordingly, under paragraph (b)(1)(ii)(A) of this section, DS1 Note B is not treated as stock when DS1 ceases to be a member of the USS1 consolidated group, provided there are no distributions or acquisitions described in § 1.385–3(b)(3)(ii) by DS1 that occur later in Year 4 (after Date C).

Example 4. Distribution after a funded consolidated group member leaves the consolidated group. (i) *Facts*. The facts are the same as in *Example 3*, except that on Date D in Year 6, DS1 distributes $100x pro rata to its shareholders ($75x to USS1 and $25x to FP).

(ii) *Analysis*. The per se rule in § 1.385–3(b)(3)(iv)(B)(*1*) does not apply to DS1 Note B and the distribution on Date D in Year 6 because under section (b)(1)(ii)(B) of this section, for purposes of applying § 1.385–3(b)(3)(iv)(B)(*1*), DS1 Note B is treated as issued on Date B in Year 2, which is more than 36 months before Date D in Year 6.

Example 5. Treatment of non-exempt consolidated group debt instrument when a consolidated group member leaves the group. (i) *Facts*. On Date A in Year 1, DS2 lends $100x to DS1 in exchange for DS1 Note. On Date B in Year 1, DS1 distributes $100x of cash to USS1. On Date C in Year 1, FP purchases 25 percent of DS2's stock from DS1, resulting in DS2 ceasing to be a member of the USS1 consolidated group.

(ii) *Analysis*. After DS2 ceases to be a member of the USS1 consolidated group, DS1 and USS1 continue to be treated as one corporation under § 1.385–1(e), such that DS1's distribution of cash to USS1 on Date B in Year 1 continues to be disregarded for purposes of § 1.385–3. Accordingly, DS1 Note is a non-exempt consolidated group debt instrument because DS1 Note, which is issued in exchange for cash, would not be treated as stock even absent the application of § 1.385–1(e) to DS2, because, taking into account the continued application of § 1.385–1(e) to USS1 and DS1, DS1 Note does not fund any transaction described in § 1.385–3(b)(3)(ii). Accordingly, under paragraph (b)(1)(ii)(A) of this section, DS1 Note is not treated as stock when it ceases to be a consolidated group debt instrument, provided there are no distributions or acquisitions described in § 1.385–3(b)(3)(ii) by DS1 that occur later in Year 1 (after Date C).

(e) *Effective/applicability date and transition rules*—(1) *In general*. This section applies to any debt instrument issued on or after April 4, 2016, and to any debt instrument treated as issued before April 4, 2016 as a result of an entity classification election made under § 301.7701–3 of

this chapter that is filed on or after April 4, 2016.

(2) *Transition rule for distributions or acquisitions occurring before April 4, 2016*. For purposes of this section, a distribution or acquisition described in § 1.385–3(b)(3)(ii) that occurs before April 4, 2016, other than a distribution or acquisition that is treated as occurring before April 4, 2016 as a result of an entity classification election made under § 301.7701–3 of this chapter that is filed on or after April 4, 2016, is not taken into account.

(3) *Transition rule for debt instruments that would be treated as stock prior to the date of publication in the* ***Federal Register*** *of the Treasury decision adopting this rule as a final regulation.* When this section otherwise would treat a debt instrument as stock prior to the date of publication in the **Federal Register** of the Treasury decision adopting this rule as a final regulation, the debt instrument is treated as indebtedness until the date that is 90 days after the date of publication in the **Federal Register** of the Treasury decision adopting this rule as a final regulation. To the extent that the debt instrument described in the preceding sentence is held by a member of the issuer's expanded group on the date that is 90 days after the date of publication in the **Federal Register** *of the Treasury decision adopting this rule as a final regulation, the debt* instrument is deemed to be exchanged for stock on the date that is 90 days after the date of publication in the **Federal Register** of the Treasury decision adopting this rule as a final regulation.

John Dalrymple.
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(Filed by the Office of the Federal Register on April 4, 2016, 5:00 p.m., and published in the issue of the Federal Register for April 8, 2016, 80 F.R. 20912)

Definition of Terms

Revenue rulings and revenue procedures (hereinafter referred to as "rulings") that have an effect on previous rulings use the following defined terms to describe the effect:

Amplified describes a situation where no change is being made in a prior published position, but the prior position is being extended to apply to a variation of the fact situation set forth therein. Thus, if an earlier ruling held that a principle applied to A, and the new ruling holds that the same principle also applies to B, the earlier ruling is amplified. (Compare with modified, below).

Clarified is used in those instances where the language in a prior ruling is being made clear because the language has caused, or may cause, some confusion. It is not used where a position in a prior ruling is being changed.

Distinguished describes a situation where a ruling mentions a previously published ruling and points out an essential difference between them.

Modified is used where the substance of a previously published position is being changed. Thus, if a prior ruling held that a principle applied to A but not to B, and the new ruling holds that it applies to both A and B, the prior ruling is modified because it corrects a published position. (Compare with amplified and *clarified*, above).

Obsoleted describes a previously published ruling that is not considered determinative with respect to future transactions. This term is most commonly used in a ruling that lists previously published rulings that are obsoleted because of changes in laws or regulations. A ruling may also be obsoleted because the substance has been included in regulations subsequently adopted.

Revoked describes situations where the position in the previously published ruling is not correct and the correct position is being stated in a new ruling.

Superseded describes a situation where the new ruling does nothing more than restate the substance and situation of a previously published ruling (or rulings). Thus, the term is used to republish under the 1986 Code and regulations the same position published under the 1939 Code and regulations. The term is also used when it is desired to republish in a single ruling a series of situations, names, etc., that were previously published over a period of time in separate rulings. If the new ruling does more than restate the substance of a prior ruling, a combination of terms is used. For example, modified and *superseded* describes a situation where the substance of a previously published ruling is being changed in part and is continued without change in part and it is desired to restate the valid portion of the previously published ruling in a new ruling that is self contained. In this case, the previously published ruling is first modified and then, as modified, is superseded.

Supplemented is used in situations in which a list, such as a list of the names of countries, is published in a ruling and that list is expanded by adding further names in subsequent rulings. After the original ruling has been supplemented several times, a new ruling may be published that includes the list in the original ruling and the additions, and supersedes all prior rulings in the series.

Suspended is used in rare situations to show that the previous published rulings will not be applied pending some future action such as the issuance of new or amended regulations, the outcome of cases in litigation, or the outcome of a Service study.

Abbreviations

The following abbreviations in current use and formerly used will appear in material published in the Bulletin.

A—Individual.
Acq.—Acquiescence.
B—Individual.
BE—Beneficiary.
BK—Bank.
B.T.A.—Board of Tax Appeals.
C—Individual.
C.B.—Cumulative Bulletin.
CFR—Code of Federal Regulations.
CI—City.
COOP—Cooperative.
Ct.D.—Court Decision.
CY—County.
D—Decedent.
DC—Dummy Corporation.
DE—Donee.
Del. Order—Delegation Order.
DISC—Domestic International Sales Corporation.
DR—Donor.
E—Estate.
EE—Employee.
E.O.—Executive Order.
ER—Employer.
ERISA—Employee Retirement Income Security Act.
EX—Executor.
F—Fiduciary.
FC—Foreign Country.
FICA—Federal Insurance Contributions Act.
FISC—Foreign International Sales Company.
FPH—Foreign Personal Holding Company.
F.R.—Federal Register.
FUTA—Federal Unemployment Tax Act.
FX—Foreign corporation.
G.C.M.—Chief Counsel's Memorandum.
GE—Grantee.
GP—General Partner.
GR—Grantor.
IC—Insurance Company.
I.R.B.—Internal Revenue Bulletin.
LE—Lessee.
LP—Limited Partner.
LR—Lessor.
M—Minor.
Nonacq.—Nonacquiescence.
O—Organization.
P—Parent Corporation.
PHC—Personal Holding Company.
PO—Possession of the U.S.
PR—Partner.
PRS—Partnership.
PTE—Prohibited Transaction Exemption.
Pub. L.—Public Law.
REIT—Real Estate Investment Trust.
Rev. Proc.—Revenue Procedure.
Rev. Rul.—Revenue Ruling.
S—Subsidiary.
S.P.R.—Statement of Procedural Rules.
Stat.—Statutes at Large.
T—Target Corporation.
T.C.—Tax Court.
T.D.—Treasury Decision.
TFE—Transferee.
TFR—Transferor.
T.I.R.—Technical Information Release.
TP—Taxpayer.
TR—Trust.
TT—Trustee.
U.S.C.—United States Code.
X—Corporation.
Y—Corporation.
Z—Corporation.

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[1]A cumulative list of all revenue rulings, revenue procedures, Treasury decisions, etc., published in Internal Revenue Bulletins 2015–27 through 2015–52 is in Internal Revenue Bulletin 2015–52, dated December 28, 2015.

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Internal Revenue Service
Washington, DC 20224

INTERNAL REVENUE BULLETIN

The Introduction at the beginning of this issue describes the purpose and content of this publication. The weekly Internal Revenue Bulletins are available at *www.irs.gov/irb/*.

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