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Proposed Regulations on Related-Party Debt Instruments Would Result in Dramatic Adverse Tax Consequences

On April 4, 2016, the US Department of the Treasury and the Internal Revenue Service proposed regulations under section 385 of the Internal Revenue Code (the "Proposed Regulations") that would recharacterize certain related-party debt instruments, in whole or in part, as equity. Although the Proposed Regulations were motivated to curb the benefits of post-inversion earnings-stripping and repatriation transactions where no new capital is invested in the US borrower, the Proposed Regulations, if finalized in their present form, would impact far more than these transactions. The Proposed Regulations would affect routine financing transactions entered into by multinational corporate groups and portfolio companies owned by private equity funds, even in instances in which the issuer is not a US corporation and the debt instrument is not issued in connection with an inversion transaction. The broad scope of the Proposed Regulations also would impact common decisions primarily motivated by non-tax concerns such as which company in an expanded group will borrow from third parties.

The Proposed Regulations would reclassify certain related-party debt instruments as stock for all US tax purposes when the debt is issued in connection with one of three specified transactions (a distribution of a note, as consideration for an acquisition of the stock of another member of the "expanded group," or as boot in connection with an intercompany asset reorganization) (the "General Rule"). In addition, subject to certain limited exceptions, the Proposed Regulations would automatically reclassify certain related-party debt instruments as stock when the debt instruments are considered issued within 72 months of any of the three specified transactions covered by the General Rule (the "Funding Rule"). The Proposed Regulations also would (i) reclassify related-party debt instruments as stock where the parties do not satisfy new contemporaneous and ongoing documentation requirements (the "Documentation Requirements") and (ii) provide the IRS with a new means to challenge the classification of related-party debt instruments by allowing the IRS to bifurcate debt instruments into separate debt and stock components for US tax purposes (the "Bifurcation Rule").

Debt Instruments Reclassified as Stock Based on Manner of Issuance (Prop. Reg. § 1.385-3)

General Rule

Under the General Rule, and subject to certain exceptions, a debt instrument between members of an "expanded group" would be reclassified as stock if: (i) the debt instrument is issued in a distribution by the issuer, (ii) the debt instrument is issued in exchange for the stock of another member of the issuer's "expanded group," other than in an

"exempt exchange" (which includes certain asset reorganizations), or (iii) the debt instrument is issued in exchange for property in connection with an asset reorganization (generally a reorganization described in section 368(a)(1)(A), (C), (D), (F) or (G)). According to the preamble to the Proposed Regulations (the "Preamble"), the three transactions identified above are instances in which stock can be replaced with debt with little or no effect other than on US taxes.

An "expanded group" generally includes two or more corporations connected through direct or indirect stock ownership of at least 80% (by vote or value). The term "expanded group" includes non-US corporations, S-corporations, real estate investment trusts ("REITs"), regulated investment companies ("RICs") and certain corporations connected indirectly through partnerships. In applying the General Rule and the Funding Rule, the Proposed Regulations adopt an aggregate approach with respect to any partnership (a "controlled partnership") in which 80% or more of the capital or profits interests are owned by members of an expanded group. Under this approach, the partners in the controlled partnership would be treated as owning their proportionate share of the controlled partnership's assets and issuing their proportionate share of any debt instruments issued by the controlled partnership. All members of a US consolidated tax group are treated as a single corporation for purposes of the Proposed Regulations, including the Documentation Requirements and the Bifurcation Rule, and thus debt issued from one member of a US consolidated tax group to another member of such group will not be recharacterized as equity under any part of the Proposed Regulations.

Two examples in the Proposed Regulations involve foreign-parent groups generally, and inverted groups in particular, that used transactions described in the General Rule to generate interest deductions to reduce US taxable income without investing new funds into the US issuer. For example, if a foreign corporation ("Foreign Parent") owns 100% of the outstanding stock of a US corporation ("US Sub") and US Sub distributes its note to Foreign Parent at a time when US Sub has no current or accumulated earnings and profits (or an applicable treaty provides for no withholding on dividends), no US withholding tax should apply to the distribution and US Sub should not recognize gain or loss in connection with the distribution. To the extent that US Sub makes interest payments under the note, it may deduct such interest payments in computing its US taxable income under current law. Further, US Sub can repatriate cash to Foreign Parent free of US withholding tax by making principal payments on the note. Under the Proposed Regulations, the debt instrument would be reclassified as stock, and all payments made under the instrument (including payments of principal) would be reclassified as distributions with respect to stock, and thus treated as dividends to the extent of the US Sub's current or accumulated earnings and profits.

Moreover, US-parented groups have been able to use transactions described in the General Rule to repatriate untaxed earnings and profits of controlled foreign corporations ("CFCs"). To illustrate, a CFC that is a first-tier subsidiary of a US parent corporation can distribute a note to its US parent in a year when the CFC has no current or accumulated earnings and profits, and so long as the US parent's tax basis in its CFC stock equals or exceeds the value of the note at the time of the distribution, the US parent is not subject to US tax as a result of its receipt of the note. Thereafter, in a year when the CFC has earnings, the CFC can pay off the note and thereby repatriate profits to the US parent without causing the US parent to be subject to US tax in connection with the repatriation. Such transactions would no longer be permissible under the General Rule.

The Funding Rule

In addition to reclassifying debt instruments that are issued in the three specified transactions subject to the General Rule, the Proposed Regulations contain the Funding Rule which, subject to certain exceptions, would reclassify related-party debt instruments as stock where such debt instruments are considered issued by the borrower (referred to as the "funded member") in connection with: (i) a distribution of cash or other property to another member of the expanded group (other than a distribution of stock in connection with an intragroup asset reorganization that is permitted to be received without the recognition of gain or income), (ii) an acquisition of the stock of another member of the expanded group by the funded member, other than in an "exempt exchange," in exchange for property (other than the stock of the funded member) or (iii) an exchange for property in connection with an asset reorganization. A debt instrument is subject to the Funding Rule if it is either (i) issued with a principal purpose of funding one of the three enumerated types of acquisitions or distributions (the "Principal Purpose Rule") or (ii) issued at any time during the 72-month period beginning 36 months before the issuing corporation engages in one of the three enumerated types of acquisitions or distributions (the "Per Se Rule"). According to the Preamble, the Funding Rule is intended to preclude a taxpayer from doing indirectly what it is precluded from doing directly under the General Rule.

For purposes of the Principal Purpose Rule, the determination as to whether a debt instrument is issued with a principal purpose of funding an applicable acquisition or distribution is based on all of the surrounding facts and circumstances. The Funding Rule is significantly expanded by the Per Se Rule, which creates a non-rebuttable presumption that an expanded group debt instrument is issued with a principal purpose where it is issued during a 72-month period beginning 36 months before the funded member engages in one of the three transactions described above (the "Relevant 72-Month Period"). The Preamble states that the Per Se Rule was adopted because money is fungible and, in light of potential assertions by taxpayers regarding the motivations for the transactions in question, it would be difficult for the IRS to establish the principal purpose of a funding transaction. If multiple debt instruments may be treated as funding an applicable acquisition or distribution, the Per Se Rule is applied to the debt instruments in the order in which they were issued, with the earliest debt instrument tested first. Likewise, if a single debt instrument may be treated as funding multiple acquisitions or dispositions, the debt instrument is treated as funding one or more acquisitions or distributions based on the order in which the acquisitions or distributions occurred, with the first acquisition or distribution being treated as the first acquisition or distribution that was funded by the debt instrument.

As stated above, all members of a US consolidated tax group are treated as a single corporation for purposes of the Proposed Regulations. While treating all members of a US consolidated tax group as a single corporation might be a taxpayer-favorable rule because the Proposed Regulations may not apply to intercompany debt instruments among members of a US consolidated tax group, this rule can result in a more expansive application of the Funding Rule. For example, if a debt instrument is issued by one member of the consolidated group ("USS") to a member of the expanded group that is not a member of USS's consolidated tax group, the debt instrument may be treated as funding a distribution that is made by the common parent of the US consolidated tax group of which USS a member ("USP") within the Relevant 72-Month Period. This is the case even though the loan was made to USS and USP is not viewed as a successor to USS. This result arises because all members of USS's consolidated tax group are treated as the "funded member" for purposes of applying the Funding Rule.

Taxpayers should be aware that debt instruments that are deemed to be reissued as a result of a "significant modification" under Treas. Reg. § 1.1001-3 will be subject to reclassification under the Per Se Rule if the deemed exchange or refinancing occurs at any time during the Relevant 72-Month Period, even if the debt instrument was originally issued outside of such 72-month period.

The Per Se Rule is subject to limited exceptions for debt instruments issued in the course of the issuer's trade or business in connection with the purchase of property or receipt of services to the extent they reflect an obligation to pay an amount that is deductible or included in the issuer's cost of goods sold or inventory. However, this exception is not intended to apply to intercompany financing or treasury center activities or to capital expenditures. To the extent a debt instrument issued in exchange for property in connection with an asset reorganization is reclassified as stock under the General Rule, such asset reorganization is not also subject to the Funding Rule.

The Funding Rule may impact the US tax classification of related-party indebtedness customarily put in place by multinational corporations and portfolio companies owned by private equity funds in connection with the financing of an acquisition of a target corporation from an unrelated person. For example, assume that a UK multinational corporation ("UKCo") owns 100% of a US corporation ("US Sub"). Further, US Sub desires to acquire either the assets or the stock of a target corporation from an unrelated person. To finance the transaction, UKCo borrows from a third-party lender and on-lends a portion of the proceeds of its borrowing to US Sub, which US Sub uses to acquire the target corporation. Under the Proposed Regulations, US Sub would be treated as the funded member. If the loan by UKCo to US Sub was put in place at any time within the Relevant 72 Month Period, the debt will be reclassified as stock for US tax purposes even though the debt proceeds were used for a permissible purpose.

Furthermore, the Proposed Regulations would have a dramatic impact on typical cash pooling arrangements customarily used by large multinational groups, which are generally intended to provide short-term liquidity to members of an expanded group and are not the related-party debt instruments that the Treasury purportedly intended to address in drafting the Proposed Regulations. Since such cash pooling arrangements generally involve intercompany payables and receivables between multiple members of a multinational group, the application of the Funding Rule will complicate the organization structure of multinational groups that utilize cash pooling arrangements. The Funding Rule may cause the treasury center to be treated as owning stock of members of the multinational group (when the treasury center loans amounts to a member of the multinational group at any time during the Relevant 72-Month Period) and other members of the multinational group to be treated as owning stock in the treasury center (when other members loan amounts to the treasury center at any time during the Relevant 72-Month Period). The application of the Funding Rule in the context of cash pooling arrangements is significantly expanded due to the cascading effect of the Funding Rule and the Successor Rule (described below). For example, if a treasury center ("Treasury Center") loans funds to a member of its expanded group ("CFC 1") at any time within the Relevant 72-Month Period, the instrument issued by Treasury Center to CFC 1 will be reclassified as stock in the other member under the Funding Rule. The Treasury Center is now treated as making an applicable acquisition of CFC 1 stock in exchange for property (the loan proceeds transferred to CFC 1). Accordingly, if any other members of the expanded group loaned amounts to Treasury Center during the Relevant 72-Month Period, all or a portion of such debt instruments will be reclassified as equity in Treasury Center under the Funding Rule to the extent that such instruments were treated as funding Treasury Center's acquisition of the CFC 1 stock.

Successor Rule

The Proposed Regulations also contain a broad rule that would treat a successor to the funded member as the funded member, which significantly expands the scope of the Funding Rule. Generally, a member of the expanded group is treated as a successor to the funded member if it: (i) acquires the assets of the funded member in a transaction described in section 381(a) (*i.e.*, a liquidation described in section 381(a) or a reorganization described in section 368(a)(1)(A), (C), (D), (F) or (G) without regard to whether the reorganization meets the requirements of sections 354(b)(1)(A) and (B)) or (ii) acquires property from the funded member in exchange for its stock in a transaction eligible for the exception for "funded acquisitions of subsidiary stock by issuance" described below. However, for purposes of applying the successor rule to the acquisition of assets of the funded member in exchange for the stock of the transferee member, the Proposed Regulations provide that: (i) the Per Se Rule applies only with respect to a debt instrument issued by the funded member during the 72-month period beginning 36 months before the date that the successor acquired the assets of the funded member in exchange for its stock, (ii) the Per Se Rule applies only to the extent of the value of the expanded group stock acquired from the issuer in the transaction and (iii) a distribution by the successor directly to the funded member is not taken into account for purposes of applying the Funding Rule. Multinational groups should consider the broad application of the successor rule before making an applicable acquisition or distribution in order to ensure that the Funding Rule will not be triggered.

Exceptions

The Proposed Regulations contain three exceptions to the reclassification of expanded group indebtedness as stock under the General Rule and the Funding Rule. First, distributions and acquisitions that otherwise would be subject to the General Rule and the Funding Rule are reduced by the distributing corporation's current earnings and profits for the applicable taxable year (*i.e.*, a debt instrument would not be subject to the General Rule and the Funding Rule if the debt instrument was issued in connection with an acquisition or distribution that did not exceed the issuer's current year earnings and profits). Second, a debt instrument is not reclassified as stock if the aggregate adjusted issue price of all of the expanded group's debt instruments that would otherwise be reclassified as stock under the General Rule and the Funding Rule does not exceed $50 million. However, if subsequently the aggregate adjusted issue price of the expanded group's debt instruments that would otherwise be reclassified as stock under the General Rule and the Funding Rule exceeds $50 million, all such debt instruments will be reclassified as stock. Finally, under the exception for "funded acquisitions of subsidiary stock by issuance," an acquisition of expanded group stock does not include an acquisition that results from a transfer of property by the issuer of a debt instrument to an expanded group member in exchange for stock of such expanded group member if, for 36 months following the issuance, the issuer of the debt instrument holds (directly or indirectly) more than 50% of the total combined vote and value of the stock of the transferee expanded group member.

Timing and Manner of Debt Reclassification

Generally, if a debt instrument is reclassified under the General Rule, it is classified as stock from its initial issuance. Where a debt instrument is reclassified in a subsequent year (for example, where an applicable acquisition or distribution occurs in a subsequent taxable year or the debt instrument is reclassified because the $50 million threshold described above is exceeded in a subsequent taxable year), it initially is respected as

indebtedness and subsequently is deemed exchanged for stock on the date of the applicable event giving rise to the reclassification in a transaction in which the holder's amount realized is equal to the holder's tax basis in the instrument. Generally, the holder should not recognize gain or loss, and the issuer should not recognize cancellation of indebtedness income or repurchase premium, when a debt instrument is reclassified under these rules. However, the parties could recognize foreign currency gain or loss in connection with the deemed exchange.

If a reclassified debt instrument is transferred outside the expanded group or its issuer or holder, as applicable, becomes a non-member of the expanded group, the reclassified debt instrument is deemed exchanged for a new debt instrument immediately before the time the debt instrument is transferred outside of the expanded group. However, unlike the situation in which a debt instrument is reclassified as stock, the amount of gain or loss recognized by the parties is not limited to the holder's tax basis in the instrument, meaning that the parties could recognize income or loss in connection with the deemed exchange.

Additionally, for purposes of applying the Funding Rule, where an instrument that had been reclassified as equity leaves the expanded group (and thus is reclassified as debt), each debt instrument of the issuing corporation outstanding at such time must be re-tested to determine whether it should be viewed as funding the applicable acquisition or distribution that was treated as funded by the reclassified instrument that becomes a non-expanded group instrument. For example, assume that (i) in Year 1, a member of an expanded group loans $100 of cash to another member of the expanded group in exchange for a debt instrument ("Note A") issued by the funded member, (ii) in Year 2, the funded member makes a $100 distribution to its parent with respect to its stock and (iii) in Year 3, a member of the expanded group loans the funded member another $100 in exchange for a second debt instrument ("Note B"). Under the Per Se Rule, Note A, the earliest issued debt instrument, would be reclassified as stock under the Per Se Rule, but Note B would not be reclassified because Note A is treated as funding the entire $100 Year 2 distribution. If the holder of Note A sells Note A to a third-party bank in Year 4, Note A would no longer be classified as stock under the Per Se Rule. Note B would then be retested to determine whether it should be treated as funding the Year 2 distribution. Since Note B was issued within the Relevant 72-Month Period, it will be reclassified as stock under the Per Se Rule unless an exception applies.

Anti-Abuse Rule & Prohibition on Affirmative Use

The Proposed Regulations contain an anti-abuse rule that will reclassify a debt instrument as stock if it is issued with a principal purpose of avoiding the application of the General Rule and the Funding Rule. The Proposed Regulations also contain a non-exhaustive list of examples of circumstances to which the anti-abuse rule may be applicable. For example, the Proposed Regulations state that the anti-abuse rule may be applicable where (i) a debt instrument is issued to, and later acquired from, a person that is not a member of the issuer's expanded group, (ii) 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, (iii) a debt instrument is issued to an entity that is not taxable as a corporation or (iv) 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, in each case, where the debt instrument is issued with a principal purpose of avoiding the application of the General Rule and the Funding Rule. Additionally, a taxpayer is prohibited from affirmatively relying on the Proposed Regulations to the extent that the taxpayer enters into a transaction that

otherwise would be subject to the Proposed Regulations with a principal purpose of reducing the US tax liability of any member of the expanded group.

Application to Disregarded Entities and Partnerships

To the extent that a debt instrument issued by a disregarded entity or partnership is reclassified as equity under the General Rule or the Funding Rule, the debt instrument will be reclassified as equity in the entity's owner, not an equity interest in the disregarded entity or partnership itself. In the case of a disregarded entity, this preserves the entity's status as a disregarded entity. However, as discussed below in more detail, if a debt instrument issued by a disregarded entity or partnership is reclassified under the Documentation Requirements, the debt instrument will be reclassified as equity of the disregarded entity or partnership. This may cause the entity to be classified as a partnership for US tax purposes and, in the case of a partnership, such reclassification will require the partnership to make certain adjustments in order to reflect the admittance of a new partner or changes in the relative interests of its existing partners and may result in other meaningful US tax consequences to the partnership and its partners.

Observations

The broad scope of the Funding Rule will severely impact decisions made by domestic and multinational groups on an ongoing basis, including decisions primarily motivated by non-US tax commercial considerations. For example, multinational groups frequently prefer to have a single treasury center that borrows from third-party lenders and then on-loans the third-party loan proceeds to other members of the affiliated group. Additionally, US lenders frequently prefer to loan to a US entity and have the US entity on-loan the third-party loan proceeds to a non-US member of the expanded group. In each of these cases, if the funded member (the borrower under the intragroup loan) borrowed at any time during the Relevant 72-Month Period, the intragroup debt instrument generally would be reclassified as stock under the Per Se Rule. This dilemma may be addressed by creating a US limited liability company that is disregarded as separate from the non-US entity to borrow from the third-party lender or rely on guarantees or other forms of credit support provided by US members of the expanded group.

Because the Proposed Regulations may be applicable to ordinary course transactions entered into by an expanded group, a taxpayer that is not familiar with the Funding Rule may inadvertently trigger its application, which may have the effect of causing a significant increase in the US tax liability of the expanded group. However, taxpayers that are aware of the Funding Rule stand a better chance of avoiding the application of such rule and possible negative US tax consequences.

Documentation Requirements (Prop. Reg. § 1.385-2)

The Proposed Regulations set forth various new rules and requirements to assist the IRS's determination of whether an expanded group instrument is debt or stock. The Proposed Regulations set forth documentation requirements that must be satisfied in order for an expanded group debt instrument to be respected as debt. According to the Preamble, the Documentation Requirements are intended to provide the IRS with sufficient information in order to permit it to determine whether an instrument should be respected as debt for US tax purposes. The Preamble also states that the Documentation Requirements will impose discipline on related-parties by requiring timely documentation and financial analysis similar to what is undertaken when third parties lend money.

The Documentation Requirements are not applicable to a debt instrument between members of an expanded group unless either: (i) the stock of any member of the expanded group is publicly traded or (ii) all or any portion of the expanded group's financial results are reported on "applicable financial statements" that reflect total assets exceeding $100 million on the date the debt instrument becomes an expanded group debt instrument or that reflect annual total revenue that exceeds $50 million for the taxable year that includes the date the debt instrument becomes an expanded group debt instrument. Under the Proposed Regulations, parties are required to undertake certain due diligence and complete documentation no later than 30 calendar days after the "applicable date" (generally the date that the debt instrument becomes held by an expanded group member) in order to establish that an expanded group debt instrument qualifies as debt for US tax purposes.

Specifically, the Proposed Regulations require that the taxpayer prepare documentation establishing the following four items: (i) the issuer was under an unconditional and legally binding obligation to pay a sum certain on a fixed date or upon demand, (ii) the holder had rights as a creditor (for example, an acceleration right upon non-payment and right to sue to enforce payment), including a superior right to shareholders in the case of dissolution, (iii) as of the date the instrument was issued, there was a reasonable expectation that the loan would be repaid (which may be established through cash flow projections, financial statements, business forecasts, asset appraisals, relevant financial ratios or information on sources of funds) and (iv) after the date of the issuance of the debt instrument, the conduct of the holder and issuer was consistent with that of unrelated parties acting on arm's-length terms, including evidence of timely interest and principal payments or, in the case of a failure to make required payments or an event of default, the holder's reasonable exercise of the diligence and judgment of a creditor. Additionally, the parties must prepare documentation of (i) each payment of principal and interest under the debt instrument and (ii) evidence of the holder's reasonable efforts to enforce creditors' rights in the case of an event of default under the debt instrument, in each case, no more than 120 calendar days from the date of the principal or interest payment or the date of each event of default, as the case may be. For purposes of the analysis of an issuer's ability to pay, if the legal issuer is a disregarded entity and all owners of the entity have limited liability for the entity's liabilities, such analysis will likely be based on the assets and financial position of the disregarded entity and not its owner.

If a debt instrument issued by a disregarded entity is reclassified as stock under the Documentation Requirements, the debt instrument would be reclassified an equity interest in the disregarded entity and generally would cause the disregarded entity to be classified as a partnership for US tax purposes.

A debt instrument will not be reclassified as stock under the Documentation Requirements discussed above if the taxpayer failed to satisfy the Documentation Requirements with a principal purpose of reducing the US tax liability of any member the expanded group or any other person relying on the characterization of the instrument as indebtedness for US tax purposes. The satisfaction of the Documentation Requirements will not preclude the reclassification of the debt instrument on other grounds, including the General Rule and the Funding Rule.

Bifurcation Rule (Prop. Reg. § 1.385-1)

Under current law, instruments are generally treated as either debt in full or stock in full for US tax purposes. The Preamble states that this all-or-nothing approach creates uncertainty when the facts and circumstances support treating an instrument as part debt and part stock. The Bifurcation Rule would allow the IRS to treat an instrument issued to a member of the issuer's "modified expanded group" as part debt and part stock based on the relevant

facts and circumstances that exist on the date that the instrument is issued under US tax principles (such as voting and conversion rights and other rights relating to dividends, redemption, liquidation and other distributions). The Bifurcation Rule provides no discernible standard for determining when the rule should be applied and, when it is, to what extent a given debt instrument should be treated as equity. Further, the Bifurcation Rule prohibits a taxpayer from affirmatively asserting that a debt instrument should be bifurcated under the rule.

A modified expanded group is broader than an expanded group, and includes a group of corporations connected by direct or indirect ownership of 50% or greater stock ownership (by vote *or* value), partnerships in which 50% or more of the capital or profits interests are owned directly or indirectly by members of the modified expanded group and individuals and entities that own (or are treated as owning) 50% or more of another member of the modified expanded group.

Impact of Reclassification

If a debt instrument is reclassified as stock under the Proposed Regulations, the parties may experience adverse and uncertain US tax consequences. The reclassification of the debt instrument as stock will cause interest payments that the parties anticipated to give rise to deductible interest to be reclassified as non-deductible dividend payments. Further, a repayment of principal under a debt instrument that a US holder anticipated would be a tax-free repayment of principal may be reclassified as a taxable dividend. Finally, where an instrument issued by a US person is held by a non-US person, the reclassification of an interest payment as a dividend may give rise to greater withholding tax to the extent that the parties are relying on a reduced treaty withholding tax rate for interest paid. The impact of the Proposed Regulations is unclear in other areas. In particular, it is unclear whether the recipient of a reclassified dividend will be entitled to a dividends-received-deduction under a 1994 ruling that held a taxpayer was not entitled to a dividends-received-deduction paid on stock that had creditor's rights. Additionally, since the reclassified debt instrument is non-voting stock, the holder of the reclassified instrument may not obtain an indirect foreign tax credit under section 902 as a result of dividends paid on the reclassified instrument. The IRS likely intends that the indirect foreign tax credit for foreign income taxes paid by the issuer of the reclassified instrument permanently disappear.

Effective Dates

The General Rule and the Funding Rule generally will apply to debt instruments issued on or after April 4, 2016. However, under a transition rule, debt instruments subject to reclassification under these rules will continue to be classified as indebtedness until the date that is 90 days after the adoption of the final regulations. This gives taxpayers the opportunity to repay or otherwise eliminate all debt instruments subject to reclassification under these rules prior to the date that the reclassification occurs. Furthermore, the Documentation Requirements and the Bifurcation Rule will apply to debt instruments issued on or after the date the Proposed Regulations are issued as final regulations.

A "significant modification" of a debt instrument that was issued before April 4, 2016, which results in a deemed exchange of the grandfathered debt for a new debt instrument under Treas. Reg. § 1.1001-3 occurring after April 4, 2016, may cause the previously grandfathered debt instrument to be subject to the provisions of the Proposed

Regulations. Accordingly, taxpayers should ensure that they do not modify grandfathered debt instruments in a manner that results in a "significant modification" and deemed exchange under Treas. Reg. § 1.1001-3.

Although the comment period for the Proposed Regulations lasts until July 7, 2016, Treasury officials have stated their hope to finalize these rules before Labor Day. Taxpayers should take steps now to ensure that they comply with the Proposed Regulations if they are quickly adopted in final form without significant changes.

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