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Tax Law Update

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by **Peter Connors, Barbara de Marigny, Michael Rodgers**

On October 13, 2016, the IRS and Treasury Department issued much anticipated regulations (the "Final" or "Temporary" Regulations) under Internal Revenue Code section 385. These regulations, which consist of both temporary1 and final regulations, aim to prevent multinational corporations from reducing their U.S. taxable income through "earnings stripping" practices. To achieve this end, the regulations provide a framework to determine whether certain interests in related entities are to be treated as equity rather than as debt for tax purposes. On April 4, 2016, the Treasury Department and IRS had promulgated proposed regulations to this effect (the "Proposed Regulations"). The Proposed Regulations were among the most ambitious and aggressive tax provisions issued in recent memory, and were criticized by many as anywhere from overly broad to unfair and unadministrable. While the Final Regulations make clear that the Treasury Department and IRS considered the criticism, the Final and Temporary Regulations do retain some of the teeth, and all of the bulk, of the Proposed Regulations. Like the Proposed Regulations, the Final and Temporary Regulations are organized into four sections: (1) general provisions, (2) documentation requirements, (3) transactional rules, and (4) consolidated return provisions. In the Proposed Regulations, the relevant provisions appeared in Prop. Reg. §§ 1.385-1 to -4. The final package consists of Final Regulations § 1.385-1, -2 and -3 and Temp. Reg. §1.385-3T and -4T.

Effective Dates

The effective dates of the new regulations vary, with certain provisions retaining the original effective date envisioned in the Proposed Regulations and others evidencing a delayed effective date. Unlike the Proposed Regulations, the Final Regulations setting forth the documentation requirements, for example, apply to debt issued on or after January 1, 2018, and the documentation requirements only need to be met as of the tax return due date for the year of the relevant date with respect to the debt. The transactional rules of Reg. § 1.385-3, on the other hand, generally apply to tax years ending on or after January 19, 2017, i.e., the date which is 90 days after the Final Regulations were published in the Federal Register (October 21, 2016). The transactional rules apply specifically to debt instruments issued on or after April 5, 2016. Transitional rules provide that covered debt instruments issued on or after April 5, 2016, but before January 19, 2017, will be recharacterized as stock as of January 19, 2017, subject to an anti-abuse rule.

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[1] While Temporary Regulations have immediate force of law, they expire at the end of three years. Typically, they will be finalized within that time frame.

The transactional rules of Final Regulations 1.385-3, as well as the Temporary Regulations 1.385-3T and 1.385-4T, apply only to "covered debt instruments," which is a new term not found in the Proposed Regulations. Reg. § 1.385-3(g)(3) provides that a covered debt instrument is any debt instrument issued by a covered member (which would exclude any foreign issuer), provided the issuer is not an excepted entity, such as a regulated financial company or a regulated insurance company. A covered member is a member of an expanded group that is a domestic corporation.

Key Takeaways

On the whole, the substantive changes made by the Final and Temporary Regulations, as compared to the provisions of the Proposed Regulations, are favorable to taxpayers, particularly U.S. based multinationals. The most significant of these changes are (1) the foreign issuer exception, (2) the elimination of the bifurcation rule (allowing debt instruments to be treated as stock in part and debt in part), (3) the modified threshold exemption, (4) the exclusion of certain short-term debt from the transactional rules of Reg. § 1.385-3, and (5) certain modifications to the attribution rules:

a. The foreign issuer exception provides that the Final Regulations now only apply to expanded group interests ("EGIs") issued by domestic corporations, including partnerships and disregarded entities with domestic owners. Expanded group interests are defined under Reg. § 1.385-2(d) as applicable interests the issuer of which is a member of an expanded group (or a disregarded entity whose regarded owner is another member of an expanded group) and the holder of which is another member of an expanded group, a disregarded entity whose regarded owner is another member of the same expanded group, or a controlled-partnership with respect to the same expanded group.

b. The Proposed Regulations had established a bifurcation rule, which provided situations in which a debt instrument could be recast as debt in part and equity in part. Because the Proposed Regulations had provided that bifurcation may happen in cases where a debt was unlikely to be repaid in its entirety without further detailing the trigger, the Proposed Regulations generated significant uncertainty with this provision and it ultimately was not adopted in the Final Regulations. Rather, the bifurcation rule has been designated as reserved for further study.

c. The Proposed Regulations had provided that small issuers would not be subject to the stringent new rules. Specifically, the Proposed Regulations provided that the documentation requirements would only be applicable to taxpayers (1) any member of the expanded group of which is publicly traded or (2) whose assets on any "applicable financial statement" on the date that an applicable instrument first becomes an EGI exceed $100 million or (3) whose total revenue exceeds $50 million. For purposes of the transactional rules, under the Proposed Regulations, an EGI would not be treated as stock if, when issued, the aggregate issue price of all expanded group debt instruments that otherwise would be treated as stock did not exceed $50 million. The Final Regulations retain the threshold applicable to the documentation requirements while providing a modified threshold exception allowing that the first $50 million of an EGI will always be exempt from application of the transactional provisions, eliminating the "cliff effect" of the Proposed Regulations, under which an expanded group that was "one dollar too large," so to speak, would be subject to the full force of the transactional rules with respect to all of its debt instruments.

d. The Final Regulations provide a rule which, under specifications included in the Temporary Regulations, excludes certain short-term debt instruments from the transactional rules of Reg. § 1.385-3 (discussed further below), greatly reducing the impact of the new rules on certain financing arrangements, such as cash pools and treasury centers.

e. The Final Regulations also modify the attribution rules which apply for purposes of determining which entities are treated as members of an expanded group. These new rules serve not only to prevent "downward attribution,"[2] but also serve to exclude certain flow-through entity types which for policy reasons do not invoke the same potential for abuse as opaque C corporations; specifically, S corporations and investment entities such as RICs and REITs.

In summary, while the impact of the Final Regulations on U.S. multinationals is lessened considerably, the Final Regulations will continue to impact U.S. groups which are foreign owned.

Changes to Documentation Rules

The Proposed Regulations required that taxpayers document purported debt according to certain specific guidelines. These guidelines included the requirement that the taxpayer maintain documentation sufficient to pass muster under four separate tests, the presence of which are indicative of an instrument's status as debt: 1) unconditional obligation to pay a sum certain, 2) creditor's rights, 3) reasonable expectation of repayment, and 4) certain actions evidencing a bona fide debtor/creditor relationship. The Final Regulations postpone the application of these rules to instruments issued on or after January 1, 2018, and render it easier for taxpayers to comply with the rules by requiring that the applicable documentation be prepared by the tax return date of the year in question, rather than within a mere 30 days of the relevant date.[3]

For these purposes, the scope of what types of instruments and arrangements will constitute debt is alarmingly broad. The term "applicable interest" is defined in Reg. § 1.385-2(d)(2) as (1) any interest that is issued or deemed issued in the legal form of a debt instrument, which therefore does not include, for example, a sale-repurchase agreement treated as indebtedness under federal tax principles, or (2) an intercompany payable and receivable documented as debt in a ledger, accounting system, open account intercompany debt ledger, trade payable, journal entry or similar arrangement if no written legal arrangement governs the legal treatment of such payable and receivable. Failure to document these interests properly may generate section 956 issues where the U.S. parent purchases inventory from its foreign affiliates.

Many commentators to the Proposed Regulations had recommended an exception in the case of all trade payables and any debt that financed working capital needs of a business. Notwithstanding the criticism, the Final Regulations declined to adopt such exceptions, stating that the goal of the documentation rules is "not solely to prevent earnings stripping, but rather also to facilitate tax administration by imposing minimum documentation standards for transactions between highly related persons to determine the federal tax treatment of covered EGIs. Such minimum documentation standards are warranted as related party transactions have historically raised

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[2] For example, the Final Regulations prevent separate brother-sister groups with noncorporate owners from being treated as part of the same expanded group.

[3] The "relevant date" depends in part on the facts surrounding each instrument and in part on which prong of the test is being satisfied, but in many cases would simply be the date of issuance.

concerns as to the use of purported debt". Importantly, this creates potential section 956 issues[4] for unsuspecting expanded groups with unpaid intercompany trade payables and receivables, not realizing that the same constitute debt which is subject to the stringent documentation requirements of Reg. § 1.385-2.

Further, the Final Regulations make additional modifications to the four prongs of the aforementioned documentation requirements.

As to the sum certain requirement, the Final Regulations accept that the documentation requirements should not apply in certain cases, such as where the debt is subject to a contingency.

As to the creditor's rights requirements, the Final Regulations make clear that where creditor's rights are a product of local law rather than the debt agreement itself, documentation need not delineate such rights, provided the documents refer generally to the local law from which those rights derive.

As to the reasonable expectation of repayment requirement, the Final Regulations provide a number of changes. First, the issuer need only be able to demonstrate that it can meet its obligations under the instrument. This means that demonstrating an ability to refinance will be an option. Additionally, the Final Regulations clarify that in the case of one issuer and multiple EGIs, a single credit analysis may be performed on an annual basis for all EGIs. Further, if an EGI is nonrecourse to the issuer, documentation must include the value of all property available to support repayment of the nonrecourse EGI.

As to actions evidencing a creditor/debtor relationship, there are also two modifications. For one, as long as payment on an EGI is, in fact, made and records maintained, documents may now be retained in any manner. Moreover, new rules now allow a simple netting of payables and receivables rather than requiring actual payment.

Importantly, the Final Regulations also remove the nonrebuttable presumption that an instrument for which there is failure to meet the documentation requirements will be automatically recast as equity on a prospective basis. Rather, the Final Regulations create a rebuttable presumption under which such recast can be averted if the taxpayer's expanded group has been "highly compliant" with the documentation rules as a whole. Under the Proposed Regulations, a taxpayer's only recourse would have been the reasonable cause exception.

The Final Regulations exclude EGIs issued by partnerships from the documentation requirements. If failure to comply with the documentation rules causes a recast of an interest issued by a disregarded entity, the Final Regulations treat the regarded entity owner of the disregarded entity as issuing stock to the interest holder in the disregarded entity (rather than treating the disregarded entity itself as having issued stock). Among other things, the application of these new rules should prevent taxpayers from, for example, inadvertently creating partnerships.

With respect to determining whether the applicable $50 million or $100 million "size threshold" has been met under the documentation requirements, the Final Regulations provide new rules pertaining to "applicable financial statements." The Final Regulations provide that in cases where more than one set of financial statements are relevant, (1) the statement with the greatest total amount of assets be used, (2) new rules designed to prevent double counting are to be used. Additionally, the Final Regulations retain the requirement that only financial statements prepared within three years of the applicable date are to be considered for these purposes.

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[4] Section 956 is an anti-deferral provision which could cause a U.S. parent with outstanding trade payables to a foreign sub to be treated as having taxable income to the extent of the lesser of (1) the earnings of the foreign sub or (2) the principal amount of the trade payables.

The Final Regulations provide certain clarifications as to how the documentation requirements apply to interests issued by certain regulated financial services and insurance companies. An EGI issued by a regulated insurance company issuer is considered to meet the documentation rules even though the instrument requires the issuer to receive approval or consent of an insurance regulatory authority before making payments of principal or interest on the EGI. An EGI issued by an excepted regulated financial company is considered to meet the documentation rules as long as it contains terms required by a regulator of that issuer in order for the EGI to satisfy regulatory capital or similar rules that govern resolution or orderly liquidation. In both situations, the parties must expect at the time of issuance that the EGI will be paid in accordance with its terms. The parties must also maintain documentation establishing that the instrument qualifies for the exception.

The Proposed Regulations provided that the regulations could not be affirmatively used by taxpayers for the taxpayer's benefit, which could be the case if a taxpayer, hoping to ensure equity treatment of an EGI, deliberately failed to adhere to the documentation requirements. The Final Regulations do not adopt this rule, reserving on it pending further study.

Like the Proposed Regulations, debt issued within a consolidated group is not subject to this provision.

Changes to Transactional Rules

The transactional rules of Reg. § 1.385-3 were among the most controversial and highly criticized aspects of the Proposed Regulations. The transactional rules contain two primary provisions: a "general rule" and a "funding rule". Under the general rule, EGIs would be automatically recast as equity in the following three scenarios:

- The EGI is transferred in a distribution
- The EGI is exchanged for expanded group stock, such as a hook stock transaction or a section 304 transaction (except in the case of certain "exempt" exchanges); or
- The EGI is exchanged for property in an asset reorganization.

Under the funding rule, taxpayers were prevented from accomplishing the same three types of transactions by carrying out any of the above in two or more steps (e.g., an intercompany lending accompanied by a distribution to a group member either 36 months before or after the lending itself). Exceptions applied (1) to the extent distributions did not exceed current year earnings and profits of the distributing company, or (2) in cases involving funded acquisitions of subsidiary stock in exchange for stock of the issuer, in part in order to prevent unnecessary creation of hook stock (i.e., stock a subsidiary holds in its own parent). While the Final Regulations retain the general and funding rules, there are several key changes which may serve to avert the widespread concerns fostered by the Proposed Regulations in April.

As mentioned above, one of the most significant of these changes is the exemption from covered debt instrument status for any debt instrument issued by a foreign person.

Other types of instruments specifically excluded from the ambit of this rule include the following:

Instruments Issued by Certain Financial Institutions

Covered debt instruments generally do not include debt instruments issued by certain entities that are subject to regulatory capital or leverage requirements, including regulated financial companies and their subsidiaries (a "regulated financial group"), provided such subsidiaries are also engaged in a financial business.[5] These types of entities include bank holding companies, certain savings and loan holding companies, insured depository institutions and other banks that are members of the Federal Reserve System, nonbank financial companies subject to a determination by the Financial Stability Oversight Council, certain U.S. intermediate holding companies formed by foreign banking organizations, Edge Act and agreement corporations, supervised securities holding companies, registered broker-dealers, futures commission merchants, swap dealers, security-based swap dealers, Federal Home Loan Banks, Farm Credit System institutions, and small business investment companies.

A similar exemption applies to debt instruments issued by insurance companies that are subject to risk-based capital requirements under state law.

Qualified Short-term Debt Instruments from the Funding Rule

There are four categories of qualified short-term debt instruments that are exempt from the funding rule of Reg. § 1.385-3(b)(3): (1) "ordinary course loans" (2) "interest-free loans", (3) "short-term funding arrangements", and (4) "deposits with a qualified cash pool header". These are addressed in the Temporary Regulations.

Ordinary course loans are covered debt instruments that are expected to be repaid within 120 days and issued as consideration for the acquisition of property (other than money) in the ordinary course of the issuer's trade or business.

Interest-free loans are covered debt instruments that do not provide for interest charges and for which interest is not otherwise imputable under, for example, the OID rules, section 482, and section 483.

Short-term funding arrangements are covered debt instruments that may be excluded under two alternate tests: the specified current asset test and the 270-day test. (The issuer may claim the benefits of only one of these tests during the year.) The specified current asset test is passed if two requirements are met: (1) the interest rate charged does not exceed an arm's-length interest rate that would be charged on a comparable debt instrument of the issuer with the term not exceeding the longer of 90 days or the issuer's normal operating cycle and (2) the total amount of the issuer's covered debt instruments satisfying one of the qualified short-term debt exceptions does not exceed the maximum of the amounts of specified current assets reasonably expected to be reflected on the issuer's balance sheet as a result of transactions in the ordinary course of business during the subsequent 90-day period or the issuer's normal operating cycle, whichever is longer. The 270-day test is satisfied with respect to a covered debt instrument if (1) the term of the CDI is 270 days or less for an advance under a revolving credit agreement, or similar arrangement, with an interest rate charged that does not exceed an arm's-length standard, and (2) the net borrowing of the covered member with a particular lender is not more than 270 consecutive days,

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[5] Subsidiaries of a bank holding company held pursuant to the complementary activities authority, merchant banking authority, or grandfathered commodities activities authority, for example, will be excluded from the group, even if they are direct subsidiaries of a regulated financial company.

ignoring covered debt instruments otherwise excluded as ordinary course or interest free. Relief is also available in the case of inadvertent error under a facts and circumstances test.

Demand deposits with a "qualified cash pool header" are also excluded from the ambit of Reg. § 1.385-3. A qualified cash-pool header means an expanded-group member, a controlled partnership, and a qualified business unit with a principal purpose of managing a cash-management arrangement for participating expanded-group members. To make use of this exception, the taxpayer must maintain adequate books and records demonstrating availability of the exemption (e.g., that the deposits consist of cash or cash equivalents)

Expansion of Earnings and Profits Exception

The Proposed Regulations contained three broad categories of exceptions. First, the Proposed Regulations exempted EGIs from the general and funding rules to the extent of the issuer's current-year earnings and profits, but not accumulated earnings and profits. Responding to comments, the Final Regulations extend the exception to accumulated earnings and profits as well, using an "expanded group earnings account" as the amount of the exemption. The account adopts rules similar to usual earnings and profits rules, incorporating, for example, account reduction upon the occurrence of distributions. Additionally, in order to get rid of the "use it or lose it" phenomenon, the exception includes certain provisions designed to prevent reuse of earnings and profits. The expanded-group earnings of a covered member do not include earnings and profits accumulated by the covered member in any taxable year ending before April 5, 2016, or earned during any year in which the entity was not a member of the same expanded group.

Expansion of Exception for Acquisition of Subsidiary Stock

As mentioned above, the Proposed Regulations provided an exception for funded acquisitions of subsidiary stock involving stock of the issuer. This exception has been expanded in the Final Regulations to include acquisition of both outstanding and newly issued subsidiary stock, provided certain control requirements are met. The exception applies regardless of whether the acquisition was effected with a covered debt instrument itself or whether indirectly funded by a covered debt instrument. The preamble to the Final and Temporary Regulations explains that this would eliminate one type of transaction that could conceivably and inappropriately create hook stock.

$50 Million Exception

As noted above, under the Proposed Regulations, an EGI would not be treated as stock if, when issued, the aggregate issue price of all expanded-group debt instruments that otherwise would be treated as stock did not exceed $50 million. The Final Regulations retain the threshold applicable to the documentation requirements while providing a modified threshold exception allowing that the first $50 million of an EGI will always be exempt from application of the transactional provisions, eliminating the "cliff effect" of the Proposed Regulations, under which an issuer that was one dollar too large would be subject to the full force of the transactional rules with respect to all of its debt instruments.

New Reduction for Qualified Contributions

Under a new "netting" rule, the amount of a distribution or acquisition by a covered member is reduced by the aggregate fair market value of the stock issued by the covered member in one or more qualified contributions during the applicable "qualified period." This new rule has the effect of reducing the amount of distributions that might otherwise trigger application of the transactional rules (i.e., both the general rule and funding rule) on intergroup distributions. This exception advances the policy concern of ensuring that the transactional rules are not unfairly triggered in cases where there has been no reduction in a group member's net equity.

To track the above, the Final Regulations establish a qualified-contributions account, which will shield application of the general and funding rules to the extent of any positive balance therein. The account is reduced based on the order of distributions and acquisitions as they occur. Unlike the earnings and profits account mentioned above, however, the account operates only on a roll-forward basis and lasts for only six years. Similarly, contributions are only taken into account during the same per se 36 month periods as apply for purposes of the funding rule.

New Exception for Acquisition of Compensatory Stock

Under the Proposed Regulations, there was a concern that a literal application of the funding rule could cause an unintended "cascading effect." Specifically, "dividends" paid on debt instruments recast as stock could trigger recharacterization of otherwise unaffected instruments within the group, seemingly to endless iterations. The Final Regulations recognize the possibility of these largely unintended ripple effects, and provide safeguards to prevent such "cascading" in two primary scenarios. The first safeguard provides that once a covered debt instrument is recharacterized as stock under the funding rule, the distribution or acquisition that caused the recharacterization cannot cause a recharacterization of another covered debt instrument after the first instrument is repaid.

The second safeguard provides a limited exception from possible "iterative" cascading. This safeguard is best explained through the example provided in the Preamble to the Temporary and Final Regulations. In the example, P is the parent of an expanded group which owns all of the stock of S1 and S2. P loans $100x to S1, S1 loans $100x to S2 and S2 distributes $100x to P. Under the funding rule, S1's loan to S2 would be recharacterized as stock and S1's acquisition of the S2 instrument would be treated as an acquisition of S2 stock that would cause S1's loan from P to also be treated as stock under the funding rule. Under the new limited exception, S1's loan to S2 would still be recharacterized as stock under the funding rule, but S1's acquisition of the S2 instrument would not be treated as an acquisition of S2 stock that would cause S1's loan from P to be treated as stock under the funding rule.

Express Inclusion of Predecessor and Successor

As was the case with the Proposed Regulations, a funded member can include both a predecessor and successor, which are generally entities preceding or succeeding the applicable member based on certain nonrecognition transactions. This rule prevents any ability of a taxpayer to avoid application of the transactional rules by simply changing the form of investments by mergers or other nonrecognition transactions that effect little or no change to the economics of the expanded group.

Tacking of Original Issue Date for Significant Modifications of CDIs

While covered debt instruments that undergo significant modifications within the meaning of Treas. Reg. § 1.1001-3 will be treated as a newly issued debt as of the modification date, such instruments will retain their original date of issuance for purposes of the funding rule. Thus, debt issued prior to the effective date of the Final Regulations will continue to be grandfathered.

New Exception for Statutory Debt Instruments

Certain debt instruments identified elsewhere in the Internal Revenue Code will be treated as "statutory debt instruments" that are not subject to the transactional rules of Reg. 1.385-3. Statutory debt instruments include, for example, production payments under section 636, regular REMIC interests under section 860G, and debt instruments deemed to arise due to transfer pricing adjustments under section 482.

Other Substantive Changes

The Final Regulations include additional modifications to the Proposed Regulations.

Rules Pertaining to Consolidated Groups

The Proposed Regulations included new Prop. Reg. § 1.385-1(e), which provided that a consolidated group would be treated for purposes of the Proposed Regulations as a single entity. The Final Regulations adopt this rule only for purposes of the transactional rules, but abandon it for purposes of the documentation requirements. Instead, under the documentation requirement provisions, an intercompany obligation's existence is respected, but is simply treated as not within the scope of the documentation rules. The Preamble explains that this change was due to a desire to foster a "simpler, more targeted approach" with respect to Reg. § 1.385-2 than would be the case under the "one-corporation" rule of Prop. Reg. § 1.385-1(e).

Rules Concerning Controlled Partnerships

Like the Proposed Regulations, the Temporary Regulations treat controlled partnerships as an aggregate of their partners. However, the Temporary Regulations effect a couple of modifications as to the treatment of these entities are as follows: (1) an expanded-group partner's share of the assets of a controlled-partnership is determined based on liquidation value rather than as a share of partnership profits, (2) an expanded-group partner is treated as the issuer with respect to such partner's share of a debt instrument issued by a controlled-partnership to an expanded-group member, and the partner's proportionate share of the instrument is based on anticipated allocations of the partnership's interest expense, and (3) a "deemed conduit" approach applies. Under the deemed conduit approach, it is necessary first to identify the "specified portion" of a debt instrument that is treated as issued by an expanded-group partner and that otherwise would be treated as stock (viewing the partnership as an aggregate of its partners rather than as an entity). Second, a "deemed transfer" occurs, under which, instead of

treating the specified portion as stock, the holder-in-form of the debt instrument is deemed to transfer a portion of the debt instrument with a principal amount equal to the adjusted issue price of the specified portion to the expanded-group partner (deemed holder) in exchange for stock in the expanded-group partner. Any portion of the debt instrument issued by the controlled-partnership that is not deemed to be transferred is treated as a retained receivable of the holder. Because the holder-in-form of the debt instrument is deemed to transfer the deemed transferred receivable, if a specified portion is created at a time when another specified portion exists, only all or a portion of the retained receivable is deemed to be transferred to the deemed holder.

An example of the application of the above is found in the Temporary Regulations.[6] In the example, FP, a foreign corporation, holds all of the stock of U.S. subsidiaries USS1, USS2, and FS. USS1 holds all the stock of its subsidiaries CFC, a controlled foreign corporation, and DS, a domestic corporation. DS, USS2, and USP, a domestic corporation, are partners in PRS, a controlled partnership. DS and USS2, both domestic corporations, each hold a 45% interest in the capital and profits of PRS. USP holds only 10% of the capital and profits interests of PRS, and therefore is not an expanded-group member. All tax items (e.g., income, loss, credit) of PRS are allocated according to the above percentages. On Date A in year 1, FP lends $200x to PRS in exchange for PRS Note. PRS uses all $200x in its business and does not make any distributions to any partner. On Date B in Year 1, DS distributes $90x to USS1, USS2 distributes $90x to FP, and USP distributes $20x to its shareholder.

Under the new controlled-partnership rules, each of DS and USS2 is treated as issuing its share of PRS Notes, with DS and USS2 taking a share of $90x (i.e., 45% of 200x), with their "specified portions." Because USP is not an expanded-group member, USP is not treated as issuing any portion of PRS Note.

Under the deemed conduit rules, the specified portions of DS and USS2 are not treated as stock. Rather, FP is deemed to transfer a portion of PRS Notes with a principal amount of $90x to DS in exchange for deemed stock in DS with a fair market value of $90x. Likewise, FP is deemed to transfer a portion of PRS Notes with a principal amount of $90x to USS2 in exchange for deemed stock in USS2 with a fair market value of $90x. The principal amount of the retained receivable held by FP is $20x (i.e., the $200x principal amount of the original PRS Note reduced by the deemed transfers of $90x each to USS2 and DS).

Conclusion

On the whole, the Final Regulations represent a significant narrowing of the provisions contained in the Proposed Regulations. The types of entities and interests that will be impacted have been narrowed significantly. The Final Regulations are particularly favorable to U.S.-based multinationals, as now both the documentation and transactional rules will no longer apply to their controlled foreign corporations. Notwithstanding this, many of the troubling ramifications present in the Proposed Regulations remain. For example, many commentators had hoped that taxpayers such as cash pools and treasury centers would be completely exempted from the burdensome documentation requirements, but no such exemption was forthcoming in the Final Regulations. Even with the extra time allowed to prepare documentation under the Final Regulations, these taxpayers will still have to expend significant time and expense fostering and implementing future compliance initiatives. Moreover, many commentators had hoped that the general and funding rules, with their punitive automatic-recast provisions, would be tabled. While the bite of those rules seems less harsh under some of the exceptions and limitations introduced

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[6] Reg. § 1.385-3T(h)(3), Example 13.

in the Final Regulations, the punitive framework remains for the taxpayers that still fall within their ambit. The taxpayers most likely to be concerned will be U.S. corporations that are owned by foreign corporations.

On the whole, even in their revised form, the rules represent a significant and important development for multinational taxpayers engaged in intergroup financing. Foreign-based multinationals will continue to be affected by the rules more significantly than U.S.-based multinationals.

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