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Re: Treatment of Certain Interests in Corporations as Stock or Indebtedness (REG-108060-15)

On April 4, 2016, the United States Department of the Treasury and the Internal Revenue Service (together, "Treasury") issued proposed regulations under Section 385 of the Internal Revenue Code (the "Proposed Regulations"). If finalized, the Proposed Regulations would cause instruments that would otherwise be treated as debt under federal income tax principles to be characterized as wholly or partially equity for federal income tax purposes.

Financial Executives International ("FEI")is a leading organization and advocate for the views of corporate financial management. Its more than 10,000 members hold policy-making positions as chief financial officers, treasurers, controllers, tax executives, and other senior-level financial executives at companies from every major industry. FEI enhances member professional development through advocacy, peer networking, career-management services, conferences, research, and publications. The members of FEI's Committees on Taxation, Treasury, and Corporate Reporting submit this letter to provide comments on the Proposed Regulations. This document represents the views of the Committee on Taxation, Committee on Corporate Treasury, and Committee on Corporate Reporting, and not necessarily the views of FEI or its members individually.

The Preamble to the Proposed Regulations states that the regulations are intended to reduce the federal income tax incentives for related parties to engage in transactions that result in excessive cross-border indebtedness. The Proposed Regulations are overbroad for this purpose. The overwhelming majority of debt instruments that are at risk of recharacterization by these rules are not motivated by federal income tax incentives. And only a small percentage of debt affected by the proposals crosses the U.S. border. Finalizing the Proposed Regulations will result in significant administrative, financial, and tax costs and uncertainties for companies, even those which are in no position to strip earnings from the U.S. The consequences of recharacterizing debt to equity will increase taxpayers' burden in unpredictable ways that have nothing to do with earnings stripping and will touch all aspects of financing from trade payables to cash management to capital investments.

For these reasons, Treasury should withdraw the Proposed Regulations. If Treasury instead moves to finalization, we urge Treasury to modify the Proposed Regulations to reduce the deleterious effects on the non-tax motivated, common transactions that comprise the treasury operations necessary for any large company.

Please feel free to contact Brian Cove, Managing Director, Technical Activities at 973.765.1092 if you would like additional information on any of the issues or recommendations in this letter.

Sincerely yours,

Committee on Taxation
Committee on Corporate Treasury
Committee on Corporate Reporting
Financial Executives International

I. General Recommendations

While we recommend withdrawal of the Proposed Regulations, if Treasury remains committed to finalization, the recommendations in this letter will somewhat reduce their impact on the innocuous transactions that comprise most debts of U.S. corporations.

The two main operative sections of the Proposed Regulations are § 1.385-2, which causes related-party instruments to be treated as equity if the taxpayer fails to prepare certain contemporaneous documentation, and § 1.385-3, which characterizes related-party debt instruments as equity if they are issued, or deemed to be issued, in connection with a distribution, certain purchases of affiliate stock, or certain reorganizations. Our comments focus on these sections as they create nearly all of members' critical concerns.

A. The effective date should be extended to January 1, 2019

The effective date of the Proposed Regulations is unreasonable and should be delayed until at least January 1, 2019. Complying with the information gathering requirements of Proposed Regulations § 1.385-2 will require major systems changes for many taxpayers. Managing treasury activity to avoid recharacterization of a debt instrument under Proposed Regulations § 1.385-3 will require taxpayers to thoroughly examine the funding arrangements throughout their entire affiliate structure and implement major changes including unwinding existing treasury centers, redirecting debt through the ownership chain, and potentially integrating third-party banks into their cash-pooling and treasury center activities. These changes must also be reviewed under foreign law and for their impact on a company's financial statements and overall credit rating. This process will require a significant amount of time to complete.

B. CFC-to-CFC debt instruments should not be subject to the Proposed Regulations

The Preamble to the Proposed Regulations indicates that Treasury is concerned that U.S. taxpayers are incentivized to create related-party debt to strip earnings from the United States. Treasury recognizes that loans between members of a U.S. tax consolidated group do not raise such concerns and excludes such loans from the scope of the regulations. Loans between one controlled foreign corporation ("CFC") and another CFC similarly do not raise the concerns that Treasury identifies and therefore should also be excluded from the provisions of Proposed Regulations §§ 1.385-2 and 1.385-3.

II. Distinguishing between cash pooling and other financing activities

In the Preamble, Treasury has expressed a particular interest in comments that will assist in writing an exclusion in the Proposed Regulations for permissible cash pooling and other short-term treasury activity. Crafting an exclusion is difficult because cash pooling and other ordinary-course treasury activities entered into for administrative convenience are complex and may vary in structure from member to member.

A. Background on cash pooling and short-term financing activities

Cash pooling is not tax-motivated and typically results in limited tax benefits because short-term interest rates are relatively low. In fact, interest rates in Europe are now so low (and sometimes negative) that cash pooling does not necessarily result in interest income in the cash-pooling entity.

Cash-pooling arrangements provide many important operational benefits to multinational enterprises.

First, a multinational group can maintain a smaller aggregate cash balance when cash pooling is functioning effectively. Cash pooling is commonly used in Europe and has been widely implemented by multinationals in Europe to take advantage of efficiencies which were made possible by the advent of the euro as a common currency. For example, consider a group of 20 CFCs that collectively maintain €100 million of cash sufficient to meet overall working capital needs. One CFC with temporary excess cash can loan to another CFC with a temporary shortfall. If the risk of equity characterization due to the Proposed Regulations forces each CFC to rely solely on its own cash on deposit with third parties to meet short-term needs, then the group as a whole must keep more cash or borrow from third-party banks. If the average cash requirement per affiliate at any particular point is €5 million, but the peak cash requirement per affiliate is €7.5 million, the group must maintain €50 million of excess cash, which provides no benefits for the multinational's shareholders. This excess is not available for repatriation or for investment in worthwhile business opportunities. The multinational is disadvantaged due to its inflated balance sheet relative to other multinationals who are able to freely operate cash pooling structures.

Second, the legal entity holding the cash pool can efficiently negotiate a single external credit facility benefiting all CFCs participating in the cash pool. The facility, even if undrawn, allows European CFCs to operate effectively with a smaller working-capital cash balance because emergency funds can be accessed with little notice.

Third, pooling facilitates operations across multiple foreign currencies. Banks earn spreads on each currency-conversion transaction. A CFC that has excess euros but a shortfall in pounds sterling can borrow pounds from the pool and deposit euros, thereby minimizing counterparty exposure and avoiding the cost of exchanging currencies due to temporary cash imbalances. Additionally, a larger pool of funds allows a multinational to negotiate a lower spread because of its economy of scale. Finally, pooling foreign currencies minimizes risk in cases where the currencies involved are subject to onerous legal restrictions on exchange.

Fourth, cash pooling facilitates the quick movement of funds to meet business needs. Equity funding, returns of capital, and dividend declarations are subject to local-country legal requirements, which often cannot be completed in a short time, or can be legally so restrictive as to be impractical. Cash pooling is an important and efficient treasury tool to cover short-term, ongoing, and recurrent critical business needs (e.g., meeting payroll).

Fifth, a dedicated cash-pooling affiliate or division allows for more efficient treasury operations. Fewer people, with greater expertise, can be dedicated to managing the pool. The internal-control environment is improved. Small CFC's often lack adequate staffing to have appropriate expertise and separation of duties.

Cash pools are not the only short-term activity that the Proposed Regulations may catch. Some multinationals manage settlement of affiliate-group invoices indirectly through the use of in-house clearinghouses. For large corporate groups, maintaining separate accounts to settle on an invoice-by-invoice basis can be inefficient. As an alternative, some multinationals have a clearinghouse maintained by an affiliate or affiliates through which affiliate payables can be managed. This arrangement centralizes and reduces the number of payables and receivables between affiliates, making them easier to centrally administer and account for. Provided the affiliate balances with the clearinghouse are settled on a similar timeline as trade payables directly between two operating affiliates, the clearinghouse performs an essentially administrative, not financing, function.

Because these arrangements are established to meet business needs, and each taxpayer has different business needs and affiliate structures, it is probably not possible to draft a narrow cash-pooling definition that will provide significant relief to all taxpayers' ordinary-course cash pooling and treasury-center activities. Furthermore, because cash pooling and other treasury-center activities are so intricately linked, it is probably not possible to draw a non-arbitrary line between a permissible cash pool and revolving loan agreements. Any such line will still require significant additional compliance and monitoring resources to ensure that affiliated transactions do not cross the line and create unintended changes in affiliate ownership. Despite these limitations, FEI suggests that Treasury consider the following exclusions to reduce the impact on cash pooling and other treasury activities.

B. Treasury-center exclusion

An affiliate or division of an affiliate that acts as the concentration point for a cash pool takes deposits from other affiliates in the cash pool. If this affiliate makes a distribution, the Proposed Regulations can recharacterize a number of deposits as equity, leading to serious adverse tax consequences and substantial compliance obligations. The affiliate acting as a cash pool leader is not likely to be taking deposits for the purpose of stripping earnings since these deposits typically bear little or no interest and are funding short-term loans to other members of the cash pool and thus generate comparable levels of interest income. Treasury should consider exempting the debts of affiliates and qualified business units of affiliates which meet the Foreign Account Tax Compliance Act's definition of a treasury center in Treas. Reg. § 1.1471-5(e)(5)(i)(D).

C. Testing of balances to distinguish cash-management debt from longer-term financing

Short-term debts typically have a low interest rate that is not conducive to earnings stripping. It is also extremely difficult for ordinary affiliate operations to function without short-term financing arrangements like cash pools and revolving loan/deposit agreements. In addition, third-party documentation for short-term loans is likely to be less extensive than for long-term loans. Treasury should exempt such short-term loans by providing that if an instrument has a committed tenor of less than twelve months it is exempt from the Proposed Regulations. Alternatively, Treasury could exempt an instrument which has a zero balance on the last day of at least one calendar quarter over a period of four consecutive quarters, adopting the measurement criteria applicable to the quarterly tests in Section 956(a).

Any concerns that taxpayers could use this rule to avoid equity recharacterization for longer-term loans are misplaced. The anti-abuse rule in Proposed Regulations § 1.385-3(b)(4) allows Treasury to recharacterize a debt instrument issued with a principal purpose of avoiding recharacterization under the rules of Proposed Regulations § 1.385-3.

These are broad exceptions, but their breadth is necessitated by the importance of preserving members' cash-management systems if the Proposed Regulations become effective.

D. Working capital exception

If an entity borrows solely to meet its working capital needs, its debts should be excluded from the operation of the proposed regulations. This type of borrowing is not conducive to earnings stripping. While it is difficult to trace a loan directly to working capital, Treasury can use financial statement metrics to provide an easily-administered minimal level of debt which can be issued to fund working capital needs without the threat of recharacterization. Treasury should exempt from the operation of the proposed regulations any debt issued during a year to the extent that total outstanding debt of the borrower does not exceed 150% of the closing balance of current assets of the borrower in the most recently completed financial statements. Taxpayers need to be able to predict the amount of debt that can be issued without triggering recharacterization, so completed financial statements, rather than current year financials, should be used as the metric. Additionally, to allow for growth of working capital, the floor should be set higher than the prior year's closing balance.

III. Comments regarding Proposed Regulations § 1.385-2 documentation requirements

A. Ordinary-course loans should be exempted from the documentation requirements

As in Proposed Regulations § 1.385-3, Treasury should exempt ordinary-course loans from the documentation rules of Proposed Regulations § 1.385-2. The definition of ordinary-course loans should be expanded to account for arrangements that taxpayers enter into among expanded groups, such as clearinghouse payment systems and expenses paid on behalf of another affiliate. Further, payments should not be restricted to currently deductible or inventory items. The concerns around debt being used to conduct general or funding transactions are not present in documentation matters. A taxpayer does not fail to document a payable for a depreciable asset to seek an advantage of any sort.

To provide such an exception, a new Proposed Regulations § 1.385-2(a)(4)(i)(C) could be added to read as follows:

> The term 'applicable debt instrument' does not include, and this section does not apply to, a debt instrument that an issuer incurs in connection with the purchase of property, the receipt of services, the payment of a rent or royalty, or reimbursements for amounts that another expanded group member paid on behalf of the issuer in connection with the issuer's purchase of property, receipt of services, or payment of a rent or royalty provided that the amount of the debt instrument outstanding at no time exceeds the amount that would be ordinary and necessary to carry on the activities of the issuer if it was unrelated to the lender and the amount of the debt instrument is repaid no later than the last day of the fourth calendar month following the month in which such amount arises. However, if local-country foreign-exchange requirements prevent repayment of a debt instrument no later than the last day of the fourth calendar month following the month in which such amount arises, the debt instrument is not an 'applicable debt instrument' if the taxpayer provides evidence of such foreign-exchange requirements.

B. Create a safe-harbor exception to the credit-analysis documentation requirement

Few tax practitioners have the skills required to prepare the credit analysis required by Proposed Regulations § 1.385-2(b)(2)(iii). Consequently, it will generally be necessary to obtain assistance to prepare this documentation, whether through personnel from outside of a company's tax function or from outside advisors. However, in many cases, the facts surrounding the expanded group instrument ("EGI") will be such that the lender undoubtedly had a reasonable expectation that the debtor would be able to meet its obligations. In these situations, the preparation of detailed financial analysis will be a meaningless gesture that will do little but impose an unnecessary compliance burden on taxpayers without advancing the goals of the Proposed Regulations.

Therefore, the Proposed Regulations should adopt a safe-harbor exception to the documentation requirements which will provide that the documentation requirement of Proposed Regulations § 1.385-2(b)(2)(iii) will be satisfied if it is documented that the debtor satisfies certain safe-harbor financial ratios. Such ratios could include (i) a minimum debt-to-equity ratio of 1:3 or (ii) a minimum interest-coverage ratio (earnings before interest, taxes, depreciation, and amortization to total interest expense) of 3:1. A borrower that meets one of these ratios can reasonably be expected to be able to meet its obligations, and these ratios can be computed and documented without third-party assistance.

C. Remove the reservation to the definition of "applicable instrument"

In Proposed Regulations § 1.385-2(a)(4)(i), Treasury reserved on the application of Proposed Regulations § 1.385-2 to instruments that are not in form a debt instrument and requested comments on the appropriate documentation for such instruments. If Treasury has yet to identify interests that are not in the form of a debt instrument but that create a documentation-related concern, Treasury should not issue rules requiring such documentation, and the reservation should be removed. The currently proposed documentation requirements are onerous enough for taxpayers that must prepare the documentation and for IRS agents who must review the documentation without having to grapple with an expanded definition attempting to catch a larger spectrum of debt. The universe of items treated as debt for U.S. tax purposes but that are not in form debt instruments is difficult to define. This lack of definition creates confusion around the compliance requirements a taxpayer must meet. Not all such items clearly fall within the factor-based debt/equity analysis performed by courts. The transactions that present earnings-stripping concerns are likely to be documented as traditional debt instruments. Absent a specific concern, we recommend limiting the application of the documentation requirements to traditional debt instruments.

D. The required documentation should be prepared by the tax return due date

Proposed Regulations § 1.385-2 requires that taxpayers timely prepare and maintain certain documentation when an EGI is issued and as long as it is outstanding. In general, the timely preparation requirement mandates that documentation regarding the issuer's unconditional obligation to pay, the holder's creditor's rights, and the reasonable expectation of repayment must be prepared no later than 30 calendar days after the EGI is issued under Proposed Regulations § 1.385-2(b)(3)(i). The documentation regarding actions evidencing a debtor-creditor relationship must be prepared within 120 days of the relevant date specified in Proposed Regulations § 1.385-2(b)(3)(i).

The members recognize that the Proposed Regulations require timely documentation in order to evidence the intent to create binding indebtedness and that the overarching requirement for debt categorization–a reasonable expectation of repayment–is satisfied. But the deadlines for preparing this documentation are unreasonably short in the context of a multinational enterprise with complex operations. In many multinationals, the finance and treasury functions operate separately from the tax function and fund transfers between entities that would be subject to the documentation rules may occur on routine basis without any involvement by the company's tax advisors. It would be extremely difficult for even the best-managed multinational enterprise, especially ones operating on a decentralized basis, to identify all transactions subject to the Proposed Regulations in sufficient time to prepare the prescribed documentation within 30 days.

Even if all intercompany loans were identified by the time of issuance, preparing the required documentation within the 30 day period would be difficult as a practical matter. Assuming no local regulatory or corporate-law requirements delay the process, a promissory note evidencing an unconditional promise to pay and establishing creditor's rights could conceivably be prepared and executed within 30 days. However, regulatory or local-law requirements may make it impossible to meet this deadline.

In addition, 30 days is an unreasonably short period of time for taxpayers to gather the necessary information and prepare an analysis of the issuer's ability to repay the EGI. Most tax professionals have neither the skills nor the experience required to prepare this credit analysis. Therefore, it will be necessary to rely on either outside advisors or other members of a multinational's finance staff, persons who undoubtedly have many competing demands on their time and may view assisting in the tax compliance process to be a peripheral responsibility. In many companies, engaging an outside advisor to prepare the credit analysis requires a lengthy contracting process that often cannot be completed within 30 days. If a taxpayer's general-contracting procedures are such that it cannot engage the necessary assistance to prepare the documentation in less than 30 days, it certainly cannot be expected to prepare the documentation itself within 30 days.

A more reasonable deadline to prepare the required documentation is the due date for the tax return, with extensions, as is the case with the transfer-pricing documentation required under Section 6662(e) and Treas. Reg. §1.6662-6(d)(2)(iii). The transfer-pricing documentation requirements serve a similar purpose to the documentation required by the Proposed Regulations: to impose discipline on related-party transactions to ensure they occur on an arm's-length basis. As the Section 6662(e) regulations indicate, this objective can be met if the necessary documentation is prepared by the due date of the tax return, with extensions. In addition, such a deadline would make preparing documentation part of the annual tax-return-preparation process. This contemporaneousness would make preparation part of a work effort under which the persons responsible for a company's tax compliance gather information from throughout the company. Information regarding intercompany loans could more readily be obtained through the process. Moreover, the deadline would give taxpayers enough lead time to obtain any assistance necessary to prepare appropriate documentation. Given the harsh and irrevocable penalty imposed on missing the documentation deadlines, we believe it is appropriate for the Proposed Regulations to follow Treasury's transfer-pricing approach and use as their deadline the tax return due date, with extensions.

E. Consider imposing a penalty rather than equity recharacterization under the documentation rules

Treasury's proposed recharacterization penalty for non-compliance with documentation of ordinary debt transactions is excessive and unpredictable. Information reporting requirements are typically enforced through financial penalties. Characterizing a loan as equity will in some cases merely disallow an affiliated interest deduction but in others cause more severe consequences like double-taxation from denial and loss of Section 902 credits. The magnitude of the recharacterization penalty increases and decreases for reasons having nothing to do with the degree of the taxpayer's failure in providing the documentation. We ask Treasury to consider replacing the equity-recharacterization rule with a financial penalty.

F. Converted equity should be issued from regarded entities

Where Proposed Regulations § 1.385-2 causes an instrument to be treated as equity, it should be treated as equity in the corporation or corporations that own the issuing partnership or disregarded entity, consistent with the rules in Proposed Regulations § 1.385-3(d)(5)-(6). The current rules in Proposed Regulations § 1.385-2(c)(5)-(6) will cause disregarded entities to be deemed to become partnerships, and partnerships will be deemed to issue another partnership interest. The formation of a U.S. tax partnership out of a disregarded entity can result in significant additional tax costs and complexity for the taxpayer. However, it is not apparent that the government derives any benefit from the treatment provided for in Proposed Regulations § 1.385-2(c)(5)-(6). We recommend Treasury reform the provisions in those documentation paragraphs to treat equity interests to be issued at the owner level as in Proposed Regulations §§ 1.385-3(d)(5)-(6).

G. Additional time for documentation of recent acquisitions

Companies subject to the Proposed Regulations may acquire foreign companies that have not been subject to the regulations. Implementing the systems to identify debt instruments and generate the necessary documentation for these newly acquired companies takes time. Treasury should allow a one-year window from the time the expanded group acquires a new member to the time the documentation requirements of Proposed Regulations § 1.385-2 apply to debt instruments issued by the newly acquired member.

IV. Comments regarding Proposed Regulations § 1.385-3

A. Eliminate the per se rule in Proposed Regulations § 1.385-3(b)(3)(iv)(B)(1)

Many of the problems caused by Proposed Regulations arise from the irrebuttable presumption that recharacterizes debt if it was issued within a 72-month period before or after a distribution from the debtor. The number of earnings-stripping transactions these regulations will prevent are insignificant next to the number of dividends and related-party debt instruments arising in a non-earnings stripping context that will need to be reconsidered or restructured to avoid the negative effects of equity characterization due to proximity in time. Treasury's apparent purpose in creating the irrebuttable presumption is to avoid the administrative difficulty of applying traditional debt/equity factors to the facts of each loan. Because the per se rule eliminates a facts-and-circumstances analysis, it appears to run contrary to Section 385's legislative intent. The general facts-and-circumstances analysis is more appropriate to address transactions with potential earnings-stripping concerns. The per se rule should therefore be eliminated or, at a minimum, be made a rebuttable presumption.

B. Reduce the period in the Proposed Regulations from 36 months before and after the date of distribution to 12 months before and after the date of distribution

If Treasury maintains the per se rule, the range of the rule should be curtailed. Affiliates of a multinational company experience cash variations based on capital projects, competitive fortunes, macroeconomic cycles, industry cycles, and seasonal cycles—among other factors. It is not realistic to have a three-year radius for distributions around a debt issuance.

Therefore, if not eliminated, Proposed Regulations § 1.385-3(b)(3)(iv)(B)(1) should be modified to state:

> 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 12 months before the date of the distribution or acquisition and ending 12 months after the date of the distribution or acquisition (24-month period).

Alternatively the rule could apply to the taxable year in which the debt instrument is issued and the preceding and succeeding taxable years, as follows:

> 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 on the first day of the taxable year of the funded member preceding the taxable year in which the debt instrument was issued and ending on the last day of the taxable year of the funded member succeeding the taxable year in which the debt instrument was issued.

C. Modify the ordinary-course exception

The ordinary-course exception in Proposed Regulations § 1.385-3(b)(3)(iv)(B)(2) should adopt the changes described in its application to the documentation rules described in III.A. of this letter.

Furthermore, the exception should be expanded to eliminate the requirement that taxpayers trace an ordinary-course instrument to an amount deductible under Section 162 or included in cost of goods sold or inventory. It is unclear why such tracing was considered necessary, and Treasury provided no rules for tracing such funds to specific items on the return. Making qualification for the ordinary-course exception contingent on funds being traced to the treatment of an item on the U.S. tax return will effectively require taxpayers to review each trade payable with a tax professional prior to its issuance to ensure that the exception is met, which will slow ordinary business activities and negate any anticipated mitigation of the administrative burden on trade payables.

Treasury should also explicitly allow such ordinary-course payables to be managed through a third affiliate other than buyer and seller to allow for clearinghouse arrangements used by some taxpayers to manage intercompany trade payables.

D. Expand the current-year E&P exception in Treas. Reg. § 1.385-3(c)(1)

A current-year E&P exception is of limited utility for many reasons including the impossibility of determining current-year E&P during the current year and legal restrictions in certain countries which slow payments of current-year E&P until the closing of the statutory books. Taxpayers should be allowed to distribute total accumulated profits without negative consequences. Taxpayers have legitimate business reasons to distribute funds beyond routine annual distributions of ordinary operating profits. For example, they may divest a line of business of the affiliate and wish to distribute the proceeds and any funds not necessary for the ongoing operations of the divested business. If the existing per se rule is in place, it significantly reduces the ability to issue debt to the affiliate for the next three years to fund unanticipated cash needs for its continuing business lines, even though there was no earnings-stripping motive to the post-divestment distribution. Adding the option to use total accumulated E&P in addition to current-year E&P provides flexibility for large or unanticipated distributions for accumulated earnings without allowing taxpayers to replace paid-in-capital with debt.

Failing that, the E&P exception should at least be expanded to all accumulated E&P before the finalization of the Proposed Regulations and the greater of current-year E&P and the total E&P of the current and the preceding two years. This allows distribution of pre-finalization earnings that taxpayers were not on notice may be subject to a restriction, and better approximates ordinary-course distributions in the future from affiliates while discouraging a large accumulation of E&P.

E. Turn off the cascading caused by the stock acquisition funding rule

The cascading effect of the funding rule applicable to the acquisition of expanded group stock should be eliminated. The objective of this rule presumably is to capture transactions that expanded group members actually engage in and not equity conversions that occur as a result of the Proposed Regulations. There seems to be no policy interest served by the consequences of an initial transaction causing ripple effects throughout an expanded group. On the other hand, such effects are a major concern for corporations that centralize treasury center activities or cash pools in dedicated affiliates. Stock deemed acquired by operation of Section 385 should be exempted from Proposed Regulations § 1.385-3(b)(3)(ii)(B). If scenarios exist where an expanded group could take advantage of this modification, Proposed Regulations §§ 1.385-2(d) and -3(e) preclude such a use.

F. Exclusion for debt instruments issued as part of acquisition of a new EGI member

Taxpayers need flexibility to incorporate newly purchased groups of corporations into their existing group structure. The issuance of debt and movement of companies as part of a larger overall restructuring in connection with an acquisition of a formerly unrelated business is not done to strip earnings but rather is intended to allow the merged business to operate efficiently going forward. The reorganization of the newly merged corporate group may require engaging in transactions that can cause a recharacterization of debt under the funding rules of Prop. Reg. § 1.385-3(b). Treasury should provide that if a member of the expanded group acquires a corporation or corporations, other than a newly formed corporation, which were not previously part of the expanded group, debt instruments issued by or to such acquired corporations are not subject to the rules of Proposed Regulations § 1.385-3(b)(3) for a period of one year after the date of such acquisition.

G. Exclusion of debt instruments if expanded group member elects to not deduct interest

The goals of the Proposed Regulations are served if the taxpayer is unable to deduct interest expense in the U.S. Recharacterization of a loan as equity eliminates such deductions but also has numerous effects under other sections of the Code. To make these regulations more tailored to their purpose and to avoid frustrating the legislative and regulatory intent of numerous other Code sections, Treasury should allow taxpayers to forgo interest deductions to avoid equity characterization. If the issuer of a debt instrument makes an irrevocable election to not deduct interest during the issuance period, as determined under the principles of Section 1001, that debt instrument should not be subject to the provisions of Proposed Regulations § 1.385-3.

V. Exclude potential double taxation by carving out a Section 902 exception

The Proposed Regulations will cause double taxation of the foreign income of U.S.-based multinationals, frustrating the purpose of Section 902. The holder of an instrument treated as equity by Proposed Regulations §§ 1.385-2 or -3 will rarely if ever have at least 10% direct voting interest in the borrower. Payments on such a recharacterized instrument will be treated as deemed dividend distributions, but the recipients of the distributions will not be entitled to claim Section 902 credits. Meanwhile the borrowers will have the foreign tax credits associated with the earnings deemed distributed eliminated from their tax pools. The foreign tax credits will therefore be lost, and the foreign earnings of the borrowers will thus be subject to foreign income taxes plus the full 35% U.S. income tax. Treasury should take steps to mitigate this double taxation by issuing rulings similar to the rulings which maintain credits in the similar situation of a deemed distribution under Section 304. See Revenue Rulings 91-5 and 92-86.

VI. Conclusion

The modifications to the Proposed Regulations discussed above will somewhat mitigate the impact of these regulations on companies' ordinary financial activities. However, the modifications do not solve all of the concerns we have with the Proposed Regulations. Even with these modifications, the Proposed Regulations create serious adverse tax consequences and substantial new compliance burdens for companies with U.S. tax-reporting obligations regardless of whether they are engaged in earnings-stripping activities. These burdens are far out of proportion to the harm Treasury is trying to prevent. Consequently, Treasury should withdraw the Proposed Regulations.

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