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VIA ELECTRONIC TRANSMISSION AND HAND-DELIVERY

CC:PA:LPD:PR (REG–108060–15)
Room 5203
Internal Revenue Service
P.O. Box 7604
Ben Franklin Station
Washington, DC 20044

Re: Comments on proposed § 385 regulations in REG–108060–15

Dear Sirs or Madams,

The Silicon Valley Tax Directors Group ("***SVTDG***") hereby submits these comments on the above-referenced proposed regulations issued under § 385 of the Internal Revenue Code of 1986, as amended, in REG–108060–15, 81 Fed. Reg. 20912 (April 8, 2016) (the "***Proposed Regs***"). SVTDG members are listed in the Appendix of this letter.

Sincerely,

Robert F. Johnson

Robert F. Johnson
Co-Chair, Silicon Valley Tax Directors Group

I. INTRODUCTION AND SUMMARY

A. Background on the Silicon Valley Tax Directors Group

The SVTDG represents U.S. high technology companies with a significant presence in Silicon Valley, that are dependent on R&D and worldwide sales to remain competitive. The SVTDG promotes sound, long-term tax policies that allow the U.S. high tech industry to continue to be innovative and successful in the global marketplace.

B. Primary recommendation—the Proposed Regs should be withdrawn

The SVTDG recommends the Proposed Regs be withdrawn in their entirety and re-proposed in a different form after consultation with U.S. businesses and other stakeholders. We acknowledge the validity of concerns about intercompany indebtedness in the context of inversions, earnings stripping transactions, and similar transactions that erode the U.S. tax base. These concerns are most properly addressed, however, through changes to § 163(j), which gives rules for limiting deductibility of interest on certain debt. Treasury and the IRS tried fashioning regulations under § 385 to deal with the concerns.[1] But the Proposed Regs go far beyond addressing the concerns and would, if finalized as proposed, have staggering, harmful consequences for many U.S. multinational enterprises ("***MNEs***") conducting ordinary-course intercompany business transactions. These consequences include—

◊ a greatly increased compliance burden, coupled with high costs of developing and implementing IT systems to monitor intercompany debt arising in treasury functions;

◊ increased uncertainty surrounding (i) running normal treasury functions, such as cash pooling and revolving credit arrangements; (ii) making distributions; and (iii) engaging in corporate restructurings;

◊ increased cost, complexity, and uncertainty for companies and their financial auditors in preparing and reviewing quarterly and annual financial statement income tax provisions (e.g., due to possible "springing equity", and unexpected book-tax differences arising from the Proposed Regs);

◊ increased cost (thus reduced profit) from having to use more third-party financing—the main beneficiaries of which will be banks—to avoid internal financing fraught with complexity, compliance burdens, and uncertainty; and

[1] In a June 28, 2016 letter to Jacob Lew (Treasury Secretary), House Ways and Means Committee Chairman Kevin Brady and 23 other Representatives respectfully pointed out that, in drafting the Proposed Regs, Treasury "co-opted section 385 to use for purposes other than what Congress had in mind."

◊ further burdening U.S. MNEs against foreign competitors, who aren't subject to onerous requirements (and associated costs) such as those in the Proposed Regs.

We don't think Treasury and the IRS envisioned the seismic effect the Proposed Regs would have on routine, day-to-day business transactions of U.S. MNEs.

It's also unclear Treasury and the IRS considered the interaction of the Proposed Regs with U.S. tax treaty obligations. The OECD has considered Article 9 tax consequences arising in cases of thinly capitalized businesses, including the possibility of recharacterizing purported debt as equity. But there's no indication U.S. tax treaty partners would accept the broad recharacterization consequences (especially as they relate to imposition of withholding tax) of the Proposed Regs. The Proposed Regs, if finalized in their current form, will conflict with treaty concepts of dividends and interest and will give rise to risks of double taxation. The tax treaty ramifications should be considered more fully before re-issuing proposed regulations under § 385.

C. Summary of secondary recommendations—changes that should be made to the Proposed Regs if they're not withdrawn

If the Proposed Regs aren't withdrawn, we recommend both broad changes and more specific changes be made to them.

We recommend, first, the scope of the Proposed Regs should be narrowed to related-party debt-issuance transactions in which a U.S. person is involved in one of the triggering transactions in either the general rule or the funding rule. This narrowing focuses the provisions on transactions that could potentially erode the U.S. tax base, but gives taxpayers more latitude in debt issuances in a purely foreign-to-foreign context. Second, all debt instruments arising in the ordinary course of an issuer's trade or business should be excluded from recharacterization under the Proposed Regs. Such an exclusion would reduce much of the taxpayer burden, costs, and uncertainty associated with the Proposed Regs, but not thwart the asserted policy concerns justifying recharacterization. Third, all cash pooling, cash sweeps, revolving credit, and similar arrangements that finance ordinary-course business transactions and satisfy modified documentation requirements should be excluded from possible recharacterization under the Proposed Regs. Such arrangements generally aren't motivated by tax considerations, and provide many business benefits. Fourth, the per se rule should be removed. By automatically recharacterizing debt instruments as equity if issued within 36 months of a distribution or acquisition transaction, the per se rule is contrary to § 385(a) by failing to prescribe factors for determining whether recharacterization is warranted. Fifth, the Proposed Regs should be rectified to prevent potential loss of § 902 foreign tax credits arising from repayment of debt recharacterized as equity of a foreign corporation. Sixth, the effective and applicability dates should be delayed. A delay is needed to give taxpayers adequate time to reorder existing

ordinary course internal debt structure and operations, and to implement tracking, documentation, and maintenance requirements imposed.

We also recommend customized changes. The part stock rules in Prop. § 1.385-1(d)(1) should more precisely describe objective criteria for splitting characterization of an EGI as part debt and part equity. It should also provide that a split characterization of an EGI can't result in less than 25 percent of the instrument being treated as equity.

The documentation and information rules in Prop. § 1.385-2 should permit EGIs to be described, and annual credit validation to be documented, in an umbrella agreement. The deadlines for documentation and information required for EGIs should tie to extended due dates for filing U.S. federal tax returns for relevant taxable years (as described below). The reasonable cause exception for failing to satisfy the documentation and information requirements should be changed to one based on willful failure; demonstration that a failure wasn't willful should automatically deem a failure to not have occurred. If a disregarded entity issues an EGI recharacterized as equity under Prop. § 1.385-2, the EGI should be treated as an equity interest in the owner of the entity. To give taxpayers enough time to develop systems and procedures to comply with the documentation and information rules, such rules should only apply to any applicable instrument issued after January 1, 2019.

The per se rule should be modified three ways. First, it should be changed to a rebuttable presumption that a "principal purpose" exists linking a debt instrument to a prescribed distribution or acquisition. Second, the per se rule shouldn't apply either to any debt instruments closed out or repaid within a year of issuance, or to any debt instrument closed out or repaid during the taxable year in which occurs the prescribed distribution or acquisition. Third, the 72-month period should be narrowed to a 36-month period comprising the taxable year of the debt issuance and the immediately prior and following taxable years. The ordinary course exception to the per se rule should be broadened to (i) remove the requirement that payment be either currently deductible under § 162 or currently included in COGS or inventory; and (ii) include debt instruments arising in the ordinary course of the issuer's trade or business in connection with the license of intangibles or the lease/rental of property. The ordinary course exception should also be clarified to cover ordinary-course debt issuances by expanded group members to the recipient to allow it to buy, license, or lease property, or to buy services.

Three changes should be made to the exceptions to the general rule and funding rule (including the per se rule). First, the aggregate amount of any distributions or acquisitions described in the general rule or funding rule should be reduced by the member's PTI (under §§ 959(c)(1) and (c)(2)) plus the greater of (i) the member's § 316(a)(2) current E&P, or (ii) the member's § 316(a)(1) cumulative E&P. Second, the threshold exception should be raised from $50 million to $500 million—i.e., a debt instrument won't be treated as stock if immediately after its issuance the aggregate adjusted issue price of debt instruments held by members of the

expanded group that would be subject to the general or funding rules but for the exception doesn't exceed $500 million. Third, there should be exceptions from application of the general rule for the issuance of debt instruments in exchange for expanded group stock, and from application of the funding rule for the issuance of debt with a principal purpose of funding an acquisition of expanded group stock, in the context of either employee stock-based compensation transactions or transactions whose purpose is to fund pension or retirement plans.

The general rule and funding rule should be effective 30 days after publication in final form, but the per se rule shouldn't be effective until January 1, 2019. Delaying the effective date of the per se rule will allow taxpayers to assess intercompany financing transactions and take steps not to inadvertently trigger recharacterization under the rule. With the modifications discussed in this letter, the "principal purpose" test can still be used by the IRS to recharacterize debt instruments under the funding rule.

II. SVTDG CONCERNS WITH, AND RECOMMENDATIONS FOR CHANGES TO, THE PROPOSED REGS

A. Secondary recommendations—broad changes to the Proposed Regs if they're not withdrawn

1. The scope of the Proposed Regs should be narrowed to transactions involving a U.S. person

We recommend the Proposed Regs should only apply to issuances of related-party debt in which a U.S. person is involved in one of the triggering transactions in Prop. §§ 1.385-3(b)(2) and -3(b)(3). That is, we recommend the Proposed Regs should only apply to issuances of debt in which (I) a U.S. person either makes or receives a debt instrument (i) in a distribution; (ii) in exchange for expanded group stock; or (iii) in exchange for property in an asset reorganization described in Prop. § 1.385-3(b)(2)(iii); (II) a U.S. person either makes or receives a debt instrument in exchange for property with a principal purpose of funding a distribution or acquisition described in Prop. §§ 1.385-3(b)(3)(ii)(A)–(C); or (III) a debt instrument is issued by a funded member corporation to a member of the funded member's expanded group in exchange for property with a principal purposes of funding a distribution or acquisition described in Prop. §§ 1.385-3(b)(3)(ii)(A)–(C) in which a U.S. person is a party.

Restricting the scope of the Proposed Regs this way would focus them on transactions signaled as being potentially abusive of U.S. federal tax principles,[2] while allowing taxpayers more latitude in debt issuances with purely foreign ramifications.

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[2] *See*, *e.g.*, preamble to Proposed Regs, 81 Fed. Reg. at 20914 ("These proposed regulations are motivated in part by the enhanced incentives for related parties to engage in transactions that result in excessive indebtedness in the cross-border context, ..."); at 20917 ("[I]nverted groups and other

2. Ordinary course business transactions should be excepted from the Proposed Regs

We recommend all debt instruments arising in the ordinary course of the issuer's trade or business—regardless of the transaction—should be excluded from recharacterization under the Proposed Regs. Ordinary course debt instruments would include those instruments described in Prop. § 1.385-3(b)(3)(iv)(B)(*2*) (i.e., arising in connection with the purchase of property or the receipt of services, to the extent deductible or included in COGS), and also include any debt instruments (a) requiring capitalization of amounts; (b) arising in connection with licenses or rentals or leases of property; (c) referred to as intercompany trade receivables in § 1.482-2(a)(1)(iii); (d) arising in connection with PCT Payments and cost sharing payments under § 1.482-7; (e) arising in connection with Rev. Proc. 99-32; and (f) arising under any other application of §§ 482 or 367(d), or associated regulations.

Issuances of such ordinary course debt instruments don't present situations for abuse described in the preamble to, and targeted by, the Proposed Regs. Excluding such ordinary-course debt instruments from the scope would in no way blunt how the policy concerns raised in the Proposed Regs are addressed through recharacterization. Excluding such ordinary-course debt instruments would, however, dramatically reduce burdens, costs, and uncertainties taxpayers would face if the Proposed Regs were finalized in their current form.

3. Cash pooling, cash sweeps, revolving credit, and similar arrangements should be excepted from the Proposed Regs

The preamble of the Proposed Regs asks for comment on "whether special rules are warranted for cash pools, cash sweeps, and similar arrangements for managing cash of an expanded group."[3] We believe special rules are warranted.

U.S. MNEs routinely conduct various forms of cash pooling, cash sweeps, revolving credit, and similar arrangements in the ordinary course of business, not motivated by U.S. federal income tax considerations. Typically one or more CFCs acting as treasury centers borrow from related parties with cash surpluses and lend—in the form of term notes, credit facilities, and other mechanisms—to related parties needing cash. Such CFCs also provide related parties with cash pooling, hedging, and similar services. These arrangements provide many benefits,[4] and

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foreign-parented groups use these types of [*Kraft*] transactions to create interest deductions that reduce U.S. source income without investing any new capital in the U.S. operations."); and at 20918 (Example in which foreign parent corporation gets—as part of a "D" reorganization—a debt instrument from a U.S. subsidiary corporation). The recharacterization results in the Examples in Prop. § 1.385-3(g)(3) would still hold under the recommended restricted scope of the Proposed Regs.

[3] Preamble to Proposed Regs, 81 Fed Reg. at 20929.

[4] Among other advantages, cash pooling centralizes control of group cash (for investment and risk management, to take advantages of economies of scale, etc.), optimizes liquidity, reduces interest

generally aren't motivated by tax considerations. The federal tax treatment of treasury center activities conducted by CFCs is governed by several Code provisions and regulations.[5] Recharacterization of a particular debt instrument in a treasury center operation could have a domino effect across "space" (other related party transactions) and "time" (other debt instruments of the same issuer)—especially under the per se rule—and also trigger unwanted and unintended federal tax consequences.[6]

We accordingly recommend all cash pooling, cash sweeps, revolving credit, and similar arrangements described in Prop. § 1.385-2(b)(3)(iii) that finance ordinary-course business transactions and that satisfy modified documentation requirements (described below) should be excluded from possible recharacterization under the Proposed Regs.

4. The per se rule in Prop. § 1.382-3(b)(3)(iv)(B) isn't justified under § 385 and should be removed

Subsection 385(b) provides "[t]he regulations prescribed under [§ 385] shall set forth factors which are to be taken into account in determining with respect to a particular factual situation whether a debtor-creditor relationship exists or a corporation-shareholder relationship exists."[7] The legislative history of § 385 echoes this. Congress directed Treasury to promulgate regulations "to set forth factors to be taken into account in determining, with respect to a particular factual situation, whether a debtor-creditor relationship exists or whether a corporation-shareholder relationship exists.[8] This much is clear: § 385 regulations must give factors that will be taken into account, in particular cases, in deciding whether debt should be recharacterized as equity.

The per se rule in Prop. § 1.385-3(b)(3)(iv)(B) doesn't do this. The per se rule automatically recharacterizes a debt instrument as equity if it's issued within 36 months of a distribution or acquisition described in Prop. § 1.385-3(b)(3)(ii). Rather than prescribing factors to be used to determine recharacterization (such as the "principal purpose" test under the funding

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charges, facilitates hedging, and avoids negative arbitrage generated by being forced to use outside borrowings if cash is available elsewhere in the group. Significantly, local country corporate law requirements generally make increases and decreases in corporate equity much more restricted in timing and potential government approval compared to intercompany debt.

5 For examples, § 263(g) (straddles), § 267 (losses, expenses, & interest for related-party transactions), § 1.446-4 (hedging transactions), § 475 (mark to market accounting for securities dealers), § 1.954-2(g) (governing foreign personal holding income and foreign currency gain or loss), § 988 (foreign currency transactions), § 1092 (straddles), § 1221 (capital assets), § 1256 (§ 1256 contracts marked to market), and § 1.1471-5(e)(5)(i)(D) (defining "treasury center" for FATCA purposes)

6 For example, recharacterization could break integrated, natural hedges.

7 Emphasis added.

8 S. Rep. No. 91-552, 91st Cong., 1st Sess., 138 (1969) (emphasis added).

rule), if the 36-month "particular factual situation" arises, issued debt instruments are automatically recharacterized as equity. Automatic recharacterization isn't the same as setting forth factors to be taken into account. Automatic recharacterization means no factors are taken into account. All debt issuances—regardless of purpose or context—are tarred with the same recharacterization brush in a 36-month-proximity fact pattern. The per se rule would thus be vulnerable as an invalid regulation. We recommend it be removed.

5. The Proposed Regs should be rectified to address the potential loss of foreign tax credits

Nominal "repayment" by a foreign corporation of debt recharacterized as equity under the Proposed Regs may be treated as a distribution that constitutes a dividend. If, after the recharacterization, the repayment-recipient corporation owns less than ten percent of the voting stock of the foreign corporation treated as having made a dividend, the recipient corporation can't qualify for a § 902 deemed paid foreign tax credit. Owners of more than ten percent of the voting stock don't get credit for the foreign taxes either. In this case, foreign taxes associated with the dividend would be lost from the pool of foreign taxes of the foreign corporation making the dividend. The Proposed Regs should be amended to prevent such potential loss of § 902 foreign tax credits arising from recharacterization of debt issued by a foreign corporation.

6. Effective dates and dates of application in the Proposed Regs should be changed

If the Proposed Regs are finalized in any form preserving their current thrusts, the consequences for U.S. MNEs will be drastic. Taxpayers should be given adequate time (a) to reorder existing ordinary-course internal debt structure and operations—along with internal distributions and acquisitions—so as not to inadvertently trigger any trip wires promulgated under a new § 385 regime; and (b) to implement any tracking, documentation, and maintenance requirements imposed. The retroactive effectives date in Prop. §§ 1.385-3(h) and -4(e) may be subject to validity challenges. In §§ II.B.2.e and II.B.3.c below we provide specific recommendations for changes to the effective and applicability dates of the Proposed Regs.

B. Secondary recommendations—specific changes to the Proposed Regs if they're not withdrawn

1. Prop. § 1.385-1(d)(1)—the part stock rule should be clarified

Prop. § 1.385-1(d)(1) provides the IRS "may treat an EGI . . . as in part indebtedness and in part stock to the extent that an analysis, as of the issuance of the EGI, of the relevant facts and circumstances concerning the EGI . . . under general federal tax principles results in a determination that the EGI is properly treated for federal tax purposes as indebtedness in part and stock in part." The thin-cap example in the Preamble shows the IRS may treat $3 million of a $5 million debt instrument as indebtedness, and $2 million as stock, because "the issuer cannot reasonably be expected to repay more than $3 million of the principal amount as of the issuance

of the [related-party] interest."[9] Little case law—other than in the thin-cap context—supports split debt-equity characterization of a debt instrument;[10] most courts have adopted an "all or nothing approach."[11] The lack of relevant case law (and other applicable federal tax principles) means the latitude given the IRS in Prop. § 1.385-1(d)(1) to recharacterize debt is vague and relatively subjective. The Proposed Regs provide almost no guidance on the extent to which a debt instrument will be recharacterized. This is contrary to the statutory and Congressional mandate that § 385 regulations—including those characterizing debt as in part equity—"shall set forth factors which are to be taken into account in determining with respect to a particular factual situation" the extent to which debt shall be treated as equity. We accordingly recommend the Proposed Regs be amended to more precisely prescribe objective criteria for splitting characterization of an EGI as part debt and part equity.

The consequences of recharacterization of an EGI as equity—in particular, consequences arising from nominal repayment of debt—can vary depending on the amount of the debt that's recharacterized. We accordingly recommend Prop. § 1.385-1(d)(1) be modified to provide a split characterization of an EGI can't result in less than 25 percent of the instrument being treated as equity.

2. Prop. § 1.385-2—documentation rules

a. Prop. § 1.385-2(b)(2)—documentation and other information required

The Proposed Regs state that Prop. § 1.385-2 "applies to each EGI separately, but the same documentation and information <u>may satisfy</u> the requirements of this section for more than one EGI."[12] We recommend the Proposed Regs be augmented by an explicit "umbrella" rule, permitting EGIs to be described, and annual credit validation to be documented, in an umbrella agreement satisfying the requirements of Prop. § 1.385-2(b)(2).

b. Prop. § 1.385-2(b)(3)—timely preparation requirement

The Proposed Regs explain the documentation requirements as follows:

> The proposed regulations are intended to impose discipline on related parties by requiring timely documentation and financial analysis . . . similar to the documentation and analysis created when indebtedness is issued to third parties. This requirement also serves to help demonstrate whether there was intent to

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9 Preamble to Proposed Regs, 81 Fed. Reg. at 20919.

10 As noted in the Preamble, "there has been a tendency by the courts to characterize an instrument entirely as debt or entirely as equity." 81 Fed. Reg. at 20914 (citing H.R. Rep. No. 101-386, 101st Cong., 1st Sess., at 56 (1989)).

11 *Id.*

12 Prop. § 1.385-2(b)(1)(i) (emphasis added).

> create a true debtor-creditor relationship that results in bona fide indebtedness and also to help ensure that the documentation necessary to perform an analysis of a purported debt instrument is prepared and maintained.[13]

To avoid automatic recharacterization of an EGI as equity, the Proposed Regs require documentation and other required information be prepared within a fixed period (30 days or 120 days, as appropriate) after "relevant dates," which generally depend both on the sort of documentation or information required and on the particular EGI. Special rules are given for determining relevant dates for certain financial arrangements, such as revolving credit or cash pooling arrangements.[14]

The documentation requirements in the Proposed Regs would impose heavy new burdens on U.S. MNEs. We believe Treasury's and the IRS's desire "to impose [third party] discipline on related parties," on an EGI-by-EGI basis, serves no good purpose. Documentation and deadlines for third-party financial arrangements make sense for various reasons—including the real possibility of commercial litigation—that have no material analog for related parties. We recommend the deadlines for documentation and information required for EGIs should tie to extended due dates for filing U.S. federal tax returns for relevant taxable years. In particular—

◊ for documentation and information described in Prop. §§ 1.385-2(b)(2)(i) & (ii) (i.e., unconditional obligation to repay; establishment of holder's creditor's rights), the deadline should be the taxpayer's extended due date for filing a U.S. tax return for the taxable year a member of the EG becomes an issuer of a new or existing EGI, or for the taxable year the applicable instrument becomes an EGI, as appropriate;

◊ for documentation and information described in Prop. § 1.385-2(b)(2)(iii) (i.e., reasonable expectation of issuer's repayment), the deadline should be the taxpayer's extended due date for filing a U.S. tax return (A) for the taxable year a member of the expanded group becomes an issuer with respect to an EGI; (B) for any subsequent taxable year in which an issuance is deemed to occur under § 1.1001-3; (C) for any subsequent taxable year in which there occurs a date specified under special rules of Prop. § 1.385-2(b)(3)(iii); and (D) for any taxable year(s) in which an applicable instrument becomes an EGI after it's issued, and in which occur any subsequent relevant dates;

◊ for documentation and information described in Prop. § 1.385-2(b)(2)(iv)(A) (i.e., payments of principal and interest), the deadline should be the taxpayer's extended due date(s) for filing a U.S. tax return for taxable year(s) in which a payment of interest or principal is due; and

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13 Preamble to Proposed Regs, 81 Fed. Reg. at 20916.

14 Prop. § 1.385-2(b)(3)(iii).

◊ for documentation and information described in Prop. § 1.385-2(b)(2)(iv)(B) (i.e., events of default and similar events), the deadline should be taxpayer's extended due date(s) for filing a U.S. tax return for taxable year(s) in which an event of default, acceleration event, or similar event occurs.

Linking documentation and information deadlines to tax return extended filing deadlines lowers for taxpayers the risk of having a foot-fault triggering recharacterization of EGI as equity. This decreased risk would be particularly helpful if some variant of the per se rule is kept: in that event foot-fault documentation failures could—if not subject to exception—further spread deemed recharacterizations backward and forward in time.

c. Prop. § 1.382-2(c)(1)—reasonable cause exception

The Proposed Regs provide that if the person characterizing an EGI as indebtedness for federal tax purposes establishes that a failure to satisfy the requirements of Prop. § 1.385-2 is due to reasonable cause, "appropriate modifications may be made to the requirements of this section in determining whether the requirements of this section have been satisfied."[15] The documentation requirements impose detailed, heavy new burdens on U.S. MNEs, and the consequences for failing to meet the requirements can be severe.

We recommend the exception be changed from reasonable cause to one based on willful failure. We also recommend the consequences of a taxpayer demonstrating non-willful failure to satisfy documentation requirements must be relief—i.e., relief shouldn't be discretionary. That is, we recommend the exception in Prop. § 1.385-2(c)(1) be changed to provide that a failure to comply with the documentation or information requirements will be deemed not to have occurred if the taxpayer demonstrates the failure wasn't willful. For this purpose, "willful" should be interpreted consistent with its meaning in the context of civil tax penalties, which would include a failure due to gross negligence, reckless disregard, or willful neglect.[16] Using this exception under the documentation and information rules excuses inadvertent, non-willful documentation failures, but keeps a threshold high enough to encourage taxpayer vigilance.

d. Prop. § 1.385-2(c)(5)—treatment of disregarded entities

The Proposed Regs provide that if a disregarded entity ("***DE***") issues EGI recharacterized under Prop. § 1.385-2 as equity, the EGI is treated as an equity interest in the DE rather than stock in the DE's owner.[17] This rule is puzzling inasmuch as debt issued by a DE is treated as

[15] Prop. § 1.385-2(c)(1) (emphasis added).

[16] Such an exception parallels the exception under § 1.367(a)-8(p).

[17] This rule is inconsistent with Prop. § 1.385-3(d)(6), which provides that if a debt instrument of a DE is recharacterized as equity under Prop. § 1.385-3, such debt instrument is treated as stock in the DE's owner.

debt of its owner for federal income tax purposes. The consequences of this rule for a U.S. MNE can be drastic, possibly altering the MNE's tax structure and how intercompany transactions are treated for federal tax purposes.

Subsection 385(a) gives the IRS authority to prescribe regulations "to determine whether an interest in an corporation is to be treated . . . as stock or indebtedness." It's clear from the context and from the legislative history that "stock or indebtedness" means stock or indebtedness of the corporation.[18] Treasury and the IRS thus have authority under § 385 to determine whether purported debt issued by a DE—which is treated as purported debt of the DE's owner—is treated as stock or debt of the DE's owner. No authority exists to treat such purported debt as an equity interest in the DE itself, which could cause the DE to be treated as a partnership.[19]

We recommend the rule for treatment of DEs in Prop. § 1.385-2(c)(5) be replaced with a rule consistent with that in Prop. § 1.385-3(d)(6)—i.e., if a DE issues an EGI recharacterized as equity under Prop. § 1.385-2, the EGI should be treated as an equity interest in the owner of the DE rather than in the DE itself.

e. Prop. § 1.385-2(f)—effective/applicability date

The documentation rules in Prop. § 1.385-2 would apply to any applicable instrument issued or deemed issued on or after that date final regulations are published in the Federal Register. The documentation requirements impose detailed, heavy new burdens on taxpayers (particularly U.S. MNEs, who may have hundreds or thousands of EGI's outstanding at any time). Taxpayers will have to develop comprehensive systems and procedures—and will almost certainly incur significant costs developing new IT systems sophisticated enough to track EGIs—to ensure documentation compliance. Treasury's signaled intention to finalize the Proposed Regs with all due speed makes it not practicably possible for U.S. MNEs to timely develop such systems and procedures.

To give taxpayers enough time to develop necessary systems and procedures to comply with the documentation and information rules in Prop. § 1.385-2, we recommend the section should only apply to any applicable instrument issued after January 1, 2019.

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[18] For example, in referring to a "corporate obligation" and the determination of "whether a debtor-creditor relationship exists or whether a corporation-shareholder relationship exists," the Senate Finance Committee clearly contemplated only these two possibilities and not, for example, a partner-partnership relationship arising from the determination; yet this would have been possible if a different legal entity held an interest in a branch or division of a corporation. S. Rep. No. 91-552, 91st Cong., 1st Sess., 138 (1969).

[19] Likewise, no authority exists under § 385 to recharacterize debt issued by a partnership.

3. Prop. § 1.385-3—distributions of debt instruments and other transactions

a. Prop. § 1.385-3(b)(3)—the funding rule

i. PTI should be excluded

Distribution by a CFC of E&P described in §§ 959(c)(1) or (c)(2) ("previously taxed income" or "***PTI***")—i.e., earnings and profits already included in a U.S. shareholder's gross income—doesn't raise the policy concerns underlying the "principal purpose debt instrument" funding rule in Prop. § 1.385-3(b)(3)(ii)(A). Distributions of PTI should thus be excepted from this clause. Such an exception can also be crafted by modifying the exception in Prop. § 1.385-3(c)(1) for current-year E&P, as we describe below.

ii. Prop. § 1.385-3(b)(3)(iv)(B)(*1*)—the per se rule, in general

(A) The per se rule should be replaced with a rebuttable presumption

The Proposed Regs justify the non-rebuttable per se rule on the grounds "money is fungible and because it is difficult for the IRS to establish the principal purposes of internal transactions."[20] But the per se rule deems all debt instruments in the time window, in all instances, to have a "principal purpose" of funding a described distribution or acquisition. Fungibility implies the possibility of a link between debt instruments and tainted funding; the per se rule deems certainty of the link. This is inequitable.

We recommend the per se rule be replaced with a rebuttable presumption. A rebuttable presumption would burden taxpayers with establishing, to the reasonable satisfaction of the IRS, no "principal purpose" linkage between a debt instrument and the tainted funding.

(B) If the per se rule is retained, certain debt instruments should be excluded

Certain debt instruments should be excluded from the per se rule because they generally don't raise the stated policy concerns underlying the rule. We accordingly recommend the per se rule shouldn't apply to (A) any debt instrument closed out or repaid within a year of issuance; or (B) any debt instrument closed out or repaid during the taxable year in which occurs the relevant distribution or acquisition in Prop. §§ 1.385-3(b)(3)(ii)(A)–(C).

[20] Preamble to Proposed Regs, 81 Fed. Reg. at 20923.

(C) If the per se rule is retained, the 72-month period rule is too broad

The 72-month period chosen seems arbitrary; it exceeds safe harbor time periods typically bearing the hallmark of independence between relevant transactions.[21] We recommend accordingly that the 72-month period rule be replaced with a rule providing that, unless the ordinary course exception applies, a debt instrument is treated as issued with a principal purpose of funding a distribution or acquisition described in Prop. § 1.382-3(b)(3)(ii) if it's issued by the funded member either during the taxable year of the distribution or acquisition, or in the preceding or subsequent taxable year (generally, a 36-month period).

iii. Prop. § 1.385-3(b)(3)(iv)(B)(*2*)—ordinary course exception should be expanded

Under the ordinary course exception, the per se rule doesn't apply to a debt instrument arising in the ordinary course of the issuer's trade or business in connection with the purchase of property or the receipt of services to the extent it reflects an obligation to pay an amount currently deductible by the issuer under § 162, or currently included in the issuer's COGS or inventory, provided the amount of the obligation outstanding at no time exceeds the amount ordinary and necessary to carry on the trade or business of the issuer if it was unrelated to the lender. The Proposed Regs state the exception "[isn't] intended to apply to intercompany financing or treasury center activities or to capital expenditures."[22] We see no rational basis for these carveouts from the exception, and believe the exception should moreover be expanded to cover other transactions.

As explained above, we believe intercompany financing and treasury center activities should be excepted from recharacterization under the Proposed Regs.

Capital expenditures—e.g., capital leases or asset purchases—arise routinely in the ordinary course of many taxpayers' businesses. The Proposed Regs fail to explain why such capital expenditures generally give rise to the policy concerns underlying the per se rule.[23] The Proposed Regs also fail to explain policy reasons for not including in the exception ordinary course debt instruments issued in connection with the license of intangibles or the lease/rental of property.

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[21] For example, under §§ 1.355-7(d)(1)–(3), a distribution and an acquisition aren't considered part of the same plan if, among other things, the acquisition occurred more than six months after the distribution, and no agreement, understanding, arrangement, or substantial negotiations regarding the acquisition occurred during the period beginning a year before the distribution and ending six months after the distribution.

[22] Preamble to Proposed Regs, 81 Fed. Reg. at 20924.

[23] To the extent capital expenditure arises in a tax motivated transaction, recharacterization could still flow from the "principal purpose" funding rule.

We accordingly recommend the ordinary course exception be broadened to (i) remove the requirement that payment be either currently deductible under § 162 or currently included in COGS or inventory; and (ii) include debt instruments arising in the ordinary course of the issuer's trade or business in connection with the license of intangibles or the lease/rental of property.

The ordinary course exception should also be clarified to cover ordinary-course debt issuances by expanded group members to the recipient to allow it to buy, license, or lease property, or to buy services.[24]

b. Prop. § 1.385-3(c)—exceptions

i. Prop. §§ 1.385-3(c)(1) & (2)—exception for current year E&P, and the threshold exception

The Proposed Regs explain that Treasury and the IRS "have determined that [the current-year E&P] exception, together with the exception for a tainted debt instrument that does not exceed $50 million . . . appropriately balance between preventing tax-motivated transactions among members of an expanded group and accommodating ordinary course transactions."[25] We believe this explanation fails to articulate any rational connection between typical fact patterns and the choices made.

The Proposed Regs don't contain a blanket exception for debt issuances in connection with ordinary course transactions, but the passage quoted above signals Treasury and IRS willingness that such transactions be accommodated. We believe the accommodation should be explicit. An exception to the per se rule in Prop. § 1.385-3(b)(3)(iv)(B)(*1*) (only) exists for certain debt instruments arising in the ordinary course of an issuer's trade or business in connection with the purchase of property or the receipt of services. Above we recommended this exception be expanded to a wider range of ordinary-course transactions, and further that it constitute an exception to any recharacterization under the Proposed Regs. The Proposed Regs don't explain why an ordinary-course exception should have any relation either to an issuer's current E&P or to the aggregate adjusted issue price of expanded group debt instruments. Characterization of a transaction as ordinary-course (thereby carving out recharacterization of associated debt issuances) should be independent of the issuer's current E&P, or the aggregate adjusted issue price of expanded group debt instruments. Excluding "ordinary course

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[24] The clarification should be accompanied by modification of the Prop. § 1.385-3(b)(3)(iv)(B)(*2*) qualifying language "provided that the amount of the obligation outstanding at no time exceeds the amount that would be ordinary and necessary to carry on the trade or business of the issuer if it was unrelated to the lender" to tailor it to the recipient of property or services—i.e., to the expanded group member borrowing from the issuer.

[25] Preamble to Proposed Regs, 81 Fed. Reg. at 20924.

transactions" from recharacterization is sound policy regardless of the issuer's current-year E&P or the threshold exception.

Any E&P-based exception to recharacterization under Prop. §§ 1.385-3(b)(2) and -3(b)(3) should depend on the extent of a member's E&P available for distribution as a dividend. Limitation to current E&P is arbitrary. We accordingly recommend the exception in the Proposed Regs be revised to provide the aggregate amount of any distributions or acquisitions described in the general rule or funding rule are reduced by the member's PTI plus the greater of (i) the member's § 316(a)(2) current E&P, or (ii) the member's § 316(a)(1) cumulative E&P.

The Proposed Regs don't explain the link between the $50 million threshold exception chosen in Prop. § 1.385-3(c)(3)(2) and the prevention of tax-motivated transactions among members of an expanded group. For U.S. MNEs in particular, aggregate adjusted issue prices of debt instruments held by members of the expanded group (and devoid of any tax-motivated purpose) routinely far exceed $50 million. We accordingly recommend the threshold exception be increased to $500 million.

ii. Exceptions for employee SBC, or pension- or retirement-plan transactions

Transactions relating to employee stock based compensation ("***SBC***") or to funding company pension or retirement plans don't raise the policy concerns underlying the recharacterization rules in Prop. § 1.385-3. We accordingly recommend there be exceptions from application of Prop. § 1.385-3(b)(2) (general rule) for the issuance of debt instruments in exchange for expanded group stock, and from application of Prop. § 1.385-3(b)(3)(ii) (funding rule) for the issuance of debt with a principal purpose of funding an acquisition of expanded group stock, in the context of either employee SBC transactions or transactions whose purpose is to fund pension or retirement plans.

Such exceptions could be crafted either under Prop. § 1.385-3(c) or by expanding the definition of "exempt exchanges" in Prop. § 1.385-3(f)(5) to cover such transactions.

c. Prop. § 1.385-3(h)—effective/applicability date and transition rules

The Proposed Regs provide that the general and funding rules apply to any debt instrument issued on or after April 4, 2016. Failure of Treasury to limit a regulation to prospective application is reviewable by courts for abuse of discretion. The *Administrative Procedure Act* generally requires publication of a substantive rule not less than 30 days before its effective date.[26] The 30-day *APA* rule allows affected persons a reasonable time to prepare for final effectiveness of a regulation and to take any action the issuance of the regulation may

[26] 5 U.S.C. § 553(d).

require. U.S. MNEs will need time to assess intercompany transactions and take steps to accommodate the potential for recharacterization under Prop. § 1.385-3—in particular, under the per se rule, which will require creating sophisticated IT systems to track distributions and acquisitions backward and forward from debt instrument issuances. We accordingly recommend Prop. §§ 1.385-3(b)(2) (general rule) and -3(b)(3)(ii) (funding rule) should be effective 30 days after publication in final form, but that Prop. § 1.385-3(b)(3)(iv)(B)(*1*) (the per se rule) shouldn't be effective until January 1, 2019. Delaying the effective date of the per se rule will allow taxpayers to assess intercompany financing transactions and take steps not to inadvertently trigger recharacterization under the rule; the delay won't however prevent the IRS from recharacterizing debt instruments under the "principal purpose" test under the funding rule, as modified above.

Appendix—SVTDG Membership

Accenture
Activision Blizzard
Acxiom Corporation
Adobe Systems, Inc.
Advanced Micro Devices, Inc.
Agilent Technologies, Inc.
Amazon.com
Apple Inc.
Applied Materials, Inc.
Autodesk
Bio-Rad
BMC Software, Inc.
Broadcom Limited
Brocade Communications Systems, Inc.
Cadence Design Systems
Chegg, Inc.
Cisco Systems Inc.
Dolby Laboratories, Inc.
Dropbox Inc.
eBay, Inc.
Electronic Arts
EMC Corporation
Expedia, Inc.
Facebook, Inc.
FireEye, Inc.
Fitbit, Inc.
Flex
Fortinet
GE Digital
Genentech Inc.
Genesys
Genomic Health, Inc.
Gilead Sciences, Inc.
GitHub
GLOBALFOUNDRIES
GlobalLogic
Google Inc.
GoPro, Inc.
Groupon
Harmonic
Hewlett-Packard Enterprise
Ingram Micro, Inc.
Integrated Device Technology, Inc.
Intel Corporation
Intuit Inc.
Intuitive Surgical
KLA-Tencor Corporation
Lam Research Corporation
LinkedIn Corporation
Marvell Semiconductor, Inc.
Maxim Integrated
Mentor Graphics
Microsemi Corporation
Microsoft Corporation
NetApp, Inc.
Netflix
Oracle Corporation
Palo Alto Networks
Pandora Media, Inc.
PayPal Holdings Inc.
Pivotal Software, Inc.
Plantronics, Inc.
Pure Storage, Inc.
Qualcomm, Inc.
Rovi Corporation
salesforce.com
SanDisk Corporation
Sanmina-SCI Corporation
SAP
Seagate Technology
ServiceNow, Inc.
Snapchat, Inc.
Symantec Corporation
Synopsys, Inc.
Tesla Motors, Inc.
The Cooper Companies
The Walt Disney Company
Trimble Navigation Ltd.
Twitter, Inc.
Uber Technologies
Veritas Technologies
VMware
Xilinx, Inc.
Yahoo!
Yelp