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Re: IRS REG-108060-15 (Proposed Regulations under Section 385)

Ladies and Gentlemen:

The Securities Industry and Financial Markets Association (SIFMA)[1] appreciates the opportunity to submit comments on the proposed regulations (the "**Proposed Regulations**") under section 385 of the Internal Revenue Code of 1986, as amended (the "**Code**").[2]

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[1] SIFMA is the voice of the U.S. securities industry, representing the broker-dealers, banks and asset managers whose nearly 1 million employees provide access to the capital markets, raise over $2.5 trillion for businesses and municipalities in the U.S., serve clients with over $20 trillion in assets and manage more than $67 trillion in assets for individual and institutional clients including mutual funds and retirement plans. SIFMA, with offices in New York and Washington, D.C., is the U.S. regional member of the Global Financial Markets Association (GFMA). This letter addresses certain issues raised by the Proposed Regulations for financial industry firms such as bank holding companies, banks and securities dealers and their corporate groups. SIFMA, through its Asset Management Group, is also submitting a

I. EXECUTIVE SUMMARY

Because of the specific commercial and regulatory position of the financial industry, we believe that (i) the Proposed Regulations, if adopted in their current form, will have uniquely deleterious effects on financial groups, and (ii) to avoid these effects, a number of changes, including various exceptions for and relating to regulated financial groups and companies, need to be made to the Proposed Regulations. Our concerns and views can be summarized as follows:

- The core business of the financial industry – financial intermediation, such as the transmission of funds between lenders and borrowers – relies upon the ability of a financial group to quickly and efficiently transfer funds between jurisdictions and between members of the group, which requires the use of intercompany loans.

- Financial groups are subject to a number of wide-ranging regulatory regimes and rules that constrain and affect virtually every aspect of their businesses, including the use of intercompany debt, and the effects of which apply, with varying force, to virtually every member of the group.

- For both of these reasons, the central premises of the Proposed Regulations – that the rules are necessary to "impose discipline" on related parties with respect to the documentation and analysis of intercompany debt, and that in many cases the incurrence of intercompany debt "lacks meaningful non-tax significance" – are simply untrue in the case of regulated financial groups, and it will often be the case that there is little or no potential for a regulated financial group to engage in meaningful "earnings stripping" through the use of intercompany debt.

- The sheer number of intercompany loans, involving many billions of dollars, in which the typical financial group engages in any year makes financial groups uniquely susceptible to the operation of the Proposed Regulations, including the potential "cascading" recharacterization of a large number of the total intercompany loans across members of the group.

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separate supplemental letter that addresses certain issues raised by the Proposed Regulations for the asset management industry.

[2] Unless otherwise indicated, references to "sections" herein are to sections of the Code.

- For these reasons, as set forth in more detail in this letter, we believe that a number of changes need to be made to the Proposed Regulations. These changes include, but are not limited to, the following:

  - The "funding rule" in Prop. Treas. Reg. § 1.385-3(b)(3), under which intercompany debt that is respected as debt under general tax principles may be nonetheless treated as stock for tax purposes solely because it is issued within 72 months of certain distributions or acquisitions (or otherwise issued for a principal purpose of funding such distributions or acquisitions), should not apply to debt issued by or to members of a regulated financial group (which would generally be defined as a corporate group the parent of which is a U.S. or non-U.S. bank holding company, bank, securities holding company or securities dealer and which group, through the parent, is subject to consolidated regulation by a banking or securities regulator).

  - If this exception for regulated financial groups is not included in the final regulations, the final regulations should include a number of specific exceptions to the "funding rule." These include exceptions for debt issued by or to certain members of a financial group, including regulated financial companies such as certain regulated holding companies, banks and securities dealers, exceptions for debt issued by or to certain members of the group in the ordinary course of business, and certain other exceptions for debt issued between members of the group, including debt between two non-U.S. members of the group, where there is no or very little potential for "earnings stripping."

  - A number of changes should also be made to the "documentation" rules in Prop. Treas. Reg. § 1.385-2, including eliminating the penalty of automatic treatment of an intercompany debt instrument as stock if there is a documentation failure with respect to the instrument and providing more flexible rules for the types of documentation that is required and when that documentation needs to be prepared.

  - We also recommend delaying the effective date of the Prop. Treas. Reg. § 1.385-2 and Prop. Treas. Reg. § 1.385-3 in order to give taxpayers adequate time to implement these regulations.

II. INTRODUCTION

We are mindful of the tax policy concerns, especially as they relate to “inversion” transactions and the opportunities that such transactions present for inverted companies to engage in “earnings stripping” through the use of intercompany debt, that contributed substantially to Treasury’s decision to issue the Proposed Regulations, and acknowledge the significant effort that went into drafting the Proposed Regulations. For the reasons discussed in this letter, however, we believe that, if the Proposed Regulations are adopted in their present form, they will have potentially catastrophic effects on the business operations of financial groups, both U.S.-headed groups and non-U.S. headed groups with operations in the United States.

While these effects are not limited to the financial industry, the specific nature of the commercial and regulatory circumstances of the financial industry will result in the Proposed Regulations having uniquely deleterious effects on financial groups. The core business of the financial industry is financial intermediation: for example, in the case of a bank, the transmission of funds from lenders to borrowers, intermediating between them, or, in the case of a dealer in securities or commodities, engaging in the purchase and sale of financial assets or commodities with customers. In a very literal sense, money is the inventory, the stock in trade, of a financial group. Similar to the way in which a multinational manufacturing group with a global supply chain and distribution network must have the ability to transfer raw materials and finished products between members of the group, a global financial group cannot operate without the ability to transfer money between jurisdictions and between members of the group through intercompany loans and other transactions treated as intercompany debt. In the ordinary course of their business, members of a financial group will engage in hundreds or thousands of intercompany debt transactions, involving many billions of dollars, over the course of a single year. The sheer number and magnitude of intercompany debt transactions between members of a financial group make financial groups uniquely susceptible to the operation of the Proposed Regulations, including the potential of the Proposed Regulations to result in “cascading” recharacterizations of intercompany debt as equity – i.e., intercompany debt treated as equity under the Proposed Regulations may give rise to deemed transactions that result in the recharacterization of additional intercompany debt as equity.[3]

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[3] Specifically, when a debt instrument that is issued by one member of an expanded group within the meaning of Prop. Treas. Reg. § 1.385-1(b)(3) (an “**EG**”) to another member of that group is recharacterized as stock under Prop. Treas. Reg. § 1.385-3(b)(3) (the “**Funding Rule**”), (i) the recharacterized debt instrument would be treated as an acquisition by the lending member of the group of stock of the borrowing member of the EG and (ii) the payments of interest and principal with respect to

In addition, U.S. and non-U.S. groups that include banks, bank holding companies and dealers in securities and commodities are subject to a number of wide-ranging regulatory regimes and rules that constrain and affect virtually every aspect of their businesses, including the use and terms of intercompany debt. Several of these regimes and rules operate to limit the extent to which the group can engage in intercompany debt transactions and require allowable intercompany debt transactions to have terms and conditions that are at arm's length. In other circumstances, the rules affirmatively require or encourage the use of intercompany debt. The effects of these regulatory regimes on intercompany funding structures and transactions, and on subsidiary capital structures, are so pervasive that what appear to be the central presumptions underlying the Proposed Regulations – that (i) with respect to the documentation rules in Prop. Treas. Reg. § 1.385-2, it is necessary to "impose discipline" on related parties with respect to the documentation and analysis of intercompany debt, and (ii) with respect to the recharacterization rules in Prop. Treas. Reg. § 1.385-3, in certain cases the incurrence of intercompany debt lacks meaningful non-tax significance – are simply untrue in the case of regulated financial groups. As applied to financial services firms, these rules would not achieve any material U.S. federal income tax policy objective.

For these reasons, we believe that, with respect to Prop. Treas. Reg. § 1.385-3, the Proposed Regulations should be withdrawn. SIFMA shares the many questions and concerns that have been articulated by taxpayers and the tax community at large about Prop. Treas. Reg. § 1.385-3, including the policy justifications for the overall approach taken by Treasury in Prop. Treas. Reg. § 1.385-3, and the consequences of Prop. Treas. Reg. § 1.385-3 for taxpayers, especially as they relate to their effect on normal commercial practices, and believes that these questions and concerns justify the withdrawal by Treasury of Prop. Treas. Reg. § 1.385-3.[4] If Treasury is concerned about tax consequences of the use of related party debt in specific contexts,

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the recharacterized debt instrument would generally be treated as distributions on its stock by the borrowing member, which in each case could result in the recharacterization of other debt issued by the lending member or the borrowing member, respectively, as stock under the Funding Rule. A financial group is uniquely susceptible to such recharacterization and its consequences given the vast number and dollar amounts of intercompany debt that the members of a financial group issue in the ordinary course of their business. Similar "cascading" recharacterizations of debt instruments can be triggered by a failure to comply with the documentation rules in Prop. Treas. Reg. § 1.385-2.

[4] We note that the Tax Section of the New York State Bar Association and the Taxation Section of the District of Columbia Bar have also recommended the withdrawal of Prop. Treas. Reg. § 1.385-3 in their respective comment letters. *See* "Report on Proposed Regulations under Section 385," 2016 TNT 126-36 (June 30, 2016) (the "**NYSBA Comment Letter**"); "Comments Regarding the Proposed Regulations on Related-Party Debt Instruments," 2016 TNT 126-35 (June 30, 2016).

such as the use of such debt in the context of "earnings stripping" or in the context of debt issued by controlled foreign corporations as part of repatriation planning, it should use its regulatory authority under section 163(j) or other provisions of the Code, to the extent consistent with Congressional intent, to issue regulations that specifically target the use of related party debt in such contexts. The Proposed Regulations, however, are overbroad to an unprecedented degree. Treasury's concerns about the use of related party debt in these contexts do not justify issuing a proposed regulation that ignores decades of settled case law and purports to articulate general principles for the characterization of an instrument as debt or equity for U.S. federal income tax purposes. The proposed regulation as drafted has the potential to turn virtually every debt instrument between members of an expanded group into equity for such purposes, and in turn having potentially catastrophic tax and commercial consequences for virtually every U.S. multinational group and non-U.S. multinational group with U.S. subsidiaries. Moreover, in light of the evolving regulatory environment in which global financial groups operate – which is likely only to grow increasingly unsettled with recent events affecting the United Kingdom and the European Union – financial groups must have the ability to adapt their funding structures, legal entity organizational structures and capital structures to meet the future demands of regulators and the future needs of their customers. We are certain that, even if we cannot predict all of the ways in which Prop. Treas. Reg. § 1.385-3 will inhibit these changes, it will have that effect in far too many circumstances.

If Treasury is unwilling to take this action, SIFMA strongly believes that the Funding Rule should not apply to a "regulated financial group" as defined later in this letter. However, if Prop. Treas. Reg. § 1.385-3 is finalized without this exception, we believe that, at the very least, a number of more specific exceptions and modifications to this proposed regulation must be made in order, among other things, to appropriately narrow its scope with respect to the financial industry. With respect to Prop. Treas. Reg. § 1.385-2, we again believe that a number of exceptions and modifications to the proposed regulation are appropriate and necessary to appropriately narrow its scope with respect to the financial industry.

Part III of this letter provides a more detailed description of the distinctive commercial and regulatory circumstances of the financial industry, including specific examples of the intercompany funding structures or transactions used by financial groups and the regulatory rules and constraints that apply with respect to structures or transactions. Part IV of this letter discusses our primary recommendation with respect to Prop. Treas. Reg. § 1.385-3. Part V of this letter discusses alternative recommendations with respect to Prop. Treas. Reg. § 1.385-3 if our primary recommendation is not accepted. Part VI of this letter discusses additional recommendations with respect to Prop. Treas. Reg. § 1.385-3 that are important to the financial industry. Part VII of this letter discusses our recommendations with respect to Prop. Treas. Reg.

§ 1.385-2. Part VIII of this letter discusses a proposed safe harbor for debt instruments issued with terms that are required by a regulator in order for the debt instrument to satisfy regulatory capital or similar regulatory requirements. Finally, Appendix I to this letter discusses other, more general recommendations and issues with respect to the Proposed Regulations.

III. COMMERCIAL AND REGULATORY CONSIDERATIONS RELEVANT TO THE FINANCIAL INDUSTRY

A. The Conduct of a Global Financial Intermediation Business Relies on the Use of Intercompany Debt

At its most basic, the financial intermediation business conducted by a global financial group involves the receipt of cash from depositors and other lenders, in the form of deposits and loans (or arrangements treated as loans, such as repos), on the one hand, and the provision of cash to customers and borrowers, in the form of loans and similar financing. Typically, a financial group may obtain most of the cash that it needs from depositors, lenders and investors through only a few legal entities – e.g., the main deposit-taking bank (or banks) or other central funding entity within the group, the top-tier company (which, in the United States and in a number of foreign jurisdictions is a holding company) that has publicly traded shares and debt and a few other financing entities which issue the third-party debt (including in the form of short-term notes and repos) that provide funds for the ordinary course funding for the group's operations. Third-party lenders typically look for rated entities within the financial group with a significant amount of assets, which typically would only constitute a select number of entities. The group's customers who require funding – its borrowers and other customers – often reside in a different jurisdiction from the depositors and customers who provide funds to the bank or other funding entity, and in such cases will often deal with separate legal entities (e.g., subsidiaries in the borrowing customer's jurisdiction or region). Moreover, the top-tier company heading a financial group – whether it is a holding company or itself an operating bank or securities firm – will generally be a source of capital and debt funding to its various domestic and foreign subsidiaries, including both operating and non-operating subsidiaries and regulated and unregulated subsidiaries, and will receive from its subsidiaries distributions in the form of dividends on capital, and interest and principal payments on debt funding, so that the top-tier company can in turn build up its own earnings, pay distributions to its shareholders and make interest and principal payments to its debtholders. To move cash from where it is sourced to where it is needed, therefore, requires a large number of frequent (i.e., daily), large (often totaling in the billions of dollars) and often temporary (i.e., short-term) movements of cash between the legal entities within the group.

For a number of commercial reasons – which are in addition to the regulatory reasons discussed in the next section – these cash movements must occur primarily through the issuance and repayment of intercompany debt rather than through equity contributions and distributions. Principally, this is because – in addition to longer-term core capital needs for any particular legal entity – there are typically short-term fluctuations in the funding needs in any given jurisdiction (and therefore in the funding needs of the group members that are located in or service that jurisdiction) as a result of market demands and conditions, which requires the group to be able to quickly redeploy funds across jurisdictions and group entities. It would be impracticable and inefficient to move capital around the group in response to such fluctuations primarily in the form of equity distributions and contributions, rather than in the form of intercompany debt. In addition, the use of intercompany debt allows the financial group to better match the duration of liabilities and assets, both across the group and within each member of the group, a necessary feature of any regulated financial group's liquidity risk management framework. For example, if the funds sourced by a group member (e.g., a bank) are in the form of deposits or are from the issuance of other short-term instruments, to the extent that the member transfers such funds to other members of the group, it must generally do so through intercompany debt of a similar or shorter duration, rather than through equity (which has a long, even indefinite, duration). This is in order to ensure that when the group member is required to repay its liabilities, it will be able to do so by relying on scheduled repayment of the intercompany debt rather than through a discretionary distribution on or a redemption of equity, which generally requires several governance actions (and, as described in the next section, may require regulatory approval as well).

The following are examples of the different types of intercompany funding used by a global financial group in the ordinary conduct of its business:[5]

- Intraday/daylight funding – operating member of the group will obtain intraday funding from other members of the group to deal with intraday cash needs, including as a result of unpredictable client needs, market volatility, non-aligned deadlines for cash and securities instructions to settle securities trades and other financial transactions and other factors.

[5] Global financial groups also use long-term intercompany debt and subordinated intercompany debt in capitalizing subsidiaries. These types of intercompany debt are often required or encouraged by regulatory considerations, and are discussed in Section III.B.

- Deposits – intercompany deposits (including time deposits, demand deposits and money-market deposits) provide both a source of funds for the receiving bank and cash management options for the depositor non-bank member.

- Cash variation margin and collateral – for regulatory and market reasons, one member of the group may enter into a derivative or similar contract with a customer, while the market risk associated with the contract may be transferred to another entity (e.g., an entity that manages all of the relevant market risk for the group) through an internal derivative contract. The client-facing entity and the market-risk entity will post cash variation margin or collateral on the intercompany contract (treated as a loan for tax purposes) with each other as the value of the contract changes.

- Secured funding – secured funding, in the form of repurchase and reverse repurchase, or "repo," transactions is used as a general funding mechanism as an alternative to more expensive unsecured funding, as well as to centralize common positions in a single dealer.

- Senior unsecured lending – senior unsecured funding (typically in the form of committed and uncommitted revolving facilities) allow the group's cash to be managed efficiently, to provide liquidity to operating entities, including in times of stress, and the centralization of liquidity at the parent or other appropriate entity within the group.

B. Financial Groups Are Subject to Multiple Regulatory Regimes and Rules That Relate to Both Intercompany Debt and Equity Transactions

U.S. and non-U.S. groups that include banks, bank holding companies and dealers in securities and commodities are subject to a number of wide-ranging regulatory regimes and rules that constrain or affect virtually every aspect of their businesses, including the use and terms of intercompany debt and equity. While these regulatory regimes and rules are discussed in detail below, there are a few themes that are relevant to the interaction of these regimes and rules with the Proposed Regulations:

- Various of these regimes and rules affirmatively or effectively require or incentivize the use of intercompany debt instead of equity, in part by restricting the ability of group entities to pay dividends or other distributions on common stock and other equity interests, to redeem or repurchase equity securities or other regulatory capital instruments, to acquire equity issued by an affiliate, or to

acquire assets or engage in asset reorganizations and other transactions that are within the scope of the Proposed Regulations.

- At the same time, these regimes and rules limit the extent to which group members may make intercompany loans or incur other intercompany credit exposures.

- While these regulatory regimes and rules apply with the greatest force to banks and other fully regulated members of the group, they apply in significant part to or affect all of a regulated financial group's members. In many cases, even where there is not a specific regulation or guidance that applies to a transaction, regulators have broad powers, under their consolidated supervisory authority, to encourage or require, or discourage or prohibit, various actions and transactions that the regulator believes may adversely affect the financial position of the parent and/or various members of the group.

- Finally, these regulations, and the manner in which regulators interpret and enforce them, change frequently, requiring financial groups to be able to respond quickly and flexibly to these changes by making corresponding changes to their consolidated and individual legal entities' capital and funding structures.

In this section, we summarize some of the most important legal and regulatory requirements that regulate the use of intercompany debt and intercompany equity investments and distributions. The key point to bear in mind is that, as a result of these regulatory requirements, regulated financial groups must strike a balance between the use of equity capital and debt in funding their subsidiaries, and between ensuring that there is sufficient capital and liquidity at each subsidiary and ensuring that the top-tier parent company can receive distributions and payments from its subsidiaries to make distributions on its own equity capital and service its own debt. The greatest risk posed by the Proposed Regulations is that, by recharacterizing debt transactions as equity, they would make it extremely difficult, if not impossible, for regulated financial groups to meet these competing requirements in an economically viable manner.

Capital Requirements

Both U.S. and non-U.S. banking organizations are subject on a consolidated basis to minimum regulatory capital requirements. Most OECD countries and other countries have adopted or are in the process of adopting the Basel III capital framework, the latest international accord on capital requirements for banking organizations, as developed by the Basel Committee

on Banking Supervision ("**Basel Committee**").[6] The Basel III capital framework consists of a set of minimum capital requirements generally applicable to banking organizations on a consolidated basis; depending on how it is implemented in a particular country, it may apply to the top-tier parent bank and any individual bank subsidiary on a consolidated basis and any individual securities firm subsidiary on a consolidated basis.[7] In the United States, the U.S. Basel III capital rules apply to any bank holding company or savings and loan holding company ("**BHC**") with $1 billion or more in total consolidated assets as well as any such holding company's insured depository institution, in each case on a consolidated basis, as well as any U.S. intermediate holding company ("**IHC**") of a foreign banking organization required to be formed pursuant to the Regulation YY issued by the Board of Governors of the Federal Reserve System (the "**Federal Reserve**"), which prescribes enhanced prudential standards.[8] U.S. broker-dealers, security-based swap dealers and swap dealers are subject to their own separate capital requirements, the latter two of which are based on the Basel III capital framework.[9] In the

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[6] *See* Basel Committee on Banking Supervision, "Basel III: A global regulatory framework for more resilient banks and banking systems" (Dec. 2010 (revised June 2011), *available at* http://www.bis.org/publ/bcbs189.pdf. The Basel Committee is the primary global standard-setter for the prudential regulation of banks and provides a forum for cooperation on banking supervisory matters. Its members are the central banks or banking and financial services regulatory agencies of the following 28 countries, regions or supranational organizations: Argentina, Australia, Belgium, Brazil, Canada, China, the European Union, France, Germany, Hong Kong, India, Indonesia, Italy, Japan, South Korea, Luxembourg, Mexico, the Netherlands, Russia, Saudi Arabia, Singapore, South Africa, Spain, Sweden, Switzerland, Turkey, the United Kingdom and the United States. In addition, the central banks or banking and financial services regulatory agencies of Chile, Malaysia and the United Arab Emirates have observer status.

[7] In certain jurisdictions, a banking organization's insurance activities may be excluded from the banking organization's consolidated Basel III capital requirements, as long as they are subject to their own separate capital requirements. *See, e.g.*, Directive 2009/138/EC of the European Parliament and of the Council on the taking-up and pursuit of the business of Insurance and Reinsurance (November 25, 2009), *available at* http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32009L0138&from=EN.

[8] *See* 12 C.F.R. Part 217 (holding companies and state banks that are members of the Federal Reserve System); 12 C.F.R. Part 3 (national banks and federal savings associations); 12 C.F.R. Part 324 (state banks that are not members of the Federal Reserve System). U.S. broker-dealers, security-based swap dealers and swap dealers are subject to separate capital requirements, the last two of which are based on the Basel III capital framework.

[9] *See*, *e.g.*, 17 C.F.R. § 240.15c3-1 (broker-dealers); 12 C.F.R. Part 237, Subpart A, 17 C.F.R. (swap dealers and security-based swap dealers); Commodity Futures Trading Commission, "Capital

European Union, the Basel III capital framework applies to credit institutions (including banks) and investment services firms (including broker-dealers), including any such locally incorporated firms that are consolidated subsidiaries of U.S. banking organizations.[10]

The Basel III capital framework, which was adopted in the aftermath of the global financial crisis of 2008, not only generally increases the amount of capital that a banking organization is required to hold, but also generally increases the proportion of capital that must be held in the form of common equity. The Basel III capital framework requires banking organizations to maintain:

(i) a ratio of "common equity Tier 1 capital" to risk-weighted assets of at least 4.5%,

(ii) a ratio of "Tier 1 capital" (consisting of common equity Tier 1 capital and "additional Tier 1 capital," which essentially consists of noncumulative perpetual preferred stock[11]) to risk-weighted assets of at least 6%, and

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Requirements of Swap Dealers and Major Swap Participants: Notice of Proposed Rulemaking," 76 Fed. Reg. 27,802 (May 12, 2011) (swap dealers).

[10] *See* Directive 2013/36/EU of the European Parliament and of the Council on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms (June 26, 2013), *available at* http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32013L0036&from=EN; Regulation (EU) No. 575/2013 of the European Parliament and of the Council on prudential requirements for credit institutions and investment firms (June 26, 2013), *available at* http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2013:321:0006:0342:EN:PDF. In addition to capital requirements, EU banking or securities organizations and the subsidiaries of U.S. banking or securities organizations that are incorporated in EU member states are generally subject to prudential supervision on a consolidated basis, including with respect to capital planning, liquidity, recovery and resolution planning and disclosure requirements. *See generally* European Banking Authority Interactive Single Rulebook, Capital Requirements Regulation, Part One, Title II, Chapter 2, Articles 11-24, available at https://www.eba.europa.eu/regulation-and-policy/single-rulebook/interactive-single-rulebook/-/interactive-single-rulebook/toc/504.

[11] In certain jurisdictions, local rules may permit "additional Tier 1" securities to be issued in the form of debt, although in light of, among other things, its perpetual nature, such securities would generally be treated as equity for U.S. federal income tax purposes. The U.S. Basel III capital rules do not permit U.S. bank holding companies or banks to issue "additional Tier 1" securities in the form of debt. *See, e.g.*, 12 C.F.R. § 217.20(c)(1)(x) (paid-in amount of additional Tier 1 capital must be classified as equity under GAAP).

(iii) a ratio of "total capital" (consisting of common equity Tier 1 capital, additional Tier 1 capital and "Tier 2 capital," which essentially consists of long-term subordinated debt) to risk-weighted assets of at least 8%.[12]

The requirements listed above are the minimum requirements for a banking organization to be considered adequately capitalized. In practice, national jurisdictions implementing the Basel III capital framework may apply higher requirements. For example, in the United States, any U.S. BHC or foreign banking organization ("**FBO**") that has elected to become a financial holding company, a status which permits it to engage in a broader range of non-banking financial activities than would otherwise be permitted under the Bank Holding Company Act of 1956 ("**BHC Act**"), must meet the standards to be considered well-capitalized, which would require the BHC or FBO to maintain a common equity Tier 1 ratio of at least 6.5%, a tier 1 capital ratio of at least 8% and a total capital ratio of at least 10%.

In addition, the Basel III capital framework requires banking organizations to maintain a capital conservation buffer, on top of the above minimum risk-based capital ratios, of more than 2.5% of common equity Tier 1 capital. Failure to maintain the full amount of this capital conservation buffer results in progressively severe restrictions on the banking organization's ability to make capital distributions (such as dividend or interest payments on capital instruments or repurchases of capital instruments) and discretionary bonus payments to senior executive officers.[13] Similarly, the largest banking organizations that are designated as global systemically important banks ("**G-SIBs**") are subject to an additional G-SIB capital surcharge, which again can be met solely with common equity Tier 1 capital; in the United States, as estimated by the Federal Reserve, the G-SIB surcharge would range from a low of 1% to a high of 4.5%, depending on the relevant G-SIB, and would effectively function as an addition to the capital conservation buffer, meaning that failure to comply with the full amount of the capital conservation buffer – as augmented by the applicable G-SIB surcharge – would result in restrictions on capital distributions and discretionary bonus payments, as described above.[14]

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[12] *See* Basel Committee on Banking Supervision, "Basel III: A global regulatory framework for more resilient banks and banking systems" (Dec. 2010 (revised June 2011), *available at* http://www.bis.org/publ/bcbs189.pdf.

[13] *See, e.g.*, 12 C.F.R. § 217.11(a).

[14] *See* 12 C.F.R. §§ 217.11(c), 217.400-406.

In addition to the risk-based capital ratios described above, U.S. banking organizations and the U.S. IHCs of FBOs are required to comply with a minimum leverage ratio, consisting of Tier 1 capital divided by average quarterly on-balance sheet assets, of at least 4% to be adequately capitalized and 5% to be well-capitalized.[15] Moreover, the Basel III capital framework introduced its own version of the leverage ratio, which consists of Tier 1 capital divided by total leverage exposure (a measure that includes both on-balance sheet and off-balance sheet exposures, just as risk-weighted assets in the Basel III risk-based capital ratios also include both on-balance sheet and off-balance sheet exposures, but which is not risk-weighted), and which in the United States will apply only to advanced approaches banking organizations and will be known as the "supplementary leverage ratio" (“**SLR**”), because it will supplement the existing U.S. leverage ratio.[16] The minimum Basel III leverage ratio (or SLR in the United States) is 3%; however, a U.S. G-SIB will be subject to an enhanced SLR requirement requiring it to maintain a Tier 1 buffer of more than 2% on top of the SLR to avoid any restrictions on capital distributions and discretionary bonus payments, and each U.S. bank subsidiary of a U.S. G-SIB will be required to meet an enhanced SLR of at least 6% to be well-capitalized. The Basel III leverage ratio and SLR will become effective on January 1, 2018.

In many cases, a financial group will be subject to regulatory capital requirements, imposed by different regulators in different jurisdictions, at multiple levels within the financial group. For example, the parent bank or BHC will be subject to regulatory capital requirements in the parent’s home jurisdiction, on a consolidated basis (and in some jurisdictions, also on an unconsolidated basis), while one or more of its subsidiaries (e.g., a holding company for operating subsidiaries or a bank) in different jurisdictions will be subject to the regulatory capital requirements imposed by the regulators in those jurisdictions.

One consequence of the Basel III capital framework is that distributions of capital (in the form of dividends or other capital distributions) by members of the group that are directly subject to these capital requirements (including, depending on the jurisdiction, banks, securities firms, U.S. IHCs of FBOs, and other institutions) are constrained by the need to comply with the requirements. If a financial group subsidiary subject to the Basel III capital framework in its jurisdiction does not meet the relevant minimum capital requirements or does not maintain the

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[15] *See, e.g.,* 12 C.F.R. § 217.10(a)(4) and (b)(4); 12 C.F.R. § 208.43(b)(1)-(2).

[16] *See, e.g.*, 12 C.F.R. § 217.10(c)(4). Advanced approaches banking organizations are those with $250 billion or more in total consolidated assets or $10 billion or more in on-balance sheet foreign exposures. The U.S. IHC of an FBO that meets the thresholds of an advanced approaches organization will also be subject to the SLR.

full amount of any applicable capital conservation buffer, countercyclical capital buffer or G-SIB surcharge, as applicable, it may not be able make any capital distributions, or only be able to make limited capital distributions, to its top-tier parent company, regardless of whether it has enough current earnings as a matter of its applicable corporate law to be able to make capital distributions. If and when the subsidiary subsequently complies in full with the applicable Basel III capital requirements and once again becomes able to make capital distributions to its top-tier parent company, it may be able, pursuant to the capital requirements, to make capital distributions – at which time such distributions may not be out of current earnings, but may be from retained earnings or even capital not attributable to earnings.

Under the Basel III capital framework, the redemption or repurchase of a regulatory capital instrument – whether common equity Tier 1 capital, additional Tier 1 capital or Tier 2 capital – generally requires the prior approval of the relevant institution's regulator.[17] As a result, to the extent that a financial group subsidiary meets its minimum Basel III regulatory capital requirements, a parent company may be incentivized to provide any additional funding in the form of a senior intercompany loan or deposit that, by its terms, does not meet the definition of any of the tiers of Basel III regulatory capital and thus is not subject to the same effective limitations on the return of capital to the parent.

The Basel III capital framework also incentivizes the use of intercompany debt between parent companies and consolidated subsidiaries through its limitations on the ability of a parent company to recognize minority interests issued to third parties by a consolidated subsidiary. Under the U.S. Basel III capital rules, for example, although there is no restriction on the ability of a U.S. banking organization's foreign consolidated subsidiary to issue Tier 2 capital (subordinated debt) to external third parties, the parent BHC or bank may not be able to recognize the full amount of any such third-party Tier 2 subordinated debt issued by the subsidiary. A parent BHC or bank may only recognize a subsidiary's Tier 2 capital issued to external third parties to the extent that the subsidiary does not have any surplus capital (i.e., capital in excess of the subsidiary's minimum capital requirements plus its capital conservation buffer). To the extent that the subsidiary has surplus capital (which is increasingly the case because regulators increasingly require regulated entities to operate with capital levels in excess of minimum requirements), the portion of the surplus held by external third parties may not be recognized as part of the parent company's consolidated capital. For example, if a foreign consolidated subsidiary of a U.S. BHC has issued Tier 2 capital in the amount of $100 million to external third parties and has surplus total capital in the amount of $300 million (none of which,

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[17] *See, e.g.*, 12 C.F.R. § 217.20(b)(1)(iii) (common equity Tier 1 capital); § 217.20(c)(1)(vi) (additional Tier 1 capital); § 217.20(d)(1)(x) (Tier 2 capital).

except for the Tier 2 capital, has been issued to any entity other than the U.S. BHC parent), the U.S. BHC would only be able to recognize $200 million of that surplus as part of its own consolidated capital and would not be able to recognize any of the $100 million of the subsidiary's Tier 2 subordinated debt.[18] However, if the subsidiary had issued the Tier 2 subordinated debt to its U.S. BHC parent instead, the parent company would have been able to recognize the full amount as part of its consolidated Tier 2 capital. As a result, the U.S. Basel III rules on recognition of minority interests generally incentivize a consolidated subsidiary to issue Tier 2 capital to its parent company or to an affiliate of its parent company.

Finally, the capital planning rules of the Federal Reserve, which apply to any U.S. bank holding company with total consolidated assets of $50 billion or more and to any U.S. IHC of an FBO, regulate capital actions and capital distributions and require the BHC or IHC to prepare and submit an annual capital plan covering a nine-quarter planning horizon to the Federal Reserve, which can object or not object to all or part of the capital plan as part of its Comprehensive Capital Analysis and Review ("**CCAR**") process.[19] Capital actions and capital distributions include the issuance, redemption or repurchase of capital instruments, i.e., common equity, preferred stock and subordinated debt instruments that count as common equity Tier 1 capital, additional Tier 1 capital or Tier 2 capital, respectively.[20] Issuances or redemptions of senior debt, or payments of interest on senior debt, are generally not considered to be capital actions or capital distributions because senior debt does not qualify as regulatory capital under the Basel III capital framework. As a result, to the extent an FBO's subsidiary that is a U.S. BHC or IHC issues senior debt to its FBO parent, the payment of principal or interest on the senior debt is not generally a capital action or distribution requiring the Federal Reserve's non-objection as part of its review of the BHC's or IHC's capital plan. Assuming that the BHC or IHC otherwise has sufficient capital to meet its capital requirements under the applicable U.S. Basel III capital rules, to the extent the FBO wishes to fund its U.S. BHC or IHC subsidiary without having to obtain the Federal Reserve's non-objection for that subsidiary to redeem or

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[18] *See, e.g.*, 12 C.F.R. § 217.21(e). The limitations on recognition of minority interests do not just apply to consolidated subsidiaries that are themselves subject to the Basel III capital framework. They apply to minority interests issued by any subsidiary that would otherwise meet the requirements for recognition as regulatory capital. If the consolidated subsidiary is not itself subject to the Basel III capital framework, the U.S. BHC must perform the necessary calculations by assuming that its own capital standards apply at the level of the consolidated subsidiary. *See, e.g.*, 12 C.F.R. § 217.21(b).

[19] *See* 12 C.F.R. § 225.8 (capital planning rule); 12 C.F.R. § 252.153(e)(2)(ii) (applicability to U.S. IHCs).

[20] *See* 12 C.F.R. § 225.8(d)(3)-(4).

repay the funding, the FBO will be incentivized to use an intercompany loan, intercompany deposit or other form of senior debt to fund the subsidiary.

Restrictions on Equity Investments in Subsidiaries

U.S. and non-U.S. banking organizations alike are generally subject to restrictions on their ability to rely solely on equity as a means of providing capital or funding to a subsidiary. As a general matter, there is a natural balance to be struck between the interests of the top-tier parent company and its consolidated home-country regulator, which will want to ensure that any capital or funding provided to a subsidiary can be repaid or redeemed to the extent that the funds are required by the top-tier parent company either to fund or recapitalize other subsidiaries or even to meet its own needs, and those of the subsidiary and its regulator, which will want to ensure that the subsidiary has enough capital and funding to sustain its operations and also withstand any period of stressed conditions. In other words, while the top-tier parent company may be incentivized to cause its subsidiary to upstream as much excess capital or liquidity as possible so that the parent has the flexibility to redeploy that capital or liquidity to other subsidiaries to absorb potential losses throughout the group, the subsidiary itself may be incentivized to preserve as much excess capital and liquidity as possible as a buffer against any future stressed conditions that could cause loss of capital or liquidity to the subsidiary. This requires a careful balance to be struck between the use of equity and debt funding. For the parent company, any distribution on or redemption of equity funding is generally dependent on discretionary dividend payments from the subsidiary, which the subsidiary may not be in a position to make either under its applicable corporate law (depending, among other things, on the level of its earnings) or any applicable regulatory capital requirements in the case of a regulated entity, whereas any distribution of or redemption of debt funding – which is generally recognized as a liability of the subsidiary and, especially in the case of senior debt, normally does not count as part of a subsidiary's capital – is generally dependent on the terms and payment schedule of the debt instrument itself.

In many cases, there are also specific legal or regulatory restrictions or limits on the ability of the parent company or other regulated entity of a financial group to capitalize or fund a subsidiary with equity rather than an intercompany loan, deposit or other form of intercompany debt. For example, U.S. banking organizations, including BHCs, banks or special subsidiaries known as Edge Act corporations that were historically formed to engage in a broader range of activities than were permissible for U.S. banks to engage in, are generally subject to limits on investments they may make in the form of equity or subordinated debt that their non-U.S. subsidiaries held under the authority of the Federal Reserve's Regulation K.[21] For example,

[21] *See generally* 12 C.F.R. Part 211, sub-part A.

investments in the capital stock of a bank's Edge Act subsidiary, which is normally the vehicle for making investments in a bank's Regulation K subsidiaries, is limited to 10% of a bank's capital stock and surplus (defined as total regulatory capital plus any balance of its allowance for loan and lease losses not already recognized as part of its regulatory capital) or, with the prior approval of the Federal Reserve, 20% of the bank's capital stock and surplus. Investments in a Regulation K subsidiary under the general consent authority of Regulation K (i.e., without requiring the specific prior approval of the Federal Reserve) are also subject to investment limits of 10% of a BHC's Tier 1 capital (if the BHC is the investor) or 2% of a U.S. bank's Tier 1 capital (if a U.S. bank is the investor).[22] The definition of "investment" for these purposes includes equity and, if the banking organization holds more than 5% of the equity of the subsidiary, subordinated debt.[23] Intercompany loans, deposits or other forms of intercompany debt by a U.S. BHC or bank to its Regulation K subsidiaries are not subject to these investment limits; as a result, U.S. BHCs and banks frequently fund their Regulation K subsidiaries through the use of intercompany debt in addition to equity and, when they have reached their investment limits in a particular subsidiary, may have no choice but to use debt for any further funding.

In addition, a top-tier parent company is generally subject to restrictions on its ability to issue debt and then use the proceeds to acquire or make additional contributions to the equity of a subsidiary, a fact pattern referred to as "double leverage." To begin with, the U.S. leverage ratio and Basel III leverage ratio (or SLR) described above apply to any entity within a banking organization that is subject to the Basel III capital framework on a consolidated basis. This effectively limits the ability of a top-tier parent company to allow excessive leverage throughout the organization, e.g., by issuing debt, contributing the proceeds as equity to a subsidiary and then allowing that subsidiary to issue additional debt to fund its assets. Since the top-tier BHC of a U.S. financial group will be subject to both the U.S. leverage ratio and, starting from January 1, 2018, the SLR, in each case on a consolidated basis, and since it must hold Tier 1 capital against its consolidated on-balance sheet assets or total leverage exposure, as applicable, any assets of its consolidated subsidiaries funded with debt issued by the subsidiaries will count against the BHC's leverage ratio or SLR. Even aside from the constraining effect of the U.S. leverage ratio or SLR, regulators of U.S. and non-U.S. financial groups have historically monitored a financial group's capital and funding structure for the extent of double leverage. Regulators discourage excessive double leverage because (i) the parent BHC may otherwise be incentivized to issue too much debt at the parent level to fund excessive growth and additional leverage at the subsidiary

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[22] *See* 12 C.F.R. §§211.5(h)(1) (investments in Edge Act corporation), 211.9(b)(2) (investments in subsidiary).

[23] 12 C.F.R. §211.2(m).

level, and (ii) in the event of subsidiary losses, excessive debt at the parent BHC level may inhibit the ability of the BHC to provide additional capital to recapitalize the subsidiary, thus increasing the potential impact of the subsidiary's losses on the banking organization as a whole. Double leverage concerns can apply at both the parent BHC level and at the level of a lower-tier holding company. As a result, U.S. banking organizations are typically subject to supervisory limits on the extent of their double leverage, i.e., the extent to which the ratio of debt to equity in its consolidated subsidiaries compares to the top-tier BHC's ratio of debt to equity.[24] Regulators of financial groups in other countries impose similar regulatory constraints, including the use of deductions from a parent company's regulatory capital for equity investments in certain consolidated subsidiaries, which may thus apply to an FBO's investments in a U.S. IHC or BHC subsidiary.[25] Finally, the extent of a banking organization's double leverage is also monitored by rating agencies as part of their rating methodologies.[26]

All of these restrictions have the effect of either requiring or incentivizing a U.S. or non-U.S. financial group to rely on intercompany debt, not just equity, as a means of funding its consolidated subsidiaries.

Liquidity Requirements

In addition to the capital requirements described above, the Basel Committee has also adopted a liquidity measure known as the Liquidity Coverage Ratio ("**LCR**"), under which banking organizations are required to hold certain categories of highly liquid assets known as "High Quality Liquid Assets" ("**HQLAs**"), in an amount at least equal to their projected net cash

[24] For example, the Federal Reserve's BHC Supervision Manual includes, in a number of places in the manual, double leverage as an area of supervisory focus. *See* https://www.federalreserve.gov/boarddocs/supmanual/bhc/bhc.pdf (sections 1050.1.3.3.2, 1050.2.3.3.2, 2010.1 and 4010.1).

[25] *See, e.g.*, European Banking Authority Interactive Single Rulebook, Capital Requirements Regulation, Part Two, Title I, Chapter 2, Article 36, available at https://www.eba.europa.eu/regulation-and-policy/single-rulebook/interactive-single-rulebook/-/interactive-single-rulebook/toc/504.

[26] *See, e.g.*, Moody's, Rating Methodology: Banking, Mar. 2015, at p. 92 ("As a guideline, where double leverage is over 115%, we will review in more detail the structure of capital and dividend flows between operating and holding companies. Where we consider this gives rise to a material weakness for the group which is not otherwise captured in our LGF ['loss given failure'] analysis, we would typically introduce a further one notch differential to holding company obligations in addition to the subordination-based notching . . . ").

outflows over a stressed 30-day period. In the United States, the LCR applies to U.S. BHCs that are advanced approaches banking organizations (and any of their U.S. bank subsidiaries with $10 billion or more in total consolidated assets) in its full form and to U.S. BHCs with $50 billion or more in total consolidated assets that are not advanced approaches banking organizations in a modified form that only requires the BHC to hold HQLAs equal to 70% of its net cash outflows over a stressed 30-day period.[27] Among other requirements, the U.S. LCR limits the ability of a U.S. BHC (or any of its U.S. bank subsidiaries to which the LCR applies) to recognize HQLAs held by any of its consolidated subsidiaries, regardless of whether the subsidiaries are domestic or foreign and regardless of whether they are themselves regulated or unregulated entities. The BHC may only recognize HQLAs held by any of its consolidated subsidiaries (1) to the extent that they are equal to the amount of the subsidiary's own net cash outflow (if the subsidiary is not itself subject to the U.S. LCR, the BHC must calculate the net cash outflow as if the subsidiary were subject to the U.S. LCR) and (2) to the extent that they are in excess of the amount of the subsidiary's net cash outflow, only to the extent that the excess HQLAs (or proceeds from their sale) may be transferred to the BHC during times of stress without being subject to any statutory, regulatory, contractual or supervisory restrictions.[28] Whereas distributions on equity or other forms of regulatory capital may be subject to such restrictions, an intercompany loan to or deposit with the consolidated subsidiary, or other form of debt issued by the subsidiary, would generally not be subject to any such restriction and in fact would represent a legal obligation of the subsidiary to its parent to make the payment or return the funds, as applicable, and as a result the U.S. BHC would be able to recognize as part of its consolidated HQLAs any excess HQLAs held by the subsidiary in the amount of the intercompany loan, deposit or debt. Consequently, the Basel III LCR also effectively incentivizes the use of intercompany debt to fund regulated or unregulated subsidiaries.

Aside from the LCR, U.S. and non-U.S. banking organizations are subject to prudential requirements with respect to asset and liability management and maturity mismatches.[29] As a

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[27] *See* 12 C.F.R. Part 249; 12 C.F.R. Part 50 (OCC); 12 C.F.R. Part 249 (Federal Reserve); 12 C.F.R. Part 329 (FDIC). The U.S. banking regulators have not yet promulgated rules applying the U.S. LCR requirements to FBOs and their U.S. IHCs.

[28] *See, e.g.*, 12 C.F.R. § 249.22(b)(3)-(4).

[29] *See, e.g.*, SR 10-6, "Interagency Policy Statement on Funding and Liquidity Risk Management," (March 17, 2010), *available at* https://www.federalreserve.gov/boarddocs/srletters/2010/sr1006.htm; SR 10-1, "Interagency Advisory on Interest Rate Risk Management," (January 11, 2010), *available at* https://www.federalreserve.gov/boarddocs/srletters/2010/sr1001.htm; Federal Reserve BHC Supervision Manual, sections 3200.1, 3210.1, 3220.1, 3230.1, and 3240.1; Basel Committee on Banking Supervision,

result, interaffiliate funding arrangements, whereby one entity funds itself from third parties by issuing debt and then on-lends the proceeds to one of its affiliates through an intercompany loan or debt with the same or shorter maturity, is the norm. It would be more unusual, and generally not consistent with prudent asset and liability and liquidity risk management principles, for the proceeds of such external debt issuances to be contributed by one affiliate to another in the form of equity and thus be subject to indefinite maturity and reliance on discretionary declarations of dividends instead of a stated maturity and scheduled principal and interest payments.

Recovery and Resolution Planning

After the financial crisis, the Federal Reserve and Federal Deposit Insurance Corporation ("**FDIC**") have required BHCs and FBOs with total assets of $50 billion or more ("**Covered Companies**"), including U.S. G-SIBs, and non-U.S. G-SIBs to submit resolution plans that describe the company's strategy for rapid and orderly resolution in the event of material financial distress or failure of the company.[30] The Federal Reserve and FDIC have issued guidance on the content of these plans and, in reviewing the plans that Covered Companies have submitted to date, have provided additional guidance.[31] In general, the Federal Reserve and FDIC have favored "single point of entry" ("**SPOE**") plans with respect to a U.S. G-SIB, which contemplate that, in the event a U.S. G-SIB or its group experiences material financial distress or failure, the parent company of the group would (i) use all of its resources, including any portfolio of investment securities and any intercompany loans to or intercompany debt of its subsidiaries, to recapitalize its major operating subsidiaries, and (ii) subsequently enter into bankruptcy proceedings, with the intention that the recapitalized subsidiaries would be able to continue to operate without themselves failing and being put into bankruptcy or receivership. The effect of

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"Principles for Sound Liquidity Risk Management and Supervision" (September 2008), *available at* http://www.bis.org/publ/bcbs144.htm.

[30] *See* 12 U.S.C. § 2365(b)(1)(A)(iv); 12 C.F.R. part 243 (Federal Reserve regulations), 12 C.F.R. part 381 (FDIC regulations).

[31] *See, e.g.,* Federal Reserve and FDIC, "Guidance for 2017 §165(d) Annual Resolution Plan Submissions By Domestic Covered Companies that Submitted Resolution Plans in July 2015" (April 13, 2016), *available at* https://www.federalreserve.gov/newsevents/press/bcreg/bcreg20160413a1.pdf.

an SPOE plan is to push up losses at the subsidiary level to the parent, to be borne by the shareholders and creditors of the parent.

With respect to U.S. G-SIBs, the Federal Reserve has issued proposed regulations that would require the top-tier BHC to maintain a minimum amount of total loss-absorbing capacity ("**TLAC**"), including a minimum amount of external eligible long-term debt ("**LTD**").[32] A U.S. G-SIB would be required to maintain minimum external LTD ratios of (i) 6% plus the applicable G-SIB surcharge calculated under the most conservative method for calculating the surcharge of the G-SIB's risk-weighted assets under the U.S. Basel III rules and (ii) 4.5% of the G-SIB's total leverage exposure for purposes of the SLR.[33] The Federal Reserve has also proposed similar TLAC regulations with respect to the U.S. IHCs of non-U.S. G-SIBs, which would require that the IHC maintain a certain amount of intra-group total loss-absorbing capacity ("**internal TLAC**"), including in the form of unsecured LTD issued solely to its direct or indirect foreign parent company ("**internal LTD**"), and would affirmatively forbid the IHC from issuing any short-term debt and incurring certain other liabilities to third parties.[34] The IHC of a non-U.S. G-SIB would be required to maintain minimum internal LTD ratios of (i) 7% of the IHC's risk-weighted assets under the U.S. Basel III rules, (ii) 3% of the IHC's total leverage purposes for purposes of the SLR (if applicable), and (iii) 4% of the IHC's average total consolidated assets.[35] As proposed by the Federal Reserve, in specified events relating to the material financial distress or failure of the IHC, the IHC would be recapitalized through the cancellation of the internal LTD or its conversion into common equity Tier 1 capital of the IHC, thereby pushing up losses at the level of the IHC and its subsidiaries to the direct or indirect foreign parent, and permitting the IHC and its subsidiaries to continue to operate without themselves being put into bankruptcy or receivership.[36] As a result, if the Federal Reserve's Proposed TLAC Rule is adopted as

[32] *See* Federal Reserve, "Total Loss-Absorbing Capacity, Long-Term Debt, and Clean Holding Company Requirements for Systemically Important U.S. Bank Holding Companies and Intermediate Holding Companies of Systemically Important Foreign Banking Organizations; Regulatory Capital Deduction for Investments in Certain Unsecured Debt of Systemically Important U.S. Bank Holding Companies; Proposed Rule," 80 Fed. Reg. 74,926 (Nov. 30, 2015) (to be codified at 12 C.F.R. pts. 217 and 252) ("**Proposed TLAC Rule**").

[33] *See* Proposed TLAC Rule, § 252.62(a).

[34] *See* Proposed TLAC Rule, §§ 252.161 (definition of "eligible internal debt security"), 252.165 (restrictions on corporate practices of IHCs).

[35] *See* Proposed TLAC Rule, § 252.162.

[36] *See* Proposed TLAC Rule, § 252.163.

proposed, the issuance of intercompany internal LTD from an IHC of a non-U.S. G-SIB to its direct or indirect foreign parent will be mandated.

The Federal Reserve's TLAC proposal is based on the Financial Stability Board's proposed standard for the adequacy of the loss-absorbing capacity of G-SIBs.[37] As a result, TLAC proposals similar to the Federal Reserve's TLAC proposal are expected to be implemented in many other jurisdictions, including the EU, and similar internal LTD requirements may thus apply to non-U.S. holding company subsidiaries of U.S. G-SIBs (i.e., any such subsidiaries to which an internal LTD requirement would apply would be required to issue LTD directly or indirectly to their U.S. parent BHC).[38]

Similarly, for U.S. G-SIBs, although the Proposed TLAC Rule requires LTD to be issued to external third parties, the Federal Reserve is also considering internal TLAC requirements, which would include two categories: (1) contributable resources (assets, such as HQLAs) and (2) prepositioned resources (such as assets or internal LTD). Prepositioned resources could in fact consist of intercompany loans made by the BHC to a subsidiary, intercompany deposits placed with a bank subsidiary, or LTD issued by the subsidiary to the BHC; these are all BHC assets that could be forgiven or otherwise converted into equity and used to recapitalize its subsidiaries. If the Federal Reserve adopts internal TLAC and LTD requirements, subsidiaries of U.S. G-SIBs will also be required to issue LTD to their parent BHCs.

In addition, the Federal Reserve and FDIC, as the agencies jointly responsible for reviewing and assessing Covered Companies' resolution plans, have indicated that "a firm's external TLAC should be complemented by appropriate positioning of additional loss-absorbing capacity within the firm (internal TLAC) . . . . balanc[ing] the certainty associated with pre-positioning internal TLAC directly at material entities with the flexibility of holding recapitalization resources at the parent (contributable resources) to meet unanticipated losses at material entities."[39] In this connection, it is important to bear in mind that a BHC's "material

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[37] *See* Financial Stability Board, "Adequacy of loss-absorbing capacity of global systemically important banks in resolution" (November 10, 2014), *available at* http://www.financialstabilityboard.org/wp-content/uploads/TLAC-Condoc-6-Nov-2014-FINAL.pdf.

[38] *See* Proposed TLAC Rule, 80 Fed. Reg. at 749480949 ("Consideration of Domestic Internal TLAC Requirement").

[39] *See* FDIC and Federal Reserve, "Guidance for 2017 §165(d) Annual Resolution Plan Submissions By Domestic Covered Companies that Submitted Resolution Plans in July 2015" at 4 (April 13, 2016), *available at* https://www.federalreserve.gov/newsevents/press/bcreg/bcreg20160413a1.pdf.

entities" may be either domestic or foreign subsidiaries and may be regulated or unregulated entities. The expectation that the parent will hold directly an appropriate amount of recapitalization resources (typically in the form of HQLAs) to meet unanticipated outflows at material entities means, among other things, that a parent company subject to resolution planning requirements cannot simply leave "excess" capital in its subsidiaries, but in fact may be required, under the terms of its resolution plan and the need to satisfy its regulators, to cause its subsidiaries to distribute such capital up to the parent for use in recapitalizing its material entities throughout the group. By the same token, the guidance on resolution planning and the emphasis on internal TLAC by definition means that there must be internal recapitalization resources in the form of intercompany loans, intercompany deposits and other forms of intercompany debt that are capable of being converted into equity. These requirements effectively mandate the use of a certain level of intercompany debt.

Another significant component of resolution planning mandated by the Federal Reserve and FDIC for U.S. Covered Companies is to require the development and implementation of criteria for legal entity rationalization designed to "best align[ ] legal entities and business lines to improve the firm's resolvability under different market conditions," with such criteria required to include "clean lines of ownership, minimal use of multiple intermediate holding companies, and clean funding pathways between the parent and material operating entities."[40] In order to comply with these requirements, a U.S. Covered Company may be required, both now and on a continuous basis as its "activities, technology, business models, or geographic footprint change over time,"[41] to engage in intercompany restructuring transactions (including transfers of subsidiary assets or stock). In certain jurisdictions, local legal or regulatory rules may require that such transfers of assets or stock occur only if the transferee delivers consideration to the transferor in the form of cash or other property, rather than occurring through a distribution or other form of transaction without consideration.

C. Significance of These Commercial and Regulatory Considerations for the Proposed Regulations

The Proposed Regulations appear to be based in large part on the assumption that (i) a taxpayer is generally free to choose whether to capitalize its subsidiaries with intercompany debt or equity, and (ii) the use of intercompany debt generally does not have any meaningful non-tax

[40] *See id.* at 19.

[41] *See id.* at 18-19.

impacts or effects.[42] These assumptions are untrue for regulated financial groups. As shown above, a regulated financial group's decisions with respect to intercompany funding are driven primarily by both commercial considerations (especially in the case of funding needed for ordinary course transactions with customers, given the variation in operating funding needs across jurisdictions and entities) and regulatory considerations (in the case of both ordinary-course funding and the subsidiary's long-term debt and equity capital structure). In a regulated financial group, intercompany equity is simply not a substitute for intercompany debt, or vice versa. Moreover, the regulatory capital, resolution planning and other regimes that apply to a regulated financial group will effectively require that the parent BHC or bank avoid "trapping" in a subsidiary (especially a foreign subsidiary subject to local regulation) earnings and capital in excess of the subsidiary's needs by causing the subsidiary to distribute such earnings and excess capital when permitted by the subsidiary's local regulator (and without regard to any U.S. tax concept of "current" earnings and profits). Because a regulated financial group (i) of necessity relies heavily on intercompany debt funding to conduct its business, and (ii) is subject to regulatory constraints and requirements that will make it difficult to alter the way in which it engages in intercompany funding transactions and avoid distributions by subsidiaries, a regulated financial group both has a reduced ability to avoid recharacterizations of intercompany debt as equity under Prop. Treas. Reg. § 1.385-3, and is uniquely susceptible to a "cascading" recharacterization of intercompany debt as equity across multiple debt instruments and multiple members of the group. Finally, given that regulated financial groups are not indifferent to the non-tax aspects of their intercompany funding, and, in fact, often are required or, for liquidity reasons, need to have intercompany funding with the legal attributes and rights associated with debt, it seems both inappropriate and unfair to deprive regulated financial groups of debt treatment for U.S. federal income tax purposes.

It is also important to note that the Proposed Regulations will affect the state income taxation of regulated financial groups, in some cases even with respect to transactions that are wholly within a federal consolidated group (and therefore, at the federal income tax level, generally outside the ambit of the Proposed Regulations). This is because the determination of state taxable income in virtually every state depends, either directly or indirectly, upon the determination of federal taxable income, and if a state does not strictly apply the federal consolidated group exception in Prop. Treas. Reg. § 1.385-1(e) (or if there is a reasonable risk of non-conformity),[43] these states may attempt to apply the Proposed Regulations to purely

[42] *See* 81 Fed. Reg. 20911, 20917-919 (Apr. 8, 2016).

[43] Most separate company reporting states (and some unitary combined reporting states) make it clear that they do not follow the federal consolidated return regulations. This casts doubt on whether the states will honor the federal consolidated group exception in Prop. Treas. Reg. § 1.385-1(e), since it is debatable

domestic transactions (by, for example, requiring taxpayers to comply with the documentation rules in Prop. Treas. Reg. § 1.385-2 solely for state income tax purposes when they have no reason to do so for federal purposes). Further, numerous states provide for a franchise tax based on capital. Any reclassification from debt to equity under the Proposed Regulations could potentially impact the franchise tax base and the related franchise tax liability. The discussion above, relating to the commercial and regulatory reasons why financial groups need to engage in intercompany debt transactions, is broadly applicable to transactions between solely domestic members of a financial group, and evidences why the potential state income and franchise tax consequences of the Proposed Regulations are of special concern for a multi-jurisdiction financial group. We believe that Treasury should be mindful of this concern as well when considering the recommendations specific to regulated financial groups and companies that are set forth below.

IV. PRIMARY RECOMMENDATION WITH RESPECT TO PROP. TREAS. REG. § 1.385-3

Recommendation 1: The Funding Rule should not apply to any debt instrument issued by or to any member of a regulated financial group.

As described above, regulated financial groups are fundamentally different from, and likely to be far more adversely affected by the operation of the Funding Rule than, other multinational non-financial groups. The conduct of what is in essence a financial intermediation business by a financial group necessarily requires that the group move cash between members of the group, principally through intercompany deposits, loans and other transactions treated as indebtedness for U.S. federal income tax purposes. These transactions can occur daily or even multiple times during a day, number into the hundreds or thousands each year, and involve, over the course of the year, tens or hundreds of billions of dollars. Regulated financial groups are also subject to regulatory rules and regimes that both (i) govern the use by the group of intercompany deposits, loans and other indebtedness in both the ordinary course of its business and in capitalizing the members of the group, and (ii) regulate and constrain the deployment of capital within the group, which require members of the group in certain instances to contribute capital or acquire debt of other members, and in other instances to distribute capital to members. Moreover, many of the regulatory regimes discussed above (such as the Basel III capital and liquidity requirements discussed above) achieve their regulatory goals only if they apply to the entire group on a consolidated basis. These regulatory rules and regimes therefore both reduce the

whether this exception relies upon the federal consolidated return regulations or merely references these regulations for definitional purposes.

ability of a regulated financial group to engage in “earnings stripping” and other types of tax planning involving intercompany debt that Treasury believes should be curtailed and make a regulated financial group uniquely susceptible to the catastrophic “cascading” effects of the application of the Funding Rule.[44]

For the purpose of this exception, we would propose that a “regulated financial group” be defined as (x) any EG the common parent of which is a regulated financial company, or (y) in any case to which clause (x) does not apply, a “regulated financial company sub-group.” For this purpose, a “regulated financial company” would mean:

(i) an entity described in clauses (1), (3), (5) or (7) of the definition of “regulated financial company” in 12 C.F.R. § 249.3 (in the case of clause (7), limited to the types of entities described in clauses (1), (3) and (5)); [45] and

[44] A regulated financial group is also uniquely susceptible to the potential “cascading” effects of the Funding Rule at the state level (if a state applies the Proposed Regulations to purely domestic transactions), because state law often requires the use of separate entities in various states as a result of state banking laws and regulations.

[45] 12 C.F.R. § 249.3 provides:

Regulated financial company means:

(1) A depository institution holding company or designated company;

…

(3) A depository institution; foreign bank; credit union; industrial loan company, industrial bank, or other similar institution described in section 2 of the Bank Holding Company Act of 1956, as amended (12 U.S.C. 1841 et seq.); national bank, state member bank, or state non-member bank that is not a depository institution;

…

(5) A securities holding company as defined in section 618 of the Dodd-Frank Act (12 U.S.C. 1850a); broker or dealer registered with the SEC under section 15 of the Securities Exchange Act (15 U.S.C. 78o); futures commission merchant as defined in section 1a of the Commodity Exchange Act of 1936 (7 U.S.C. 1 et seq.); swap dealer as defined in section 1a of the Commodity Exchange Act (7 U.S.C. 1a); or security-based swap dealer as defined in section 3 of the Securities Exchange Act (15 U.S.C. 78c);

..

(ii) to the extent not already included in (i), a U.S. intermediate holding company formed by a foreign banking organization (as defined in Section 211.2(o) of the Regulation K of the Board of Governors of the Federal Reserve System ("Federal Reserve")) pursuant to Section 252.153 of Regulation YY of the Federal Reserve.

Clause (x) of this definition would therefore cover a group composed of regulated banks, BHCs, IHCs, securities broker-dealers and their regulated and unregulated affiliates – generally, a U.S. or non-U.S. banking or securities group (other countries generally do not have separate regulators for banks and securities dealers), which is typically subject to what in U.S. banking parlance is referred to as "prudential" regulation.[46] For purposes of clause (y) of this definition, a

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(7) Any company not domiciled in the United States (or a political subdivision thereof) that is supervised and regulated in a manner similar to entities described in paragraphs (1) through (6) of this definition (e.g., a foreign banking organization, foreign insurance company, foreign securities broker or dealer or foreign financial market utility).

Clause (7) of the definition of "regulated financial company" would include certain entities (such as insurance companies, described in clause (4) of the definition in 12 C.F.R. § 249.3) that are outside the scope of this comment letter.

[46] We understand that Treasury may be concerned about a lack of uniformity in the "robustness" of the regulatory regimes and rules and/or regulatory institutions across various jurisdictions, and may therefore wish to consider limiting this or any other exceptions based on the regulated status of a group or entity to certain jurisdictions. We note that Treasury has addressed similar concerns in the context of Treas. Reg. § 1.954-2(e), which excludes gains and losses from the sale or exchange of "dealer property" from the definition of foreign personal holding company income under section 954(c). In the context of defining "dealer property," Treas. Reg. § 1.954-2(a)(4)(v) provides special rules for a "licensed securities dealer," defined as follows:

> A licensed securities dealer is a controlled foreign corporation that is both a securities dealer, as defined in section 475, and a regular dealer, as defined in paragraph (a)(4)(iv) of this section, and that is either –
>
> (1) registered as a securities dealer under section 15(a) of the Securities Exchange Act of 1934 or as a Government securities dealer under section 15C(a) of that Act; or
>
> (2) licensed or authorized in a country in which is chartered, incorporated, or organized to purchase and sell securities from or to customers who are residents of that country. <u>The conduct of such securities activities must be subject to bona fide regulation, including appropriate reporting, monitoring, and prudential (including capital adequacy)</u>

"regulated financial company sub-group" would mean a "regulated financial company," as defined above, and any "affiliated group," as defined in section 1504(a) but determined without regard to paragraphs (1) through (8) in section 1504(b), of which such regulated financial company would be the common parent (without taking into account the inclusion of such common parent as a member of any other affiliated group). Clause (y) of the definition is intended to cover a situation in which a regulated financial group is part of a larger EG but only the regulated financial group is subject to regulation by a financial regulator, and therefore covers only the regulated financial sub-group. An example of this situation would be a securities

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> requirements, by a securities regulatory authority in that country that regularly enforces compliance with such requirements and prudential standards. (emphasis added)

See also Prop. Treas. Reg. § 1.1296-6(b)(3)(ii) (adopting the same requirement with respect to the exception in the PFIC rules for securities income earned by an active dealer or broker licensed in a foreign country). This requirement appears to be getting at the same type of concerns that Treasury may have with respect to a regulated group or entity exception to the Funding Rule, and Treasury could therefore consider adopting a similar requirement (in the case of an exception with respect to a regulated financial group, with respect to the regulated financial company parent of the group). If Treasury does so, we would also recommend that Treasury provide that, for purposes of this or any similar "bona fide" regulation requirement, a nonexclusive rule that this requirement is satisfied in the case of any regulated financial group or entity that is located (in the case of a regulated financial group, in which the regulated financial company that is the parent of the group is located) in specific jurisdictions, identified by objective criteria that evidence that regulated financial groups or companies located in such jurisdictions are subject to substantial regulation. These criteria, for example could require that the jurisdiction (i) adhere to the Basel Committee on Banking Supervision's Core Principles for Effective Banking Supervision, as evidenced by membership in the Basel Committee, and (ii) has been the subject of a determination by the Federal Reserve that FBOs in that country are subject to "comprehensive consolidated supervision" ("**CCS**"). *See* Basel Committee on Banking Supervision, "Core principles for effective banking supervision" (September 2012), *available at* http://www.bis.org/publ/bcbs230.htm. An FBO is considered to be subject to CCS if the Federal Reserve determines that the FBO is supervised or regulated in such a manner that its home country supervisor receives sufficient information on the worldwide operations of the FBO, including the relationship of the FBO to its affiliates, to assess the FBO's overall financial condition and compliance with laws and regulations. Currently, countries that would meet both of these requirements include Argentina, Australia, Austria, Belgium, Brazil, Canada, Chile, China, Finland, France, Germany, Greece, Hong Kong, Ireland, Israel, Italy, Japan, Mexico, the Netherlands, Norway, Portugal, Puerto Rico, South Korea, Spain, Switzerland, Taiwan, Turkey and the United Kingdom.

dealer group that is sub-group in a larger EG that includes a parent corporation and other sub-groups that are not subject to financial regulation.[47]

Treasury and the Internal Revenue Service (the "**IRS**") have recognized in other contexts the appropriateness of excepting financial entities from the operation of proposed and temporary regulations that could have uniquely adverse impacts on financial entities. For example, Prop. Treas. Reg. § 1.987-1(b)(i)(iii) provides that the proposed regulations under section 987, which prescribe rules for determining the taxable income or loss of a taxpayer with respect to an eligible qualified business unit with a functional currency different from its owner, do not apply to "banks, insurance companies and similar financial entities (including, solely for purposes of section 987, leasing companies, finance coordination centers, regulated investment companies and real estate investment trusts)." The preamble to the section 987 regulations acknowledged that currency translation could present unique challenges for financial entities, and states that the IRS and Treasury "believe it is appropriate to request comments regarding how the rules of the proposed regulations need to be precisely tailored to address issues unique to financial entities."[48] Similarly, Temp. Treas. Reg. § 1.861-9T(b)(6)(v) reserves on the application of the rules with respect to the treatment of gains or losses on financial products for purposes of the apportionment of interest expense under section 861 to financial entities (as defined in Treas. Reg. § 1.904-4(e)(3)). The preamble to Temp. Treas. Reg. § 1.861-9T explained that the IRS believes that "similar treatment should be accorded to the gains and losses of financial services entities and other taxpayers" but noted that the regulation reserved on the application of the rules to financial services entities and solicited their comments, presumably based on an understanding that such entities are subject to certain unique considerations.[49] The Funding Rule would have consequences for all of the members of a regulated financial group that dwarf in magnitude, both from a tax and a commercial perspective, the potential consequences of the application of the proposed regulations under section 987 and temporary regulations under section 861, and

[47] If Treasury has concerns about the scope of clause (y) of the definition, we would suggest as an alternative that a "regulated financial group" be defined as (x) any EG the common parent of which is a regulated financial company, or (y) in any case to which clause (x) does not apply, any regulated financial company. In this case, the scope of clause (x) would remain the same, but clause (y) would include only directly regulated entities.

[48] 71 Fed. Reg. 52876, 52880 (Sept. 7, 2006).

[49] 54 Fed. Reg. 31816 (Aug. 2, 1989).

therefore the justification for an exception to the application of the Funding Rule is even greater.[50]

If Treasury has concerns about the scope and consequences of an exception from the Funding Rule that covers all of the members of a regulated financial group, we would suggest that, as an alternative to including a permanent exception in the final regulations, Treasury consider reserving on the application of the Funding Rule (and providing that the Funding Rule shall not apply) to a regulated financial group pending further study of whether and how the Funding Rule should apply to a regulated financial group and its members. Such a study would permit Treasury and the financial industry to consider, more fully than has been possible in the short time period between the date the Proposed Regulations were issued and today, the interplay between the Treasury's policy goals served by the Funding Rule, the operation and potential consequences of the Funding Rule across a regulated financial group, and the non-tax regulatory policy goals and concerns of bank and financial regulators in the United States and other jurisdictions. Tax policymakers worldwide have consistently recognized that the circumstances of the financial industry require special caution, and careful study and deliberation, in the context of developing rules with respect to debt-equity issues and the deductibility of interest on debt, in order to avoid unintended adverse regulatory and commercial consequences. *See, e.g.*, Organisation for Economic Co-operation and Development, Limiting Base Erosion Involving Interest Deductions and Other Financial Payments (Action 4: 2015 Final Report), Chapter 10, pp. 75-79:

> 183. In developing a best practice approach to combat base erosion and profit shifting involving interest, a number of particular features of groups in the banking and insurance sectors need to be taken into account.

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[50] The need for special rules for financial services entities is also recognized in other provisions of the Code. *See* § 864(e)(1), (5) (allocating and apportioning interest expense of enumerated financial institutions separately from non-financial institutions in the same affiliated group), § 904(d)(2)(C) (providing special treatment of "financial services income" as general category income for purposes of section 904); § 954(h) (providing exclusion from the definition of "foreign personal holding company income" for qualified banking or finance income of an eligible controlled foreign corporation); § 956(c)(2)(A) (providing exclusion from the definition of "United States property" for deposits with any bank or certain non-banks 80% of the stock of which is owned directly or indirectly by a bank holding company or financial holding company); Treas. Reg. § 1.864-4(c)(5) (providing special rules for purposes of determining whether income from stocks or securities is effectively connected with the conduct of a banking, financing or similar business in the United States). Similarly, many states have special tax rates, apportionment methodologies and other tax rules for financial services entities.

> 184. An important consideration is that the role interest plays in a banking or insurance business is different to that in other sectors. Banks and insurance companies hold financial assets and liabilities as an integral part of their main business activities. In addition financial sector business in most countries are subject to strict regulations which impose restrictions on their capital structures. . . .
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> . . . .
>
> 190. It is not intended that entities operating in the banking and insurance sectors, or regulated banking or insurance entities within non-financial groups, should be exempted from the best practice approach to tackle base erosion and profit shifting involving interest. Instead, in order to tackle base erosion and profit shifting by groups in all sectors, it is essential that a best practice approach include rules which are capable of addressing risks posed by different entities. Further work will therefore be conducted to be completed in 2016, to identify best practice rules to deal with the potential base erosion and profit shifting risks posed by banks and insurance companies, taking into account the particular features of these sectors. This will include work on regulated banking and insurance activities within non-financial groups (such as groups operating in the manufacturing or retail sector). <u>In particular, it is crucial that any recommended interest limitation rules do not conflict with or reduce the effectiveness of capital regulation intended to reduce the risk of a future financial crisis. . . .</u> (emphasis added)

See also HM Treasury, Tax deductibility of corporate interest expense: consultation on detailed policy design and implementation, 41-43 (May 2016) (noting, among other things, that the UK government is considering the case for "modified or any bespoke" interest restriction rules for banking and insurance activities and that any such rules would "need to recognise the integral role of interest within a banking group and the potential for a restriction on its tax deductibility to have unintended consequences or to create significant administrative burdens"). [51]

[51] This and other recommendations in this letter with respect to Prop. Treas. Reg. § 1.385-3 are made against the backdrop of the broad anti-abuse rule of Prop. Treas. Reg. § 1.385-3(b)(4), which we believe should adequately addresses any potential concerns about "gaps" in the recommendations that might be perceived as providing an opportunity for abusive tax planning.

V. ALTERNATIVE RECOMMENDATIONS WITH RESPECT TO PROP. TREAS. REG. § 1.385-3 IF TREASURY DOES NOT ACCEPT RECOMMENDATION 1

If Prop. Treas. Reg. § 1.385-3 is finalized without an exception from the Funding Rule for debt instruments issued by or to any member of a regulated financial group, we believe that the following specific exceptions and modifications should be made to Prop. Treas. Reg. § 1.385-3.

Recommendation 2: Debt instruments issued by or to a regulated financial company should be exempt from the Funding Rule.

As described in Part IV above, we strongly believe that the commercial and regulatory considerations described above support an exception to the application of the Funding Rule to the entirety of a regulated financial group. Absent such a group-wide exception, we believe that it will be extremely difficult, if not impossible, for a regulated financial group to operate in a commercially sound manner and comply with all of the various regulatory rules and regimes that apply directly or indirectly to all of the group's members, even those members that are not themselves banks, BHCs, IHCs, securities dealers or other directly regulated entities, while avoiding completely the recharacterization of any debt instrument between members of the EG as stock under the Funding Rule. Given that the characterization of even a single debt instrument as stock under the Funding Rule has the potential to cause "cascading" recharacterizations of other debt instruments across a regulated financial group, the members of which typically engage annually in hundreds or thousands of intercompany debt transactions across the group involving many billions of dollars, an exception for the entire group is necessary in order to avoid this result. Failure to adopt this exception could have a significant impact on global capital markets.

However, if, despite these considerations, Treasury is unwilling to include an exception to the application of the Funding Rule for the entire regulated financial group because it does not believe the exception should apply to members of the group that are not themselves regulated entities, we would urge Treasury, at the very minimum, to include an exception to the application of the Funding Rule to debt instruments issued by or to a regulated financial company, for all of the commercial and regulatory reasons described above. For the purposes of this exception, we define a "regulated financial company" in the same manner as defined in Recommendation 1 above, except that if a corporation consists of multiple qualified business units (for example, because it has subsidiaries that are disregarded entities for U.S. federal income tax purposes) then it is only treated as a regulated financial company with respect to debt instruments issued by or to a qualified business unit that would be classified as a regulated financial company if such unit were classified as a separate corporation. A debt instrument would be considered issued by

or to a qualified business unit if such item is reflected on the separate set of books and records, as defined in Treas. Reg. § 1.989-1(d), of such unit.

Recommendation 3: Exceptions to the Funding Rule should be added for (i) any distribution made by an EG member that is a regulated financial company, and (ii) any distribution made by an upper-tier EG member that is directly or indirectly attributable to any distribution described in clause (i).

As noted above, a regulated financial company is generally subject to regulatory capital requirements that constrain its ability to pay dividends or otherwise make capital distributions (including through redemptions of stock) and, in some cases, is affirmatively required to receive the permission of a regulator before making any such dividend or capital distribution. As a result, as compared to a company that is not subject to any regulatory capital requirements, a regulated financial company is not free to determine the timing or amounts of its dividends or capital distributions. For the same reason, the companies (whether or not they are also regulated financial companies) that sit between the regulated financial company and the parent of the EG have comparatively little control over the timing or amounts of their dividends or capital distributions, to the extent that such dividends or capital distributions are funded by a dividend or capital distribution from the subsidiary regulated financial company. In each case, the result is that the time at which such a company may be permitted to pay or make, and actually effect, a dividend or other capital distribution will be dictated and constrained by regulatory and commercial considerations, and there can be no assurance that any such dividends or other capital distributions can be made in any manner that will be eligible for the current year earnings and profits exception in Prop. Treas. Reg. § 1.385-3(c)(1) or any similar exception for "ordinary course" distributions that may be included in the final regulations.

For these reasons, we believe that an exception to Prop. Treas. Reg. § 1.385-3(b)(3)(ii)(A) should be added for (i) any distribution made by an EG member that is a regulated financial company (defined as above) or (ii) any distribution made by an upper-tier EG member that is directly or indirectly attributable to any distribution described in clause (i).[52] For the purpose of clause (ii), a distribution by an upper-tier EG member would be deemed to be directly or indirectly attributable to a distribution described in clause (i) to the extent that (x) the distribution occurred in the same taxable year as the distribution described in clause (i) and (y) did not exceed the amount of the distribution described in clause (i) from the regulated financial

[52] We note that, if Treasury agrees with Recommendation 2 and exempts debt instruments issued by or to a regulated financial company from the Funding Rule, we would no longer need Treasury to adopt the recommendation in clause (i), but the recommendation in clause (ii) would still be needed for the reasons stated in the text.

company (or in the case of any indirect upper-tier EG member, from any lower-tier EG member that was directly or indirectly attributable to a distribution described in clause (i) under these rules).

Recommendation 4: An exception to the Funding Rule should be added for any debt instrument issued by an upper-tier EG member, at least 80% of the assets of which are attributable to one or more regulated financial companies (including the assets of all qualified business units and entities that are directly or indirectly owned by such member).

Because of, among other things, the preference in recovery and resolution planning for SPOE plans (discussed in Part III), it is anticipated that financial groups will in certain cases provide debt funding to a regulated financial company within the group by making a series of intercompany loans first through one or more intermediate holding companies and then from an intermediate holding company to the regulated financial company. In the absence of the exception proposed in this recommendation, debt funding for a regulated financial company that would be exempt from the Funding Rule under Recommendation 2 could, in effect, become subject to the Funding Rule as a result of channeling the funding through a holding company that is not itself a regulated financial company, which would conflict with the goal of implementing funding structures that are conducive to rapid and orderly resolution in the event of material financial distress or failure of all or part of the group.

To address this issue, we believe that any debt instrument issued by an upper-tier EG member, a substantial portion of the assets of which are attributable to regulated financial companies, should be exempt from the Funding Rule. For the purpose of this exemption, a substantial portion of the assets of an upper-tier EG member will be treated as attributable to regulated financial companies if at least 80% of the member's assets, taking into account any assets held by any subsidiary of the member and qualified business units of the member or any of its subsidiaries, are attributable to the assets of one or more regulated financial companies.

Recommendation 5: An exception to the Funding Rule should be added for debt instruments issued in certain ordinary course transactions.

Debt instruments issued by a member of an EG to another member of that EG that fall within one or more of the categories below should be exempt from the Funding Rule:

a. Any debt instrument issued by or to a dealer in securities (within the meaning of section 475(c)(1)) in the ordinary course of its business of dealing in securities;

b. Any debt instrument issued by or to a dealer in commodities (within the meaning of section 475(e)(1)) in the ordinary course of its business of dealing in commodities;

c. Any debt instrument issued by or to an "eligible controlled foreign corporation" (within the meaning of section 954(h)(2)) in the ordinary course of its banking, financial or similar business; and

d. Any debt instrument issued by or to a bank[53] in the ordinary course of its banking business (whether or not such business is in the United States).

This exception is necessary because dealers, banks and entities subject to substantially the same regulations as banks issue debt instruments to, and acquire debt instruments from, members of their EG in the ordinary course of their businesses, and doing so is fundamental to their businesses.

Treasury has acknowledged that the policy objectives of the Proposed Regulations are not served by inhibiting or penalizing transactions entered into in the ordinary course and has sought to address this by, among other things, providing in Prop. Treas. Reg. § 1.385-3(b)(3)(iv)(B)(2) an exception to Prop. Treas. Reg. § 1.385-3(b)(3)(iv)(B)(1) (the "***Per Se*** **Rule**") for debt instruments that arise in the ordinary course of the issuer's trade or business in connection with the purchase of property or the receipt of services provided certain requirements are satisfied (the "**Trade or Services Payables Exception**"). That exception, however, is grossly inadequate in the context of the businesses of dealers, banks and entities engaged in similar financial businesses because the overwhelming majority of debt instruments issued by or to such entities in the ordinary course of business are *not* issued or acquired in connection with the purchase of goods or receipt of services, as narrowly contemplated by such exception. Given the critical importance of EG debt to the functioning of these businesses, the rationale underlying the Trade or Services Payable Exception applies with even greater force to the exception proposed in this recommendation. Moreover, because the proposed exception applies only to debt instruments issued by or to such entities in the ordinary course of their businesses, and because such entities are typically subject to significant regulatory constraints (as discussed in Part III), the proposed exception would be unlikely to present a significant opportunity for abuse.

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[53] For this purpose, we would propose to define the term "bank" by reference to the definition of an entity described in clauses (3) or (7) of the definition of "regulated financial company" in 12 C.F.R. § 249.3 (in the case of clause (7), limited to the types of entities described in clause (3)).

Unlike the Trade or Services Payable Exception as currently drafted, the exception we have proposed in this recommendation would exempt the applicable debt instruments from the Funding Rule entirely (rather than just exempting such debt instruments from the *Per Se* Rule). This is necessary because subjecting such debt instruments to the Funding Rule would impose undue burdens on, and significantly impede the functioning of, the businesses of dealers, banks and entities engaged in similar financial businesses, including because the frequency at which expanded debt is issued or acquired in the ordinary course of the businesses of such entities means that it is highly likely that any distribution or acquisition by an issuer of such debt will take place near in time to an issuance of such debt, at which point it may be difficult for the issuer to establish that the issuance did not have a principal purpose of funding the distribution or acquisition.

Recommendation 6: An exception to the Funding Rule should be added for debt instruments issued by a member of an EG that is acquired by a dealer that is a member of the same EG in the ordinary course of its business of dealing in securities, and an acquisition of stock issued by a member of an EG by a dealer that is a member of the same EG in the ordinary course of its business of dealing in securities should not be taken into account in applying the Funding Rule, in each case provided certain conditions are satisfied.

We believe that it is necessary to add an exception to the Funding Rule for acquisitions of certain debt instruments or stock by a securities dealer.[54] Under this exception, debt instruments or stock issued by a member of an EG that is acquired by a securities dealer that is a member of the same EG in the ordinary course of its business of dealing in securities would be excepted from recharacterization as stock under the Funding Rule (in the case of debt instruments) or would not be treated as an acquisition of EG stock described in Prop. Treas. Reg. § 1.385-3(b)(3)(ii)(B) (in the case of stock), provided, in each case, that (A) the dealer accounts for the debt instruments or stock as securities held primarily for sale to customers in the ordinary course of business, (B) the dealer disposes of the debt instruments or stock (or the debt instruments mature) within a period consistent with the holding of the debt instruments or stock for sale to customers in the ordinary course of business, taking into account the terms of the debt instruments or stock and the conditions and practices prevailing in the markets for similar debt instruments or stock during the period in which it is held, and (C) the dealer does not sell or

[54] This recommendation differs from Recommendation 5 in that, while Recommendation 5 deals with debt instruments that are issued in connection with the ordinary course transactions described therein, this recommendation addresses the acquisition of existing debt instruments (and stock) previously issued by members of an EG that a securities dealer acquires in the ordinary course of its business of dealing in such securities.

otherwise transfer the indebtedness or stock to a person in the same EG (other than in a sale to a dealer that in turn satisfies the requirements of this exception).

For purposes of applying this exception, the principles of Treas. Reg. § 1.108-2(e)(2)(ii) (relating to the treatment of exchanges of debt instruments) and Treas. Reg. § 1.108-2(e)(2)(iii) (relating to the determination of whether a period is consistent with the holding of a debt instrument for sale to customers in the ordinary course of business) should apply.

This proposed exception is modeled on the exception for securities dealers in Treas. Reg. § 1.108-2(e)(2).[55] That exception reflects an acknowledgement by Treasury that it would be inappropriate to inhibit or penalize acquisitions and dispositions of debt instruments by securities dealers in the ordinary course of their businesses by permitting such acquisitions to trigger realization by the issuer of discharge of indebtedness income. The same rationale justifies the proposed exception set forth in this recommendation – i.e., it would be similarly inappropriate to inhibit or penalize the acquisitions and dispositions of debt instruments or stock by securities dealers by subjecting such debt instruments to potential recharacterization under the Funding Rule, or treating an acquisition of stock as a transaction that can trigger recharacterization of debt instruments under the Funding Rule.

[55] Treas. Reg. § 1.108-2(e)(2) is an exception for dealers to the general rule provided in Treas. Reg. § 1.108-2(a). Treas. Reg. § 1.108-2(a) very generally requires an issuer of a debt instrument to realize income from discharge of indebtedness (to the extent required by section 61(a)(12) and section 108) when a person related to the issuer acquires the debt instrument.

Recommendation 7: An exception to the Funding Rule should be added for debt instruments that are issued by or to a member of a regulated financial group and which have a stated term to maturity not exceeding one year.

The preamble to the Proposed Regulations indicates that the regulations are primarily intended to address concerns relating to "earnings stripping." [56] Short term debt with a stated term to maturity of less than one year that bears interest at a rate that is commensurate with the term of the debt is not susceptible to being used as a device to effectively engage in "earnings stripping." In the case of regulated financial groups, which, as discussed in Part III, are subject to numerous regulatory constraints and considerations, the potential for abuse is particularly low. Moreover, the exemption proposed in this recommendation is particularly important to regulated financial groups because, as previously discussed, it is typical for members of regulated financial groups to issue large amounts of debt to, and acquire large amounts of debt from, other members of the same EG, which is necessitated by commercial and regulatory considerations, and a very significant portion of this debt is typically short term debt with a term of less than one year. Finally, the "cascading" effect described above is most likely to occur with respect to short term debt, given that an issuer is likely to issue and retire (typically through a refinancing with other short term debt) short-term debt on a repeated basis over a short period of time. For these reasons, we believe that it is necessary and appropriate to exempt from the Funding Rule debt instruments that are issued by or to a member of a regulated financial group and which have a stated term to maturity of less than one year.[57]

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[56] *See* 81 Fed. Reg. at 20914 (Apr. 8, 2016) ("The notices state, in particular, that the Treasury Department and the IRS are considering guidance to address strategies that avoid U.S. tax on U.S. operations by shifting or "stripping" U.S.-source earnings to lower-tax jurisdictions, including through intercompany debt."); 81 Fed. Reg. at 20917 (Apr. 8, 2016) ("In many contexts, a distribution of a debt instrument similar to the one at issue in Kraft lacks meaningful non-tax significance, such that respecting the distributed instrument as indebtedness for federal tax purposes produces inappropriate results. For example, inverted groups and other foreign-parented groups use these types of transactions to create interest deductions that reduce U.S. source income without investing any new capital in the U.S. operations.").

[57] Short term debt is treated differently from other debt in other circumstances. *See, e.g.*, § 163(f)(2)(A) (excluding from the definition of "registration-required obligation" obligations that have a maturity at issue of not more than one year); § 871(g)(1)(B)(i) (excluding from the definition of "original issue discount obligation" obligations payable 183 days or less from the date of original issue); § 1271(a)(4) (generally providing for ordinary treatment of any gain recognized on the sale or exchange of a short-term nongovernmental obligation to the extent such gain does not exceed an amount equal to the ratable share of original issue discount with respect to such obligation); § 1278 (excluding from the definition of

In addition, we note that similar considerations apply to short term debt issued by or to taxpayers that are not members of regulated financial groups (e.g., in the context of cash pooling arrangements and similar treasury center arrangements that are commonly maintained by multinational groups), and we urge Treasury to consider extending the exemption proposed in this recommendation more broadly to include short term debt issued by all taxpayers.

Recommendation 8: An exception to the Funding Rule should be added for debt instruments issued by a non-U.S. corporation that are held by another non-U.S. corporation, and distributions or acquisitions between non-U.S. corporations should not be taken into account for purposes of applying the Funding Rule.[58]

As noted above, the preamble to the Proposed Regulations makes it clear that Prop. Treas. Reg. § 1.385-3 has been promulgated primarily to deal with "earnings stripping," the reduction or elimination of a U.S. corporation's U.S. tax liability through interest deductions on indebtedness held by a foreign parent corporation or other foreign affiliates that are not generally subject to U.S. tax. Conversely, the preamble cites the absence of any potential for "earnings stripping" as the justification for the exemption of indebtedness between members of a consolidated group from the Proposed Regulations.[59]

Where a non-U.S. corporation holds a debt instrument of another non-U.S. corporation, the interest deduction on the debt does not reduce U.S. source income or U.S. tax on U.S.

"market discount bond" any obligation with a fixed maturity date not exceeding one year from the date of issue); § 1283 (defining "short-term obligation" to mean any "bond, debenture, note certificate or other evidence of indebtedness which has a fixed maturity date not more than one year from the date of issue" and providing special coordinating rules for such obligations).

[58] In this recommendation, we have focused on an exemption from, and exceptions to, the Funding Rule because in this context that aspect of Prop. Treas. Reg. § 1.385-3 is most consequential to SIFMA's members. We note, however, that the NYSBA Comment Letter has generally recommended a broader exemption from Prop. Treas. Reg. § 1.385-3 (including the "general rule" in Prop. Treas. Reg. § 1.385-3(b)(2)) for foreign-to-foreign transactions, and we encourage Treasury and the IRS to also consider a broad exemption of that type. *See* NYSBA Comment Letter at 88-91.

[59] *See* 81 Fed. Reg. at 20914 (Apr. 8, 2016) ("Nonetheless, the Treasury Department and the IRS also have determined that the proposed regulations should not apply to issuances of interests and related transactions among members of a consolidated group because the concerns addressed in the proposed regulations generally are not present when the issuer's deduction for interest expense and the holder's corresponding interest income offset on the group's consolidated federal income tax return.").

operations (even where one or both corporations are controlled foreign corporations ("**CFCs**")). It is for this reason that section 163(j) does not apply to non-U.S. corporations (including CFCs). Similarly, the types of distributions and acquisitions described in Prop. Treas. Reg. § 1.385-3(b)(3)(ii) involving two non-U.S. corporations do not reduce U.S. source income or U.S. tax on U.S. operations and therefore do not implicate "earnings stripping" concerns.[60] For these reasons, we do not believe that a debt instrument issued by a non-U.S. corporation to another non-U.S. corporation should be subject to the Funding Rule, and we do not believe that distributions or acquisitions between non-U.S. corporations should be taken into account for purposes of applying the Funding Rule.

We acknowledge that Prop. Treas. Reg. § 1.385-3 can apply to debt issued by a non-U.S. corporation to a U.S. corporation, where both corporations are members of the same EG, and that no earning stripping concerns are present in that situation (indeed, in that situation, the interest income included by the U.S. corporation would, in isolation, increase the U.S. tax liability of the U.S. corporation). The preamble to the Proposed Regulations explains the rationale for the application of Prop. Treas. Reg. § 1.385-3 as follows:

> In addition, U.S.-parented groups obtain distortive results by, for example, using these types of transactions to create interest deductions that reduce the earnings and profits of controlled foreign corporations (CFCs) and to facilitate the repatriation of untaxed earnings without recognizing dividend income. An example of the latter type of transaction could involve the distribution of a note from a first-tier CFC to its United States shareholder in a taxable year when the distributing CFC has no earnings and profits (although lower-tier CFCs may) and the United States shareholder has basis in the CFC stock. In a later taxable year, when the distributing CFC had untaxed earnings and profits (such as by reason of intervening distributions from lower-tier CFCs), the CFC could use cash attributable to the earnings and profits to repay the note owed to its United States shareholder. The taxpayer takes the position that the note should be respected as indebtedness and, therefore, that the repayment of the note does not result in any

[60] In addition, for the reasons outlined in the NYSBA Comment Letter, the application of Prop. Treas. Reg. § 1.385-3 to debt issued in such distributions or acquisitions (or debt issued to fund such distributions or acquisitions) does not appear to meaningfully advance any goal relating to the repatriation of profits from a non-U.S. member of a group to a U.S. member. *See* NYSBA Comment Letter at 88-91.

of the untaxed earnings and profits of the CFC being taxed as a dividend to the United States shareholder.[61]

We do not think, however, that this fact or the explanation in the preamble undermines the rationale stated above for the proposed exception. In the case of indebtedness held between two CFCs, the reduction in the issuing CFC's earnings and profits by reason of interest deductions on the indebtedness will be matched by an increase in the lending CFC's earnings and profits by reason of the corresponding interest income. Similarly, in the case of a distribution or acquisition involving two CFCs, any reduction in one CFC's earnings and profits that results from the acquisition (e.g., as a result of the operation of section 304) or distribution would be matched by an increase in the other CFC's earnings and profits. Moreover, application of the Funding Rule to indebtedness between two CFCs, which indebtedness was used to fund a distribution by a CFC to a United States shareholder, does not change the U.S. tax treatment of the distribution (i.e., if the distributing CFC has no earnings and profits, the distribution that is funded by the indebtedness will continue to avoid dividend treatment even if the indebtedness is treated as stock under the Funding Rule). In short, application of the Funding Rule to indebtedness between non-U.S. corporations, or in connection with distributions or acquisitions between non-U.S. corporations, does not serve any tax policy that Prop. Treas. Reg. § 1.385-3 seeks to address.

Recommendation 9: An exception should be added to the Funding Rule for a debt instrument issued by a U.S. corporation to either (i) a non-U.S. corporation if interest on the debt instrument is treated as "effectively connected income" to such non-U.S. member under section 864(c) and therefore is subject to tax under section 882, or (ii) another U.S. corporation.

For commercial reasons (typically relating to the ability to efficiently hedge foreign currency exposure and to centralize U.S. dollar ("**USD**") borrowing within the group), it is typical for a non-U.S. bank that is a member of a group that includes one or more U.S. subsidiaries that require USD funding for their ordinary course operations (e.g., as a securities dealer or credit card issuing bank) to provide such USD funding to the U.S. subsidiaries through intercompany loans, rather than having such U.S. subsidiaries fund their USD needs by borrowing from unrelated third parties. The interest on such intercompany loans is income that is effectively connected with the conduct of a U.S. trade or business ("**ECI**")[62] by the non-U.S. bank and is therefore taxable in the United States under section 882. Because such interest is ECI,

[61] 81 Fed. Reg. at 20917 (Apr. 8, 2016).

[62] *See* § 864(c); Treas. Reg. § 1.864-4(c)(5).

it is not "disqualified interest" under section 163(j)(3) and is therefore not subject to the limitations on the deduction of interest paid to related persons under section 163(j)(1). Similarly, interest that is ECI is not subject to the rules of section 267(a)(3), which generally require a taxpayer to use the cash method of accounting with respect to the deduction of interest on indebtedness owed to a related foreign party. Instead, the taxpayer is allowed to use the accrual method of accounting with respect to the deduction of such interest.[63]

Because the exclusion of interest on an intercompany loan that generates ECI from the application of section 163(j) and section 267(a)(2) is an express acknowledgement that such loans do not raise any "earnings stripping" issues, we believe that the Funding Rule should contain an exception for a debt instrument issued by a member of the EG that is a U.S. corporation to a non-U.S. member of the EG if interest on the debt instrument is treated as ECI to such non-U.S. member under section 864(c) and therefore subject to tax under section 882. In addition, such an exception would equalize the treatment of the non-U.S. bank group with respect to such debt instruments with the treatment of a U.S. bank that makes an intercompany loan to a member of its consolidated group, as to which the Funding Rule would not apply.[64] Absent this exception, the potential for recharacterization of debt instruments issued by a member of the EG that is a U.S. corporation to a non-U.S. member of the EG but which produce ECI would unfairly discriminate against non-U.S. banks with such intercompany funding structures.

For similar reasons, we believe that the Funding Rule should not apply to indebtedness between two U.S. corporations (even if not part of the same consolidated group).[65] While we acknowledge that the preamble to the Proposed Regulations notes in passing that "federal income tax liability can also be reduced or eliminated with excessive indebtedness between domestic related parties,"[66] the preamble does not elaborate on this concern, and the remainder of the preamble generally addresses indebtedness in cross-border contexts. Congress has not seen fit to adopt any analogue to section 163(j) in the purely domestic context; a non-tax exempt U.S. corporate lender's interest income on indebtedness issued by another U.S. corporation is fully subject to U.S. tax, which is sufficient to render section 163(j) inapplicable, without regard to

[63] *See* Treas. Reg. § 1.267(a)-3(c)(1).

[64] *See* Prop. Treas. Reg. § 1.385-1(e).

[65] This exception would not apply to debt held by a tax-exempt corporation.

[66] 81 Fed. Reg. at 20914 (Apr. 8, 2016).

whether, after taking into account both the interest expense and interest income on the indebtedness and the parties' other tax attributes, the aggregate U.S. tax liability of the lender and borrower is reduced. Moreover, in the context of a consolidated group, although the Proposed Regulations will not apply to indebtedness between members of the group for purposes of determining the group's U.S. federal income tax liability, Treasury should be cognizant of the fact that many states may apply Prop. Treas. Reg. § 1.385-3, but without regard to the exception for indebtedness between members of a consolidated group (because the state does not recognize the consolidated group for state tax purposes). In the absence of any clearly identifiable (as opposed to purely theoretical) tax policy concern with respect to indebtedness between related U.S. corporations that are not members of a consolidated group, we believe that the Funding Rule should not apply to such indebtedness.

Recommendation 10: An exception should be added to the Funding Rule for a debt instrument issued by a non-U.S. corporation the interest expense on which is subject to Treas. Reg. § 1.882-5.

In the case of a debt instrument issued by a non-U.S. corporation the interest expense on which is subject to Treas. Reg. § 1.882-5 (a "**Branch Debt Instrument**"), there is very little potential for "earnings stripping." Treas. Reg. § 1.882-5 is a well-developed regime that very generally allocates interest expense of a non-U.S. corporation to ECI of the corporation by reference to the actual worldwide debt-to-equity ratio of the corporation or a fixed ratio. Where the actual debt-to-equity ratio is used, Treas. Reg. § 1.882-5 in effect treats the non-U.S. corporation's U.S. trade or business as having the same debt-to-equity ratio as the corporation's worldwide debt-to-equity ratio. Where the fixed ratio is used, Treas. Reg. § 1.882-5 in effect mandates a 95 percent debt-to-equity ratio for the non-U.S. corporation's U.S. trade or business. In either case, it is exceedingly difficult to opportunistically engage in "earnings stripping" where interest expense is allocated under these rules.[67]

In addition, subjecting Branch Debt Instruments to the Funding Rule would inappropriately penalize the use of a branch, rather than a corporation, to conduct a U.S. trade or business. Specifically, in the absence of the exception proposed in this recommendation, activities by a non-U.S. corporation that are unrelated to its U.S. branch and which otherwise

[67] We acknowledge that Treas. Reg. § 1.882-5(a)(5) contemplates that section 163(j) could apply after interest expense is allocated to ECI under Treas. Reg. § 1.882-5 but would observe that, as a practical matter, section 163(j) is unlikely to apply to U.S. trades or businesses maintained by non-U.S. financial institutions, which, because their business relies on earning a spread between funds lent and funds borrowed, generally do not have "net interest expense."

have no bearing for U.S. tax purposes would be relevant for purposes of applying the Funding Rule with respect to Branch Debt Instruments (e.g., a distribution by the non-U.S. corporation that is unrelated to its U.S. trade or business could cause a Branch Debt Instrument to be recharacterized under the Funding Rule). By contrast, if the non-U.S. corporation conducted its U.S. trade or business through a U.S. corporate subsidiary, the activities of the non-U.S. corporation would not be relevant for purposes of applying the Funding Rule to debt issued by its U.S. corporate subsidiary. Subjecting Branch Debt Instruments to the Funding Rule would also result in significant compliance burdens because it would require the monitoring of transactions that would not otherwise have relevance for U.S. tax purposes, and in many cases would add further complexity to computations under Treas. Reg. § 1.882-5.

VI. ADDITIONAL RECOMMENDATIONS WITH RESPECT TO PROP. TREAS. REG. § 1.385-3

Regardless of whether our recommendation in Part IV or our recommendations in Part V are accepted, we believe that all of the following additional exceptions and modifications should be made to Prop. Treas. Reg. § 1.385-3.

Recommendation 11: An acquisition of stock of a member of an EG by another member of the EG for use in an employee compensation program should not be taken into account for purposes of applying Prop. Treas. Reg. § 1.385-3(b).

We believe that an exception to Prop. Treas. Reg. § 1.385-3(b) should be added such that an acquisition of stock of a member of an EG by another member of the EG for use in an employee compensation program is not taken into account for purposes of applying Prop. Treas. Reg. § 1.385-3(b).

Financial groups, like many other groups, often grant equity-based compensation (for example, in the form of options, restricted stock or restricted stock units) that relate to the publicly traded common stock of the parent of the group to employees of the group, many or most of whom may be employees of subsidiaries. In such situations (especially in the case of subsidiaries that are located in a different jurisdiction from the parent), it is not uncommon for the employer subsidiary that obtains the parent stock that is transferred to employees in connection with such awards to acquire newly issued stock directly from the publicly traded parent. In some cases (e.g., where local tax law requires that the subsidiary pay consideration for the stock in order to claim a compensation deduction in the local jurisdiction), the subsidiary may provide consideration to the parent, in the form of cash or a note, for the parent stock, or no consideration may be provided.

In any case, in the absence of the exception proposed in this recommendation, the acquisition of stock of an EG member by a subsidiary EG member for use in its employee compensation program would be within the scope of the "general rule" in Prop. Treas. Reg. § 1.385-3(b)(2)(ii) (the "**General Rule**") or the Funding Rule. In particular, where the stock of the EG member is acquired for a note issued by the subsidiary EG member, the note would generally be treated as stock under the General Rule, and where the stock of the publicly traded member is acquired for cash or is transferred without consideration, the acquisition of stock may be within the scope of Prop. Treas. Reg. § 1.385-3(b)(3)(ii)(b) and may result in the recharacterization of debt instruments issued by the non-publicly traded member.[68]

The use of equity compensation programs in incentivizing and compensating employees is a common business practice, and the acquisition by a subsidiary of stock of its parent for use in connection with such programs should accordingly be considered a transaction that occurs in the ordinary course of an employer's trade or business. Moreover, the policy objectives of the Proposed Regulations are not served by inhibiting or penalizing the use of member stock in employee compensation programs of other members in the same EG, and we believe that the exception proposed in this recommendation is necessary for financial groups (and other taxpayers) to continue to efficiently incentivize their employees.

Recommendation 12: Prop. Treas. Reg. § 1.385-3 should be effective only for debt instruments issued, and specified distributions and acquisitions occurring, on or after the date that is one year after the date on which Prop. Treas. Reg. § 1.385-3 is issued in final form.

As Treasury is aware, Prop. Treas. Reg. § 1.385-3, if finalized in anything approaching its current form, will in effect completely rewrite the law with respect to the characterization as debt or equity for tax purposes of debt instruments issued to a member of the issuer's EG. Once the regulations are finalized, an EG will have to build, test and implement (i) systems to identify, monitor and characterize for tax reporting purposes debt instruments issued between members of the EG, taking into account the ordering and timing rules in Prop. Treas. Reg. § 1.385-3(b)(3)-(4) and -3(d), (ii) systems to identify and monitor distributions and other transactions that may, under the Funding Rule, cause debt issued by the distributing member of the EG to another member of the EG to be treated as stock, and (iii) systems to determine, on a real-time basis,

[68] Where the publicly traded stock is transferred for no consideration, Treas. Reg. § 1.1032-3 would generally deem the non-publicly traded member to have acquired the stock for fair market value for cash, which for purposes of Prop. Treas. Reg. § 1.385-3(b)(3)(ii)(b) may be treated the same as an acquisition of expanded group stock for cash.

whether such distributions or other transactions will likely qualify under the various exceptions in Prop. Treas. Reg. § 1.385-3, including the exception for current year earnings and profits, as it may be modified in the final regulations, and any other exceptions contained in the final regulations.

This is a massive task for any U.S. or non-U.S. multinational, especially for a regulated financial group that engages annually in hundreds or thousands of intercompany debt transactions. It will take taxpayers substantial time both (i) to digest and understand the final regulations, and (ii) to build the systems necessary to apply the final regulations. In addition to the potential for "cascading" recharacterizations of debt as stock across multiple debt instruments and members of the group, it is unreasonable for the regulations to apply before taxpayers have time to even read the final regulations, not to mention build, test and implement the necessary systems to apply the final regulations and make the necessary adjustments to their operations to avoid the recharacterization of debt as stock (if any such adjustments are even possible). Taxpayers will also need time to learn whether and how tax departments and agencies in the various states will apply the Proposed Regulations for state tax purposes.

In these circumstances, we believe that it is imperative, both as a practical matter and as a matter of fundamental fairness, that there be a transition period of at least one year, after the final regulations are promulgated, before they become effective. Specifically, we propose that (i) Prop. Treas. Reg. § 1.385-3 should apply only to debt instruments that are issued on or after the date that is one year after the final regulations are issued, and (ii) for purposes of the Prop. Treas. Reg. § 1.385-3(b)(3), a distribution or acquisition described in Prop. Treas. Reg. § 1.385-3(b)(3)(ii) occurring on or before the date that is one year after the final regulations are issued should not be taken into account.

Recommendation 13: The "anti-abuse" rule in Prop. Treas. Reg. § 1.385-3(b)(4) should be clarified to confirm that it can apply only when a debt instrument is issued and held by members of the same EG.

Prop. Treas. Reg. § 1.385-3(b)(4) provides an anti-abuse rule under which a debt instrument is treated as stock if "it is issued with a principal purpose of avoiding the application of this section or §1.385-4." As drafted, therefore, the anti-abuse rule could apply where a debt instrument is issued by a member of an EG to an unrelated third party and the debt instrument is at all times held by that third party (or other unrelated third parties), with the determination whether the anti-abuse rule would apply being based on the intentions of the issuer. For two reasons, we do not think that it is appropriate for the intentions of the issuer to be relevant, and therefore for the anti-abuse rule to apply, in this circumstance. First, the third party lender in this situation will typically not have any insight into or knowledge of whether the issuer's "primary

purpose" for the borrowing is to avoid the application of Prop. Treas. Reg. § 1.385-3 or Prop. Treas. Reg. § 1.385-4, and thus whether it is in fact holding debt or equity of the issuer (which can have far-reaching consequences for the lender, such as the possibility of U.S. withholding tax on payments if the instrument is treated as stock). It is unfair to put an unrelated third-party lender in this position, and this issue is of particular concern to financial groups, which are in the business of making loans to unrelated borrowers. Second, given the facts that (i) one of the primary purposes of the Proposed Regulations is to address concerns about "earnings stripping," and (ii) section 163(j), the principal provision of the Code that addresses "earnings stripping," explicitly applies to certain types of "guaranteed" unrelated third party debt as well as related party debt, Treasury's decision *not* to have the Proposed Regulations apply to unrelated third party debt can only be seen as a deliberate decision to limit the design and scope of the Proposed Regulations, which decision should not be capable of being undone through the application of a general anti-abuse rule, where the debt is issued to and continuously held by an unrelated third party.

VII. RECOMMENDATIONS WITH RESPECT TO PROP. TREAS. REG. § 1.385-2

Recommendation 14: A failure to comply with Prop. Treas. Reg. § 1.385-2 should not result in automatic treatment of an EGI as stock, but only a presumption that such EGI is stock that can be rebutted if the facts and circumstances establish that the EGI is debt under general U.S. federal income tax principles.

Under Prop. Treas. Reg. § 1.385-2(a)(1), "[i]f the requirements of this section are not satisfied with respect to an EGI the substance of which is regarded for federal tax purposes, the EGI will be treated as stock." For the reasons set forth below, we believe that the consequences of a failure to satisfy the documentation requirements with respect to an EGI should not be that the EGI is automatically treated as stock, but rather that the EGI should be presumed to be stock unless the facts and circumstances establish that the EGI is debt under general federal tax principles.

First, in the preamble to the Proposed Regulations, Treasury states that Prop. Treas. Reg. § 1.385-2 is intended "to impose discipline on related parties by requiring timely documentation and financial analysis," because "[t]he absence of reasonable diligence by related-party lenders can have the effect of limiting the factual record that is available for additional scrutiny and thorough examination."[69] Given the purposes of the documentation rules, the penalty for a failure to satisfy the documentation rules should be proportional to, and intended to remedy, the

[69] 81 Fed. Reg. at 20915 (Apr. 8, 2016).

consequences of the failure. Automatic treatment of an EGI as stock in the case of a failure to comply with the documentation rules is out of proportion to, and goes well beyond what is necessary to remedy, the consequences of such a failure. The direct consequences of treating an EGI as stock, e.g., the disallowance of interest deductions, the treatment of payments (including payments of principal) on the EGI as section 301 distributions and the creation of another class of equity ownership of the issuing member, are unwarranted and wholly disproportionate to the failure where, notwithstanding the failure, it is beyond doubt that the EGI is debt under general tax principles – e.g., a taxpayer's failure to retain written evidence of a single interest payment on the instrument or a taxpayer's failure to prepare adequate documentation regarding the issuer's ability to pay, where it is beyond dispute, given the principal amount of the EGI and the issuer's financial condition, that an unrelated third party would have extended the loan on the same terms. But the consequences of treating an EGI as stock under Prop. Treas. Reg. § 1.385-2(a)(1) can extend far beyond just the consequences with respect to that specific EGI, in light of the potential "cascading" consequences of such treatment by reason of the Funding Rule under Prop. Treas. Reg. § 1.385-3.

In other cases in which the facts and circumstances in a factually complex transaction or series of transactions are such that heightened scrutiny of the transaction or series of transactions is warranted, Congress and Treasury have usually dealt with such situations through the creation of rebuttable presumptions, and not irrebuttable presumptions (which is in effect what Prop. Treas. Reg. § 1.385-2(a)(1) does in the event of a failure to satisfy the documentation rules). For example, under section 355(e)(2)(B), if there is a direct or indirect acquisition of stock representing a 50% or greater interest in the distributing corporation or a controlled corporation during the four-year period beginning on the date that is two years before the date of the distribution, the acquisition "is treated as occurring to a plan [that includes the distribution] . . . unless it is established that the distribution and the acquisition are not pursuant to a plan or series of related transactions." As in these cases, the proper characterization of an EGI as to which a taxpayer has failed to comply with all of the documentation rules in Prop. Treas. Reg. § 1.385-2 may warrant heightened scrutiny, but the appropriate approach should be to impose a rebuttable, rather than an irrebuttable, presumption.

Finally, if Treasury believes that the failure to create or maintain adequate documentation and financial analysis with respect to an EGI is a potentially insufficient factual record for an examination of the EGI on audit, then the consequences of such failure should be a presumption that the EGI is stock, which the taxpayer would be required to overcome based on all of the facts and circumstances. Depending on the specific circumstances of the taxpayer's failure to create or maintain adequate documentation of the existence and legal enforceability of the EGI, proof of the issuer's financial wherewithal to support the EGI, or its actions with respect to enforcing

repayment of the EGI, the taxpayer will have more or less difficulty overcoming the presumption: if the failure is material and highly probative, the taxpayer will accordingly face a more difficult burden in overcoming the presumption.[70] For these reasons, if a taxpayer fails to satisfy all of the requirements of Prop. Treas. Reg. § 1.385-2 with respect to the EGI, a presumption that an EGI is stock, coupled with the taxpayer's ability to rebut the presumption as described herein, is a more appropriate and proportional consequence of such failure.

Recommendation 15: Prop. Treas. Reg. § 1.385-2 should be effective only with respect to applicable instruments issued on or after the date that is one year after the date on which the final regulations are published.

As currently drafted, the documentation rules in Prop. Treas. Reg. § 1.385-2 will generally apply to any applicable instrument issued or deemed issued on or after the date that the proposed regulation is published as a final regulation. Because members of a financial group engage in intercompany lending transactions on a daily basis, this would mean that many taxpayers would be required to begin producing fully compliant written legal documentation under Prop. Treas. Reg. § 1.385-2(b)(2)(i) and (ii), and written documentation establishing a reasonable expectation of repayment under Prop. Treas. Reg. § 1.385-2(b)(2)(iii), within 30 days after the date on which the proposed regulation is finalized.

For many of the same reasons as stated above with respect to Recommendation 12, we believe that Prop. Treas. Reg. § 1.385-2 should be effective only for applicable instruments issued on or after the date that is one year after the date on which the proposed regulation is published as a final regulation.[71] It will take taxpayers substantial time both (i) to simply read and understand the final regulations – which we expect will contain substantial changes from the proposed regulations – and (ii) to build the IT and other systems, involving personnel from

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[70] In addition, we point out that under section 6662(a), the IRS can impose a 20% penalty on any underpayment of tax that is attributable to, among other things, "negligence," and that negligence is defined in the applicable Treasury Regulations to include "the failure by the taxpayer to keep adequate books and records or to substantiate items properly." Treas. Reg. § 1.6662-3(b)(1).

[71] This recommendation assumes that Treasury has accepted Recommendation 14 (which proposes that a failure to comply with Prop. Treas. Reg. § 1.385-2 should result only in a rebuttable presumption that a debt instrument is equity) and Recommendation 18 (which makes recommendation with respect to the "reasonable cause" exception in Prop. Treas. Reg. § 1.385-2), both of which moderate the consequences of a documentation failure with respect to a debt instrument. If Treasury does not adopt both of these recommendations, we believe that Treasury should consider delaying the effective date of Prop. Treas. Reg. § 1.385-2 for two years, rather than just one year, to allow taxpayers to build the type of systems needed in order to comply with documentation rules that are so intolerant of failure.

treasury, legal, tax and accounting functions, necessary to comply with the final regulations. This is especially the case for taxpayers, like financial groups, that are composed of numerous separate entities that engage annually in hundreds or thousands of intercompany lending transactions that are in form indebtedness. (As noted above, taxpayers will also need time to learn whether and how tax departments and agencies in the various states will apply Prop. Treas. Reg. § 1.385-2 for state tax purposes, and thus what debt instruments need to be brought within the scope of the systems they are required to build.) Moreover, given the punitive consequences of failing to comply with all of the documentation requirements – the treatment of the applicable instrument as stock, even if it would otherwise qualify as debt under applicable law – and the ability of such treatment to in turn trigger catastrophic “cascading” consequences under Prop. Treas. Reg. § 1.385-3, such systems must be built to ensure virtually a zero failure rate (if such a thing is even possible). While we recognize the desire of Treasury to implement the proposed regulations in an expeditious manner, taxpayers will have to rely on their documentation systems, and live with the consequences of any failures in such systems, for years to come, which on balance we believe supports allowing taxpayers a transition period in which to prepare to comply with the documentation rules in Prop. Treas. Reg. § 1.385-2 when they are finalized.

Recommendation 16: Prop. Treas. Reg. § 1.385-2(b)(3)(i) should be amended to provide that, with respect to any EGI to which Prop. Treas. Reg. § 1.385-2 applies, the documentation required by Prop. Treas. Reg. § 1.385-2 is required to be prepared no later than the date on which the taxpayer’s tax return is due (including extensions) for the relevant taxable year that includes the relevant date for the applicable documentation.

Prop. Treas. Reg. § 1.385-2(b)(3)(i) generally requires that documentation be prepared no later than 30 calendar days after each relevant date in the case of documents described in Prop. Treas. Reg. § 1.385-2(b)(2)(i), (ii) and (iii), and that documentation be prepared within 120 calendar days after the relevant date in the case of documents described in Prop. Treas. Reg. § 1.385-2(b)(2)(iv).

We recommend that Prop. Treas. Reg. § 1.385-2 be amended to provide that the documentation required by Prop. Treas. Reg. § 1.385-2 be prepared no later than the date on which the taxpayer’s tax return is due (including extensions) for the taxable year that includes the relevant date for the applicable documentation. We make this recommendation for two reasons. First, the deadlines reflected in Prop. Treas. Reg. § 1.385-2(b)(3)(i) are in many cases simply too short of a time period to identify and gather all of the relevant documentation (and prepare any new documentation that is required), especially for members of a financial group which may issue hundreds or thousands of EGIs that are potentially subject to Prop. Treas. Reg. § 1.385-2. Second, we believe that a 30-day requirement (in the case of Prop. Treas. Reg.

§ 1.385-2(b)(2)(i), (ii) and (iii)) or 120-day requirement (in the case of Prop. Treas. Reg. § 1.385-2(b)(2)(iv)) is not necessary to serve the stated primary purpose of Prop. Treas. Reg. § 1.385-2. The preamble to the Proposed Regulations clearly establishes that the primary purpose for the promulgation of Prop. Treas. Reg. § 1.385-2 is to ensure that there is an adequate and clearly identifiable set of documentation relating to an EGI available for examination by the IRS on audit.[72] The relevant time period for the preparation of the documentation required by Prop. Treas. Reg. § 1.385-2 should therefore be calibrated towards this purpose, and there is no reason why, in order for this documentation to be available to the IRS on audit, this documentation needs to be prepared within 30 calendar days after an EGI is issued. In similar circumstances involving section 482 transfer pricing documentation, the relevant regulations, responding to similar administrative goals, require that such documentation "must be in existence when the return is filed."[73] A similar rule should apply for purposes of the documentation required by Prop. Treas. Reg. § 1.385-2.

Recommendation 17: Prop. Treas. Reg. § 1.385-2(b)(2)(iii) should be amended to clarify that the documentation required by that section with respect to any EGI issued by a member of a regulated financial group may be prepared on the basis of the most recent audited or unaudited financial statements or similar financial information prepared for the issuer, provided that (i) financial statements or similar

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[72] *See, e.g.*, 81 Fed. Reg. at 20915 (Apr. 8, 2016) ("The absence of reasonable diligence by related-party lenders can have the effect of limiting the factual record that is available for additional scrutiny and thorough examination."); 81 Fed. Reg. at 20915 (Apr. 8, 2016) ("Historically, the absence of clear guidance regarding the documentation and information necessary to support debt characterization in the related-party context did not pose a significant obstacle . . . . [t]he relevant documentation was readily identifiable, available on hand, and able to be analyzed by the Commissioner in due course."); 81 Fed. Reg. at 20915-916 (Apr. 8, 2016) ("The lack of such guidance, combined with the sheer volume of financial records taxpayers produce in the ordinary course of business, makes it difficult to identify the documents that will ultimately be required to support such a characterization, particularly with respect to whether a reasonable expectation of repayment is present at the time an interest is issued. The result can be either the inadvertent omission of necessary documents from disclosure to the IRS or the provision of vast amounts of irrelevant documents and material, such that forensic accounting expertise is required to isolate and evaluate relevant information. In either case, the ability of the Commissioner to administer the Code efficiently with respect to related-party interests is impeded. In addition, the absence of guidance makes it difficult for U.S. taxpayers to determine what steps they must take to ensure that essential records are not only prepared, but also maintained in a manner that will facilitate their being made available upon request . . . .").

[73] Treas. Reg. § 1.6662-6(d)(2)(iii)(A).

financial information for the issuer are prepared at least annually and (ii) the taxpayer is not aware of any material adverse change in the financial condition of the issuer since the date of the issuer's last financial statements or similar financial information.

Prop. Treas. Reg. § 1.385-2(b)(2)(iii) provides that the documentation that may be used to establish that, as of the date of issuance of the applicable instrument, the issuer's financial position supported a reasonable expectation that the issuer intended to, and would be able to, meet its obligations pursuant to the terms of the applicable instrument, includes "cash flow projections, financial statements, business forecasts, asset appraisals, determination of debt-to-equity and other relevant financial ratios of the issuer in relation to industry averages, and other information regarding the sources of funds enabling the issuer to meet its obligations pursuant to the terms of the applicable instrument." Although this list explicitly references "financial statements," it is unclear whether, if a taxpayer wishes to rely on the issuer's financial statements or similar financial information as part of the documentation used to satisfy the requirement of Prop. Treas. Reg. § 1.385-2(b)(2)(iii), Prop. Treas. Reg. § 1.385-2(b)(2)(iii) requires the preparation of a financial statement or similar financial information as of the date that the applicable instrument is issued (which is the date as of which the issuer's financial condition relating to the reasonable expectation of repayment must be established), or whether a taxpayer can rely on financial statements or similar financial information prepared as of an earlier date.

It is normal commercial practice between unrelated parties for a lender, in making a decision whether to make a loan or otherwise extend credit to a borrower, to rely on, among other things, the most recently regularly-prepared financial statements or similar financial information for the borrower. Moreover, given the large number of intercompany loans between members of a regulated financial group, it is simply impractical, if not impossible, to prepare financial statements for each member of the group on each day in which it issues an intercompany loan to another member of the group. For these reasons, we believe that the ambiguity in Prop. Treas. Reg. § 1.385-2(b)(2)(iii) should be clarified to provide that the documentation required by that section with respect to any EGI issued by a member of a regulated financial group may be prepared on the basis of the last audited or unaudited financial statements or similar financial information that was prepared for the issuer, provided that (i) financial statements or similar financial information for the issuer are prepared at least annually and (ii) the taxpayer is not aware of any material adverse change in the financial condition of the issuer since the date of the issuer's last financial statements or similar financial information.

Recommendation 18: The exception for "reasonable cause" in Prop. Treas. Reg. § 1.385-2(c)(1) should be modified (i) to provide that if a taxpayer establishes reasonable cause for a failure to satisfy the documentation rules, an EGI will not be treated as stock solely by reason of such failure, and (ii) to specify certain situations involving inadvertent failures in which a taxpayer will be treated as having established that a failure to satisfy the documentation rules is due to reasonable cause.

Prop. Treas. Reg. § 1.385-2(c)(1) provides that

> [i]f the person characterizing an EGI as indebtedness for federal tax purposes establishes that a failure to satisfy the requirements of this section is due to reasonable cause, appropriate modifications may be made to the requirements of this section in determining whether the requirements of this section have been satisfied. The principles of §301.6724-1 of this chapter apply in interpreting whether reasonable cause exists in any particular case.

We have two comments with respect to this exception.

First, we believe that, if a taxpayer establishes reasonable cause for a failure to satisfy any of the requirements of Prop. Treas. Reg. § 1.385-2 with respect to a particular EGI, the result should be that the EGI is not treated as stock under Prop. Treas. Reg. § 1.385-2(a)(1), but rather is treated as debt or equity under other applicable rules. As currently drafted, the provision ambiguously provides only that unspecified "appropriate" modifications "may" be made to the requirements of the section in determining whether those requirements have been satisfied, without any guidance as to what modifications are "appropriate" or when and under what circumstances such modifications should be made. (In this respect, we note that, under section 6724(a), if a taxpayer establishes reasonable cause under section 6724 with respect to a failure to comply with various information returns, the result is the automatic waiver of any penalties with respect to such failure.) Especially in light of the draconian penalty for failure to satisfy all of the documentation requirements in Prop. Treas. Reg. § 1.385-2, this penalty should simply not apply to a taxpayer that in fact establishes reasonable cause for a failure.

Second, again taking into account the draconian penalty that applies for failure to satisfy the documentation requirements in Prop. Treas. Reg. § 1.385-2, we believe that the exception for reasonable cause in Prop. Treas. Reg. § 1.385-2(c)(1) should be clarified to provide that, in the case of a taxpayer who has made a good faith effort to comply with the documentation requirements with respect to all of its EGIs, a failure to

satisfy the documentation requirements with respect to a specific EGI by reason of a "foot fault" or similar inadvertent failure will be considered to be due to reasonable cause. Under Treas. Reg. § 301.6724-1(a)(2), "reasonable cause" for waiving a penalty relating to an information reporting requirement will exist, among other cases, if "there are significant mitigating factors with respect to the failure" and the person responsible for filing the information report establishes that it "acted in a responsible manner." For this purpose, mitigating factors include "the fact that the filer has an established history of complying with the information reporting requirement to which the failure occurred."[74] In addition, "acting in a responsible manner" means that the filer exercised "reasonable care, which is the standard of care that a reasonably prudent person would use under the circumstances in the course of its business" and that the filer took significant steps to avoid or mitigate the failure, including "[r]ectifying the failure as promptly as possible once . . . the failure was discovered."[75] In light of this definition of "reasonable cause" and the disproportionate consequences that may ensue from a failure to satisfy the documentation requirements, Treasury should clarify the exception to give taxpayers more certainty that, if a taxpayer makes a good faith effort to comply with the documentation requirements with respect to all of its EGIs, an inadvertent failure with respect to a specific EGI will not result in the treatment of that EGI as stock under Prop. Treas. Reg. § 1.385-2(a)(1). For example, Treasury should consider adding an example to the exception demonstrating that in the case of a taxpayer that (i) establishes systems and procedures reasonably designed to ensure that the documentation requirements are consistently, timely and fully fulfilled with respect to all of a group's EGIs subject to Prop. Treas. Reg. § 1.385-2, and (ii) as a result of such systems and procedures, demonstrates a high rate of compliance with the documentation requirements with respect to the group's EGIs, an inadvertent failure to comply with all of the documentation requirements with respect to a specific EGI, which failure is promptly rectified after the taxpayer becomes aware of the failure, will be considered to be due to reasonable cause.

[74] Treas. Reg. § 301.6724-1(b)(1).

[75] Treas. Reg. § 301.6724-1(d)(1).

Recommendation 19: An exception to Prop. Treas. Reg. § 1.385-2 should be added for EGIs issued in certain ordinary course transactions.

We believe that an EGI that falls within one or more of the categories below should be exempt from Prop. Treas. Reg. § 1.385-2:

a. Any EGI issued by or to a dealer in securities (within the meaning of section 475(c)(1)) in the ordinary course of its business of dealing in securities;

b. Any EGI issued by or to a dealer in commodities (within the meaning of section 475(e)(1)) in the ordinary course of its business of dealing in commodities;

c. Any EGI issued by or to an "eligible controlled foreign corporation" (within the meaning of section 954(h)(2)) in the ordinary course of its banking, financial or similar business; and

d. Any EGI issued by or to a bank[76] in the ordinary course of its banking business (whether or not such business is in the United States).

These exceptions are necessary because the volume of EGIs issued or acquired in the ordinary course of the businesses of dealers, banks, and entities engaged in similar financial businesses means that subjecting such EGIs to the documentation requirements of Prop. Treas. Reg. § 1.385-2 would impose undue burdens on, and significantly impede the functioning of, these businesses. In addition, debt instruments, including EGIs, issued or held in the ordinary course of business by a dealer, bank or other entity engaged in a similar financial business, many of which will typically be short-term in nature (e.g., deposits) would not naturally be likely to be treated as stock under general U.S. federal income tax principles, given the circumstances in which they would be issued or acquired. Finally, given that, as the regulations are currently drafted, a failure to satisfy the documentation requirements in Prop. Treas. Reg. § 1.385-2 generally results in recharacterization of the relevant EGI as stock, application of Prop. Treas. Reg. § 1.385-2 to an EGI issued or acquired in the ordinary course of business could have catastrophic consequences for dealers, banks, and entities engaged in similar financial businesses because of the volume and magnitude of EGIs issued or acquired by such entities in the ordinary course of business. Accordingly, we believe these requested exceptions are necessary and appropriate.

[76] The term "bank" would be defined in the same manner as such terms are defined in Recommendation 5 above.

Recommendation 20: Prop. Treas. Reg. § 1.385-2 should not apply to any EGI issued by or to a member of a regulated financial group with a stated term to maturity not exceeding one year.

As discussed in Recommendation 7, short term debt with a stated term to maturity of less than one year that bears interest a rate that is commensurate with the term of the debt is not susceptible to being used as a device to effectively engage in "earnings stripping." This is especially true in the case of EGIs issued by or to members of a regulated financial group, which in many cases are subject to numerous regulatory constraints and considerations, and as such do not implicate the primary concerns on which the Proposed Regulations are focused. Moreover, because regulated financial groups typically issue and acquire very large amounts of EGIs with stated terms of less than one year, for EGs that include regulated financial groups, compliance with Prop. Treas. Reg. § 1.385-2 with respect to such EGIs will be unduly burdensome. Whatever benefit, if any, that may be provided to Treasury by subjecting such EGIs to the documentation requirements in Treas. Reg. § 1.385-2 is outweighed by the corresponding burden borne by regulated financial groups. For these reasons, we strongly recommend that Treasury exempt from Treas. Reg. § 1.385-2 all EGIs with a stated term to maturity of less than one year that are issued by or to members of regulated financial groups.

In addition, we again note that similar considerations apply to short term EGIs issued by or to taxpayers that are not members of regulated financial groups (e.g., in the context of cash pooling arrangements and treasury centers arrangements that are commonly maintained by multinational groups), and we urge Treasury to consider extending the exemption proposed in this recommendation more broadly to include short term EGIs issued by all taxpayers.

Recommendation 21: Prop. Treas. Reg. § 1.385-2 should apply only to applicable instruments that are in form debt instruments, and should not be extended to other instruments that are treated as debt for U.S. tax purposes but are not in form debt instruments (e.g., repo agreements, cash collateral with respect to other contracts, such as securities loans and derivatives contracts, and deemed loans arising out of deferred payment transactions).

Prop. Treas. Reg. § 1.385-2(a)(4)(i)(A) reserves on the inclusion in the definition of "applicable instrument," to which the documentation rules of Prop. Treas. Reg. § 1.385-2 apply, of instruments that are not in form debt. The preamble to the Proposed Regulations requested comments on "other instruments that should be subject to the proposed regulations, including other types of applicable instruments that are not indebtedness in form that should be subject to proposed § 1.385-2 and the documentation requirements that should apply to such applicable

instruments."[77] We believe that Prop. Treas. Reg. § 1.385-2 should apply only to instruments that are in form debt instruments, and should not be extended to other instruments treated as debt for U.S. tax purposes (e.g., repo agreements, cash collateral with respect to other contracts, such as securities loans and derivatives contracts, and deemed loans arising out of deferred payment transactions).

The types of documentation maintained by financial groups with respect to instruments that are in form debt are significantly different from the types of documentation maintained by such groups with respect to other instruments treated as debt for U.S. tax purposes, and varies significantly depending upon the nature of the underlying transactions. There would be very significant uncertainty with respect to the application of the documentation requirements contained in Prop. Treas. Reg. § 1.385-2 to instruments that are not in form debt, and we do not believe that it would be feasible for financial groups or other taxpayers to comply with these requirements with respect to instruments that are not in form debt. Given this fact, and the extreme consequences of failing to comply with these rules with respect to an EGI, we strongly believe that it would be inappropriate to extend the application of Prop. Treas. Reg. § 1.385-2 to instruments that are not in form debt.

In addition, we recommend that Prop. Treas. Reg.§ 1.385-2(a)(4)(i)(A) be amended to clarify that contractual payment obligations that arise in connection with the purchase of property, the receipt of services, transfer pricing arrangements or tax sharing agreements ("**Intercompany Payables**") are not in form debt, and accordingly are not subject to Prop. Treas. Reg. § 1.385-2. An Intercompany Payable is a contractual obligation with respect to the purchase of property, receipt of services, a cost sharing arrangement or tax sharing agreement that is not embodied in an instrument that is separate from the underlying contract and therefore should not be regarded as in form debt. While we are confident that an Intercompany Payable should not be regarded as in form debt, given that many taxpayers will typically have a high volume of Intercompany Payables in any given year and that the consequences of failing to satisfy Prop. Treas. Reg. § 1.385-2 where it is applicable may be very significant, we believe that it is important that the Prop. Treas. Reg. § 1.385-2 explicitly acknowledge this point in order to provide certainty to taxpayers.

[77] 81 Fed. Reg. at 20929 (Apr. 8, 2016).

Recommendation 22: Any changes to existing documentation required to comply with Prop. Treas. Reg. § 1.385-2(b)(2)(i) or (ii) that are required to be approved by a regulator should in no event be required to occur prior to the date when approved by the regulator.

In the case of a regulated financial group, debt instruments to which Prop. Treas. Reg. § 1.385-2 applies will in some cases be governed by existing documentation, changes to which may require approval by a regulator. In those circumstances, any changes to such documentation that are required by Prop. Treas. Reg. § 1.385-2(b)(2)(i) or (ii) may be delayed for reasons that are outside the control of the taxpayer, in which case it would be inappropriate to treat the taxpayer as failing to comply with those requirements. To address this issue, Prop. Treas. Reg. § 1.385-2 should be amended to provide that if changes to documentation that exists at the time the Proposed Regulations are finalized are necessary to comply with the requirements of Prop. Treas. Reg. § 1.385-2(b)(2)(i) or (ii) and regulatory approval is required to make such changes, documentation satisfying such requirements will in no event be required prior to the date when approved by the regulator, provided that the taxpayer makes a good faith effort to cause such changes to be made.

Recommendation 23: An exception should be added to Prop. Treas. Reg. § 1.385-2(b)(2)(iv)(B) for circumstances in which a regulator does not permit a holder of an EGI to enforce its rights as a creditor.

Under Prop. Treas. Reg. § 1.385-2(b)(2)(iv)(B), in the event of a nonpayment of interest or principal that is due and payable, or on the occurrence of any other event of default or similar event, "there must be written documentation . . . evidencing the holder's reasonable exercise of the diligence and judgment of a creditor." The proposed regulation provides that such documentation "may include evidence of the holder's efforts to assert its rights under the terms of the EGI . . . and any documentation detailing the holder's decision to refrain from pursuing any actions to enforce payment."

In the case of a regulated financial group, regulators may require that, either pursuant to the terms of the debt instrument or otherwise, in certain circumstances, members of a regulated financial group who hold debt instruments issued by a bank or other regulated company within the group refrain from exercising their rights as a creditor against the issuer, even if the issuer fails to make a payment on the debt instrument when due or otherwise is in default, or regulators may otherwise prohibit the issuer from repaying the debt. In these circumstances, the requirements of Prop. Treas. Reg. § 1.385-2(b)(2)(iv)(B) would be in conflict with the demands of regulators seeking to reduce the likelihood of bank failure and the resulting impact on the markets and taxpayers of such failure. Where the holder of a debt instrument is prevented from

enforcing its rights under the instrument by a regulator, Prop. Treas. Reg. § 1.385-2(b)(2)(iv)(B) should not apply.

VIII. PROPOSED SAFE HARBOR FOR DEBT INSTRUMENTS ISSUED TO SATISFY REGULATORY CAPITAL OR SIMILAR REGULATORY REQUIREMENTS

Recommendation 24: A debt instrument that contains terms that are required by a regulator in order for the debt instrument to satisfy regulatory capital or similar rules should be treated as indebtedness for all federal income tax purposes, notwithstanding any other tax rules (including regulations under section 385) to the contrary.

SIFMA believes that Treasury should adopt a safe harbor for regulatory capital securities in the form of debt, and other debt securities issued by a member of a regulated financial group that contain terms required by a regulator in order for the debt instrument to satisfy regulatory capital or similar rules (such as internal TLAC debt that, under rules proposed by the Federal Reserve and the FDIC, is required to be issued by certain IHCs of certain FBOs to the direct or indirect foreign parent of such IHCs). The reason this safe harbor is necessary is that, after the financial crisis, both U.S. and non-U.S. regulators have required, or are likely in the future to require, that investors in long-term debt securities of a bank or a bank affiliate share in the risk that the bank or bank affiliate will suffer losses or otherwise fail to satisfy regulatory capital or similar requirements, typically through a requirement that such debt be canceled or converted into equity upon the occurrence of certain conditions and/or the order of the regulator. This requirement raises issues not only with the Proposed Regulations (including, for example, the documentation rules in Prop. Treas. Reg. § 1.385-2), but also with current law on the characterization of instruments as debt or equity for U.S. federal income tax purposes. As a result, we believe that the safe harbor should treat all debt instruments within its scope as indebtedness for all U.S. federal income tax purposes, including under current law and without regard to the application of the Proposed Regulations.

We are aware that the Institute of International Bankers ("**IIB**") has provided or will provide Treasury and the IRS, in its comment letter on the Proposed Regulations (or otherwise), with a detailed proposal for such a safe harbor, and the reasons why such a safe harbor is supported by sound tax and non-tax policy. For the reasons stated by the IIB, we support the proposal of the IIB for Treasury to adopt such a safe harbor.

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We appreciate your consideration of our views and concerns, and we would appreciate the opportunity to discuss further the issues in this submission with you and your colleagues.

Please do not hesitate to contact me at (202) 962-7300 or ppeabody@sifma.org, or our outside counsel Michael Mollerus at Davis Polk & Wardwell LLP. Michael can be reached at (212) 450-4471 or mollerus@dpw.com.

Respectfully submitted,

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Appendix I

OTHER RECOMMENDATIONS WITH RESPECT TO THE PROPOSED REGULATIONS

I. OTHER RECOMMENDATIONS WITH RESPECT TO PROP. TREAS. REG. § 1.385-3

Recommendation 25: The *Per Se* Rule should be eliminated.

If a member of an EG makes a distribution or acquisition described in Prop. Treas. Reg. § 1.385-3(b)(3)(ii) (and to which no exception applies), a debt instrument issued by that EG member to another member of the EG within three years before or after the date of such distribution or acquisition can be automatically treated as having been issued with a "principal purpose" of funding such distribution or acquisition, and therefore treated as stock of the issuing member, under the *Per Se* Rule. This rule applies without regard to the presence or absence of any actual connection between the issuance of the debt instrument and the distribution or acquisition, even if the issuer of the debt instrument can affirmatively prove the absence of any such connection (as would be the case where the issuance of the debt instrument resulted, for example, from the occurrence of a modification of a pre-existing debt instrument that resulted in the deemed issuance of a new debt instrument under section 1001).

We agree with the comments that have been submitted to Treasury and the IRS by other commenters that the *Per Se* Rule will result, in far too many instances, in the inappropriate treatment of debt instruments as stock where the issuance of the debt instrument is not in fact connected to the relevant distribution or acquisition and does not achieve the economic result of a distribution or acquisition involving the direct issuance of a debt instrument to which the General Rule would apply. This is especially true in the context of a global financial group, the business of which depends on the use of intercompany debt funding on a daily basis and in amounts running into the billions of dollars.[1] Accordingly, we believe that the *Per Se* Rule should be eliminated, and a debt instrument should be subject to treatment as stock under the Funding Rule only if, under Prop. Treas. Reg. § 1.385-3(b)(3)(iv)(A), it is issued with a "principal purpose" of funding a distribution or acquisition described in Prop. Treas. Reg. § 1.385-3(b)(3)(ii), or is otherwise subject to treatment as stock under the anti-abuse rule in Prop. Treas. Reg. § 1.385-3(b)(4). In this respect, in the case of a debt instrument issued to refinance another borrowing (including a new debt instrument deemed to have been issued as a result of a

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[1] In this respect, we note that the *Per Se* Rule could apply at the state level to lending transactions and distributions or acquisitions wholly within the consolidated group, if a state did not strictly apply the consolidated group exception in Prop. Treas. Reg. § 1.385-1(e). This would have the effect of extending the onerous consequences of the *Per Se* Rule to such transactions, notwithstanding the fact that the transactions would not be subject to the *Per Se* Rule at the federal level.

debt modification treated as a sale or exchange under section 1001), the debt instrument should be treated as having been issued for the same purpose as the refinanced borrowing, and therefore would be subject to treatment as stock under the Funding Rule only if and to the extent that the original borrowing were treated as stock under the Funding Rule.

Recommendation 26: The Trade or Services Payable Exception in Prop. Treas. Reg. § 1.385-3(b)(3)(iv)(B)(2) should be amended to (x) provide that debt instruments that qualify for the Trade or Services Payable Exception are not subject to the Funding Rule and (y) include within its scope any contractual payment obligation that arises in connection with a transfer pricing arrangement or tax sharing agreement.

The Trade or Services Payable Exception as currently drafted would exempt only the trade or service payables described in that exception from the *Per Se* Rule, but would otherwise leave such payables subject to the Funding Rule. We believe that the Proposed Regulations should be clarified to provide that debt instruments that arise in the ordinary course of the issuer's trade or business in connection with the purchase of property or the receipt of services should not be subject to the Funding Rule (rather than simply not being subject to the *Per Se* Rule).

This clarification is particularly important for financial groups because entities in such groups frequently need to make distributions for commercial and/or regulatory reasons. It is likely that entities making such distributions will periodically incur trade or services payables near in time to making such distributions, at which point it may be difficult to establish that payables were not incurred with a principal purpose of funding the distribution. The proposed clarification described in this recommendation would address this issue.

In addition, we recommend that the Trade or Services Payable Exception be expanded to also include any contractual payment obligation that arises in connection with a transfer pricing arrangement or tax sharing agreement. Such obligations, which again arise in the ordinary course of the issuer's trade or business, are similar to debt instruments already covered by the Trade or Services Payable Exception, and should be covered as well.

Recommendation 27: An exception should be added to the Funding Rule for certain debt instruments issued to a member of an EG that has outstanding indebtedness to persons other than members of the EG.

For commercial efficiency and other reasons, many U.S. and non-U.S. multinational groups use funding structures in which one or more members of the group (such as the parent of the group or one or more finance subsidiaries) fund the entire group's capital needs by issuing debt to unrelated third parties, and then lend the proceeds of that debt on an intercompany basis to other members of the group. This is especially true in the case of regulated financial groups, where, for example, the most efficient form of funding may be deposits collected by an insured

bank, which then funds the financing needs of other members of the group to the extent such funds are in excess of the funding needs of the bank and to the extent allowed under applicable rules and regulations. Similarly, regulatory rules (such as the constraints on "double leverage" and the proposed "internal TLAC" requirements discussed in Part III) may mean that the parent of the group is required to issue long-term debt securities to unrelated third parties, the proceeds of which are in turn transferred to its subsidiaries in the form of intercompany debt. Further, third party lenders would typically lend to rated entities with a significant amount of assets. In each of these circumstances, the existence of the intercompany debt is attributable to the fact that it is not possible or practicable, for commercial or regulatory reasons, to have the member that requires capital to issue external debt itself.

The Funding Rule does not apply to debt that a member of an EG issues to a person that is not a member of the EG ("**non-EG debt**"), unless the non-EG debt is issued with a principal purpose of avoiding the application of Prop. Treas. Reg. § 1.385-3 (or Prop. Treas. Reg. § 1.385-4).[2] This is true even if the non-EG debt issued by the member of the EG is guaranteed by one or other members of the EG. As a result, if instead of issuing debt for property ("**funding debt**") to another member of its EG, a member of an EG were to fund itself solely with non-EG debt, there would be no basis upon with the Funding Rule could apply to treat such non-EG debt as stock (again, absent the application of the anti-abuse rule in Prop. Treas. Reg. § 1.385-3(b)(4)). This creates a powerful incentive for taxpayers to "decentralize" their issuances of non-EG debt, by having each member of the EG issue its own non-EG debt to fund its capital needs, in order to avoid the issuance of funding debt that would otherwise be required in connection with the issuance of non-EG debt by another member of the group for the purpose of funding the group's capital needs.

As noted in Part III, however, there are generally commercial reasons, and in the case of regulated financial groups, often regulatory reasons, why it is inefficient or impossible to decentralize the issuance of non-EG debt in this way. While we acknowledge Treasury's concerns about the fungibility of money and its apparent view that a regime which would attempt to "trace" the sources and uses of funds is unadministrable, we nonetheless believe that it is appropriate to include an exception to the Funding Rule for funding debt issued by one or more members of the EG that is held by another member of the EG (the "**funding EG member**") to the extent that such other member of the EG has non-EG debt outstanding (or funding debt that itself qualifies for the exception). Specifically, we would propose that Prop. Treas. Reg. § 1.385-3(b)(3) should apply to funding debt issued by one or more members of the EG that is held by the funding EG member only to the extent that, on any date on which such funding debt is outstanding, (i) the aggregate amount of all such funding debt held by the funding EG member (based on adjusted issue price) exceeds (ii) the aggregate amount of the sum of (x) non-EG debt issued by the funding EG member and (y) funding debt issued by the funding EG member that

[2] Prop. Treas. Reg. § 1.385-3(b)(4).

qualifies for this exception (in each case, based on adjusted issue price) that in each case is outstanding on such date. Any funding debt that ceases to qualify for this exception will be treated as issued for purposes of Prop. Treas. Reg. § 1.385-3(b)(3) only when and to the extent such excess exists. For simplicity, we would suggest that, where the funding EG member holds more than one funding debt, in the event that such an excess exists, the exception apply to such funding debt in the order in which it was acquired, such that the funding debt treated as issued whenever and to the extent such excess exists would be the most recently acquired funding debt.

The application of this exception can be illustrated by the following example:[3]

> Example: At all times during Year 1, FP has $100x of non-EG debt (based on adjusted issue price) outstanding. During Year 1, FP loans $50x to USS1 and $50x to USS2, and at all times during Year 1 the adjusted issue price of each loan does not exceed $50x. Neither the USS1 loan nor the USS2 loan may be treated as a principal purpose debt instrument under Prop. Treas. Reg. § 1.385-3(b)(3)(ii) at any time during Year 1 because at no time during Year 1 does (i) the aggregate amount of non-EG debt (based on adjusted issue price) issued by FP and outstanding during Year 1 exceed (ii) the aggregate amount (based on adjusted issue price) of the USS1 loan and the USS2 loan held by FP.

Under this proposal, as a consequence of the decision not to base the exception on a "tracing" methodology, neither the maturity date, interest rate or other terms of the non-EG debt, nor the maturity date, interest rate or other terms of any of the funding debt are relevant to the application of the exception. We recognize that this could mean, for example, that the funding debt covered by the exception may have, for example, a longer term and therefore a higher interest rate than the non-EG debt issued by the funding EG member. We do not think that this is inappropriate or otherwise a basis for rejecting this proposal. Members of an EG that issue funding debt are likely to be engaged in functional activities, and accordingly have financial profiles, funding needs, and capital structures that differ not only from other members of the group but also from the group as a whole, and therefore justify differences between the terms of the funding debt issued by the member of the EG and the terms of the non-EG debt issued by the funding member. In fact, applying the external funding rate automatically to internal funding (essentially treating the external funding entity as a "conduit") would violate the arm's length standard under section 482, which would require that the lending entity take into account the tenor of the assets and specific financial capability of the borrower. This is especially true in the case of a regulated financial group, where, for example, financial intermediation involves borrowing capital in the form of short-term non-EG debt in the form of bank deposits, and lending capital in the form of longer-term, less liquid loans (such as residential or commercial mortgage loans) to customers. Section 163(j) and general principles of tax law on the

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[3] This example assumes the same facts as in Prop. Treas. Reg. § 1.385-3(g)(1).

characterization of instruments as debt or equity would still apply to police any perceived abuses associated with the differences in the terms of funding debt that qualifies for this exception.

Recommendation 28: The exception in Prop. Treas. Reg. § 1.385-3(c)(1) for current year earnings and profits should be expanded (x) to include accumulated earnings and profits and previously taxed income, and (y) to permit distributions by a parent to the extent attributable to distributions received in the same year from a subsidiary that fall within the scope of Prop. Treas. Reg. § 1.385-3(c)(1), without regard to the parent's earnings and profits or previously taxed income.

We believe the exception in Prop. Treas. Reg. § 1.385-3(c)(1) should be expanded to include accumulated earnings and profits and previously taxed income. Thus, for purposes of applying Prop. Treas. Reg. § 1.385-3(b) to a member of an EG with respect to a taxable year, the aggregate amount of any distributions or acquisitions that are described in the section should be reduced by an amount equal to the sum of (A) the member's current year earnings and profits for such taxable year described in section 316(a)(2), (B) the member's accumulated earnings and profits described in section 316(a)(1) as of the beginning of the such taxable year and (C) to the extent not attributable to amounts described in (A) and (B), the amount of the member's previously taxed earnings and profits described in section 959 ("**PTI**").

This change is particularly important to financial groups because, as a commercial matter, financial groups must from time to time redeploy funding on a long term basis as the profitability and funding needs and sources for entities within the group change over time, which may necessitate distributions in excess of the current year earnings and profits in any given year. In addition, a member's current year earnings and profits, as determined under U.S. federal income tax principles, will often not reflect changes in its actual capital and liquidity position (and thus its ability to actually make distributions) because of various non-cash items included in the computation of earnings and profits, some of which may be quite significant in the context of financial companies (for example, in the case of securities dealers, as a result of applying the mark-to-market method of accounting mandated by section 475). Moreover, entities in financial groups may be restricted by regulators from making distributions of current year earnings and profits in any given year, such that in certain cases the exception in Prop. Treas. Reg. § 1.385-3(c)(1) as written does not adequately address ordinary distributions of excess capital. The proposed change would address these issues. We acknowledge that in some cases this change would cause the exception to apply to distributions in excess of what might be viewed as the amount distributed in the "ordinary course" by a particular entity. However, such an exception is necessary to address the commercial needs of financial groups and the comprehensive regulatory environment in which they operate.

In addition, Prop. Treas. Reg. § 1.385-3(c)(1) should be expanded to permit distributions by a member of an EG to the extent they are attributable to distributions received in the same year from a subsidiary EG member that fall within the scope of Prop. Treas. Reg. § 1.385-3(c)(1),

without regard to the parent EG member's earnings and profits or PTI. An appropriate ordering rule should also be added to ensure that this modification does not have duplicative effects. This modification to Prop. Treas. Reg. § 1.385-3(c)(1) is a simplifying rule that would permit an amount that is distributed in a distribution that falls within the scope of Prop. Treas. Reg. § 1.385-3(c)(1) to be distributed through chains of subsidiaries without requiring retesting under Prop. Treas. Reg. § 1.385-3(c)(1) at each corporate level. We believe this is consistent with the policy underlying Prop. Treas. Reg. § 1.385-3(c)(1) – in the context of a distribution up a chain of members, once it is established that the initial distribution by an EG member is of a type that falls within the scope of Prop. Treas. Reg. § 1.385-3(c)(1) and thus is considered to be an "ordinary course" distribution, whether an intermediate EG member has, for example, a deficit in current earnings and profits, should not affect the ability of that intermediate EG member to make a further distribution of the amounts received in the initial distribution in the same year – such further distribution should retain the same "ordinary course" characterization as the initial distribution. This modification is also particularly important for regulated financial groups because, as a result of regulatory and commercial constraints, there may be significant limitations on the ability of a regulated financial group to delay a distribution through a chain of members in order to ensure that, when tested at an intermediate company, the distribution falls within the scope of Prop. Treas. Reg. § 1.385-3(c)(1).

In making this recommendation and the recommendations below relating to Prop. Treas. Reg. § 1.385-3(c)(1), we want to emphasize that, while we believe that these recommendations are necessary to address some of the deficiencies associated with Prop. Treas. Reg. § 1.385-3(c)(1) for regulated financial groups and other taxpayers, they are not by themselves in any way sufficient to address the unique issues of regulated financial groups – in other words, even if Treasury were to accept all of our recommendations with respect to Prop. Treas. Reg. § 1.385-3(c)(1), the Funding Rule as currently proposed would remain deeply problematic for regulated financial groups.

Recommendation 29: For purposes of applying the exception in Prop. Treas. Reg. § 1.385-3(c)(1) with respect to current year earnings and profits, an acquisition or distribution occurring no later than one year following the close of the taxable year to which such earnings and profits relate should, at the election of applicable EG member, be treated as occurring in the taxable year to which such earnings and profits relate.

Prop. Treas. Reg. § 1.385-3(c)(1) provides an exception that, for purposes of the Funding Rule, reduces the amount of distributions or acquisitions by a member of an EG in a taxable year by an amount equal to the member's current year earnings and profits. Because the amount of current year earnings and profits in many cases is not known until after the close of the taxable year (most typically, not until the taxpayer files its tax return for the taxable year), and in certain cases there are regulatory or legal constraints on making distributions of current year earnings

and profits before the close of the taxable year, taxpayers often would be unable to rely upon the exception in Prop. Treas. Reg. § 1.385-3(c)(1) as currently drafted.

To address these issues, we believe that the exception should be changed such that for purposes of applying the exception in Prop. Treas. Reg. § 1.385-3(c)(1) with respect to current year earnings and profits, an acquisition or distribution occurring no later than one year following the close of the taxable year to which such earnings and profits relate should, at the election of applicable EG member, be treated as occurring in the taxable year to which such earnings and profits relate.

This proposed change is modeled after sections 855(a) and 858(a), which very generally permit a regulated investment company or real estate investment trust, respectively, to elect to treat dividends declared and paid after the close of a taxable year as having been paid during such taxable year provided certain requirements are satisfied.

Recommendation 30: For purposes of applying the exception in Prop. Treas. Reg. § 1.385-3(c)(1), the current year earnings and profits reflected on a timely filed tax return for the applicable taxable year should be conclusively treated as the current year earnings and profits for such year, and any adjustments to current year earnings and profits for such year that arise out of an audit adjustment or amended tax return should not be taken into account.

The preamble to the Proposed Regulations states that "[t]he exception . . . for distributions and acquisitions that do not exceed current year earnings and profits [in Prop. Treas. Reg. § 1.385-3(c)(1)] would accommodate many ordinary course distributions and acquisitions, providing significant flexibility to avoid the application of [the] per se rule. The Treasury Department and the IRS have determined that this exception . . . appropriately balance[s] between preventing tax-motivated transactions among members of an expanded group and accommodating many ordinary course transactions."[4] A taxpayer that intends to rely on this exception will necessarily be required to rely upon its good-faith determination of the relevant EG member's current year earnings and profits for the relevant taxable year, which determination must be made, under the current form of the Proposed Regulations, during that taxable year or, if our Recommendation 29 is implemented, within one year after the end of the taxable year. In either case, if the purpose of the exception is to accommodate "ordinary course" transactions, and whether a transaction is in the "ordinary course" depends on a timely good-faith determination of an EG member's current year earnings and profits, it is both unfair and inconsistent with the concept of "ordinary course" to permit later events which can affect the amount of current year earnings and profits – such as an audit adjustment or the filing of an amended tax return – to cause a distribution or acquisition (or portion thereof) by that EG

[4] 81 Fed. Reg. at 20924 (Apr. 8, 2016).

member that was previously not taken into account for purpose of the Funding Rule to be taken into account, and potentially cause a debt instrument issued by the EG member to be treated as stock. We therefore recommend that, for purposes of the exception in Prop. Treas. Reg. § 1.385-3(c)(1), an EG member's current year earnings and profits for any taxable year should be deemed to be equal to the amount of current year earnings and profits of the EG member as determined by the EG member in good faith within one year after the end of the taxable year. For most taxpayers, we would expect that a good faith determination of the amount of an EG member's current year earnings and profits for any taxable year would be based on a timely-filed tax or information return filed with respect to such EG member for such year.

Recommendation 31: For purposes of applying Prop. Treas. Reg. § 1.385-3(b) to a member of an EG with respect to a taxable year, the aggregate amount of any distributions or acquisitions that are described in that section should be reduced by the aggregate amount of money and the fair market value of any property contributed to that member in transactions governed by section 1032 the Code in that year.

We believe that for purposes of applying Prop. Treas. Reg. § 1.385-3(b) to a member of an EG with respect to a taxable year, the aggregate amount of any distributions or acquisitions that are described in the section should be reduced by the aggregate amount of money and the fair market value of any property contributed to that member in transactions governed by section 1032 in that year.

This exception is appropriate because distributions and acquisitions made by a member of an EG during the year do not have the effect of reducing the member's equity to the extent they do not exceed the equity contributions that are made to such member during the same year. And, to the extent that distributions and acquisitions do not have the effect of reducing a member's equity for a given year, we do not believe the policies concerns underlying Prop. Treas. Reg. § 1.385-3(b) are implicated.

Recommendation 32: If one or more members of an EG are acquired and become members of another EG, distributions and acquisitions by the acquired members that occurred prior to becoming members of the acquiring EG should not be taken into account for purposes of applying the Funding Rule with respect to the acquiring EG.

We believe that if one or more members of an EG (the "**first EG**") are acquired and become members of another EG (the "**acquiring EG**"), distributions and acquisitions by the acquired members that occurred prior to becoming members of the acquiring EG should not be taken into account for purposes of applying the Funding Rule with respect to the acquiring EG.

This exception is necessary in order to mitigate the disruptive effects the Proposed Regulations would have on ordinary public and private mergers and acquisitions. In particular, in

the absence of this exception, it would become critically important to know the history of distributions and acquisitions by the acquired members that occurred prior to their acquisition, which would impose very substantial costs from a due diligence perspective on the acquirer. Furthermore, in certain cases there may not be sufficient records to ascertain the complete history of any distributions or acquisition that may be relevant to the Funding Rule (e.g., in the case of an acquisition of non-U.S. companies that were not CFCs for U.S. federal income tax purposes, the Funding Rule may not have been relevant to the acquired companies prior to their acquisition, and accordingly, they may not have maintained a history of all acquisitions and distributions for purposes of ensuring that the *Per Se* Rule is not applied). In the absence of the proposed exception, the Funding Rule could have significantly adverse consequences for mergers and acquisitions involving EGs with U.S. members. Finally, in situations in which the distribution of property was made to (or the property transferred in connection with an acquisition described in Prop. Treas. Reg. § 1.385-3(b)(3)(ii)(B) or (C) was received by) a member of the first EG that is not itself acquired by the acquiring EG, the transfer of such property would necessarily have independent non-tax significance, given that such property was received by a person that was not a member of the acquiring EG.

II. OTHER RECOMMENDATIONS WITH RESPECT TO PROP. TREAS. REG. § 1.385-2

Recommendation 33: A safe harbor should be added to Prop. Treas. Reg. § 1.385-2(b)(2)(i) and Prop. Treas. Reg. § 1.385-2(b)(2)(ii) providing that with respect to any EGI, the documentation requirements of those sections will be satisfied by documentation that is comparable to documentation used by the issuer of the EGI for comparable transactions with unrelated third parties.

The preamble to the Proposed Regulations indicates that the Proposed Regulations are "intended to impose discipline on related parties by requiring timely documentation and financial analysis that is similar to the documentation and analysis created when indebtedness is issued to third parties."[5] However, in certain cases the documentation that is contemplated in Prop. Treas. Reg. § 1.385-2(b)(2)(i) and Prop. Treas. Reg. § 1.385-2(b)(2)(ii) is not consistent with and is more extensive than the documentation that is actually used with respect to debt instruments issued by entities within a financial group to third parties. In such cases, as drafted, the proposed regulation would impose significant additional compliance burdens on financial groups without furthering the policy underlying these rules. The addition of the safe harbor proposed in this recommendation would address this issue and would be consistent with the stated intent of the Proposed Regulations.

[5] 81 Fed. Reg. at 20915 (Apr. 8, 2016).

Recommendation 34: For purposes of Prop. Treas. Reg. § 1.385-2(b)(2)(iii), documentation demonstrating the issuer's ability to refinance the principal amount of an EGI with a third party may be considered in establishing that the issuer's financial position supported a reasonable expectation that the issuer intended to, and would be able to, meet its obligations pursuant to the terms of the EGI.

We believe that Prop. Treas. Reg. § 1.385-2(b)(2)(iii) should be amended to clarify that documentation demonstrating the issuer's ability to refinance the principal amount of an EGI with a third party may be considered in establishing the issuer's ability to meet its obligations pursuant to the terms of the EGI.

Such documentation would be relevant to a third party lender, and presumably would affect the other types of documentation that a third party lender would require to establish the issuer's ability to meets its obligations under the EGI. As such, the proposed clarification is appropriate and consistent with the purpose of the Proposed Regulations to imposed discipline on related parties by requiring documentation that is similar to what would be required by a third party lender.

Recommendation 35: For purposes of Prop. Treas. Reg. § 1.385-2(b)(2)(iv)(A), the creation of (or addition to) an intercompany payable from the issuer to the holder pursuant to a book entry should be treated as a payment of interest or principal with respect to an EGI, and a book entry evidencing the creation of (or addition to) such intercompany payable should satisfy the requirement that there exist written evidence of such payment.

Under Prop. Treas. Reg. § 1.385-2(b)(2)(iv)(A), "[i]f an issuer makes any payment of interest or principal with respect to an EGI . . ., and such payment is claimed to support the treatment of the EGI as indebtedness under general tax principles, documentation must include written evidence of such payment" that is prepared by the time the payment is due. The provision adds that "[s]uch evidence could include, for example, a wire transfer record or bank statement reflecting the payment."

Most corporate groups use centralized cash management systems in conjunction with systems in which payables and receivables within the group are recorded, adjusted and settled through the use of intercompany book entries. For example, a trade and service receivable that is created by the provision of goods or services by one member of the group to another member is not settled through a separate wire transfer from the bank account of the payee to the payor, but through book entries on an intercompany ledger. More often than not, the relevant book entries may not even be made between those two members, but between each of those two members and the parent of the group (or sub-group), or a treasury center within the group (with one book entry recording an amount payable by the parent or other member acting as a "treasury center" to the member providing the goods or services, and a separate book entry recording any amount

receivable by the parent or treasury center from the member that received the goods or services). Indeed, many members of the group may not even have separate bank accounts (with all cash receipts and transfers being handled by the treasury center on behalf of the relevant members, and recorded again through book entries reflecting the creation of (or addition to) an intercompany payable or receivable from the relevant member that corresponds to the cash receipt or transfer), and so would be incapable of making a wire transfer or actual payment to another member. Where cash does move between members of the group, it is typically done through a daily or other periodic cash "sweep" of all cash held by a member to the treasury center, again with a corresponding book entry reflecting the creation of (or addition to) an intercompany payable from the treasury center to the member (or a reduction in an outstanding intercompany payable by the member to the treasury center).

Like any other payable or receivable that arises between members of the group, interest (and principal) that becomes due and payable on an intercompany loan (including outstanding intercompany balances under the system described in the preceding paragraph) would not be settled through a separately identifiable transfer of cash, but through book entries in the intercompany ledger. Such amounts are no different than other trade and service payables and receivables that arise in the ordinary course of the group's business, and there is no reason why they should be treated any differently, including through a separately-documented payment. (We acknowledge that the effect of such book entries is to increase the total amount of EGI, in the form of an intercompany payable, that the borrowing member may have outstanding, as compared to if it actually paid the interest or principal in cash. However, Prop. Treas. Reg. § 1.385-2(b)(2)(iii) will require the maintenance of documentation that establishes a reasonable expectation that the borrowing member intends to, and will be able to, meet its obligations under this EGI, taking the increase in the amount of the intercompany payable and any other indebtedness that the borrowing member has outstanding into account.) For these reasons, we believe that, for purposes of Prop. Treas. Reg. § 1.385-2(b)(2)(iv)(A), the creation of (or addition to) an intercompany payable from the issuer to the holder pursuant to a book entry should be treated as a payment of interest or principal with respect to an EGI, and a book entry evidencing the creation of (or addition to) such intercompany payable should satisfy the requirement that there exist written evidence of such payment.[6]

[6] This exception is intended to apply solely for purposes of Prop. Treas. Reg. § 1.385-2 and is not intended to override other rules relating to when interest is paid or deductible (e.g., section 267).

Recommendation 36: Prop. Treas. Reg. § 1.385-2(c)(5) should be amended to provide that if a disregarded entity is the issuer of an EGI, and that EGI is treated as equity under § 1.385-2, the EGI is treated as stock in the entity's owner rather than an equity interest in the entity.

The Proposed Regulations are inconsistent in their treatment of debt issued by disregarded entities that is treated as stock. Under Prop. Treas. Reg. § 1.385-3(d)(6), if such debt is treated as stock pursuant to Prop. Treas. Reg. § 1.385-3, it is treated as stock in the owner of the disregarded entity. The preamble to the Proposed Regulations indicates that this is appropriate in part because it addresses policy concerns that are similar to those that Treasury sought to address in Prop. Treas. Reg. § 1.385-3(d)(5)(ii), under which debt issued by a partnership that is treated as stock pursuant to Prop. Treas. Reg. § 1.385-3 is treated as stock in the EG partners in the partnership.[7] Specifically, the preamble to the Proposed Regulations explains that this treatment of debt issued by a partnership is necessary because "if a debt instrument issued by a controlled partnership were to be recharacterized as equity in the controlled partnership, the resulting equity could give rise to guaranteed payments that may be deductible or gross income allocations to partners that would reduce the taxable income of the other partners that did not receive such allocations."[8]

By contrast, if debt issued by a disregarded entity is treated as stock pursuant to Prop. Treas. Reg. § 1.385-2, it is treated as an equity interest in the disregarded entity under Prop. Treas. Reg. § 1.385-2(c)(6). The preamble to the Proposed Regulations does not explain the rationale for this treatment, and we do not believe it is appropriate. We believe the same policy concerns identified by Treasury as a basis for the rule in Prop. Treas. Reg. § 1.385-3(d)(6) are implicated where debt issued by a disregarded entity is treated as stock pursuant to Prop. Treas. Reg. § 1.385-2. Moreover, under certain circumstances there could be significantly adverse collateral consequences of treating such debt as an equity interest in the disregarded entity, such as unintended deconsolidation.[9] There is no apparent policy justification for these

[7] *Id.* at 20927.

[8] *Id.*

[9] When a disregarded entity has two or more members, it is treated as a partnership under Treas. Reg. §301.7701-3(b), unless it elects to be treated as a corporation. Because a partnership is not an includible corporation under section 1504(b), it cannot be a member in a consolidated group under Treas. Reg. §1.1502-1, and corporations whose stock is held by the partnership will not be a member of the same consolidated group as a corporation that holds interests in the partnership (unless the requisite amount of stock in the corporations whose stock is held by the partnership is held by another shareholder that is an includible corporation with respect to the consolidated group whose members hold interests in the partnership).

consequences.[10] For these reasons, we believe Prop. Treas. Reg. § 1.385-2(c)(5) should be amended to provide that if a disregarded entity is the issuer of an EGI and that EGI is treated as equity under Prop. Treas. Reg. § 1.385-2, the EGI is treated as stock in the entity's owner rather than an equity interest in the entity.

III. OTHER RECOMMENDATIONS

Recommendation 37: Prop. Treas. Reg. § 1.385-3 should be amended to eliminate the possibility of "cascading" recharacterizations of intercompany debt as equity.

As discussed above in Part II of the letter, the Proposed Regulations would result in many cases in "cascading" recharacterizations of intercompany debt as equity, essentially multiplying the effects of any single recharacterization under Prop. Treas. Reg. § 1.385-3 or Prop. Treas. Reg. § 1.385-2. Because of the great volume and magnitude of intercompany debt transactions between members of financial groups, financial groups are uniquely susceptible to "cascading" recharacterizations of intercompany debt, and for this reason this aspect of the Proposed Regulations is extremely problematic for financial groups. We urge Treasury to amend Prop. Treas. Reg. § 1.385-3 to eliminate the possibility of "cascading" recharacterization of intercompany debt as equity.

The New York State Bar Association has recommended that this issue be addressed by revising Prop. Treas. Reg. § 1.385-3 to state that, when an intragroup debt instrument is recast as equity, the deemed issuance of that equity, and any transfer or (actual or deemed) redemption of that equity, will not be treated as a distribution or acquisition described in Prop. Treas. Reg. § 1.385-3(b).[11] We generally agree with this recommendation, except that we believe it should be broadened in two respects. First, we believe that this recommendation should be broadened to apply the recharacterization of a debt instrument as equity under Prop. Treas. Reg. § 1.385-2 as well as under Prop. Treas. Reg. § 1.385-3. A "cascading" recharacterization of intercompany debt can be triggered by the application of either of these proposed regulations, and in each case such a "cascading" recharacterization is both unwarranted and can have potentially draconian consequences. Second, the exclusion for distributions on debt instruments that are recharacterized as equity under Prop. Treas. Reg. § 1.385-2 or Prop. Treas. Reg. § 1.385-3 should apply to any payment on the rechararacterized debt instrument that is treated as a distribution (and not merely distributions in redemption). Even "interest" payments that are

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[10] Treating debt of a disregarded entity as an equity interest in the entity, rather than in the owner of the entity, could have a variety of state tax consequences as well, including possibly diluting stock ownership in some members below the 50-80% thresholds used among various states for determining filing groups for state tax purposes. This could, among other things, create non-conformity problems in mergers and acquisition transactions, subsidiary liquidations, distributions (including ineligibility for state dividends received deductions) and internal reorganizations.

[11] NYSBA Comment Letter at 161.

treated as distributions on the recast debt have the ability (albeit more slowly, because of the smaller amounts involved relative to the amount of the redemption payment at maturity) to result in "cascading" recharacterizations of other intercompany debt. Debt that is recharacterized as equity under Prop. Treas. Reg. § 1.385-2 or Prop. Treas. Reg. § 1.385-3 should, in its entirety, not be the basis for further recharacterizations of other intercompany debt.[12]

Recommendation 38: Prop. Treas. Reg. § 1.385-1(b)(3)(ii) should be modified such that, for purposes of the determining the members of an EG, the attribution of stock from a partner to a partnership should be subject to the same limitations that apply with respect to attribution of stock from a shareholder to a corporation.

As Prop. Treas. Reg. § 1.385-1(b)(3)(ii) is currently drafted, where a partnership is a member of an EG, the attribution rules of section 318(a)(3)(A) can apply to cause stock that is owned (or treated as owned) by a partner that holds any interest in a partnership, regardless of the size of the interest, to be treated as owned by the partnership. By contrast, where a shareholder owns stock in a corporation (the "**first corporation**"), stock in another corporation (the "**second corporation**") owned (or treated as owned) by such shareholder would not be treated as owned by the first corporation unless the shareholder owns at least 5% of the first corporation (because of the limitations in section 318(a)(3)(C), as modified by section 304(c)(3)(B)).[13] There does not appear to be a basis in policy for treating partnerships and corporations differently in this context, and we strongly recommend that Treasury modify Prop. Treas. Reg. § 1.385-1(b)(3)(ii) to eliminate this disparity.[14] This issue is of particular concern to financial groups, as otherwise unrelated financial groups often own interests (often quite small) in partnership joint ventures. Unless the "downwards" partnership attribution rule is fixed as

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[12] Our expression of general agreement with respect to this particular recommendation in the NYSBA Comment Letter should not be viewed as implying disagreement with other recommendations included in that comment letter.

[13] In general, under section 318(a)(3)(C) as modified by section 304(c)(3)(B), if a shareholder owns less than 5% of the value of the stock of the first corporation, stock in the second corporation that is owned by that shareholder is not treated as owned by the first corporation. If the shareholder owns between 5% and 50% of the first corporation, stock in the second corporation that is owned by that shareholder is treated as owned by the first corporation in the same proportion as the value of the stock of the first corporation owned by the shareholder bears to the value of all of the stock of the first corporation. Only if the shareholder owns 50% of more in value of the stock of the first corporation is all of the stock of the second corporation that is owned by the shareholder attributed to and treated as owned by the first corporation.

[14] For this purpose, we recommend that the ownership threshold that is used for purposes of determining the extent of attribution from a partner to a partnership be based on the partner's percentage interest in both the capital *and* profits of the partnership (as opposed to either capital *or* profits).

suggested in the preceding sentence, it is possible that the ownership of all of the stock of one or more of the corporate members of otherwise unrelated financial groups could be attributed to a partnership in which each of the groups owns only a small interest, which in turn could result in such corporations being treated as members of a single EG by reason of the common ownership of all of the stock of such corporations by the partnership after attribution.[15]

> **Recommendation 39: Prop. Treas. Reg. § 1.385-2 and Prop. Treas. Reg. § 1.385-3 should be modified so as to eliminate the inappropriately punitive results with respect to the application of section 902 to distributions on indebtedness that is treated as stock under the Proposed Regulations.**

In many cases, indebtedness that is treated as stock under Prop. Treas. Reg. § 1.385-2 and Prop. Treas. Reg. § 1.385-3 will not have any voting rights, and will therefore be treated as nonvoting stock for U.S. federal income tax purposes. When payments of interest and principal are made on the recharacterized indebtedness, such payments will usually be treated as dividends (under sections 301 and 302(d)) to the extent of the issuer's current or accumulated earnings and profits, but, because the indebtedness is treated as nonvoting stock, unless the holder otherwise owns 10% or more of the voting stock of the issuer, the holder will not be entitled to claim any foreign tax credits in respect of taxes paid by the issuer under section 902(a) (or, if the holder is a foreign corporation, will not be entitled to include any taxes paid by the issuer in the holder's tax pool under section 902(b)(1)). In these circumstances, the foreign taxes allocable to such dividends will be permanently lost.

This result is far afield from the earnings-stripping and other concerns articulated by Treasury in the preamble as the reasons for the promulgation of the Proposed Regulations, and the permanent loss of foreign tax credits (and the double taxation of foreign earnings that will result) serves none of the purposes of the Proposed Regulations. In most cases, intercompany debt that is treated as stock under the Proposed Regulations would qualify as "nonqualified preferred stock" ("**NQPS**"). Relying on the broad regulatory authority granted under section 351(g)(4) to prescribe rules on the treatment of NQPS,[16] we recommend that Treasury eliminate this inappropriately punitive result by providing that, solely for purposes of section 902, indebtedness that is treated as NQPS under Prop. Treas. Reg. § 1.385-2 and Prop. Treas. Reg. §

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[15] We note that the NYSBA Comment Letter recommends that, for purposes of the Proposed Regulations, the threshold for "downward attribution" under section 318(a)(3) be increased to 80%. *See* NYSBA Comment Letter at 41-43. We support this recommendation and emphasize that any change in such threshold should apply equivalently for "downward attribution" to partnerships and corporations.

[16] Section 351(g)(4) provides that "[t]he Secretary may prescribe such regulations as may be necessary or appropriate to carry out the purposes of this subsection and sections 354(a)(2)(C), 355(a)(3)(D), and 356(e). The Secretary may also prescribe regulations, consistent with the treatment under this subsection and such sections, for the treatment of nonqualified preferred stock under other provisions of this title."

1.385-3 be treated as stock possessing 10% of the voting power of the issuer, but, for the avoidance of doubt, will not be taken into account in determining the voting power of any other stock, including indebtedness that is treated as stock under Prop. Treas. Reg. § 1.385-2 and Prop. Treas. Reg. § 1.385-3, of the issuer. The "avoidance of doubt" clause in the preceding sentence is needed in order to avoid any adverse effects of the exception on the voting power of any outstanding stock of the issuer – it would make no sense to "solve" the section 902 problem with respect to indebtedness treated as NQPS under the Proposed Regulations if it would adversely affect the application of section 902 to dividends paid on other stock of the issuer – and to address the fact that, because of the "cascading" effect of the Proposed Regulations, there may be multiple members of the EG holding debt instruments issued by an EG member that are treated as NQPS under the Proposed Regulations.

Recommendation 40: Prop. Treas. Reg. § 1.385-2 and Prop. Treas. Reg. § 1.385-3 should not apply with respect to any debt issued, or any distribution or acquisition described in Prop. Treas. Reg. § 1.385-3(b) that is completed by a non-U.S. corporation, in each case at a time when the non-U.S. corporation is not required to file a U.S. tax return and is not a CFC, where the transaction (i) is entered into with an EG member that is also not at that time a U.S. corporation, a CFC or a non-U.S. corporation required to file a U.S. tax return and (ii) is not otherwise entered into with a view to reducing U.S. tax liability by avoiding application of the Proposed Regulations.[17]

Where the first EG is composed entirely of non-U.S. corporations that are not CFCs and are not required to file U.S. tax returns (because, e.g., none of the corporations has a U.S. branch or effectively-connected income), the first EG generally would not have any reason to ensure compliance with the rules under Prop. Treas. Reg. § 1.385-2 or Prop. Treas. Reg. § 1.385-3 with respect to any debt instrument or transactions between the non-U.S. members of the EG. (Indeed, if the EG is composed of solely non-U.S. corporations, the EG would generally not have any reason to care about, or even be aware of, U.S. tax law generally or Prop. Treas. Reg. § 1.385-2 or Prop. Treas. Reg. § 1.385-3 specifically.) Under these circumstances, an acquisition of one or more members of the first EG by any member of an acquiring for which the Proposed Regulations are relevant could be problematic. In particular, in this context it would be difficult to determine whether the requirements of Prop. Treas. Reg. § 1.385-2 have been satisfied with respect to any intercompany debt instrument issued prior to the acquisition, whether any debt instruments have been recharacterized under Prop. Treas. Reg. § 1.385-3, or whether any transactions that could potentially result in recharacterization under Treas. Reg. § 1.385-3 of intercompany debt issued after the acquisition have been entered into prior to the acquisition. There does not appear be a policy basis for Treasury to give effect to the Proposed Regulations

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[17] This recommendation, along with several other related recommendations, has been made by the New York State Bar Association. *See* NYSBA Comment Letter at 168-170.

with respect to debt issued and transactions entered into prior to the acquisition because characterization of the debt for U.S. tax purposes would be without consequence for first EG, and in such circumstances, where it is unreasonable to expect compliance with the Proposed Regulations by the first EG, it would be unduly harsh for an acquiring EG to be saddled with the consequences of such non-compliance by the first EG.