Bryan Zumwalt
VICE PRESIDENT
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July 7, 2016

The Honorable Jacob Lew
Secretary of the Treasury
U. S. Department of the Treasury
1500 Pennsylvania Avenue, N.W.
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Mr. Robert Stack
Deputy Assistant Secretary
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The Honorable John Koskinen
Commissioner
Internal Revenue Service
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Mr. William J. Wilkins
Chief Counsel
Internal Revenue Service
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Re: REG-108060-15 Proposed Section 385 Regulations
Submitted electronically with the Federal eRulemaking Portal at
www.regulations.gov (IRS REG-108060-15)

Dear Sirs:

The American Chemical Counsel ("ACC") is pleased to enclose comments on the recently proposed regulations under section 385. ACC represents the leading companies engaged in the business of chemistry. ACC members apply the science of chemistry to make innovative products and services. The business of chemistry is an $812 billion enterprise and a key element in the nation's economy. It is the nation's largest exporter, and the membership involves both U.S.-owned and foreign-owned chemical companies. Plentiful and affordable domestic supplies of natural gas have led to massive new investment in U.S.-based chemistry and plastics production. As of this month, 267 projects valued at $163 billion have recently been completed, or are under construction or in the planning phase. Fully 62% of this is foreign direct investment. These new factories and capacity expansions could create $105 billion in new annual chemical industry output and 738,000 permanent new jobs throughout the U.S. economy by 2023. As a result, our members are interested in the proposed section 385 regulations and the impact that they may have on their business operations.

Our membership greatly appreciates the opportunity to comment on these proposed regulations. If you have any questions with respect to these comments or wish to discuss these further, please call me at (202) 249-6200.

Sincerely,

Bryan Zumwalt
Vice President
Federal Affairs

The following comments are offered by the American Chemistry Council ("ACC") with respect to the proposed Treasury Regulations under section 385 of the Internal Revenue Code of 1986, as amended, published in the Federal Register on April 8, 2016.

Introduction

On April 4, 2016, the Department of the Treasury and the Internal Revenue Service (Treasury/IRS) released to the public proposed regulations (REG-108060) under section 385. In very basic terms, the proposed regulations would do the following:

- Authorize the Commissioner of the Internal Revenue Service to treat certain related party interests in a corporation as indebtedness in part and stock in part for federal income tax purposes;
- Establish requirements for the preparation and maintenance of extensive documentation as a necessary condition for certain related party debt instruments to be treated as indebtedness for federal income tax purposes; and,
- Treat as stock certain related party interests that otherwise would be treated as indebtedness for federal income tax purposes.

Although the impetus for the proposed regulations was to address inversions and other perceived tax-motivated earnings stripping transactions, the extension of the rules in their proposed form to all large corporate groups with a United States nexus would result in an unacceptable and immediate impact on normal business transactions entered into by members of ACC in both the domestic and international contexts. The potential consequences of the proposed regulations to non-tax motivated intercompany financial transactions would be severe enough to virtually cripple the mechanisms by which day-to-day business operations and new business investments are currently funded. Additional documentation requirements that would apply to essentially all intercompany financial transactions conducted throughout the global operations of our member companies would add substantial transaction costs without providing any incremental benefit.

The regulations would impose unwarranted restrictions on the financial policies of our members and interfere with the management of the capital structure of member entities. These are not trivial matters. Moreover, the breadth of transactions and operating entities to which the proposed regulations would apply, in addition to the cascading "ownership" changes and other collateral effects that the rules could set in motion, leave open to question whether it would be possible, in practical terms, to implement the regulations. These are among the reasons that ACC respectfully requests that the Treasury/IRS withdraw the proposed regulations.

If, despite these serious concerns, the Treasury/IRS move to issue final regulations, a decision with which ACC would strongly disagree, major changes would be needed to mitigate the harmful effects and make the regulations workable for the chemical industry. At a minimum, changes would be needed to allow members to continue key internal treasury practices and other routine lending practices that are essential to the financial management of a large corporate group, to accommodate other business concerns expressed herein, and to provide a new effective date to implement the proposals as revised. If final regulations are put into effect, it is imperative that that they reflect clear policy judgments and that they be grounded in sound tax principles. The Treasury/IRS must find ways to address our policy concerns without discouraging or unnecessarily intruding on the legitimate business practices of the companies that have invested heavily in the economy of the United States.

The chemical industry has been a vital source of investment in the manufacturing sector of the United States, particularly with the growth of shale gas production and lower costs for fuel and feedstock. To date, the chemical industry has announced over 260 new projects to be constructed in the United States, amounting to $164 billion in new capital investment, more than 60 percent of which is direct foreign investment. These investments are expected to create 426,000 permanent new jobs in the chemical industry and its direct suppliers, as well as an additional 312,000 jobs in communities where workers spend their wages. By 2023, these new projects are projected to produce $301 billion in new economic output and $22 billion in new federal, state, and local tax revenues. The chemical industry is important to the United States, and the United States has become an attractive destination for new manufacturing capacity to serve the domestic market.

These new investments will all require funding. To carry out these investment projects, the member companies of ACC will need to rely on their internal treasury functions to ensure a timely, reliable, and efficient flow of funds. Especially because of our members' concerns that the proposed regulations would impede their internal treasury functions, ACC appreciates the opportunity to present its views on the proposed regulations and to provide an overview of the workings of our members' internal treasury functions and how the proposed regulations would affect them.

Our comments in this letter are divided into three parts. Part I discusses some preliminary authority issues with regard to the proposed regulations. Part II describes the financing environment for large, affiliated groups with global operations and the general impact of the proposed regulations on the internal treasury functions of an affiliated chemical group. Part III explains certain specific issues raised by the proposed regulations and offers our recommendations.

Executive Summary

Because of concerns regarding the authority of the Treasury/IRS to issue the proposed regulations, because the proposed regulations would impede key internal treasury functions and subject corporate funding networks to unacceptable risks, and because the breadth of the regulations would make their implementation impractical, ACC respectfully requests the Treasury/IRS to withdraw the proposed regulations to avoid undue harm to the U.S. chemical industry and other businesses that contribute so much to the economy of the United States.

There are numerous conceptual flaws and negative implications with the proposed regulations, including:

- The Treasury/IRS do not have the necessary authority to issue the proposed regulations under section 385; section 385 does not authorize the promulgation of "per se" anti-abuse rules targeted at perceived earnings stripping among a select group of corporate taxpayers.
- The proposed regulations would unnecessarily disrupt companies' treasury functions and dividend policies by linking loans and dividend distributions and other transactions through various "per se" rules even though such transactions are not related and serve real business purposes.
- The proposed regulations would cripple the internal networks that ensure adequate funds are supplied where needed to support day-to-day, global business operations and investments in a reliable cost efficient, timely, and risk-controlled manner.
- The proposed regulations would impose an unwarranted 72 month "waiting period" for issuing debt that would prevent companies from accessing group funds when needed to meet unexpected expenses and to respond quickly to emergencies, changes in the business environment, or new opportunities.
- The proposed regulations would give rise to situations in which even one, inadvertent transaction could trigger the "per se" funding rule to set in motion a cascading series of recharacterizations of intercompany debt, which in turn would trigger a series of severe collateral tax consequences, such as taxing the repayment of principal on a loan as if it were income to the lender.
- The proposed regulations will impose unnecessary and overly burdensome documentation requirements at significant costs by including unrealistic requirements and time limits and imposing "per se" equity treatment for failure to satisfy any of these requirements.
- The proposed regulations would apply to too many inconsequential high-volume transactions to make implementation workable or to permit taxpayers to effectively control against missteps.
- The proposed regulations seek to apply U.S. tax law and standards in jurisdictions not subject to U.S. tax authority.
- The proposed regulations conflict with many U.S. treaty provisions, thereby subjecting U.S. taxpayers to double taxation.

- The proposed regulations represent a unilateral action inconsistent with the BEPS recommendations of the OECD, and will act as roadblocks for multi-national affiliated groups attempting to align their intercompany debt to comply with BEPS-oriented tax measures enacted by other OECD members.
- The proposed regulations do not correspond to their stated purposes; the use of "excessive indebtedness" to reduce U.S. tax liability is cited as the policy concern they were intended to address, but the evidence from reports by the Treasury Department have concluded that debt levels were excessive only within a limited group of taxpayers—U.S. companies that had engaged in inversion transactions; further, despite the intent to address such excessive indebtedness and associated interest deductions, the anti-abuse measures would apply without regard to the level of indebtedness of the taxpayer and without regard to whether the debt instrument bore sufficient interest to materially affect the U.S. tax liability of the debtor; and, despite the intent to target debt that was not associated with an increase in the assets of the debtor, they would apply to many transactions that do increase the debtor's assets and to debt instruments issued for the specific purpose of financing the purchase or construction of an asset.

If the Treasury/IRS move to finalize the regulations, then we believe the following recommendations should be incorporated, at a minimum, to reduce interference with legitimate business functions and ordinary business transactions, and to ease the administrative burdens and costs required to comply with the proposed regulations. Additional details regarding these recommendations can be found in Part III of this letter.

- Provide exceptions to address concerns raised with cash pooling;
- Provide an exemption for debt issuances that have little or no bearing on Treasury's concern that intercompany debt could be used to generate "excessive" interest deductions against U.S. taxable income (short-term debt and low-interest rate loans);
- Change the proposed regulations such that a documentation failure is not a fatal flaw;
- Provide a mechanism for companies to overcome an inadvertent documentation violation;
- Make the documentation requirements better suited to corporate practice and business needs;
- Permit acquisitions and restructuring of ownership of affiliates for business purposes;
- Protect intercompany debt issued for valid business purposes from being recast by permitting tracing principles or some other method to exempt debt that can be traced to business use of cash by the borrower;
- Provide a metric that would give greater flexibility and certainty than would be provided by the exception for distribution of current earnings and profits;
- Limit the cascading effect of the rules;
- Prevent the loss of deemed paid foreign tax credits due to payment on a debt recast as equity;
- Limit the collateral fallout from artificial ownership percentages; and,
- Provide a realistic effective date that will allow companies adequate time to prepare for and implement policy and system changes needed to comply with the regulations.

Part I. Preliminary Authority Issue

As an initial matter, ACC believes the proposed regulations are not within the scope of authority delegated to the Treasury Department by Congress in section 385. Section 385(a) authorizes the Treasury/IRS "to prescribe such regulations as may be necessary or appropriate to determine whether an interest in a corporation is to be treated for purposes of this title as stock or indebtedness (or as in part stock and in part indebtedness)." Section 385(b), however, provides that regulations must set forth factors for purposes of analyzing and determining whether an interest is to be characterized as debt or equity for U.S. tax purposes, and includes several factors which the Treasury/IRS may consider in promulgating regulations. The clear implication from the statute is that Congress intended that regulations would apply to all interests in corporations and would provide uniform standards for determining whether such interests are properly viewed as debt or equity for federal income tax purposes. The proposed regulations do not consider any of the facts and circumstances factors enumerated in section 385(b) and instead provide certain “per se” rules that focus on leverage interjected into a corporate group in a way that the Treasury/IRS consider tax avoidance – *i.e.*, where debt that is otherwise classified as debt under the case law is created in a related party corporate transaction without a corresponding increase in cash or other property that would generate additional income.[1] The focus, therefore, is on perceived tax avoidance through earnings stripping within related corporate groups, not whether the terms of an instrument cause it to be classified as debt or equity to the holder and issuer or whether the debt is arm’s length and meets commercial standards.[2] Indeed, under the proposed regulations, a note distributed by a corporation with no current earnings and profits (“E&P”) to its wholly-owned corporate shareholder would be treated as equity even though its terms were in all respects identical to those of a note issued to a major bank by the same related party issuer. The tax avoidance focus of the regulations is confirmed by rules that specifically prohibit taxpayers from using the “per se” equity treatment affirmatively to produce a federal income tax benefit.

In apparent anticipation of the authority concerns that these regulations raise, the Preamble cites to the legislative history to support that the regulations need not rely on the factors listed in section 385(b). That legislative history, however, does not justify presenting no factors at all and instead using section 385 as an anti-abuse rule to address perceived tax

[1] As a policy matter, ACC also believes that it is debatable whether the tax law should put limits on a corporate group’s ability to recapitalize its operations with additional debt when a company has grown organically even if no new capital is interjected into the corporate group. The import of this policy would be that corporate groups would not be permitted to recapitalize their operations even where they could borrow from an unrelated bank and make distributions to achieve the same result. We note that the Preamble to the proposed regulations provides no meaningful discussion as to why limiting the ability of corporations to recapitalize their businesses with debt when the recapitalization does not result in an increase in new capital is an appropriate tax policy, particularly in light of the significant problems that enforcing such a rule imposes on ordinary business transactions, as illustrated by these proposed regulations.

[2] As explained by the Supreme Court in *Chevron U.S.A. Inc. v. Nat. Res. Def. Council, Inc.*, 467 U.S. 837, 844 (1984), even a legislative regulation must be a reasonable means of achieving the objectives committed to the agency’s care by the statute.

avoidance earnings stripping transactions within a select group of taxpayers – *i.e.*, highly related corporate groups. The Preamble further asserts as justification for the proposals that a debt instrument issued between highly related corporations "lacks meaningful non-tax significance." Yet, as discussed below, it is precisely because of the essential role that intercompany debt plays in the financial management of a large corporate group that ACC member companies are so profoundly disturbed by these proposed rules. Further, it is well established that taxpayers—even related taxpayers—may choose whether to use debt or equity to finance their business, even if one reason for using debt is to obtain an interest deduction. (*Cf.* H.R. Rep. No. 111-443, at 296 (2010) "section 7701(o) does not apply to alter the tax treatment of "certain basic business transactions . . . merely because the choice between meaningful economic alternatives is largely or entirely based on comparative tax advantages, including *the choice between capitalizing a business enterprise with debt or equity*."). Moreover, the proposed rules do not treat all related party corporate debt as equity or focus on the presence or absence of such significance as would be the case if the lack of meaningful non-tax significance were actually a factor. Instead, the proposed regulations treat only certain related party debt that is perceived as tax avoidance as "per se" equity without regard to the terms, company debt levels, or the reality of the transactions.[3]

In light of the authority issue that the regulations raise by using section 385 for a purpose for which it was not intended, the serious issues these proposed regulations present for normal business transactions (as discussed in more detail below), and the difficulty in revising the regulations to make them work properly for normal business transactions, ACC recommends that Treasury/IRS withdraw the proposed regulations.

If the Treasury/IRS, however, continue to pursue finalizing these proposed regulations, significant changes are needed in the substantive rules and in the effective dates to make these rules workable for the chemical industry.

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[3] In the recent case of *Altera Corp. v. Commissioner*, 145 T.C. No. 3, at 23 (2015), (quoting *Motor Vehicle Mfrs. Ass'n of United States, Inc. v. State Farm Mut. Auto. Ins. Co*., 463 U.S. 29, 43 (1983)), the Tax Court invalidated a Treasury regulation on the basis that "(1) by failing to engage in any fact finding, Treasury failed to 'examine the relevant data,' and (2) Treasury failed to support its belief that unrelated parties would" transact in the manner prescribed by the regulations. The Treasury/IRS have cited no evidence or empirical study that large corporate taxpayers as a whole have created intercompany indebtedness as a means of generating "excessive indebtedness" in the United States, which the Preamble states as a justification for these regulations. Indeed, the last Treasury study conducted in 2007, based on 2004 data, did not find evidence that foreign controlled domestic companies were reducing U.S. taxable income with interest disproportionately to U.S. owned domestic companies, although it did recognize evidence of this in the specific case of inverted corporations. *See* "Report to the Congress on Earnings Stripping, Transfer Pricing and U.S." November 2007 at www.treasury.gov/resource-center/tax-policy/Documents/Report-Earnings-Stripping-Transfer-Pricing-2007. An analysis of more recent data does not indicate any change. *See, e.g.*, Scott Hodges's analysis at www.taxfoundation.org/blog/irs-data-contradicts-kleinbard-s-warnings-earnings-stripping-inversions. Accordingly, the proposed regulations may be susceptible to challenge under this line of authority as well.

Part II. The Impact of the Proposed Regulations on Internal Treasury Functions

ACC members are deeply concerned that the proposed regulations would thwart key internal treasury functions of their companies that are grounded in established principles of corporate finance and designed to promote and maintain the financial health of the corporation. Although tax and other transaction costs are taken into account, core treasury policies are driven by *treasury* goals – (i) to develop and administer efficient procedures to ensure funds are available as needed for day-to-day operations and for new investments and business projects in accordance with board-directed strategies; (ii) to implement effective internal controls that safeguard company assets; (iii) to meet regulatory standards including those designed to prevent misappropriation, money laundering, or illegal use of funds; (iv) to ensure that subsidiary dividends are compliant with restrictions on capital and distributions under local law and that the amount of the dividends is sufficient to the parent's strategic requirements and to pay expected dividends to external shareholders; (v) to manage foreign currency exchange matters; and, (vi) to manage the capital structure of the company, including the balance of its debt and equity, in ways that secure solvency, limit financial risks and optimize the cost of capital. In a large corporate group, centralized management coordinates the finances of the group subsidiaries to ensure implementation of coherent treasury policies and controls throughout the group.

The proposed regulations would directly affect these internal treasury functions. They would interfere with dividend policies, impede management of the company's capital structure, impose arbitrary documentation requirements on debt, and subject intercompany debt and payables to unacceptable uncertainties posed by their possible recharacterization as stock, resulting in inappropriate and severe collateral consequences, in addition to the loss of interest deductions. Further, the proposed regulations appear to regard debt and equity within the context of an affiliated group as indistinguishable but for their tax consequences. Distinctions between debt and equity within the affiliated group are neither arbitrary nor meaningless, and it is primarily their non-tax consequences that determine the role they play in the financing of a large corporate group.

Understanding the impact of the proposed regulations on global affiliated groups requires an understanding of how internal treasury functions ensure the funding of the group's global operations and the importance of intercompany lending in supporting business operations and investment.

A. Funding the Global Operations of a Large Corporate Group

Despite the Preamble's assertion that it "lacks meaningful non-tax significance," intercompany debt is a key component of the financial management of a large corporate group. Intercompany debt provides the most reliable, efficient channel for supplying the funds provided by external debt financing and by internal operations throughout the group.

1. The Role of External Debt Financing

It is axiomatic to business finance that holders of debt require a lower return than the risk-adjusted returns demanded by equity holders, and further, that this provides a cost advantage to debt financing apart from the tax deductibility of interest. Businesses leverage their operations with managed levels of external debt because it is less costly and more flexible than equity capital. The amount of debt can be increased or decreased quickly in response to changing business and financial conditions and the company's needs. Debt reduces the corporation's weighted average cost of capital. Because debt provides external shareholders the opportunity—albeit at increased risk—for enhanced returns on their equity investment, businesses use managed levels of external debt to provide the prospect of more attractive returns to shareholders. The use of an appropriate level of external debt is a competitive necessity.

External debt financing of a large corporate group is generally centralized within the parent. The parent can access more extensive credit markets, commercial paper and corporate bonds in ways unavailable to its subsidiaries, the parent can capitalize on the volume of group transactions in order to achieve economies of scale, and the parent can manage maturities of debt issuances in order to reduce risk. Further, financing at the parent level takes into account the value of the group as a whole, the entire range of group assets and the diversity of the group's mix of business activities, markets, and regional operations so that the parent is viewed as being more creditworthy than its separate subsidiaries. For example, a parent may merit an A rating, while its individual subsidiaries might merit, on average, a B or BB rating. The difference in interest rates between those applied to a parent and those that might apply to a subsidiary obtaining its own external financing might be 475 to 500 basis points. The parent can access broader credit markets and obtain financing at far lower interest rates than would its subsidiaries pursuing external financing on their own.

Although external group financing is obtained and managed centrally, it must be disseminated among the subsidiaries where needed to maintain operations and carry out approved investments in plant, property, and development of the business. Arm's length principles dictate that affiliates bear their own costs of financing and, conversely, be compensated for use of their surplus funds by the group. An appropriate mix of debt and equity financing at the subsidiary level is considered by treasury in order to achieve financial ratios that are within financially sound, industry norms and to match cash flow at the subsidiary level with the debt that the subsidiary incurs to fund investment and operating costs. It is through intercompany debt that the funds obtained externally and associated borrowing costs are distributed where needed within the group. This function of intercompany debt has far more than insignificant non-tax benefits. It is how affiliates access funds procured by the parent from a broad range of external sources, such as commercial paper and bonds, otherwise unavailable to the subsidiary.

2. Internal Sources of Cash

The external debt capacity of the group is limited. Creditors are unwilling to provide debt financing above certain levels or would do so only at an unacceptably high cost. Debt must be kept within levels appropriate to the risk profile and expectations of governing boards and external shareholders. Accordingly, internal business operations are an important, low-cost source of funds that support business investment without increasing the overall debt exposure of the group.

The chemical industry is subject to perennial business cycles. The timing of these business cycles differs by region and by product market so that subsidiaries located in different regions and with different product portfolios may provide cash surpluses during one period, but have cash deficiencies in another. Further, more mature subsidiaries operating in more stable environments tend to generate more reliable cash flow than their younger siblings operating in developing markets. Moving and redeploying cash surpluses generated by affiliates where needed in the group are critical internal treasury functions. What might otherwise be idle cash is quickly and efficiently reinvested in business operations. Intercompany debt is the vehicle by which this is accomplished. This function of intercompany debt, too, has considerable non-tax significance to the group. It is how day-to-day business operations throughout the globe are funded.

3. Jurisdictional and Governance Restrictions on Dividends and Capital

Dividend distributions also move funds throughout the group, but in a far more limited, costly manner. The distribution of dividends is highly restricted both by corporate governance and by local law. Most foreign jurisdictions allow dividends to be paid only from accounting profits and many require certain minimum legal reserves. Specific requirements on how profits are measured, how prior year losses are taken into account, and the amount and type of required reserves vary by jurisdiction. Restricting dividend payments to jurisdictional limits is often enforced by criminal sanctions against corporate officers and by holding them personally liable for repayment of the excess distributions. Withholding taxes and legal and accounting fees procedures for shareholder approval add transaction costs to each dividend payment. Further, dividends are payable only to shareholders, not to upper-tier entities or brother-sister corporations. Each step up the ownership chain must meet the relevant legal restrictions and will add transaction costs. Using dividends distributions to move funds to the affiliate needing them could be blocked altogether if even one step in the ownership chain fails to meet the relevant restrictions.

Further, dividend distributions cannot move cash quickly, making them unsuitable to meet rapidly changing business and financial conditions. The timing of dividend distributions is highly restricted in most foreign jurisdictions, many of which prohibit payment of any interim dividends (*i.e.*, those declared outside the annual meeting). Where permitted, they are subject to further restrictions and typically would require preparation of audited interim financial statements. According to the estimates of one of our members, the additional accounting fees for each interim audit for each entity in the ownership chain, which would vary depending on the size of the entity and relative complexity of the jurisdictional restrictions, would range from $10,000 to up to $480,000 for major operational entities in restrictive localities such as Switzerland, China, Brazil, and Hong Kong.

Thus legal restrictions and transaction costs make dividend distributions ill-suited for moving surplus cash throughout the group, but dividends are primarily intended as the means to distribute earnings to shareholders. Jurisdictional restrictions placed on dividends are generally directed toward ensuring that dividends are paid from earnings, without drawing down capital or capital reserves. Dividends provide the shareholding entities a return on their investment, and, importantly, the income needed to pay dividends upstream.

The correlative of the jurisdictional limitations on payment of dividends is the virtual prohibition against recovery of capital contributions before the liquidation of the corporation. Reflecting their characterization under law, internal governance provisions of large corporate groups generally consider and treat capital contributions as permanent financial investments in a subsidiary. Capital contributions and reductions in capital are undertaken only after extensive review and with formal Board-level approval. In certain jurisdictions, a lengthy governmental approval process is required in order to increase the capital of a subsidiary. This makes capital contributions wholly unsuitable as a means for moving funds to finance operations throughout the group. Further, affiliates making their temporary cash surpluses available to the group do not intend and have no reason to permanently capitalize the affiliate who happens to need funding at the time. *Affiliates lend money to the group, because like third party lenders, they expect to be repaid.* Similarly, treasury centers within the group provide intercompany loans to affiliates to meet their business needs at the time—to provide timely funding apart from and beyond the approved level of permanent capital investment; they do not provide funds intended to increase the permanent investment commitment.

4. Conclusion: The Importance of Intercompany Debt

Intercompany debt is often the only effective means of ensuring adequate and timely funding of the group’s global operations. Capital contributions are highly inflexible infusions that become a permanent part of an affiliate’s structure. Dividend distributions must travel up the ownership chain, are associated with high transaction costs, and are subject to severe legal restrictions on the amount and timing of distributions. Further, using dividends for general funding purposes would detract from their vital, primary function—moving earnings up the ownership chain to support the payment of dividends to external shareholders. In contrast, intercompany debt instruments are flexible, can move funds virtually across the globe, and can be adapted quickly to accommodate changing financial conditions, fluctuating liquidity needs, and the funding of special projects. It is through intercompany debt that proceeds from external debt and internally generated cash surpluses are channeled where needed. Intercompany debt provides the funding lifeline to the group.

B. Impact of the Proposed Regulations on Group Funding Practices

In the opinion of ACC members, the proposed regulations would impose restrictions on the internal flow of funds and introduce substantial uncertainty into internal funding mechanisms, thereby jeopardizing the efficient funding of global business operations. Of particular concern is the impact that the proposed regulations would have on the use of intercompany debt. As explained, intercompany debt is the key means of providing reliable funds for group operations and investments. It is how external debt and internal cash surpluses are deployed where needed. It is the only vehicle for moving group funds quickly and efficiently.

The proposed regulations would subject intercompany debt to possible re-characterization as stock for tax purposes because of a failure to meet arbitrary documentation requirements that exceed requirements under current law and do not reflect the documentation and analysis typically needed for business purposes. Alternatively, intercompany debt might be treated as stock for tax purposes because a "per se" funding rule would arbitrarily link the debt to certain corporate distributions, acquisitions of affiliate stock or business reorganizations that happened to occur within 3 years before or 3 years after the debt was issued. The result would be that the debt, even though incurred for a specific, unrelated purpose, would be deemed to have been issued for the principal purpose of funding the distribution or acquisition and would thereby be recast as stock.

1. Severity and Inappropriateness of Collateral Consequences

The consequences of debt being recast as stock for tax purposes would be substantial. In addition to loss of interest deductions, a host of seemingly haphazard collateral consequences would stem from the basic approach taken by the proposed regulations to determine whether debt instruments should be treated as stock for tax purposes. Instead of looking to the "particular factual situation" to determine "whether a debtor-creditor relationship exists or a corporation-shareholder relationship exists" (as directed by section 385), the proposed regulations distinguish debt from stock on the basis of mechanical rules and extraneous factors which render irrelevant the factual situation prompting the debt issuance, the nature of the instrument, and the relationship of the parties. As a result, parties that have the legal and economic rights of a creditor—but no equity rights—could arbitrarily be treated for tax purposes as if they were equity holders. [4]

[4] Only bona fide debt instruments would be recast as stock under the proposed regulations. Under the framework of the proposed regulations, any purported debt instrument which was not debt in substance would be characterized as equity under current common law and principles developed under case law, without application of the proposed rules. Bona fide debt instruments that were not supported by required documentation or issued in a distribution would be recharacterized under the proposed rules. Other bona fide debt instruments might be treated as such when issued, but could be recast later on the occurrence of an unrelated distribution or acquisition within the 36 months after debt issuance, even though the terms of the debt and the relationship of the parties had remained unchanged, and even though the purpose for which the debt was issued and for which its proceeds were used had remained unchanged. For example, an intercompany debt may be treated under the proposed rules as a valid debt when issued

The problem with formulating tax rules that are not grounded in the reality of transactions, which treat transactions as if they were something else, is that collateral tax treatments will be wholly inappropriate. By disregarding the substance of the transaction, the proposed regulations undermine the integrity of the Code and all its provisions that have been purposefully fashioned to provide tax treatment appropriate to the degree of economic and legal control that one entity has—or does not have—over another entity.

For example, section 351 codifies a basic tenet of our tax system that permits a tax-free incorporation of a business and tax-free contributions to the capital of a corporation by its controlling shareholder. However, under the proposed regulations, intercompany debt issued by a wholly owned corporation to another member could be recast as stock, perhaps because a piece of documentation had been deemed insufficient by a tax auditor, or because of an error in calculating or estimating earnings and profits, or because an audit adjustment or the decision of competent authority resulted in a deemed distribution that exceeded current year earnings and profits. Under such circumstances, the proposed rules would create a new, artificial class of stock deemed to be held by the creditor. It would not matter that the debt was clearly debt, that the new "class of stock" did not exist, or that the creditor clearly had the rights of a creditor but no equity rights and that the sole shareholder was clearly the only shareholder. The shareholder would no longer have the requisite control under section 351 to make tax-free contributions to its wholly owned subsidiary. By recasting the debt as stock, the proposed regulations would frustrate the purpose of section 351 and many other provisions that turn on the existence of ownership in the form of stock.

Similarly, the repayment of what is legally and economically valid debt, and which would be treated as the repayment of debt under current tax law would be treated instead as a section 302(d) distribution, with the result that repayment of the debt would be taxed as dividend income to the creditor. Whether or not it would constitute sound tax policy, Congress can limit the deductibility of expenses, like interest expense, under certain conditions, or provide for a different treatment of income, like interest income, depending on the conditions under which it arises. But it is beyond the authority of the income tax law, and certainly beyond the regulatory authority of the Treasury/IRS, to tax what is not income, but a return of principal. That the tax regulations would treat valid debt as if it were stock does not change the substance of the debt. Indeed the proposed regulations make no assertion that such recharacterized debt *is* or would *become* stock, simply that it will be "treated as stock" for purposes of U.S. income tax law. It is still debt; the lender still has the rights of a creditor, not an equity holder, and the issuer still has the obligation of a debtor to repay the loan. Such a repayment of principal is not income to the creditor under tax principles or under any economic or accounting standard. If no economic

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and up until a time, within the following 36 months, that a distribution or acquisition described in §1.385-3(b)(3) occurred. At that time, the debt would be recast as stock despite its characteristics remaining unchanged. *See* Example 6. Similarly, an intercompany debt that is valid debt would be treated as such as long as the $50 million threshold described in § 1.385-3(c)(2) had not been met, but would be treated as stock beginning on the date that the threshold had been exceeded. *See* Example 17.

income is realized from a transaction, the tax regulations cannot pretend that income was realized and tax the fictitious income so created. Tax law cannot deem income into existence.

The loss of the deductibility of the debtor's interest expense and the application of different withholding rates to the interest income of the creditor would be direct results of the recharacterization of the debt. These consequences were clearly intended and are the only ones that could have any bearing on the stated target of the proposed regulations—the deduction of interest expense from "excess indebtedness" for purposes of reducing U.S. income tax liability. However, the re-characterization of valid debt would do more than change the tax treatment of the interest. As noted above, it would result also in the creation of artificial ownership interests that would serve to dilute the actual ownership interests. And because of the pervasiveness of Code provisions that apply different tax treatments tailored to the degree of control over an entity, the list of potential consequences from the recharacterization of a debt instrument is long. In itself, the economic cost of taxing repayment of loan proceeds under section 302(d) would be staggering. Other consequences are discussed later in this letter, but a sampling follows here: reorganizations that would be tax-free under section 368 and stock acquisitions that would fall under section 304 based on *actual* share ownership would become taxable exchanges; payment of interest and repayment of debt proceeds would result in the transfer of foreign taxes paid from the tax pool of the entity eligible to credit such taxes against U.S. tax to an entity that did not hold the requisite ownership interest, with the result that foreign tax credits would be lost permanently; consolidated groups could be deconsolidated; controlling shareholders might lose eligibility for the favorable Treaty rates that corresponded to their actual ownership interest; hedges could be disassociated from the hedged loan. These collateral consequences would impose steep and unwarranted tax burdens on the implicated transactions. None of these consequences would serve the stated purpose of the proposed regulations, but they all would prevent application of the particular tax treatment to the specific factual conditions and ownership relationships they were intended to address, and would misapply tax treatments intended to address conditions and ownership relationships that would be absent from the situations at hand. Accordingly, these collateral consequences are not only severe but unwarranted and wholly inappropriate to the substance of the underlying transactions and relationships; they would undermine the intended purpose of many provisions of the Code.

2. Breadth of Proposed Rules Would Make It Difficult to Avoid Recharacterization

Given the severity of the consequences, companies would want to avoid the risk of an intercompany loan or payable being recharacterized. Because of the breadth of transactions to which they would apply, this would be difficult at best. First of all, the funding rule would apply to all members of the expanded affiliated group—there are no exceptions based on the residence of an affiliate or the jurisdictions in which it conducts business. The documentation requirements would apply to any intercompany loan that is relevant for U.S. tax purposes. However, because of the cascading effect from the recharacterization of intercompany debt that is arranged through a finance affiliate or treasury center, any intercompany loan that is connected to the funding network of the treasury center (or of another treasury center to which the first treasury center is connected) could be relevant for U.S. tax purposes. The number of foreign affiliates of ACC members may range from 40 to well over 400 operating in anywhere from two to six dozen foreign jurisdictions. One member company reported having about 400 intercompany loans outstanding at any given time, not counting payables from daily cash pooling and intercompany business transactions. A larger member company reported that over 400 new intercompany loans (again, not including cash pooling or intercompany business payables) are issued each year. Trying to ensure that supporting documentation is maintained for each debt instrument, and that the documentation maintained outside the United States would meet U.S. tax standards would be a monumental task, especially in regions that do not have business and legal norms comparable to those in the United States. Contracts, agreements and documentation written in other regions of the world would not typically reflect the same level of specificity used in U.S. business. Further, affiliates outside the United States are not subject to U.S. tax law, but will be concerned with the tax and legal requirements within their own jurisdiction. In the case of a U.S. subsidiary of a foreign-owned group, it is not at all clear how, or if, the U.S. subsidiary could explain the U.S. requirements to affiliates in other countries, must less require the affiliates to comply, or for the U.S. subsidiary to even know whether they have complied.

Second, the exceptions from the documentation rules and the funding rules are very limited. There is no exception applicable to a large corporate group for *de minimis* transactions or for low- or no-interest intercompany loans or payables. The "ordinary course exception," which applies to the "per se" funding rule, is limited to payables for certain expenses that would be currently deductible under section 162 or for costs currently included in the cost of goods sold or inventory. ACC companies may have thousands of intercompany transactions per year with cumulative amounts in the billions. Including in-house banking for third party payables and receivables would entail tens or hundreds of thousands of transactions per year. Because the ordinary course exception does not apply to the documentation requirements, the full volume of intercompany payables would be subject to the documentation rules. Intercompany payables for the purchase of raw materials, an inventory cost, might be excluded from the funding rule, but not payables for rents and royalties or for engineering services that would be capitalized as plant construction costs, or for research services, or for interest. Since intercompany payables are generally netted on a global basis without distinguishing the types of transaction giving rise to the payables, it would be exceedingly difficult to isolate payables that were, from those that were not, subject to the funding rule. Given the huge volume of intercompany payables, it would be virtually impossible to know if they each had satisfied the documentation requirements, and if undocumented payables implicated as funding sources for a distribution or acquisition described in § 1.385-3(b)(3) could be identified, it would be impossible to track them and the deemed ownership changes that might result from recharacterization.

3. The Purpose of A Debt Instrument or the Use of Debt Proceeds Would Not Protect Against Recharacterization

Further, it would not matter if it could be clearly demonstrated that an intercompany loan or payable had been incurred in order to provide funds to acquire or construct business assets or to meet operating expenses. Under the proposed regulations, the actual use of the funds or the reason the debt had been issued would not protect the debt from being recharacterized under either the funding rule or the documentation requirements; neither would the substance of the debt or the existence of a debtor-creditor relationship.

4. Time Constraints Placed on Dividends and Debt Issuance Would Impede Investments and a Business's Ability to Respond to Unexpected Changes

What would matter is whether a corporate distribution or acquisition had occurred within the same 6-year period in which an intercompany debt instrument had been issued or renewed. To avoid such an occurrence, no affiliates anywhere in the world[5] could be permitted to pay a dividend if the affiliate had a loan outstanding that had been issued in the past 36 months, even if the affiliate repaid such loan during the year of the distribution, and no affiliate could pay a dividend if within the following 36 months, the affiliate *might* need to issue a note, or renew or modify an existing note. Further, no affiliate could issue, renew, or modify a note if that affiliate had paid a dividend in the prior 36 months, and an affiliate that did issue, renew, or modify a note would be precluded from paying dividends within the following 36 months.

Such prohibitions, if followed, might provide some protection from the recharacterization of intercompany debt and payables under the funding rule, but at what cost? These are serious restrictions that would severely impede group dividend policies and the funding of new investment projects. The payment of dividends from accumulated earnings to shareholders is a legitimate corporate activity, one in line with what is arguably the main purpose of an incorporated business – to provide a return to shareholders on their equity investment. Simply because the dividend is paid from a subsidiary to a parent corporation does not lessen its importance. Similarly issuing debt to fund business operations, expansions, construction or purchase of new business assets or upgrading existing assets, or business acquisitions is a legitimate business activity. That the two events happen to take place within the same 6-year period does not transform these legitimate activities into tax avoidance schemes. Our members do not believe it is abusive for an entity to distribute a dividend and then, a year or two later, for the same entity to embark on building a new plant financed by intercompany debt.

The funding rules of the proposed regulations would effectively prohibit the funding of new investments within 36 months after payment of a dividend, thereby discouraging new investments in the United States for an unduly lengthy period. This prohibition would exacerbate the planning challenges already faced by the chemical industry. Planning for and constructing a new chemical plant is a major undertaking that literally takes years. Before the project can even be assessed for approval, market projections, anticipated revenues, future raw material prices and other manufacturing costs must all be forecasted over at least a 10-year period, in addition to the cost of constructing the plant. Between the time such projections are evaluated and the time that the plant and infrastructure are designed and then constructed, the safety and operational procedures developed, the technology tweaked, the production processes

[5] Intercompany debt that was issued and held by members of a U.S. consolidated return group, however, are excepted from the scope of the rules and thus would not be impacted if dividends were paid.

started up and tested, and the time that saleable product is first manufactured, the economic, financial and political environments will all have been changing, sometimes rapidly. Oil and natural gas prices may rise and fall dramatically; a regional market may be growing exponentially one year and stagnate or decline the next. Political upheaval, changing public attitudes, even the weather all require nimble responses. New investment opportunities may arise, but only for those companies that can act quickly enough. The chemical industry must manage long-term strategies and respond quickly to current, changing conditions. What all this means is that a 72 month waiting period to obtain needed funding would have a devastating effect on the ability of the chemical industry to respond to and thrive in a rapidly changing environment.

5. Exception for Distributions of Current E&P Is Too Limited

The exception from the funding rule for distributions of current year earnings and profits provides little flexibility. As it would permit the distribution of only one year's earnings at a time, the requirement does not coincide with the legal restrictions on payment of dividends imposed in many jurisdictions. Further, the amount of current year earnings and profits cannot be determined until after the close of the year; estimates made in the current year would not be reliable; and, the amount of earnings and profits would be subject to further adjustment on audit or by competent authority. The proposed regulations would restrict dividend distributions far beyond the legal restrictions to which they are already subject under law, potentially blocking the distribution of earnings because of the existence of an unrelated loan. Expecting companies to repay all loans before distributing dividends is unrealistic and out of line with third party principles. As explained earlier, the capital structure of the parent manages the balance of debt to equity to optimize the cost of capital and to provide attractive returns to investors. Under third party principles, the cost of debt for the group cannot remain concentrated within the entity of the parent, but must be distributed among the subsidiaries benefitting from the funds provided. Further, if intercompany debt is held to third party standards, then so should equity. What unrelated party shareholder would tolerate a complete pay down of the corporation's debt before dividends could be paid?

6. Risk of Inadvertent Violations of the "Per Se" Funding Rules Cannot Be Controlled

Even if the timing of intercompany dividends and debt issuances could be managed successfully throughout the group and complete documentation of all intercompany debt instruments and payables could be ensured, the risk of a debt recharacterization would remain. A subsequent transfer pricing adjustment or an adjustment made by competent authority—with respect to any affiliate participating in group funding networks—could give rise to an unexpected deemed dividend that would result in distributions exceeding current year earnings and profits. The ramifications arising from even a single inadvertent incident could easily be widespread enough to bring havoc throughout the group funding networks. Intercompany financing would be subject to such undue risk that it would no longer be viable, putting at risk the liquidity of the group and crippling the means by which business operations are funded. To understand how far-reaching the implications of a single misstep could be, it is necessary to understand how the funding rule would strike at the heart of intercompany financing, such as the use of central or regional treasury centers.

C. The Cascading Effect and the Use of Group Finance Companies or Treasury Centers

The funding rule in the proposed regulations hits the basic structure used to facilitate and administer intercompany debt—the group finance company or treasury center. In most large multi-national chemical companies, one or more affiliates act as in-house banks or treasury centers with which group members may deposit or loan surplus funds and from which affiliates may borrow the group funds supplied from external debt and operational surpluses. This structure is conducive to centralized management and oversight of intercompany debt and the establishment of effective internal controls. However, under the proposed regulations, the same structure used to support the flow of funds throughout the group can spread the taint from the transactions targeted by the funding rule throughout the network of affiliates which transact with the treasury center.

Once a single loan is treated as stock under the regulations, that loan will set off a contagious series of additional recharacterizations throughout the group. For example, if an affiliate borrows from the treasury center and the note is recast, then the treasury center will be treated as acquiring the "stock" of an affiliate, itself a targeted transaction. Accordingly, under the" per se" rule and the proposed ordering rule, the earliest deposits with or loans to the treasury center made during the previous 36 months could be deemed as having funded the "stock" acquisition, and that loan to the treasury center would in turn be recast as stock, with the result that the interest would then be treated as dividend income, and the repayment of the loans as a stock redemption taxable as a dividend. The interest payments on the first recast loan would be treated as dividend distributions on stock, and would constitute a second targeted transaction to which a debt instrument issued by the affiliate would be linked and then recast as stock.

This cascading effect makes the cash rich affiliate which lends it surplus to the treasury center thereby susceptible to having its loan recast on account of any documentation failure with respect to any of the intercompany loans emanating from the treasury center, or on account of any targeted transaction engaged in by any affiliate in the group which borrowed and will borrow funds from the treasury center during the applicable 72 month period.

These cascading effects are multiplied in the case of overnight cash pooling through the treasury center, described in the following section of this letter, in which "loans" and "deposits" are made on a daily (or nightly) basis by a network of participating affiliates. The risk of a single recast debt instrument infecting the entire pool or network of affiliates which lend money to or borrow money from the treasury center jeopardizes the entire network through which intercompany loans are made and funds flow through the group. The consequences are so harsh and would be so widespread that it is not clear whether the treasury center structure or the funding of the group through intercompany loans would be viable. Yet there are no other reasonable alternatives that would move funds through the group with the same reliability and efficiency. Our members rely on internal treasury centers to conduct their businesses and have no realistic alternatives. Clearly drastic changes would be needed in the regulations to allow our members to maintain their network of intercompany loans to fund group operations.

D. The Proposed Rules Do Not Correspond to the Stated Purpose of the Proposed Regulations

There should be a strong justification for regulations that would have such a profound effect on the conduct of ordinary business transactions. The stated purpose of the proposed regulations is to address the incentives (*i.e.*, interest deductions) for related parties to engage in transactions that result in "excessive indebtedness." As noted earlier, the only evidence cited concerning use of excessive indebtedness for purposes of reducing tax liabilities implicates the actions of companies that have completed an inversion transaction.[6] The justification cited for the funding rules are policy concerns with the distribution of a note or with what are viewed as comparable transactions, the acquisition of affiliate stock or a reorganization resulting in the acquisition of an affiliate's assets. The Preamble considers it appropriate to treat intercompany notes distributed in such transactions or intercompany notes that fund, or which under the "per se" funding rules are irrefutably presumed to fund, such transactions, as if the notes were stock because "no new capital is introduced" in connection with the debt, typically there is no substantial non-tax business purpose, and, accordingly, it can be concluded that the debt issued in the transaction (or deemed to fund the transaction) has "minimal or nonexistent non-tax effects." The Preamble goes on to acknowledge, but dismiss, the importance of the different legal rights attendant to the stockholders because it considers such differences to be of limited significance when the parties are related.

What is troubling about these justifications for so severely restricting the payment of dividends and the issuance of debt is first, the regulations would apply broadly to all corporate groups having a U.S. nexus, not just those that have completed an inversion. Second, that there are no exceptions from the documentation requirements or the funding or the "per se" rules for loans that *do not* result in "excessive indebtedness." Indeed, there is no indication of what level of indebtedness is "excessive" nor do the criteria under which the proposed rules would treat debt as stock make any reference to the level of debt or interest deductions resulting from issuance of the debt. There is no exception from the rules for no-interest loans: the recast rules would apply equally to debt issued by entities that had no other outstanding debt.

Further, there is no exception from these rules for loans that *do* introduce new capital into the entity issuing the debt, or for distributions that *do* have a substantial non-tax business purpose.[7] That the issuance of the debt occurred within 36 months before or 36 months after the

[6] *See, supra,* note 3.

[7] The distribution of a note may be warranted for non-tax business reasons in instances in which it is necessary for the parent to receive additional dividend income from its subsidiaries in order to support payment of a dividend to external shareholders at a time when the subsidiary has sufficient earnings to support the distribution but insufficient liquidity to distribute cash. Further, as different jurisdictions enact limitations on the deduction of interest in line with the BEPS recommendations, complying with such limitations may require groups to redistribute debt within the group.

transaction would be deemed sufficient to link the debt to the funding of the transaction and consequently treat the debt as if it were stock, regardless of whether the debt funded new investment in the debtor's business. The Preamble's conclusion about the legal distinction between debt holders and stock holders within an affiliated group belies the fact that the distinctions are real and that they matter. As discussed, there is a great deal of significance to the distinction between debt and equity in the context of an affiliated group. The two are not interchangeable at will. An affiliate that permits use of its surplus funds for a certain time period through an intercompany loan fully expects that it will have the right to repayment of those funds in accordance with the terms of the debt instrument. This is a major difference from the legal right of a shareholder to distributions of earnings but not to the withdrawal of capital contributions for what may be an indefinite time period. Our members are extremely concerned that the proposed regulations dismiss the significance of these and other distinctions between intercompany debt and equity.

E. Extensive Changes Needed

It is difficult in the short period of time since our members were presented with the proposed regulations for ACC members to identify all the corollary impacts that would jeopardize the systems developed to fund their global operations or to be confident that they have determined what changes would be sufficient for the regulations to be made workable. But the changes listed below would be needed at a minimum. Specific recommendations along these lines are presented in Section III.

- ***The Scope of the Documentation and Funding Rules Must Be Narrowed.*** The broad scope of the proposed regulations would make implementation virtually impossible, would further strain IRS audit resources, and would lead to inevitable missteps with potentially disastrous consequences. Debt issuances that have little or no bearing on Treasury's concern that intercompany debt could be used to generate "excessive" interest deductions against U.S. taxable income should be exempt from both the documentation and funding rules. (*e.g.*, low-interest loans, short-term debt, and debt that is neither issued nor held by an entity subject to U.S. tax).

- ***Make the documentation requirements better suited to corporate practice and business needs--far more flexible***. Change the proposed regulations so that a documentation failure is not a fatal flaw

- ***Protect intercompany debt issued for valid business purposes from being recast***. Permit tracing principles or some other method to exempt debt that can be traced to business use of cash by the borrower.

- ***Provide a more suitable, flexible metric than current year E&P for exempting distributions.*** Use an earnings metric that is knowable with reasonable certainty at the time the dividend is declared and paid, that is based on more than one year's earnings and which would therefore not require dividend distributions each year, and that is compatible with the dividend restrictions under applicable law.

- ***Permit acquisitions of affiliates for business purposes.*** Business integration and entity reduction are real business purposes that must be exempted.

- ***Limit the cascading effect and limit the collateral fallout from artificial ownership percentages.***

- ***Provide reasonable time periods for implementation***. Businesses will need considerable time to survey and evaluate their current internal treasury practices to determine what changes would be needed, to attempt to develop alternative practices that minimize risk that debt would be recast but would still accomplish the corporate goals of controlling company assets, using cash efficiently, ensuring liquidity, etc., and to implement them.

Part III. Specific Issues and Suggested Modifications

A. Cash Management -- Cash Pooling

1. Cash Management is Critical to the Efficient Conduct of the Chemical Business

Cash pooling is a critical tool used by the treasury organization of a large affiliated group to implement effective and efficient cash management strategies. Cash pooling manages the cash surpluses and deficits of group members through intercompany borrowing and lending, either with or without involvement of a third party bank. Mobilizing cash on a global basis through the use of notional and physical cash pools allows cash balances held by individual group members to be aggregated, typically by currency, so that accounts with cash surpluses and those that require funding can be identified easily and funds can be transferred as required. Such structures allow the group treasury to view and manage its foreign exchange positions on a global basis and to ensure they are hedged appropriately. According to the Association for Financial Professionals, companies seek to mobilize global cash for a variety of reasons, including: (i) improving the efficient use of cash, including cash needed to meet working capital requirements; (ii) reducing borrowing costs; (iii) maximizing opportunity for investment; (iv) improving control of group cash; and, (iv) reducing foreign exchange risk.

There are two ways of pooling cash—physical and notional. Physical pooling involves the physical movement of cash from one account to a header or master account. All cash balances on participating bank accounts are physically transferred to the header account. This header account is usually held in the name of the group treasury or headquarters, or in the name of a separate treasury company. There are a number of different ways to operate a physical pooling structure. One way is referred to as an "automated sweep." As of a specified time towards the end of the day, balances are automatically swept from participating accounts to the header account. The size of the transferred balance can be varied. The simplest form of sweep is a zero-balancing pool. This has the effect of reducing all balances on participating bank accounts to zero (where a bank account is in deficit, the transfer takes the form of a payment from the center). A second method is referred to as "compulsory participation in an in-house bank." Requiring group entities to participate in an in-house bank creates a *de facto* physical cash pool. Cash is concentrated at the in-house bank as group entities are required to hold bank accounts with the in-house bank, rather than with external banks. A third method is referred to as "discretionary participation on periodic basis." Balances are pooled when cash surpluses reach a certain level, or on a weekly, monthly or quarterly basis, at the discretion of an authorized individual. Unlike a physical cash pool, a notional cash pool does not involve any physical movement of cash balances. Instead, a bank notionally aggregates balances participating in the pool, and allocates debits or credits interest to each participating bank account as appropriate. Unlike a physical cash pool, all participating entities must hold bank accounts with the same bank. A notional cash pool means that participating entities retain control of their bank accounts.

ACC members use cash pooling primarily to accommodate the working capital needs of the group. When used in this way, deficit cash positions of members would generally be maintained only for short time, typically no longer than 12 months. Deficit balances that remain outstanding for more than 12 months would prompt an assessment of the reasons behind the cash shortages and of the continued viability of the subsidiary. If it were determined that intercompany debt is still appropriate, the procedure followed by some members would be to remove the balance from the pool (at least notionally, even if the debt remains in the cash sweep mechanism), transferring it to a short- or medium-term intercompany loan, while other members might leave the balance in the cash pool treating it as a revolving loan. However, some ACC members permit the pool to be used not only for short-term working capital needs but also to fund construction or other capital projects. Moreover, there is variation among ACC members in how cash pools are organized. Some ACC members, particularly U.S.-owned chemical companies, use regional treasury centers to avoid section 956 issues and thus apply cash pooling strictly on a regional basis. Other members, particularly foreign-owned chemical companies, may apply cash pooling on a global basis. Pools may also be organized by region and by currency, but then integrated globally.

As discussed in the previous section of this letter, cash pooling is but one example of intercompany funding structured through the use of treasury centers. When the funding rule in the proposed regulations is applied to debt structured through a treasury center, the debt is particularly vulnerable to being recast on account of unrelated transactions, even if carried out by entities under different ownership chains and which have few if any common business dealings. Further the treasury center framework, whether used in cash pooling or other intercompany debt, is conducive to the cascading of collateral consequences of a debt recharacterization throughout all entities participating in the network of intercompany loans. [8]

Cash pooling multiplies these adverse effects through the volume, magnitude and frequency of transactions taking place within the cash pool. As an example of this volume, one ACC member provided data showing that within its cash pooling structure, more than 270 group companies hold more than 350 automatic and 100 manual cash pool accounts in more than 35 countries, resulting in approximately 35,000 transactions per year. The average value of transactions is over $310 million *per day*. If a single transaction resulted in the recast of a transaction in the pool thereby setting in motion the inevitable cascading of collateral ownership changes, it would be virtually impossible to track the resulting daily fluctuations in ownership, deemed dividends, deemed redemptions, and deemed acquisitions of affiliate stock, or to identify which entities would be deemed to have funded the proscribed distributions and acquisitions that would continue to cascade through the group. Clearly the proposed rules could not be administered without broad exemptions for the vast majority, if not all, of the transactions occurring within the pool.

As demonstrated from the above explanation, it is of critical importance to ACC members that normal treasury cash management functions, including cash pooling, be allowed to continue without being subject to recharacterization as equity with all the collateral consequences that follow. Cash pooling is necessary to ensure the liquidity of the group—to ensure that each participating member can meet its payroll on time, regardless of when customers pay their invoices. Cash pooling substantially reduces the cost of financing. An unrelated party assessment of a cash pooling network for one member estimated associated savings of nearly $4 million per year. These are vital functions that are business motivated and are essential to ACC member companies.

The myriad ways in which members manage cash pooling makes it difficult to provide a single solution that would address the concerns of all members. Further, since other types of intercompany debt are structured through treasury centers in essentially the same general lending network used for overnight cash pooling, the problems raised by applying the proposed regulations to cash pooling apply also to other forms of intercompany debt. Accordingly, ACC does not recommend that specific changes to the regulations be applied solely to cash pooling, but believes that a number of changes to the regulations would be needed in order to address concerns affecting cash pooling and other forms of intercompany debt.

[8] *See* the attached article by PwC entitled, “Section 385 proposed regulations would vitiate internal cash management operations,” for a detailed discussion of the cascading and other significant problems that the proposed regulations would create for cash pooling and other intercompany funding arrangements.

2. Suggested Proposals

ACC requests two modifications to the proposed regulations to ease what would otherwise cripple our members' ordinary cash management operations. These modifications would also help alleviate similar problems that would arise from cash pooling, such as intercompany payables and intercompany netting arrangements. Within an affiliated group in the chemical industry billions of dollars of product sales would typically occur in thousands of transactions each year. Implementation of the documentation and funding rules would not be at all possible without exclusion of these high-volume transactions in addition to the cash pooling transactions. Other important modifications offered in the letter, although not specifically geared to cash management, would help address the issues raised by these arrangements. As discussed, the proposals are not intended to be limited to cash pooling arrangements but to apply broadly for all purposes of § 1.385-2 and § 1.385-3.

(i) Provide an Exception for Short-Term Debt

A short-term exception would address many of the problems that are presented with cash pooling and other similar cash management arrangements. Short-term debt does not present the same sort of earnings stripping concerns that the § 1.385-3 rules target or the concerns on the appropriateness of the treatment of the instrument as debt under the documentation rules. Accordingly, the final regulations should include an exception in § 1.385-2 and § 1.385-3 for short-term obligations. ACC recommends that debt with a committed tenor of 365 days or less be exempt from consideration under § 1.385-2 and § 1.385-3. If the Treasury/IRS will not accept a general exception for short-term debt that is outstanding for 365 days or less, but would provide an exception for debt outstanding for a shorter time period, then ACC recommends that taxpayers that can demonstrate seasonal working capital needs and cash flows be permitted to use a longer period that reflects the seasonal nature of the business. For example, in the agriculture chemical business, no sales occur at all until the beginning of the growing season when crops are planted, and under the terms of sale extended to agricultural businesses, cash payments are typically not received until crops are harvested. Thus, the funding of a subsidiary that is engaged in such a seasonal chemical business will often need to be in place for at least a year.

(ii) Provide an Exception for Low-Interest Rate Loans

In order to mitigate the cash pooling and ongoing revolver draw documentation requirements and potential recasts, a further exclusion suitable to both Treasury's and members' concerns should be added. Treasury regulations already provide a "safe haven" interest rate under the section 482 regulations for bona fide indebtedness, with the lowest amount in a range from 100 percent to 130 percent of the "Short Term AFR." *See* Treas. Reg. § 1.482-2(a)(2)(iii). Any cash pooling or revolver draw which results in a U.S. interest deduction at a rate equal to or less than 130 percent of the Short Term AFR (which would include short-term trade payables that do not provide for any interest) should not be subject to automatic recasting as equity on account of a failure to meet any of the documentation requirements, and the debt should not be subject to the general rule or the funding rule of §§ 1.385-3 (b)(2) or (b)(3). The current short term 100 percent AFR is 0.87 percent compounded annually. That is not a rate that can be used for earnings stripping and exempting loans priced at this or a lower rate would considerably narrow the scope of the regulations to a more reasonable scale. Neither the government nor the taxpayer would need to devote valuable resources scrutinizing the high volume of no- or low-interest rate, ordinary intercompany transactions that would have no or little bearing on earnings stripping concerns. This exception should apply for both § 1.385-2 and § 1.385-3 purposes.

B. Documentation Requirements

Prop. Reg. § 1.385-2 would establish extensive contemporaneous documentation requirements that would need to be satisfied for certain related-party interests in a corporation to be treated as indebtedness for federal tax purposes. ACC has the following concerns with these proposals.

1. Penalty for Not Complying is Overly Harsh

A fundamental problem with the proposed documentation requirements is that even though the documentation requirements exceed what is needed under current legal standards to establish the validity of debt, if they are not met, the debt will automatically be recast as stock. This means that a debt that is sufficiently documented under current law and which constitutes true debt in substance, but which failed one of the documentation requirements, would be recast as stock with the attendant collateral consequences discussed in greater detail below. In ACC's view, this is a harsh result for missing documentation requirements, especially standards, which as the Preamble notes, exceed what current law and current business practice deem sufficient for related party loans. Indeed, the Courts have recognized that this type of formal documentation is generally a less consequential factor in determining whether related party debt should be respected.[9] Given the motivation for the proposed documentation requirements provided in the Preamble regarding the audit needs of the IRS, ACC members are concerned that a relatively minor factor is being elevated to unwarranted status as an *essential* requirement of intercompany debt in order to provide a relatively mechanical test for intercompany debt that could easily be reflected on a standard Information Document Request used in tax audits. Although ACC is sympathetic to the need of the IRS to streamline audit procedures and to use scarce resources efficiently, in ACC's opinion, it would be misguided to direct the audit towards examination of documentation standards that have been considered a poor indication of the validity of intercompany debt.

The situation is also troublesome because the tests may not be as mechanical as they might first appear. It is not clear what standard an individual IRS agent would apply on audit to judge whether the documentation provided would be acceptable, especially with respect to the analysis of the ability of the debtor to repay, or documentation of enforcement of the terms of the

[9] *See*, *e.g.*, *C. M. Gooch Lumber Sales Co. V. Comm'r*, 49 T.C. 649 (1968) ('[t]he absence of a written debt instrument, security, or provision for payment of interest is not controlling; formal evidences of indebtedness are at best clues to proof of the ultimate fact."

loan. If documentation is maintained and presented to an IRS auditor, but the auditor does not think the projections were sufficiently rigorous, or thinks that the enforcement actions were too lax, the proposed regulations would give the auditor the latitude to dismiss the validity of a loan solely because in the agent's subjective judgment, the documentation insufficiently addressed an element of the documentation requirements. In other words, even though the taxpayer thought it fulfilled the documentation steps, the auditor could deem one portion of the documentation to be inadequate and solely on that basis recast the loan without regard to facts and circumstances that support the substance of the debt. This increases the uncertainty regarding whether the debt will be respected.

Further, ACC believes that applying U.S. tax standards to the expanded affiliated group's foreign debt could be problematical, as documentation will generally focus on what is important under local law and to the local tax authorities. Thus, the focus of documentation of loans issued outside the U.S. may be almost entirely on demonstrating that the interest rate is at arm's length, with little regard to U.S. tax standards. Imposing U.S. tax standards that go beyond normal commercial standards and local law standards shows the overreach of the proposed regulations from an administrative standpoint. From an administrative standpoint, implementation of these standards outside the United States will be difficult for taxpayers to implement and for the IRS to audit.

Although the regulations provide a "reasonable cause" exception that would incorporate the "principles of § 301.6724-1," this standard imposes a high bar for obtaining relief, which in the experience of ACC members is exceedingly difficult to meet. ACC members have little confidence that such a standard would provide much relief from this harsh treatment.

2. Dramatic Increase in Administrative Burdens and Costs

The proposed contemporaneous documentation requirements will dramatically increase the administrative burden and costs associated with the issuance and maintenance of intercompany debt. The Preamble provides that the Office of Management and Budget ("OMB") has estimated that the total annual reporting burden for complying with the § 1.385-2 documentation requirements is 735,000 hours based on a total pool of respondents of 21,000, or 35 hours per respondent. The OMB has further estimated the total annual cost associated with this burden to be approximately $13 million, or approximately $630 per respondent based on the approximate $18 per hour used by the OMB to estimate the total costs. These estimates vastly understate the costs associated with complying with the proposed documentation rules. The systems costs to implement the rules will also be significant. The OMB computations do not include start-up costs to implement the rules.

ACC has asked members to estimate the potential costs associated with complying with the proposed documentation rules. Estimates per company have ranged up to 20 additional full-time equivalent staff and several millions of dollars in additional automation.

3. Suggested Proposals

(i) Failure to Satisfy the Documentation Should Not Automatically Result in Equity Treatment

Under the proposed regulations, any violation of the documentation requirements “will” result in the treatment of the instrument as stock. Thus, for example, if a taxpayer is judged as having failed to adequately document the ability to pay or to document payments of interest or principal or to take actions consistent to those it is thought an unrelated creditor would take in response to a failure to pay timely -- any of which is likely to happen with respect to some intercompany loan within a large corporate group with hundreds of subsidiaries in over 30 different jurisdictions -- the result is that the instrument will be classified as stock, resulting in non-deductible interest expense, the imposition of withholding taxes, the treatment of principal repayment as a section 302(d) dividend, the loss of foreign tax credits, and potential ownership problems as well as other issues. Further, the recharacterization is likely to cause other intercompany payables and debt to be recharacterized through the cascading effect discussed elsewhere in this letter.

ACC believes that there is also a significant authority issue as to whether the Treasury/IRS can require an instrument that is otherwise debt to be classified as stock merely because the taxpayer failed to satisfy one of the documentation requirements, or failed to timely satisfy a documentation requirement, particularly given the severe impacts of equity classification. The only specific grant of authority is in section 385(c)(3), which provides as follows: “The Secretary of the Treasury is authorized to require such information as is deemed necessary to implement this subsection.” The subsection in question is section 385(c), so that the authority granted is limited to that needed with respect to information related to whether the issuer and the holder have treated the instrument consistently, not more broadly. Even this grant of authority does not authorize automatic “deemed” equity treatment.

ACC believes there is no tax policy reason for imposing such a severe penalty for failing to properly document what is in substance debt, and that the proper treatment would be to simply treat a failure as one factor in the facts and circumstances analysis provided under the case law of whether the instrument should be classified as debt or stock. Treating the failure to document as simply another factor to be considered in the analysis would be consistent with the section 385 statutory grant of authority.

If the Treasury/IRS are unwilling to adopt this proposal, then, at most, the failure to document should create a rebuttable presumption that the instrument should be treated as equity. Taxpayers would at least then be allowed to demonstrate on a facts and circumstances basis that the instrument should still be classified as debt.

(ii) Provide Certainty that Minor and Inadvertent Violations Will Be Excused

Given the significant number of intercompany instruments that ACC members incur on a daily basis in the ordinary course of their business, it is critical that a change be made to ameliorate the impact of an inadvertent failure to comply with the documentation requirements. ACC recommends that the final regulations specifically provide that taxpayers will be excused for minor or inadvertent violations if the taxpayer has made a good faith effort to comply with the documentation requirements and any violations are promptly cured.

(iii) Provide Ordinary Course of Business Exception and Other Similar Exceptions

Prop. Reg. § 1.385-3(b)(3)(iv)(*2*) provides an ordinary course of business exception for certain intercompany debt. However, by its terms, this exception applies only for purposes of the funding rule in § 1.385-3**.** By not including the exception in the § 1.385-2 documentation rules, the number of intercompany debt transactions that must be documented increases dramatically. The cost of tracking and documenting such ordinary business transactions, even if it could be done, is not justified given the low risk that these transaction raise about inappropriate deduction of interest on intercompany debt used to fund these ordinary course transactions. ACC therefore strongly recommends that the same ordinary course business exception in § 1.385-3 be extended to § 1.385-2.[10] Exempting these transactions from the documentation rules in § 1.385-2 would not preclude the IRS from arguing, in appropriate cases, that the intercompany debt is stock because of the nature of the interest created, it would simply mean that the § 1.385-2 and § 1.385-3 rules would not apply.

In addition to an exception for ordinary course business transactions, other exceptions to the § 1.385-3 rules that are proposed below (*e.g.*, for short-term debt, low- or no-interest debt, and foreign-to-foreign transactions) should also apply for § 1.385-2 purposes. Given that these transactions do not raise significant policy concerns and the time and effort that it would require to document each and every one of these transactions in accordance with the regulation to avoid the harsh treatment that failing to comply entails, ACC believes that these proposed exceptions, as discussed in more detail below, are important to apply for § 1.385-2 purposes also.

(iv) Extend Time for Preparing Documentation

The time for preparing the documentation is too short. The proposed regulations generally provide that documentation is treated as timely prepared if it is prepared no later than

[10] As discuss later in the text, ACC believes that the ordinary course of business exception in § 1.385-3 should be expanded to include other ordinary course transactions and that such expanded exception should also apply for § 1.385-2 purposes.

30 days after the relevant date, in the case of documenting the obligation to repay, the existence of creditor rights, and the reasonable expectation of repayment. Documentation is considered timely prepared if it is prepared no later than 120 days after the relevant date in the case of documenting payment or the exercise of creditor rights on default. Many of ACC member companies complete their sub-ledger accounts on a quarterly rather than monthly basis. Thus, imposing a 30 day requirement would require major changes to their accounting systems. Moreover, even if these accounts were completed on a monthly basis, given the massive amount of intercompany transactions that would need to be monitored it is simply not practical to require companies to comply with the short time frames provided in the proposed regulations. Indeed, such documentation time frames are not imposed under section 482 for the very transactions subject to these new rules. ACC therefore recommends that the documentation be treated as timely prepared if it is prepared no later than the time the return (including extensions) for the relevant year is filed. This would allow taxpayers the opportunity to cure documentation deficiencies (particularly for loans made outside the United States) uncovered during the course of the year-end independent financial audit and the review of materials during tax return preparation, would be consistent with the documentation timing requirements for other purposes, and would still ensure that contemporaneous documentation would be available to the IRS at the time of audit.

C. Bifurcation Rules & Discretionary Authority

Prop. Reg. § 1.385-1(d) would give the IRS authority to treat related party debt instruments between members of the modified expanded group as partly debt and partly stock, which is a dramatic change in the current common law approach. A "modified expanded affiliated group" is defined similarly to the expanded group but the ownership threshold is dropped from 80 to 50 percent. Despite the dramatic change from current law, the proposed rules provide little guidance as to how such a determination would be made. No standards for determining when an instrument would be bifurcated are provided. In practice, therefore, substantial discretion would rest with IRS examining agents. It is unlikely that this is what Congress had in mind when it authorized Treasury to write regulations under section 385.

The Preamble includes one example in which a related party issues a $5 million loan but can repay only $3 million. The Preamble says that in that situation the debt would be bifurcated into $2 million of equity and $3 million of debt. Not much guidance can be derived from this example which is more of a restatement of the rule. Expectation of repayment seems to be the decisive factor but more guidance is required with respect to how to establish this "reasonable expectation of repayment," and further, more guidance is needed on the import of this factor since, as the Courts have acknowledged, third party commercial lenders may make their credit decisions based on the expected ability of the borrower to obtain refinancing, and not necessarily on its ability to repay the full principal. The only facts and circumstances identified is the Preamble example where the agent concludes that there was a "reasonable expectation" as of the date of issuance of the instrument that only a portion of the principal amount would be repaid.

This type of broad rule with unlimited discretion granted to tax authorities has been criticized by the U.S. Treasury in the context of the BEPS project. A more targeted approach, including additional guidance as to the type of instruments that can be bifurcated, using objective standards (*e.g.*, thin capitalization) or providing safe harbors as to elements that support debt characterization, would provide taxpayers with a better ability to predict potential consequences of the transactions.

Additionally, more guidance is required on the consequences of the application of the bifurcation. What can a taxpayer do to unwind the portion treated as equity, such as contributing that portion to the company in exchange for stock? What is the appropriate treatment of the cash payments made through the life of the instrument? ACC believes that a taxpayer should be allowed to designate its transactions—*i.e.*, have the equity portion contributed back to capital such that the only cash payments made are with respect to the debt piece and thus no portion is made with respect to the equity unless paid out under the normal terms of the equity. This would allow the taxpayer to avoid the section 302(d) treatment that would otherwise occur on repayment of the "deemed" equity piece. For example, in *Example* 17, absent further guidance, instead of originally issuing a single note for $19 million, the taxpayer would need to issue, say, 19 separate notes for $1 million over 19 different days in order to tranche the debt to make sure the amount of any single mixed debt/equity instrument was minimized if a subsequent recast occurs, as the taxpayer then could affirmatively capitalize the loans that were treated as "deemed" equity before repayment, so that no repayments were made on that portion that would trigger section 302(d) dividend treatment.

Further, the use of a special relatedness standard, the modified expanded group, for purposes of applying the bifurcation provision instead of the related-party threshold used throughout the rest of the proposed regulations adds additional complication to an already dense, difficult set of rules. ACC suggests in order to simplify the proposed regulations a consistent relatedness test, the expanded group, should be used and the modified expanded group concept should be eliminated.

D. Certain Distributions of Debt Instruments and Similar Transactions

Prop. Reg. § 1.385-3(b)(2) provides as a general rule that a debt instrument is treated as stock to the extent that the debt instrument is issued by a corporation to a member of the corporation's expanded affiliated group either (1) in a distribution, (2) in exchange for expanded group stock or (3) in exchange for property in an asset reorganization where a shareholder that is a member of the issuer's expanded affiliated group immediately before the reorganization receives the debt instrument with respect to stock in the transferor corporation. The general rule is intended to target what is considered abusive earnings stripping, by interjecting debt into a corporation without a corresponding increase in the assets of the corporation. However, many of the transactions that would be impacted by these rules, even many in the examples given in the Preamble and the proposed regulations, do increase the assets of the borrower, and are not tax motivated but instead serve substantial business purposes. For these rules to be workable for the chemical industry, substantial exceptions must be provided.

1. Acquisition Integration and Entity Structuring

The proposed 385 regulations place severe restrictions on the ability of a member to align its businesses within the appropriate legal entities through distributions, related party stock purchases, and asset reorganizations. Common transactions to accomplish these business objectives are section 368(a)(1)(D) asset reorganizations, section 304 stock acquisitions, and section 332 liquidations – all of which could result in tainted debt under the general rules in § 1.385-3(b)(2).

For example, when an ACC member acquires a target from a third party seller or shareholders, a common reason for making the acquisition is that the business of the target complements the acquirer's existing business. The savings and additional revenues expected to arise from business synergies obtained from the acquisition would have been included in the valuation of the acquisition. The business may seek to unite the target's technical and research staff with its own in order to fill gaps in its knowledge base or simply to combine research efforts. It may wish to supplement its product lines with those of the target in order to offer a full palette of products to customers. After the acquisition, the acquirer will wish to combine sales, marketing, manufacturing, and supply chain processes within the member's existing legal entity structure in order to realize the anticipated value of the acquisition. Nearly always, only one member of the acquirer's affiliated group will be a party to the acquisition, but the target will have business assets and/or separate business entities in a number of jurisdictions. Accordingly, a member often follows a third party acquisition with a series of asset or share transfers between the target's legal structure and the member's legal structure, frequently to combine same-country distribution, manufacturing or other business operations. Outside of acquisitions, businesses often seek to consolidate legal entities in order to streamline processes and minimize costly administrative duplication. Entity restructures are also completed in order to facilitate more efficient cash deployment and minimize currency risk.

In a section 304 transaction, aligning legal ownership of same country affiliates can be the desired business integration end state, in order to isolate legal liability, retain certain incentives, or secure consolidated reporting, while at the same time capturing synergies created through common ownership. Integration through section 304 or section 368(a)(1)(D) transactions offers the tax efficient means to accomplish the business integration goal. Yet, the Preamble asserts, without providing any support, that in a D reorganization the non-tax consequences are "typically insignificant relative to the federal tax benefits obtained through the introduction of a related party debt instrument." This is dismissive of a D reorganization's very real business purpose.

A section 332 liquidation is also frequently used to accomplish legal entity reduction objectives. If the liquidating entity issued a debt instrument to a related party within the prior 36 months, as discussed below, the proposed 385 regulations would recast the debt as equity. This split ownership may well result in all or a part of the liquidation no longer meeting the 80 percent ownership requirement to qualify for a section 332 liquidation. As a result, all or a part of the liquidation would instead be treated as a taxable section 331 liquidation.

These business driven integration transactions, however, would nonetheless fall into the category of suspect transactions identified in both the general and the funding rules of §§ 1.385-3(b)(2) and (3). Regardless of whether the acquisitions were funded by intercompany notes, by third party commercial financing, or, in unusual circumstances, without the need for additional debt, these normal business transactions would taint any outstanding intercompany debt that had been issued by the acquirer within the previous 36 months or that might be issued within the next 36 months. The tainted debt would be treated as if it were stock for tax purposes, with all the odious collateral consequences.

The proposed regulations would create an untenable situation in which the only way a business could achieve the necessary level of integration to combine businesses after an acquisition or to streamline the group's legal entity structure would result in the recharacterization of valid intercompany debt as stock. The Preamble to the proposed regulations acknowledges that "the change in direct ownership of the affiliate's stock may have a non-tax significance…such as harmonization of a group's corporate structure following an acquisition" but the proposed regulations do not carve out an exception for situations in which there is a non-tax reason for the sale of affiliate stock or assets.

With respect to debt-financed asset acquisitions, the Preamble fails to even acknowledge the business purpose of placing new assets in the entity in which the business will be integrated and managed. The Preamble notes that such transactions do not increase the assets of the group or change the "ultimate" ownership of the assets. This misses the point. It is not the group that is issuing the debt, it is the entity to which the business assets are being transferred. Ownership of the asset may remain within the group, but that does not mean that the ownership of the assets has not changed. It matters which entity within the group holds the legal ownership rights, and that entity has changed. Indeed, aligning ownership within the appropriate entity may been the purpose of the reorganization. Consistent with the Preamble's policy concern that an increase in an entity's debt should be accompanied by an increase in its assets, the transaction introduced new investments and assets into the entity issuing the debt. Consistent with the arm's length principle, the entity using the assets and benefitting from their use must bear their cost, including the financing cost of acquiring the assets.

The proposed section 385 regulations would block business driven, post-acquisition integration and entity structure optimization that are not tax motivated. In current form, the proposed section 385 regulations would prevent members from efficiently achieving business objectives related to acquisition integration and legal entity consolidation.

2. Suggested Proposals

ACC recommends, at a minimum, that the following modifications be included in the final regulations: (i) an exemption for stock and/or asset transfers within one year of an unrelated party acquisition; (ii) a same country exception – *i.e.*, where stock or assets are being sold to an affiliate in the same country in order to combine in-country operations; and, (iii) an exception if the stock acquisition will permit consolidation in the same affiliate group as the acquirer or if the acquired entity is merged into the acquirer or the assets are used in the business activities of the acquirer.

E. The Funding Rule

Perhaps the most troublesome proposal in the regulations is the funding rule. Prop. Reg. § 1.385-3(b)(3) provides a rule that treats a debt instrument that qualifies as a principal purpose debt instrument as stock. A principal purpose debt instrument is a debt instrument to the extent it is issued by a corporation to an expanded affiliate group member in exchange for property with a principal purpose of funding various transactions that the regulations assume are economically equivalent to the transactions described in § 1.385-3(b)(2). Thus, if a member loans to another member for the principal purpose of funding any of (1) a distribution to another member, (2) an acquisition of stock from another member (with a limited exception), or (3) certain acquisitions of property from another member in asset reorganizations, the funding rules can apply to treat the loan as stock.

As noted below, the funding rule will implicate many unrelated transactions which clearly should not be impacted by the proposed regulations. The funding rule is the source of many problems and ACC believes significant changes are needed to narrow its scope.

1. The Non-Rebuttable Nature of the Presumption is Unreasonable and Does Not Reflect the Realities of Possible Business Transactions

Although described initially as a "principal purpose" test that is based on all facts and circumstances, the funding rule includes a non-rebuttable presumption that a debt instrument is issued with a principal purpose of funding an applicable distribution or acquisition if the instrument is used by the funding member during the period beginning 36 months before the funded member makes an applicable distribution or acquisition and ending 36 months after the applicable distribution or acquisition. Thus, a taxpayer cannot show any facts and circumstances to prevent the conversion of debt to stock under the funding rule if the funding occurs with the 72 month period. It matters not whether there are net distributions during a period that need to be funded with debt; a gross distribution by the funded member will trigger the rule even if it has been repaid or is matched with a capital contribution to the funded member from shareholders. The financial condition of the borrower is similarly irrelevant. The rule applies even where a loan is repaid before the distribution or stock purchase it purportedly funds is made. Nothing matters, except for the existence of an intercompany loan and a distribution or member stock purchase by the borrower over a 72 month period.

These rules would have a chilling effect on the funding of the chemical industry. As explained earlier in this letter, debt is a necessary component of the capital structure of a company. Corporations must use debt in order to achieve an optimal cost of capital and to provide attractive returns to investors. Further, the funding of operations of a large affiliate group requires the use of intercompany debt. The funding and "per se" rules make any intercompany loan incurred for any business reason vulnerable to being labelled as the funding instrument for an unrelated acquisition or distribution, regardless of whether the transaction was within the control of the issuer of the debt, and regardless of whether the transaction served legitimate business purposes.

Although similar "per se" rules have been included to address inversions under the section 367 and 7874 regulations,[11] ACC believes that the approach is not appropriate here. Unlike in the inversion context, the proposed rules would disrupt many non-tax motivated commercial activities and would have significant, unwarranted federal income tax implications, including non-deductible interest, imposition of U.S. withholding taxes, treating principal repayment as a section 302(d) dividend or denying foreign tax credits as discussed in more detail below.

ACC recommends that the regulations be amended to follow the approach taken in the conduit rules under Treas. Reg. §§ 1.881-3 and Temp. Treas. Reg. § 1.956-1T(b)(4). Namely, the final regulations should treat the funding rule as an anti-abuse rule that serves to backstop the rules in § 1.385-3(b)(2). Thus, the funding rule should apply only in cases where a taxpayer makes a loan as part of a plan or arrangement that includes a distribution or acquisition described in § 1.385-3(b)(2) by the funded member which has a principal purpose of achieving substantially the same economic effect as the applicable distributions and acquisitions in § 1.385-3(b)(2). Accordingly, taxpayers should be permitted to prove that the funds were used for capital investment, when the borrowed funds can be shown to have been invested in working capital or other business investments, and permitted to show tracing for back-to-back borrowing, for example, if foreign parent borrows and relends to its U.S. subsidiary within reasonable parameters.

If the Treasury/IRS insist upon retaining some deemed period, then ACC recommends that the rule be limited to fundings that occur 12 months before and after the relevant distribution or acquisition, and that the rule be made a rebuttable presumption, so that the taxpayer can rebut on a facts and circumstances basis.

2. Ordinary Course Business Exception

Although Prop. Reg. § 1.385-3(b)(3)(iv)(B) contains an exception to the application of the § 1.385-3 "per se" rule for debt instruments that arise in the ordinary course of the issuer's trade or business, that exception is limited to debt instruments that arise in connection with the purchase of property or the receipt of services that are deductible under section 162 or included in a taxpayer's cost of goods sold or inventory. There are many other situations where a debt instrument may arise in the ordinary course of the issuer's trade or business that should be addressed by this rule. In particular, the exception does not address normal course transactions for capital intensive or research intensive industries, such as the chemical industry. ACC recommends that the ordinary course business exception should apply to all transactions that arise in the ordinary course of the trade or business of the group. Section 956 provides such an

[11] *See* Treas. Reg. §§ 1.367(a)-3T(c)(3)(iii)(C), 1.7874-10T.

exception and we see no reason that the same exception should not apply here.[12] If the Treasury/IRS are unwilling to allow all ordinary course business transaction to qualify, then the exception needs to be expanded to at least cover the following:

- ***Capital Expenditures.*** The exception should cover debt instruments arising in connection with the construction or purchase of property that reflect a current obligation to pay an amount that will be capitalized, and then depreciated or amortized under section 167 or section 197. Like section 162 expenses, the expense incurred in these transactions will be deductible, and in many cases the depreciation or amortization of the cost will be included in the cost of inventory. But, as currently proposed, the exception would not be available until the costs are deducted or included in inventory costs, which would occur over the period of time prescribed for depreciation and amortization, not when the associated debt instrument arises. The exemption for the payable is not available at the time the payable is incurred and due. Debt instruments that arise in connection with the construction, purchase or process of property that reflect a current obligation to pay an amount will be capitalized, and then depreciated or amortized under section 167 or section 197. Like section 162 expenses, the expense incurred in these transactions will be deductible, and in many cases the depreciation or amortization of the cost will be included in the cost of inventory. But these costs that will be deducted or included in inventory costs occur over the periods of time prescribed for depreciation and amortization, not when the associated debt instrument arises. The exemption for the payable is not available at the time the payable is incurred and due.

  For example, say that a chemical company constructing a plant incurs an intercompany payable for engineering services in Year 1. That payable would constitute a debt instrument that arises in the ordinary course of business, but the services being purchased would not be deductible under section 162; they would be capitalized as part of the basis of the chemical plant. In Year 3, construction has been completed, the plant is placed in service and is producing inventory. In Year 3, a portion of the capitalized construction costs, say 20 percent, will be included as depreciation in the cost of the inventory produced in Year 3. Had the payable for the engineering services arisen in Year 3, 20 percent of the payable would have been excluded under the ordinary course business exception. However, the payable arose and payment was due in Year 1, and in Year 1, the payable would not have been excluded under the current ordinary course exception in the proposed regulations. Likewise, the company providing the engineering services was doing so in its ordinary course of business and reflecting the revenue in its current income.

[12] *See* Treas. Reg. §§ 1.956-2(b)(1)(v),-2T(d)(2)(i)(B).

- ***Section 174 deductions.*** Debt instruments that arise in connection with the purchase or property or the receipt of services that would give rise to a section 174 deduction, regardless of whether the taxpayer elects to currently deduct or amortize the deduction, or regardless of whether some portion of the amount qualifies for a credit under section 41.

- ***Rent and royalties.*** The proposed rule is unclear as to how it would apply to debt instruments that give rise to payment of amounts that constitute rents or royalties. For example, it appears that such amounts would qualify as a debt instrument that arises in connection with the acquisition of property, but would only be covered if the amounts are not currently deductible under section 162. The final regulations should make clear that debt instruments that give rise to payment of rents or royalties are covered regardless of whether the payments are currently deductible under section 162 or must be capitalized and deducted over a longer period of time.

- ***Captive insurance or reinsurance.*** Normally payments for captive insurance or reinsurance are deductible under section 162. However, it is unclear whether the intercompany payable that arises for such payments would be considered a debt arising in connection with the payment for services. The final regulations should make clear that these transactions are covered.

- ***Trade or Business.*** A clarification should be provided that it is the expanded group's trade or business that is considered, not only the issuer's trade or business. Members are concerned that trade or business is an ambiguous standard that could be interpreted to exclude some types of entities despite those entities incurring innocuous trade payables. For example, an expanded group member functioning as partner in an operating partnership could be viewed as not having a trade or business and therefore be ineligible for the proposed regulations' ordinary course exception. A subsidiary that is in a start-up situation also may not be considered engaged in a trade or business when the debt obligation arises. The final regulations should also treat a start-up business as engaged in a trade or business for this purpose if the activities that it is engaged in will be treated as constituting a trade or business in the future.

- ***Netting and similar arrangements.*** Finally, the exception should apply to netting arrangements, internal clearing houses, and reimbursements related to amounts described in the ordinary course business exception.

These exceptions should also apply for purposes of § 1.385-2.

F. Modification and Inclusion of Other Exceptions to § 1.385-3 Rules

1. Expand Current Year E&P Exception

Prop. Reg. § 1.385-3(c) provides an exception to the operation of the § 1.385-3 rules for amounts equal to the current earnings and profits ("E&P") of the relevant member. If subsidiaries do not distribute their current year E&P, the profits effectively become "trapped." Members will be hesitant to distribute accumulated earnings due to the possible application of the recast rules. Under the proposed regulations, therefore, the only way that a company can retain its right to make distributions while retaining access to intercompany debt when needed for new investment would be to distribute no more than 100 percent of its current E&P each year. The rules should not force taxpayers to make annual, current year distributions in order to minimize the amount of cash becoming "trapped."

As the amount of current year E&P cannot be calculated until after the close of the tax year, it would be necessary to set the amount of the distribution based on an estimate of what the current year E&P will be. Even after the close of the year, it might not be possible to determine the amount with any certainty. This makes current year E&P an unsuitable metric for determining the "safe" amount that may be distributed or used in an acquisition without triggering the recharacterization of debt under the funding rule. Estimation error and subsequent adjustment are certain to occur, with serious consequences.

Additionally, many foreign countries do not allow a company to distribute current year earnings. As discussed earlier, legal restrictions on distributions are strictly enforced and vary by jurisdiction. In general, however, they do not reference current year E&P. Instead, they permit earnings to be distributed only after they have been reflected on the audited statutory accounts for the preceding year. Further E&P is not the earnings metric used. Typically, earnings would be measured in accord with the statutory accounting and in some cases, in accord with specific accounting standards mandated by the jurisdiction.

Greater flexibility is needed to allow normal dividend distributions to be made without fear of a potential recast. ACC members need certainty that their companies can make dividend distributions that comply with jurisdictional restrictions when they are needed for business purposes, such as to fund stock buy backs and pay dividends to external shareholders or to provide cash for strategic projects of the parent.

Accordingly, ACC recommends that the current year E&P exception be dropped and replaced with a modified, expanded exception that would encompass accumulated E&P, starting from the first year before the final regulations are effective. Thus, if the final regulations were made effective on January 1, 2019, accumulated E&P for this purpose would include accumulated E&P for the taxable year beginning on January 1, 2018 for a calendar year taxpayer and all additional accumulated E&P for years thereafter. If the Treasury/IRS are unwilling to allow accumulated E&P to be taken into account on a going forward basis, then the E&P exception should at least be expanded to include accumulated E&P in the three years prior to the relevant year at issue. Additionally, to address concerns that arise with computing E&P under U.S. tax principles for every member of the expanded affiliated group that might be relevant, ACC recommends that taxpayers be allowed to elect to use either U.S. tax E&P, U.S. GAAP, IFRS, or local statutory books and records to compute accumulated E&P. The election would be binding on members of the expanded affiliated group that filed a consolidated return in the United States, but otherwise allowed on a country-by-country basis provided that the taxpayer applied the election consistently to entities located in each such country. Interest, tax, depreciation, depletion, and amortization should be added back in making the annual computations of accumulated E&P pool to better reflect cash flow available for distributions or acquisitions subject to the rules. To address concerns where a business may generate losses that eliminate positive E&P amounts, an E&P deficit attributable to a year included in the pool should be excluded from the pool computation. A special rule for previously taxed income should also be considered. Subpart F inclusions under section 951 create previously taxed income ("PTI"). Although previously taxed, these earnings are part of the earnings and profits of the controlled foreign corporation, the rules provided by Congress in section 959 clearly intend that taxpayers should be allowed to distribute or otherwise make investments of PTI in the United States without triggering further U.S. tax consequences. Indeed, the ordering rules under section 959(c) provide that previously taxed earnings are treated as distributed first. Consideration should therefore be given to including in accumulated E&P pool E&P attributable to PTI that relates to subpart F inclusions from the E&P of a year not included in the pool.

Finally, ACC notes that as a result of going to a pooling concept, the available pool would need to be reduced by the amounts that previously were excluded from § 1.385-3 as a result of the E&P exception. Rules will also be needed to account for distributions not subject to the exclusion, and certain other ordering rules may be necessary.

Example. Assume that ACC's proposal to permit distributions from E&P accumulated since the first year prior to the effective date of final regulations, as well as the other recommendations regarding the election to use alternative income measures and the various adjustments to E&P are adopted, and that the regulations are finalized on January 1, 2019. Foreign parent owns 100 percent of the stock of a U.S. subsidiary that distributes a note in 2021 for $100 to its foreign parent. U.S. subsidiary elects to use E&P as calculated under U.S. tax principles to compute its accumulated E&P beginning in 2018. U.S. subsidiary's current E&P in each year as adjusted by adding back interest, tax, depreciation, depletion and amortization for 2018 was ($30), for 2019 was $70, for 2020 was $40, and for 2021 is $50. U.S. subsidiary has made no distributions prior to 2021 that would impact E&P, or distributions or acquisitions that otherwise would result in an exclusion as a result of accumulated E&P exception under § 1.385-3.

Because the ($30) deficit in 2018 is excluded from the pool, accumulated E&P pool equals $110. Thus, the entire amount of the note distribution in 2021 of $100 is excluded. At the end of 2021, the accumulated E&P pool is $60 ($110 pool at the end of 2020 minus $100 § 1.385-3 E&P exclusion plus 2021 current E&P of $50).

2. Limit § 1.385-2 and § 1.385-3 to Cases Where a Difference in Tax Status Exists

Many of the problems with the § 1.385-2 and § 1.385-3 rules in the outbound context could be ameliorated if the final regulations were to limit these rules to transactions in which the tax status of the issuer differed from that of the holder of the debt. Those members of ACC that apply cash management on a regional basis, for example, would largely be excluded from the reach of these rules were such a limitation adopted, and numerous potentials for "foot faults" due to documentation requirements and the § 1.385-3 funding rules that are more likely to occur outside the United States with the draconian tax effects that follow would largely be eliminated. If such a limitation were adopted, transactions between CFCs with no U.S. branch or effectively connected income and transactions in which neither party were subject to U.S. tax would be exempt from these rules. The rules would apply only to the extent that they involved transactions between a U.S. corporation and such a CFC or between U.S. and foreign corporations that are not CFCs or between a U.S. corporation and a tax exempt entity.

The two policy concerns that are identified for outbound transactions between CFCs in the Preamble do not appear to justify the problems that the rules would create for such transactions. The first example provided by the Preamble is where interest deductions are used to reduce the earnings and profits of a CFC. Loans between related CFCs, however, are not intended to have any immediate U.S. tax consequences. Section 954(c)(6) was enacted specifically to allow U.S. shareholders to reinvest or deploy active foreign earnings of one CFC in a related CFC without current taxation. Thus it seems questionable from a policy standpoint to enact a rule by regulation that would deny a deduction on such loans.

The second example involves the use of intercompany debt to "facilitate the repatriation of untaxed earnings without recognizing dividend income." For example, as the Preamble notes, a first-tier CFC with no earnings and profits could distribute a note to its U.S. shareholder that is repaid in subsequent years with the proceeds of distributions from the earnings and profits of a lower-tier CFC, or could borrow from a related CFC and distribute cash. Or a first-tier CFC with a relatively high ratio of foreign taxes to earnings and profits could distribute cash to its U.S. shareholder that is funded by the proceeds of a loan from a CFC with a relatively low ratio of foreign taxes to earnings and profits so as to allow the repatriation of income that is shielded by foreign tax credits. But except for the note distribution from the CFC to the U.S., which would still be covered, the application of the regulations would not eliminate the tax benefits from the transactions proposed to be excluded. Taxpayers could achieve the same results through capital contribution in exchange for a separate class of voting stock. One CFC could contribute cash to another CFC that would then distribute the cash to the United States. Because the contribution could be structured as a separate class of stock with voting rights, the various collateral consequences, discussed below, of a deemed recast of debt to stock could be avoided.

Furthermore, ACC believes that foreign to foreign transactions between non-CFCs should be excluded from the application of the proposed regulations, as there is no relevance to the U.S. fisc. Foreign affiliates of inbound companies having no U.S. connection whatsoever should not be subjected to these U.S. tax rules, *e.g*., documentation requirements, "per se" rules, looking to foreign distributions or acquisitions, etc. Holding these foreign affiliates to standards and restrictions imposed under U.S. tax law would not only be questionable tax policy, but would impose serious questions regarding the administration of the rules. How would a U.S. subsidiary impose the rules on its foreign affiliates? Who in the foreign affiliate would understand the rules and be able to implement them? How could entities outside the jurisdiction of the United States be audited by U.S. tax authorities?

ACC believes that foreign-to-foreign transactions do not raise the same sorts of tax policy concerns as transactions involving a U.S. party and that the Treasury/IRS should except these transactions given the significant business concerns that applying these rules in the foreign context would raise. The potential damage that applying these rules creates to the general corporate and international tax rules in the outbound context outweighs any positive policy objectives that might be achieved. With regard to the issue of whether applying the rules only to transactions that are between related parties with a different tax status would violate the non-discrimination rules under tax treaties, it seems that such an approach would be similar to that taken in Section 163(j), which restricts the deductibility of interest only on loans between related parties with a different tax status, where, as a result of that tax status, the interest income is subject to a reduced rate of U.S. tax. For example, section 163(j) does not apply to interest paid by a foreign corporation to another foreign corporation where neither is subject to U.S. tax even if both are CFCs, nor does it apply to interest paid between two U.S. C corporations. It only applies to debt between a related U.S. corporation and a foreign corporation where there is a reduced rate of tax imposed on the interest paid to the foreign corporation, or between a related U.S. corporation and a U.S. tax exempt entity. If the Treasury/IRS do not believe that section 163(j) violates the non-discrimination rules under our tax treaties, they should not be concerned that non-discrimination rules preclude their providing a similar approach here. Moreover, the proposed regulations already exclude transactions between consolidated return members and between individuals, on the basis that they do not raise the same sorts of earnings stripping concerns. Therefore providing an exception for transactions between corporations that do not have a different tax status for similar reasons should not raise an additional authority issue under section 385.

3. Provide an Exception for Use of Parent Stock to Compensate Employees of Subsidiary and Other Deemed Payables

Under the proposed regulations, a subsidiary's use of parent stock not in the consolidated group of the subsidiary causes unintended consequences when used to compensate employees, and in other circumstances. The funding rule presumption should therefore not apply to such transactions and a direct tracing should be applied to except publicly traded stock used by a subsidiary for employee compensation or otherwise meeting the requirements of Treas. Reg. § 1.1032-3. A purchase of shares by a subsidiary company from its parent is a transaction causing the proposed funding rule to apply. Even if the parent contributes the shares in-kind to the subsidiary, the Treasury regulations deem that the subsidiary purchased the stock from the issuing corporation immediately before disposing of the stock. *See* Treas. Reg. § 1.1032-3(b). However, this would not apply if the subsidiary were instead to purchase the shares from the public market. That would at least entail additional costs. The proposed regulation as written therefore will cause subsidiary companies outside the consolidated group of the public parent to purchase the parent's stock from third parties before immediately distributing the shares to employees or other third parties. The subsidiary potentially faces a gain or loss transaction from holding stock in the parent which is not acquired pursuant to § 1.1032-3, so purchasing from the public market adds a risk of a gain or loss on the shares. Treas. Reg. § 1.1032-3 has the safeguard that contributed stock must be immediately be disposed of, therefore providing a tracing without any fungibility question. The proposed regulations should permit a tracing of such § 1.1032-3 stock transactions to except them from the § 1.385-3 funding rule and the § 1.385-2 documentation requirements, albeit on the condition that the stock is disposed of to a person that is not a member of the expanded group containing the issuer

Even if no tracing is provided, the retroactive effect of these proposed regulations is irresponsible. No notice has been given by the Treasury to taxpayers of this far reaching consequence for taxpayers in order to change their ordinary course use of parent stock by subsidiaries. Accordingly, transactions otherwise governed by Treas. Reg. § 1.1032-3 should not become subject to the funding rule until at least six months after the proposed regulations become final to the extent the stock has not been provided to a member of the expanded group.

In addition, similar tracing exceptions should apply for deemed payables that arise as a result of section 482 adjustments pursuant to Rev. Proc. 99-32, or section 367(d) or other similar provisions.

G. Collateral Consequences Need to Be Addressed

1. Disproportionate Consequences

The collateral consequences of debt being reclassified as stock are not in proportion to the policy concern with intercompany debt that the regulations attempt to address. The most obvious collateral result is denying the interest deductions and treating payments of interest and principal as dividends to the extent of earning and profits under section 302(d). Many other consequences can also result that could create significant tax impacts, including the following:

Elimination of foreign tax credits. Foreign tax credits can be lost because the lender does not meet the stock ownership tests needed to claim credits under section 902, which requires a corporation to own 10 percent of the voting stock of a foreign corporation in order to claim indirect credits. Normally a debt instrument would not provide for voting rights. And typically the newly converted equity would not own 10 percent of the stock. Another lesser, but still important, consideration, is that the holder might not satisfy the minimum holding period test under section 901(k) because of the commercial rights it has as a creditor. *See* Rev. Rul. 94-28, 1994-1 C.B. 86.

Withholding tax consequences. U.S. treaties generally have a different withholding tax rate for interest than dividends. Thus, a payment of interest that would have had a zero U.S. withholding tax rate would now be subject to potentially 15 percent U.S. withholding tax. This would be in addition to the non-deductibility of interest expense, which would create multiple levels of taxation for inbound taxpayers. This will obviously impact foreign direct investment into the United States.

Basis shifts within the group. If a debt instrument that is recast as stock is repaid, then to the extent the repayment is treated as a dividend, the lender will have unrecovered basis in the loan. Under Treas. Reg. § 1.302-2(c), if the lender is not otherwise a direct shareholder of the borrower, the basis will migrate to a related direct shareholder. With the potential for multiple recasts, basis may shift back and forth among members, even during the same year.

Uncertainties in location of E&P. If debt is recast as stock, payments are treated as dividends that move earnings and profits, not just equal to the interest paid but also for payments of principal, as noted above. In the international context, knowing the amount of E&P of various subsidiaries is of critical importance.

Ownership shifts, with uncertain consequences. If recast as stock, the lender now is treated as an owner of potentially a separate preferred class of stock. This may prevent transfers to the borrower from benefitting from section 351 or other provisions where control is defined by reference to test in section 368(c), such as section 355. Control under section 368(c) means the ownership of stock possessing at least 80% of the total combined voting power of all classes of stock entitled to vote and *at least 80% of the total number of shares of all other classes of stock of the corporation*. Additionally, if the loan to a U.S. company that was part of a consolidated group was large enough, it could cause the U.S. company to become deconsolidated.

Mismatches in the timing and character of income. For example, if the lender hedges the loan and had integrated the loan and swap under Treas. Reg. § 1.1275-6 or § 1.988-5, that integration no longer is allowed because the integration rules do not apply to stock. Or the special foreign exchange rules in section 988 (and the related rules netting foreign exchange gains and losses in computing subpart F income under section 954(c)(1)(D)) would no longer apply because issuing stock is not a section 988 transaction. There are many other examples because under many provisions in the tax law debt and stock are treated differently in computing timing and character.

Cascading effects. The treatment of one loan as stock under the proposed regulations could have a cascading effect. The recast of debt as stock can result in other debt instruments being recast as stock. For example, the recast as stock under the proposed regulations constitutes a purchase of member stock, and the repayment of the loan would be a distribution by a member to another on stock, which will trigger the funding rule as applied to other debt instruments. There could be no end to these results, particularly if modifications are not made to address cash pooling. We would also note that these cascading effects could also happen with respect to long term lending which is typically not covered under cash pooling.

Creation of hybrid instruments, with uncertain foreign law and BEPS implications and potentially triggering section 909. Given that the proposed regulations recharacterize as equity what is otherwise a debt instrument, this will give rise to an increase in the proliferation of hybrid instruments. Thus the hybrid instruments would be subject to the recommendations in BEPS Action 2 that are likely to be adopted by foreign countries and could have negative ramifications under foreign law. Section 909 could also apply. Under those rules, a foreign tax credit splitting event occurs if a taxpayer receives income under an instrument that is equity for U.S. purposes and debt for foreign law purposes, if the income and deductions for foreign law purposes do not match the income inclusion on the equity for U.S. tax purposes.[13]

2. Suggested Proposals

ACC members believe that the consequences of recasting debt as equity should be limited to the denial of interest expense**.** Thus, in our view, every effort should be made to provide rules that would eliminate the significant collateral impact of recharacterizing what is otherwise debt as stock. At a minimum, however, the following changes should be made.

(i) Limit Cascading Impacts

The successive and perpetual application of the rules should be prevented by providing that (i) the acquisition of a recharacterized debt instrument does not constitute an acquisition described in § 1.385-3(b)(3)(ii)(B), and (ii) a repayment of a recharacterized debt instrument does not constitute a distribution described in § 1.385-3(b)(3)(ii)(A).

(ii) Addressing the Elimination of Foreign Tax Credits

Treasury should issue regulations under section 902 which provide that, for purposes of computing section 902 credits allowed on a distribution with respect to an instrument treated as stock by § 1.385-2 or § 1.385-3, the lender is treated as owning at least 10 percent of the voting stock of the distributing company if the expanded group owns at least 10 percent of the voting stock of the distributing company. Treasury has allowed for similar treatment for deemed distributions under section 304 in Revenue Rulings 91-5, 1991-1 C.B. 114, and 92-86, 1992-2 C.B. 199, and the basis for such rulings should be extended to address the denial of foreign tax credits concerns here. The Treasury/IRS should also make clear that section 901(k) will not apply if it did not apply to other shares of the group that constitute 10 percent voting power for this purpose.

[13] Treas. Reg. § 1.909-2(b)(3).

H. Partnership Issues

1. Relationship to Guaranteed Payment Treatment for Payments with Respect to Capital

Prop. Reg. § 1.385-2(c)(6)(ii) would recast a loan to a partnership as equity in that partnership in the event of failing to meet the documentation requirements. The Preamble does not indicate that the drafters have considered the guaranteed payment implications under section 707(c) with respect to substantiation of related party indebtedness. Recast debt under § 1.385-2 would be treated as a guaranteed payment for the use of capital, and under section 707(c), that is essentially treated the same as interest—a reduction in taxable income to the other partners (*i.e.*, equivalent to an interest deduction) and an ordinary income payment made to a non-partner for that use (*i.e.*, taxable income). *See also* Treas. Reg. § 1.707-1(c). Accordingly, it is unnecessary to recast a loan from the expanded affiliated group to a controlled partnership as equity on account of a substantiation failure since section 707(c) basically would have the same result as debt treatment. Similarly, it would be unnecessary to recast a loan to a disregarded entity as equity for a debt substantiation failure. *See* Prop. Treas. Reg. § 1.385-2(c)(5).

2. Springing Partnerships When a DRE's Debt is Recharacterized

Prop. Reg. § 1.385-3(d)(6) is meant to avoid the possibility of "springing partnerships" with respect to the potential recharacterization of debt issuances under the general and funding rules. That is, when a debt instrument issued by a DRE is treated as stock under the proposed regulations, instead of it being treated as stock of the DRE, it is treated as stock of the DRE's regarded owner. The Preamble provides that this treatment is consistent with that of the application of the aggregate partnership theory as well as other policy concerns.

To satisfy the documentation thresholds of § 1.385-2, an expanded group instrument must, in addition to other items, be supported by a reasonable expectation of the borrowing entity to repay the debt. To this end, § 1.385-2(b)(2)(iii) states that if a DRE is the issuer of a debt instrument, and the DRE's owner has limited liability under Treas. Reg. § 301.7701-3(b)(2)(ii) (meaning that the DRE's owner has "no personal liability for the debt of or claims against the entity by reason of being a member" under local law), then "only the assets and financial position of the [DRE] are relevant for purposes" of testing the ability to repay the debt. If the DRE's owner does not have limited liability, then all the assets and financial position of both the DRE and the DRE's owner are relevant for testing purposes. To this end, if the expanded group instrument issued by a DRE were to fail the documentation requirements, § 1.385-2(c)(5) recasts that debt as stock of the DRE and thus potentially causes a partnership to spring to life. While it was clearly the intention of the Treasury/IRS to require an analysis of the DRE's ability to repay debt for documentation purposes, it's not evident how this is supposed to coordinate with § 1.385-3(d)(6)'s rule (discussed above) that treats a DRE as a branch of its regarded owner (as is the prevailing case throughout most of the Internal Revenue code and Regulations).

To eliminate this mismatch, the Treasury should modify § 1.385-2(c)(5) to track the manner in which DREs are treated in the § 1.385-3 rules under § 1.385-3(d)(6) and make a potential recast of debt as equity in such circumstances as discussed above as stock in the DRE's owner rather than that of the DRE. This would still require an analysis of the DRE's ability to repay, of which the Treasury is clearly concerned, without prejudicing the entity classification election process and remaining consistent with a DRE's treatment as a branch of its owner, which is respected throughout the rest of the Internal Revenue Code and regulations.

3. Elect-Out Partnerships

Only certain unincorporated ventures engaged in strictly limited joint activities are eligible to elect complete exclusion from Subchapter K. Eligible organizations formed for the joint production, extraction or use of property are eligible only if they do not jointly sell services or product; if each participant under the operating agreement reserves the right to separately take or sell its share of production; and, significantly, if the arrangement is simple enough to permit each participant to calculate its own taxable income without need for a calculation of partnership income. In the chemical industry, such operating agreements are often formed to share the cost and use of production equipment or facilities and associated operating expenses. Joint expenses are typically shared on a proportionate basis consistent with underlying co-ownership rights, with each participant recording its own revenue and expenses on its own books and records. It would be unusual for a venture with such minimal joint activity to incur joint debt to finance operations. Conceivably, co-owned property might be subject to debt, in which case each participant would record on its own books its portion of the liability and its share of debt service costs as agreed to by the participants. The analysis of any such debt for purposes of section 385 should be consistent with the separate accounting mandated under Treas. Reg. § 1.761-2(a): each participant should be treated as issuing its share of debt as determined under the venture agreement. There is no need for organizations excluded from Subchapter K to be treated either as controlled partnerships or as modified controlled partnerships for purposes of the section 385 regulations.

I. Timing of the Regulatory Process, Effective Dates and Implementation Timelines

The proposed regulations would distinguish debt from stock for tax purposes based, not on the relationship of the parties and their respective rights, obligations and conduct with respect to the debt instrument, but on other conditions: whether the issuance of the debt and certain fairly common corporate transactions occurred within the same 72 month period and on whether specific types of documentation, significantly different from what is needed for business purposes, has been completed and maintained. Moreover the funding rules of the proposed regulations would bring the inquiry regarding the tax treatment of a debt instrument beyond an analysis of the instrument at hand and the parties to such debt, taking into account unrelated lending transactions occurring anywhere within the same expanded affiliated group.

This approach is novel. It has never before been presented to the public as part of any prior proposal regarding debt or the deductibility of interest expense, either from the administration or from Congress, or from the OECD. The 90 days that have been allotted for the public to analyze the proposed rules, understand how they might affect business practice, and what changes might make them workable has been too short a period for ACC members to feel confident that we have identified all problem areas or that the suggestions presented here would adequately address them. The inadequacy of time provided for public comment is why ACC joined with 22 trade groups and organizations on May 12, 2016, to write Treasury Secretary Lew to request an extension of the comment period; a request also made by the American Institute of Certified Public Accountants, the U.S. Chamber of Commerce, and the Michigan Chamber of Commerce.

We reiterate that the proposed regulations will profoundly impact the ordinary, day-to-day intercompany finance transactions essential to enabling the chemical industry to function. We trust that the Treasury/IRS will carefully consider the concerns presented here as well as those submitted by others within the business community. Further, we ask that the Treasury/IRS actively engage in dialogue with the business community as they consider how to change the proposed rules with an eye, not only to policy concerns, but also to the impact of the rules on legitimate business practice, and the practical challenges of implementing them across global organizations.

Complying with the proposed rules will require extensive changes to the internal policies and procedures developed by our members to supply funds as needed throughout their global operations and maintain sufficient oversight over their use. Because these regulations hit at the heart of their financial operations, great care will be needed to ensure that changes made to comply with the regulations will not impede the reliability of cash flows, or weaken controls against misappropriation of funds or money laundering.

The degree of changes needed will depend largely on the modifications made to the proposed rules, particularly whether sufficient exemptions are added to exclude a large volume of ordinary business transactions that would have little, if any, relevance to the purported purpose of the rules. This will be of the utmost importance to implementation efforts and costs. Intercompany payable transactions, cash pooling transactions and other daily intercompany transactions can amount to hundreds of thousands of transactions per year for a multi-national group.

However the proposed regulations are modified, it will take our members time to analyze rules in final form, survey their global finance operations to identify specific impacts, develop and assess possible responses, and implement necessary changes in global policies, procedures and internal controls. Dividend payments, acquisitions, and intercompany loans of affiliates in dozens of jurisdictions would need to be tracked for one or two hundred subsidiaries for some of our member companies, while larger groups may need to track transactions of over 600 subsidiaries. Documentation of hundreds of actual intercompany loans will need to be produced, reviewed, and monitored by a taxpayer. Much of the staff who design and implement the global intercompany financial systems of our members work outside the United States. The treasury functions of our members, not their tax functions, make and carry out company finance policies, so the staff involved will not have tax backgrounds and little understanding of U.S. tax rules.

Training and hiring of staff will be considerable. Typically, commercial financial institutions are involved in the administration of internal cash networks so that changes in internal systems will need to be coordinated with third parties and applicable contracts renegotiated. Considerable cost and effort would be needed to implement the new processes and new IT systems, and to undergo extensive legal and tax reviews with respect not only to U.S. law, but the laws of the many jurisdictions in which our members do business. Changes to financial policy of this magnitude will require extensive internal review and board level approvals.

It remains to be seen whether systems can be designed to sufficiently monitor and control the timing of dividend distributions and coordinate these against the timing of debt issuance of all affiliates throughout the global organization for the purpose of avoiding recharacterization of debt under the funding and "per se" rules. Further, it is not clear whether it would be possible to comply with the restrictions under the "per se" rules while still maintaining intercompany cash flows; ensuring payment of dividends, compliant with all local regulations, and sufficient to support dividends to external shareholders; and, ensuring that loans can be made to affiliates when needed. Accordingly, we have recommend that the "per se" rule be withdrawn and that the funding rule be withdrawn or, if retained, modified considerably.

Should these portions of the rules not be withdrawn and other portions not sufficiently modified, it is not clear that intercompany financing will remain viable. It may be necessary for our members to incur the greater costs and risks associated with arranging commercial loans to subsidiaries. Especially for subsidiaries which are not fully established or which are located in regions or business units experiencing the inevitable downward portions of the chemical industry business cycles, substituting commercial loans for intercompany debt will be costly and difficult. It will take time to adequately vet commercial suppliers and to negotiate terms for affiliates, which have relied on the efficiencies and cost-effectiveness of intercompany financing based on the parent's well-developed relationships within the credit markets. Corporate leaders will need to make business decisions in light of these additional risks. Assessing such a situation from a business perspective will also take time.

The effective dates proposed with these rules do not provide a realistic timetable for businesses to make these decisions and the extensive changes needed for implementation. Other regulatory projects in recent history with significant implementation requirements have provided considerably more time for public discussion and extensive dialog between business, tax professionals and the administration before final rules were issued, and then permitted longer periods for implementation after regulations were finalized. For example, after enactment of section 409A, preliminary guidance, issuance of proposed rules and dialog with businesses extended for roughly 2 ½ years before final regulations were issued, after which employers were given 20 ½ months to modify compensation arrangements, to amend or redraft plan documents, and to modify administrative procedures, all changes which, while considerable, were far more limited than those proposed here. It was 7 years after enactment of withholding requirements under section 871(m) that the regulations were effective, during which time 3 sets of regulatory guidance were issued reflecting considerable dialogue between the administration and affected businesses. The regulations regarding capitalization of tangible property were not made effective until nearly 10 years after the Treasury/IRS first requested public comment on the issues, during which time considerable dialog with taxpayers was reflected in issuance of proposed regulations, their withdrawal, followed by issuance first of re-proposed regulations and then, of temporary regulations, before the regulations were made final.

In line with these prior regulatory projects, ACC proposes that should the regulations be finalized, *with the "per se" rule withdrawn*, that their effective date be no less than 24 months after final rules are issued, but in any event, not before January 1, 2019. Should the "per se" rule not be withdrawn, it is difficult to estimate the time that would be needed.

Section 385 proposed regulations would vitiate internal cash management operations

L.G. "Chip" Harter, Jared A. Hermann, Aaron H. Junge[1]

I. Introduction

A principal treasury function in the day-to-day operations of a multinational enterprise is to redeploy cash generated by one member of the affiliated group to fund operations of other group members. Such cash deployment can take place both within a single country and across the globe. Internal cash management allows multinational enterprises, whether based in the United States or abroad, to reduce their external financing expense and maximize their returns on equity.

Multinational enterprises efficiently redeploy cash through a variety of internal cash management techniques, including cash pools and intercompany loans. As discussed below, however, recently proposed regulations would create prohibitive tax costs and complexities with respect to these arrangements, impairing their effectiveness and potentially upending the practice as more costly than beneficial.

On April 4, 2016, Treasury and the IRS proposed regulations under section 385 (the "Proposed Regulations").[2] The Proposed Regulations appear to be intended to limit the effectiveness of certain tax planning techniques by recharacterizing certain related-party financings as equity, even where the financing is in the form of straight debt instruments. Although the Proposed Regulations identify targeted transactions discussed below, the rules would apply generally to recharacterize as equity a number of related-party financings that routinely arise in the ordinary course of business operations, both domestically and internationally.

In particular, the Proposed Regulations would have, and already have begun to have, a profound impact on a range of modern treasury management techniques, including cash pooling and intercompany cash mobilization and deployment. Given that the most relevant part of the Proposed Regulations would apply to financial instruments issued on or after April 4, 2016 (with effect from the date 90 days after regulations are issued in final form), taxpayers must immediately analyze the potential impact these rules would have on their routine business transactions and treasury management functions carried on currently.

II. Overview

This article begins by providing brief descriptions of the Proposed Regulations and of common treasury management practices of multinational enterprises. This article then focuses on the application of the Proposed Regulations to one of those practices in particular: internal cash management. The broad issues

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[2] *See* 81 Fed. Reg. 20912 (Apr. 8, 2016). Note that the Proposed Regulations were first made available for public inspection on April 4, 2016, and later published in the Federal Register on April 8, 2016.

discussed with respect to common practices include (i) how cash management transactions can easily trigger the per se recharacterization rules of the Proposed Regulations; (ii) the consequences of recharacterizing internal funding transactions as equity; and (iii) the extent to which the iterative application of the rules of the Proposed Regulations in the context of a global cash management system likely would recharacterize most cash pool balances as equity. The goal of this article is to identify and describe significant technical interactions between the rules of the Proposed Regulations and the operations of cash pooling and intercompany financing arrangements that would have been extremely difficult for the drafters to have anticipated.

Cash pools act as internal banks within a multinational group, taking deposits, or borrowing, from dozens or hundreds of affiliates and lending the proceeds to dozens or hundreds of affiliates. The balances often roll and fluctuate on a daily basis, resulting in hundreds or thousands of related-party borrowings and repayments per day passing through the corporation acting as the cash pool (*i.e.*, the "cash pool leader" or "cash pool head"). As described below, the sequential and iterative application of the recharacterization rules set forth in the Proposed Regulations—combined with the subchapter C consequences of iterative issuances and redemptions of equity—would have a viral, self-replicating effect. The result is that an initial recharacterization of a single small borrowing from the cash pool could be replicated many times and magnified to the point that most of the deposits and borrowings running through the cash pool could be recharacterized as equity.

The cataclysmic adverse tax consequences of such a random and sweeping recharacterization could not have been intended by the drafters of the Proposed Regulations. It therefore will be necessary to reconsider the approach of Prop. Reg. §§ 1.385-3 and -4 to determine whether the stated policy goals of the Proposed Regulations can be achieved in a manner that does not cripple the everyday treasury operations of multinational enterprises.[3]

III. The Proposed Regulations

Section 385 provides Treasury with authority to prescribe regulations as may be necessary or appropriate to determine whether an interest in a corporation is to be treated for U.S. federal tax purposes as stock or indebtedness, in whole or in part.[4] This authority is broad, but it is clear from the statutory language that Congress intended for any regulations so prescribed to set forth factors to be taken into account in determining with respect to a particular factual situation whether a debtor-creditor or corporation-shareholder relationship exists.[5]

At a high level, the Proposed Regulations contain three sets of rules: (i) they authorize the IRS to treat certain related-party debt arrangements as part stock and part debt;[6] (ii) they establish a contemporaneous documentation requirement that must be satisfied for certain related-party debt to be

3 This article focuses on the impact of the Proposed Regulations on cash management activities, but other corporate treasury functions also may be affected. For example, as discussed below, corporate treasury departments may aggregate the enterprise's foreign currency exposures through a cash pool and hedge its net exposure with an unrelated counterparty. By treating the cash pool's balances as equity, the Proposed Regulations introduce the potential for noneconomic subpart F income that increases the cost of a treasury department's foreign currency risk management function. Additionally, common internal treasury operations such as netting centers and centralized payment/collection systems would raise similar issues as the cash pools discussed herein as they too would result in frequent intercompany balances that fluctuate on a daily basis.

4 Section 385(a).

5 Section 385(b) ("The regulations prescribed under this section shall set forth factors which are to be taken into account in determining with respect to a particular factual situation whether a debtor-creditor relationship exists or a corporation-shareholder relationship exists.").

6 Prop. Reg. § 1.385-1(d)(1).

respected as debt;[7] and (iii) they treat certain related-party debt that is issued in connection with certain distributions and/or acquisitions as stock for all purposes of the Code.[8] This article will focus on the third set of rules, contained in Prop. Reg. §§ 1.385-3 and -4, and their potential application to multinational enterprises' internal treasury and cash management functions.

The recharacterization rules of Prop. Reg. § 1.385-3 (hereinafter referred to as the "Per Se Recharacterization Rules") contain both a "General Rule" and a "Funding Rule." The General Rule would recharacterize related-party debt instruments[9] as stock if the instrument is issued (i) in a distribution,[10] (ii) to acquire related-party stock,[11] or (iii) as consideration in an asset reorganization.[12] The Funding Rule would recharacterize as equity a loan made with "a principal purpose" of funding an affiliate's entering into one of the three transactions described in the General Rule.[13] For example, a loan made between affiliates with a principal purpose of funding a cash dividend by the funded affiliate may be recharacterized as equity under the Funding Rule.

Significantly, although the Funding Rule's use of the term "principal purpose" implies a subjective, intent-based standard, for many situations the rule is quite mechanical and not dependent on intent. Under the "per se" prong of this rule, a related-party debt instrument would be conclusively treated as issued with a principal purpose of funding a distribution or acquisition if the instrument is issued within three years either before or after the distribution or acquisition (*i.e.*, within a 72-month period centered on the date of the distribution or acquisition).[14] Thus, if one affiliate (*i.e.*, the funded member) borrows from another affiliate and if, within three years of the date of the borrowing, the funded member makes a distribution or acquisition, the debt is deemed to be a "principal purpose" debt instrument and is therefore recharacterized as equity.

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7 Prop. Reg. § 1.385-2.

8 Prop. Reg. §§ 1.385-3, 1.385-4.

9 This article uses terms such as "related-party debt instrument" and "related party" as shorthand. The Per Se Recharacterization Rules generally apply to debt instruments issued by a member of an expanded group and held by another member of an expanded group. *See* Prop. Reg. § 1.385-3(b)(2), (3). An expanded group is generally defined as an affiliated group under section 1504(a) but without regard to the exceptions under section 1504(b)(1)-(8) (relating to foreign corporations and certain other corporations), by changing the requisite ownership threshold to 80 percent of vote or value (rather than vote and value), and by extending the group to corporations indirectly held by other members, applying the constructive ownership rules under section 318 as modified by section 304(c)(3). *See* Prop. Reg. § 1.385-1(b)(3). For this purpose, a debt instrument means an interest that would, but for the application of Prop. Reg. § 1.385-3, be treated as a debt instrument as defined in section 1275(a) and Treas. Reg. § 1.1275-1(d). *See* Prop. Reg. § 1.385-3(f)(3).

The Proposed Regulations do not apply to indebtedness between members of a consolidated group and instead treat a consolidated group as a single taxpayer (*i.e.*, one corporation). Prop. Reg. § 1.385-1(e). However, certain debt instruments may become subject to the Proposed Regulations if and when the instrument or a party to the instrument ceases to be within the consolidated group. In this regard, various transition rules generally provide that if an instrument or corporation enters or exits the consolidated group, then such instrument, or any instruments issued or held by such corporation, will be treated as repaid on the date of entry or issued on the date of exit, as appropriate.

10 Prop. Reg. § 1.385-3(b)(2)(i).

11 Prop. Reg. § 1.385-3(b)(2)(ii).

12 Prop. Reg. § 1.385-3(b)(2)(iii). Prop. Reg. § 1.385-3(b)(2)(i)-(iii) sets forth the three broad categories of proscribed transactions that will be recharacterized as stock under the General Rule.

13 Prop. Reg. § 1.385-3(b)(3)(ii).

14 Prop. Reg. § 1.385-3(b)(3)(iv)(B).

An exception is provided for instruments that arise from a sale of inventory or the performance of services (other than treasury services)[15] in the ordinary course of the issuer's business.[16] There are a few limited exceptions under the Per Se Recharacterization Rules,[17] but there are no exceptions for cash pools, short-term obligations, working capital loans, purchase property indebtedness, or de minimis transactions.

When a debt instrument is recharacterized under the Proposed Regulations as equity, whether pursuant to the Commissioner's discretion, due to a documentation failure, or as a result of the Per Se Recharacterization Rules, it is so characterized for all purposes of the Code. The type of stock it becomes is determined based on the terms of the instrument.[18] Consequently, recharacterized debt frequently will be treated as nonvoting preferred stock with a fixed redemption date.[19]

IV. Background on multinational enterprises' internal treasury practices

Typical corporate treasury departments take on several roles: (1) funding procurement; (2) cash management; (3) interest rate, currency, and commodity risk management; (4) payments and collections; and (5) accounting, reporting, and other compliance. In respect of cash management, a vital treasury function in operating a multinational enterprise is the redeployment of earnings and capital of one affiliate to fund the operations of other affiliates, both within a country and internationally. This internal cash management allows multinational enterprises, whether based in the United States or abroad, to operate on a global basis while minimizing their external financing costs and maximizing their return on equity.

Effective internal cash management requires the ability to mobilize and redeploy cash quickly. Theoretically, an enterprise's available funds could be redeployed through distributions and capital contributions, but practically it is difficult to do so. Declaring and paying distributions takes time; many jurisdictions restrict entities from declaring distributions in excess of distributable reserves; and cross-border distributions frequently are subject to withholding taxes. These concerns multiply as funds travel through each level of a sprawling corporate structure. Consequently, a more efficient manner of mobilizing and deploying cash is through direct intercompany loans. Frequently, these loans can be issued and repaid in less time, with less cost, and subject to fewer restrictions than distributions and capital contributions.

Two common practices for internal cash management are long-term intercompany financing and short-term cash pooling. Long-term intercompany financing typically involves term loans or revolving credit facilities pursuant to which a cash-rich affiliate makes available to a cash-poor affiliate significant funds for capital expenditures and related investments. These loans are similar to bank loans, with the benefit

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15 *See* 81 Fed. Reg. 20912, 20924 (Apr. 8, 2016) ("This exception . . . is not intended to apply to intercompany financing or treasury center activities . . . .").

16 Prop. Reg. § 1.385-3(b)(3)(iv)(C).

17 There are three notable exceptions: First, the aggregate amount of distributions and acquisitions taken into account with respect to any given taxable year is reduced by the issuer's current-year earnings and profits. Prop. Reg. § 1.385-3(c)(1). Second, a funded stock acquisition will not result in the recharacterization of the funding debt instrument if the stock is acquired in exchange for property contributed to the issuer of the stock and the transferor owns more than 50 percent of the voting power and value of the issuer of the stock for at least three years thereafter. Prop. Reg. § 1.385-3(c)(3). Finally, the Per Se Recharacterization Rules do not apply at all if the aggregate amount of debt that would otherwise be recharacterized under the per se rules is less than $50 million. Prop. Reg. § 1.385-3(c)(2). Aside from these three exceptions and the ordinary course exception described above, no other exceptions apply.

18 *See* 81 Fed. Reg. 20912, 20922 (Apr. 8, 2016).

19 It therefore frequently would be nonqualified preferred stock for purposes of section 351(g)(2). Depending on the circumstances, it also could be section 306 stock, section 1504(a)(4) preferred stock, or fast pay preferred stock.

that the interest income that would have been earned by the bank instead is kept within the enterprise to further promote growth and investment.

Cash pooling typically involves multiple affiliates pooling excess funds and making those funds available to other affiliates with cash shortfalls.[20] This pooling typically is accomplished by having each affiliate maintain a separate bank account within which it deposits its cash or from which it can overdraw on a daily basis to meet its operating needs. Under a standing set of transfer instructions, all positive cash balances in affiliates' accounts are swept at the end each day into the bank account of the entity serving as the cash pool leader, and all overdrafts in accounts of affiliates are covered by automatic transfers from the cash pool leader's account. Because under such arrangements the closing daily balance in the account of each affiliate other than the cash pool leader is zero, such arrangements often are referred to as daily zero-balance cash pooling.

When positive cash amounts are transferred from an affiliate's account to the cash pool leader account, that transfer generally is recorded pursuant to standard facility documentation as a loan to, or deposit with, the entity that owns the cash pool leader account. If, however, the affiliate currently is in a net borrowing position with the cash pool, the cash transfer is recorded as a repayment against that borrowing. When cash is transferred automatically from the cash pool leader account to cover an overdraft in an affiliate's account, that cash transfer is recorded as a loan to that affiliate. Because these sweeps can occur on a daily basis among dozens or hundreds of affiliates, the corporation serving as the cash pool leader can be entering into dozens or hundreds of related-party funding transactions a day, and hundreds or thousands of related-party funding transactions per year.

These cash pooling arrangements allow a multinational enterprise to deploy liquidity across its various operating subsidiaries, while minimizing both the aggregate cash balances needed and external funding costs. Cash pools also allow an enterprise to aggregate cash surpluses and shortfalls within currency environments and thus minimize the enterprise's net foreign currency exposure that must be hedged.[21] In larger multinational enterprises, these cash pools often are tiered, sometimes with affiliates directly participating in a local country cash pool, which participates in a regional cash pool, which in turn participates in a global cash pool.

For the sake of simplicity, this article focuses on an unrealistically simple hypothetical fact pattern relating to cash pooling and variations thereof. USP, a U.S. parent of a multinational group, owns all the outstanding stock of four foreign subsidiaries: FS1, FS2, FS3, and FS Pool (collectively, with USP, the "USP Group"). FS1, FS2, and FS3 are operating companies, and FS Pool serves as the foreign group's treasury center and cash pool leader.

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20 Treasury regulations with respect to the Foreign Account Tax Compliance Act ("FATCA") provide a definition of treasury center activities not dissimilar from this common understanding of short-term cash pooling:

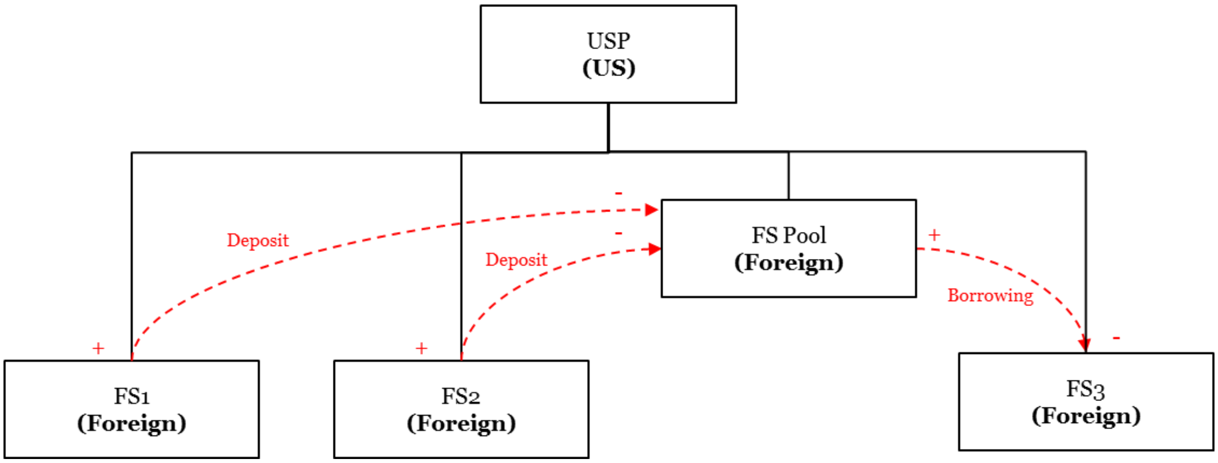
> Managing the working capital of the expanded affiliated group (or any member thereof) such as by pooling the cash balances of affiliates (including both positive and deficit cash balances) or by investing or trading in financial assets solely for the account and risk of such entity or any members of its expanded affiliated group.

Treas. Reg. § 1.1471-5T(e)(5)(i)(D)(1)(iv).

This definition does not, however, include the related and equally important function of long-term intercompany financing.

21 Because an enterprise's affiliates typically maintain their accounts in their own functional currencies, the debts arising between the affiliates and the cash pool typically are denominated in the functional currencies of the affiliates, and the foreign currency risk is centralized in the entity serving as the cash pool leader, where it can be managed through hedging. Interest generally accrues on affiliates' borrowings from the cash pool at a rate that is a few basis points higher than the rate of interest that accrues on their deposits with the cash pool, with the result that the cash pool leader earns a spread on its activities.

To the extent the foreign operating entities have excess cash, they deposit that cash with FS Pool in the cash pool. If one of the foreign operating entities needs funds (*e.g.*, to service monthly payroll expenses), the entity borrows from FS Pool rather than obtaining financing through the use of a third-party lender.



As discussed below, significant collateral consequences arise under the Proposed Regulations in situations in which cash pool participants recall deposits or repay borrowings. These events frequently occur on a daily basis because a participant's balance with the cash pool fluctuates on a daily basis.

For example, if in the example above FS3's balance with the pool was $0 on May 1, -$10 on May 2, -$5 on May 3, and -$15 on May 4, FS3 would be treated as borrowing $10 on May 2, repaying $5 of that borrowing on May 3, and borrowing an additional $10 on May 4. Similarly, if FS1's balance with the pool was $0 on May 1, +$5 on May 2, +$15 on May 3, and +$10 on May 4, FS Pool would be treated as borrowing $5 from FS1 on May 2, borrowing an additional $10 from FS1 on May 3, and repaying $5 of its borrowings to FS1 on May 4.

Entity	Day	Daily Change	Balance
FS3	05/01	-	$0
	05/02	Borrow $10 (-)	-$10
	05/03	Repay $5 (+)	-$5
	05/04	Borrow $10 (-)	-$15
Entity	Day	Daily Change	Balance
FS1	05/01	-	$0
	05/02	Loan $5 (+)	+$5
	05/03	Loan $10 (+)	+$15
	05/04	Received $5 Repayment (-)	+$10

V. Application of the Proposed Regulations to internal cash management practices

The potential application of the Proposed Regulations to internal cash management practices would create significant and pervasive problems. As discussed below, the Per Se Recharacterization Rules can be triggered in innocuous circumstances. Once triggered, the recharacterization of debt into stock creates an array of tax issues, ranging from lost foreign tax credits to taxable contributions, taxable reorganizations, and noneconomic subpart F income. In the context of global cash management systems, these consequences do not remain confined to the source of the transaction. Instead, due to the volume of transactions entered into by the treasury centers and participants, these consequences have the potential to spread like a virus, infecting the entire system and all its participants.

These adverse consequences flow from the interactions of equity recharacterizations under the Funding Rule, the subchapter C consequences of serial issuances and redemptions of equity in the related group context, and the frequency and volume of related-party funding transactions that occur through a cash pool. More specifically, once a borrowing from a cash pool is recharacterized as equity under either the General Rule or the Funding Rule, the repayment of that borrowing typically will be characterized as a distribution under section 302(d),[22] and that distribution will result in a recharacterization of subsequent borrowings under the Funding Rule. In addition, once the loan to one affiliate from the cash pool is recharacterized as equity, the cash pool will be considered to have acquired equity of an affiliate, which results in the deposits it takes from other affiliates being recharacterized as equity under an iterative application of the Funding Rule.

These technical interactions would have been very difficult for the drafters of the Proposed Regulations to have anticipated, and the consequences of these interactions are surely unintended. The following discussion attempts to illustrate these interactions and their consequences in greater detail.

1. Triggering the Per Se Recharacterization Rules

Taking the example described above, if FS3 borrows funds from FS Pool (via the cash pooling arrangement) and if at any time within the 36-month period prior to FS3's borrowing of funds from FS Pool FS3 engaged in a proscribed distribution or acquisition, then FS3's borrowing would be recharacterized as an issuance of stock.[23] As a result, FS Pool would be deemed to hold FS3 stock.

The only possible response to this consequence would be to avoid the initial recharacterization by adopting specific internal controls. A multinational enterprise could attempt to prevent any affiliate that engages in a distribution or acquisition that would trigger the Funding Rule from participating as a borrower in a cash pool for the period beginning three years before and ending three years after the date of the distribution or acquisition. Even if such controls could be maintained perfectly, such a practice would greatly diminish the utility of cash pooling by excluding a significant portion of a group's affiliates.

In practice, however, it would be virtually impossible to maintain such controls, and triggering events might be deemed to occur in more obscure circumstances. For example, a participant could pay a dividend out of its current-year earnings and profits, only to learn later that it had incorrectly computed its earnings.[24] A retroactive transfer pricing adjustment could deem a participant to have made a distribution.[25] A participant could pay its officers and employees with parent stock, which might be treated as a deemed cash-purchase of that stock depending on the structure of the stock compensation

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[22] Even where the repayment that is recharacterized as a stock redemption is not a section 302(d) redemption, it would appear to be a "distribution" with respect to stock within the meaning of Prop. Reg. § 1.385-3(b)(3)(ii)(A).

[23] *See* Prop. Reg. § 1.385-3(b)(3)(ii).

[24] Note that if the dividend had been equal to or less than the participant's current-year earnings and profits, the dividend would not be taken into account for purposes of Prop. Reg. § 1.385-3(b)(3)(ii), due to the application of the current-year earnings and profits exception set forth in Prop. Reg. § 1.385-3(c)(1) (*i.e.*, the aggregate amount of distributions and acquisitions taken into account with respect to any given taxable year is reduced by the issuer's current-year earnings and profits).

[25] *See* Treas. Reg. § 1.482-1(g)(3) (requiring conforming adjustments to be made with respect to transfer pricing adjustments, including potential deemed dividends); 81 Fed. Reg. 20912, 20922 ("[T]he term distribution is broadly defined as any distribution by a corporation to a member of the corporation's expanded group with respect to the distributing corporation's stock, regardless of whether the distribution is treated as a dividend within the meaning of section 316.") (Apr. 8, 2016).

system.[26] Or the IRS could retroactively treat some or all of a participant's borrowing as stock, either under the discretionary bifurcation rules set forth in the regulations[27] or due to a foot fault on the new documentation requirements.[28] In any of these cases (and likely others[29]), a taxpayer could go to great lengths to prevent cash pool participants from entering into proscribed distributions or acquisitions but, nonetheless, still find a cash pool borrowing recharacterized as stock.

2. Consequences of recharacterization in a global cash management system

As noted above, once a debt instrument is recharacterized as stock under the Proposed Regulations, it is recharacterized as such for all purposes of the Code.[30] The type of stock it becomes is based on the terms of the instrument, which in many cases will be nonvoting preferred stock with a fixed redemption date.[31] Turning back to the example above, the severity of the collateral consequences that can arise from this recharacterization becomes clear.

Assume FS3 engages in a proscribed transaction (*e.g.*, it experiences a retroactive transfer pricing adjustment resulting in a deemed dividend). First, any interest payments on FS3's borrowing will be treated as distributions with respect to the deemed stock now treated as held by FS Pool.[32] Furthermore, principal payments on the borrowing, including the repayment of the draw, will be characterized as redemptions of the stock and treated as distributions under section 302(d). This deemed dividend then will result in FS3's next draw from the cash pool being recharacterized as equity, and so on *ad infinitum*. These distributions will result in dividends to FS Pool to the extent of FS3's earnings and profits.[33]

The dividends will reduce the foreign taxes in FS3's foreign tax pools,[34] but will not move the foreign taxes to FS Pool's foreign tax pools because FS Pool does not own at least a 10-percent voting interest in FS3.[35] Consequently, the USP Group will permanently lose foreign tax credits associated with the earnings and profits paid from FS3 to FS Pool. In the context of cash pools issuing and extinguishing debt on a daily basis, this effect could result in a U.S. multinational enterprise's foreign tax credits slowly being leeched out of the system to the point that the group faces pervasive double taxation on its foreign earnings.

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26 *See* Treas. Reg. § 1.1032-3(b)(1).

27 *See* Prop. Reg. § 1.385-1(d).

28 *See* Prop. Reg. § 1.385-2(a)(1). The Proposed Regulations provide relief from a documentation failure if the taxpayer can establish such failure is due to reasonable cause. Prop. Reg. § 1.385-2(c)(1) (cross-referencing Treas. Reg. § 301.6724-1).

29 For example, a funded entity could run afoul of the Funding Rule if its wholly-owned subsidiary liquidates in a tax-free section 332 transaction, irrespective of whether that subsidiary is itself a funded entity, because the liquidation is a distribution of property and an acquisition of expanded group member stock for property to which no specific exception applies and after the liquidation the funded entity becomes a successor to the liquidated subsidiary. *See* Prop. Reg. § 1.385-3(f)(11)(i).

30 Prop. Reg. § 1.385-3(b)(1).

31 *See* 81 Fed. Reg. 20912, 20922, 20925 (Apr. 8, 2016).

32 *See* section 301(c).

33 Sections 301(c)(1), 316(a). Presumably these dividends would not result in subpart F income due to the related-party look-through exception. *See* section 954(c)(6); *see also* Notice 2007-9, 2007-1 C.B. 401.

34 Treas. Reg. § 1.902-1(a)(8).

35 *See* Treas. Reg. § 1.902-1(a)(1)-(4), (8)(i), and (11).

Next, because FS3's borrowing is recharacterized as a nonvoting equity interest held by FS Pool, USP no longer controls FS3 within the meaning of section 368(c) while the borrowing is outstanding.[36] Therefore, any contributions of assets by USP to FS3 become taxable exchanges rather than tax-free contributions,[37] and any intended reorganizations with FS3 likely will fail because USP no longer controls FS3.[38]

In addition, if FS3's borrowing is denominated in a nonfunctional currency of FS Pool, as is frequently the case for a cash pool, then any hedging transactions with respect to FS Pool's receivable under the borrowing no longer qualify as hedging transactions for U.S. federal income tax purposes[39] and any resulting foreign currency gains likely will constitute subpart F income,[40] currently includible in USP's taxable income.[41] This result is harsh, given that FS Pool will not experience economic foreign currency gain because the hedging transaction merely counteracts the foreign currency loss incurred with respect to the borrowing (*i.e.*, a loss that is not taken into account for subpart F purposes).

Similar concerns also arise in the context of foreign-parented groups. For example, consider the following fact pattern. FP, a foreign corporation, wholly owns USP, a domestic corporation, FS Pool, a foreign corporation, and FS, a foreign corporation. USP wholly owns US2, a domestic corporation that files a consolidated return with USP. US2 wholly owns CFC, a controlled foreign corporation, which wholly owns FDE, a foreign disregarded entity.

USP and FDE deposit excess cash with FS Pool, while US2, CFC, and FS borrow from FS Pool. Assume further that FS makes a distribution to FP in excess of FS's current-year earnings and profits.

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36 In particular, section 368(c) defines control as direct ownership of stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of other class of stock. In the example described above, after the FS3 borrowing is recharacterized, USP would continue to own 100 percent of the total combined voting power of FS3, but it would own zero percent of FS3's nonvoting stock (*i.e.*, the deemed stock).

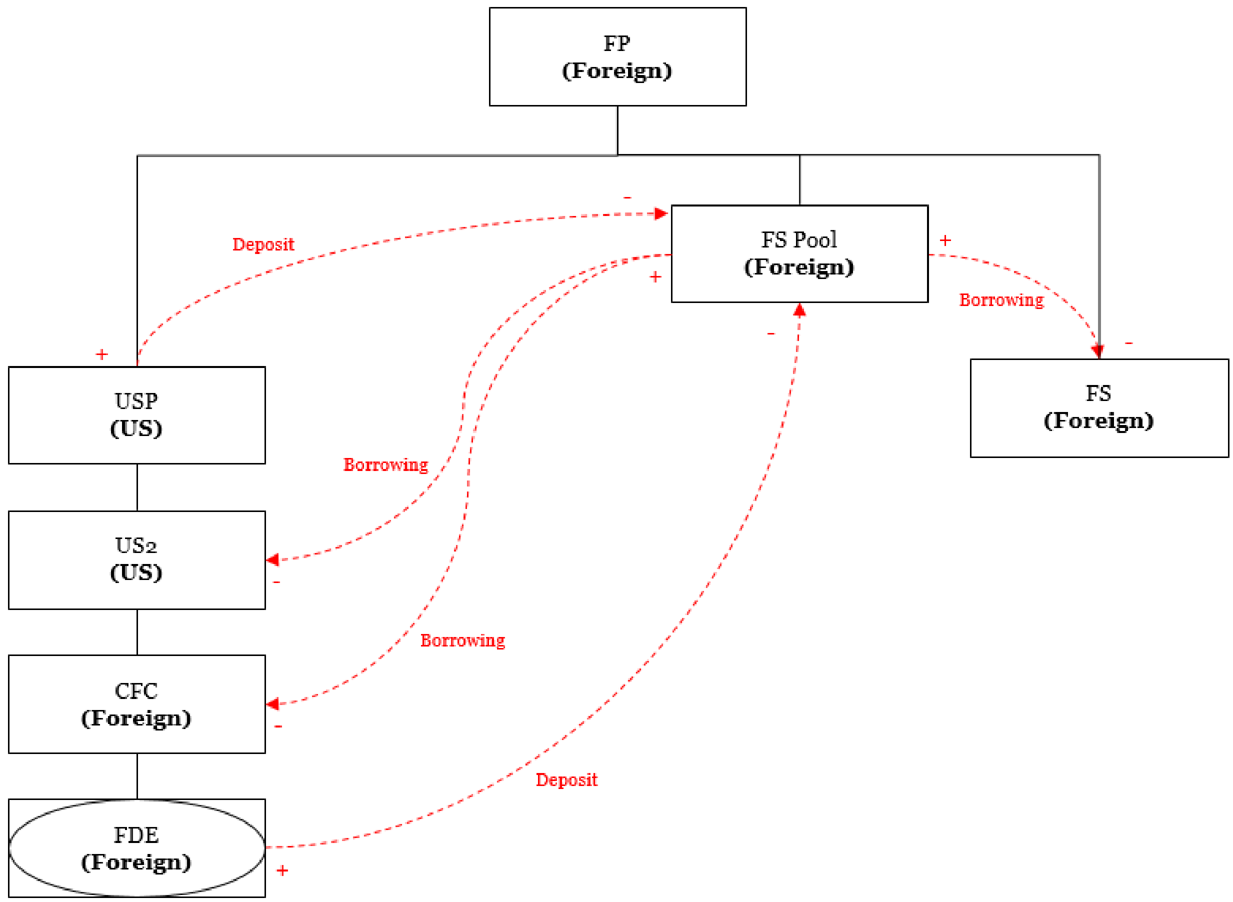
37 *See* section 351(a) (requiring the transferor(s) control the transferee within the meaning of section 368(c)).

38 *See* sections 355(a)(1)(A) (requiring a distribution of section 368(c) control) and 368(a)(1) (describing transactions that qualify as reorganizations, often by reference to control under section 368(c)).

39 Treas. Reg. § 1.1221-2 sets forth detailed rules for when a transaction constitutes a hedging transaction for U.S. federal income tax purposes. These rules generally apply for subpart F purposes. *See* Treas. Reg. § 1.954-2(a)(4)(ii)(A). Under Treas. Reg. § 1.1221-2(b)(2), a hedge qualifies as a hedging transaction only if it manages risk with respect to ordinary property or ordinary obligations. Thus a hedge with respect to stock (typically a capital asset) generally does not qualify as a hedging transaction for U.S. federal income tax purposes. *See Hoover Co. v. Comm'r*, 72 T.C. 206 (1979) (concluding that a hedge entered into with respect to foreign currency risks associated with subsidiary stock did not constitute a hedging transaction for U.S. federal income tax purposes), *acq.* 1984-2 C.B. 1. Similarly, with respect to qualified hedging transactions under Treas. Reg. § 1.988-5, the recharacterization of a qualifying debt instrument may result in a "legging out" (*i.e.*, integrated treatment of the debt and the qualifying hedge ends). *See* Treas. Reg. § 1.988-5(a)(6)(ii).

40 Section 954(c)(1)(D).

41 *See* section 951(a)(1)(A).



Under these facts, FS's borrowing would be recharacterized as stock.[42] Consequently, because FS Pool is now treated as acquiring FS stock (*i.e.*, stock of an expanded group member) for cash,[43] USP's and FDE's deposits are treated as funding FS Pool's acquisition of FS stock and therefore are recharacterized as stock.[44] Next, because FDE is a disregarded entity of CFC, CFC is treated as acquiring FS Pool stock (*i.e.*, stock of an expanded group member) for cash; therefore, its borrowing from FS Pool is recharacterized as stock.[45] Similarly, because USP and US2 are treated as a single taxpayer for these purposes,[46] US2 is treated as acquiring FS Pool stock (*i.e.*, stock of an expanded group member stock) for cash and therefore its borrowing from FS Pool is recharacterized as stock.[47]

As a consequence of these recharacterizations, and in addition to the concerns noted above, both US2's interest and principal payments would be characterized as dividends and be subject to U.S. withholding tax. This operation of the Proposed Regulations could effectively override treaty obligations of the United

42 *See* Prop. Reg. § 1.385-3(b)(3)(ii)(B).

43 FS Pool's acquisition of the FS shares would not qualify under the Prop. Reg. § 1.385-3(c)(3) exception for funded acquisitions of subsidiary stock by issuance because FS Pool does not directly or indirectly control FS under the principles of section 958(a).

44 *See* Prop. Reg. § 1.385-3(b)(3)(ii)(A).

45 *Id.* Again, the exception in Prop. Reg. § 1.385-3(c)(3) would not apply.

46 *See* Prop. Reg. § 1.385-1(e).

47 *See* Prop. Reg. § 1.385-3(b)(3)(ii)(A).

States in that such deemed dividends would be subject to higher rates of U.S. withholding than applicable to interest payments under many tax treaties.[48] Given that CFC's repayment of its borrowing from the pool would be a dividend to a shareholder not qualifying under section 902, the loss of its foreign tax credits also would effectively override a treaty with CFC's jurisdiction of residence to provide credits for taxes paid to that jurisdiction.

In addition, US2 could become deconsolidated from USP if the equity that it is deemed to issue does not qualify as section 1504(a)(4) stock.[49] Query whether it would if such equity is a recharacterized foreign currency denominated debt instrument.

The simple example could present other issues as well. Suppose, for example, that CFC has a low-tax earnings and profits pool. The repayment of its recharacterized borrowing would therefore be a deemed dividend pulling its low-tax earnings out from under the United States taxing jurisdiction, potentially providing a significant tax benefit. Would the "no affirmative use" rule of Prop. Reg. § 1.385-3(e) therefore prevent the recharacterization? Or would the recharacterized stock instead constitute fast-pay stock under Treas. Reg. § 1.7701(l)-3, resulting in the deemed dividend running up through the U.S. consolidated group and constituting a listed transaction that must be reported by USP?[50]

Other potential issues exist beyond the scope of our simple example. Are deemed loans (*e.g.*, non-periodic payments made with respect to notional principal contracts[51]) also impacted such that the arrangement is recast as equity and, thus, results in unanticipated timing and character mismatches of offsetting contracts or payments? To the extent a repayment is made by a domestic corporation or a foreign corporation with U.S.-source earnings and profits, is the recipient denied a dividends-received deduction because the deemed stock carries creditors' rights?[52]

3. Extent of recharacterization in a global cash management system

As discussed above, any participant in an internal cash management system could easily engage in a transaction that triggers the Funding Rule by paying employees with parent stock, experiencing a retroactive transfer pricing adjustment, missing an estimate of current-year earnings and profits, and so forth. Once one of these transactions occurs, the participant enters into a viral, self-replicating cycle of recharacterization.

Although the amount of a borrowing recharacterized under the Funding Rule is limited to the amount of a funded distribution in excess of current earnings and profits or the amount of the stock acquired in connection with the funding, this limitation would not operate effectively in the cash pool context. The reason is that once a debt is characterized as equity, the repayment of the debt generally will be characterized as a distribution by the borrower, resulting in recharacterizations of future borrowings. In

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48 *Compare, e.g.*, United States Model Income Tax Convention, art. 11(1) (2016) (generally providing for a 0 percent rate of withholding on interest income), *with id.* art. 10(2) (generally providing for a 15, 5, or 0 percent rate of withholding on dividend income, depending on certain ownership and other requirements).

49 *See* section 1504(a)(1) (requiring direct ownership of at least 80-percent vote and value to maintain affiliated group status).

50 *See* Treas. Reg. § 1.7701(l)-3(b)(2)(i), (f)(1)(ii); Notice 2009-59, 2009-31 I.R.B. 170. Recharacterized debt that provides for an amortization of principal over its term would appear to be subject to these rules. The fixed date for redemption of such equity also might result in fast pay classification.

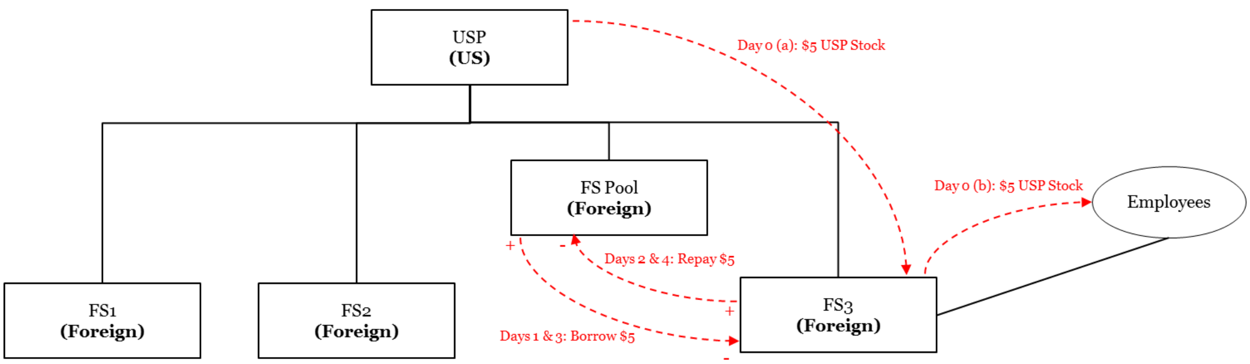
51 *See, e.g.,* Treas. Reg. § 1.446-3.

52 *See* Rev. Rul. 94-28, 1994-1 C.B. 86 (denying a dividends-received deduction on the basis that the requisite holding period was not satisfied because the stock carried creditors' rights); *see also* section 245 (providing for a dividends-received deduction with respect to dividends from foreign corporations with U.S.-source earnings and profits); PLR 200952031 (Dec. 24, 2009) (confirming that a controlled foreign corporation may take a dividends-received deduction against its subpart F income for dividends received from a domestic corporation).

addition, the characterization of the loan receivable as equity in the hands of the cash pool results in the cash pool having acquired equity in an affiliate, thereby resulting in the recharacterization of the deposits taken by the cash pool as equity.

For example, assume that on Day 0, FS3 pays its employees with $5 of USP stock, resulting in a $5 deemed acquisition of expanded group member stock in exchange for property. Further assume that FS3 has a balance with the cash pool of -$5 on every odd day and $0 on every even day (as a proxy for FS3's fluctuating balance over the year).

Entity	Day	Daily Change	Balance
FS3	1	Borrow $5 (-)	-$5
	2	Repay $5 (+)	$0
	3	Borrow $5 (-)	-$5
	4	Repay $5 (+)	$0



Under the Proposed Regulations, all of FS3's borrowing on Day 1 would be recharacterized as equity because it would be deemed to fund FS3's Day 0 acquisition of USP stock.[53] FS3's repayment of the borrowing on Day 2 would constitute a redemption of the equity issued on Day 1, resulting in a deemed distribution from FS3 to FS Pool.[54] FS3's borrowing on Day 3 also would be recharacterized as equity because it would be deemed to fund FS3's Day 2 distribution.[55] Thus, FS3's repayment on Day 4 would constitute another redemption and another distribution.[56] This cycle would continue indefinitely, with FS3 never escaping the $5 taint created by the Day 0 transaction, even after the 72-month period has expired with respect to that acquisition.[57]

Even more concerning than FS3's perpetual subjection to the Funding Rule, however, would be the impact on FS Pool and the collateral consequences to other cash pool participants. Because FS3's

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53 Prop. Reg. § 1.385-3(b)(3)(ii)(B); *see also* Treas. Reg. § 1.1032-3(b)(1).

54 *See* section 302(d).

55 *See* Prop. Reg. § 1.385-3(b)(3)(ii)(A).

56 *See* section 302(d).

57 This analysis assumes that each subsequent borrowing is treated as funding only a distribution or acquisition not already treated as funded by a prior borrowing. Note that although Prop. Reg. § 1.385-3(b)(3)(iv)(B)(3) provides that if two or more debt instruments could be treated as funding a single distribution or acquisition then they are tested in the order issued, it is not clear whether this rule prevents a later debt instrument from being treated as funding a distribution or acquisition that was funded by a prior debt instrument that has since been retired. If it does not, then FS3's subsequent borrowings also could be treated as funding the Day 0 acquisition and other borrowing repayments, magnifying FS3's taint under the Proposed Regulations.

borrowing is treated as equity, FS Pool is treated as acquiring expanded group member stock.[58] Consequently, FS Pool's borrowings from other participants (*i.e.*, from FS1 and FS2) would be recharacterized as equity.

As of Day 1, FS Pool will be deemed to have acquired $5 of FS3 stock, thereby recharacterizing $5 of FS1's and FS2's deposits with FS Pool.[59] As of Day 3, however, FS Pool will be deemed to have acquired $10 of FS3 stock ($5 on Day 1 and $5 on Day 3), increasing the amount of the deposits recharacterized. This effect is cumulative, resulting in an array of serial expanded group member stock acquisitions deemed to be undertaken by FS Pool and, therefore, an ever-expanding taint on deposits accepted by FS Pool. The results of the preceding example are depicted in the below table:

Entity	Day	Daily Change	FS3 Receivable Balance	Total Related-Party Stock Acquisitions
FS Pool	1	Borrow $5 (-)	$5	$5
	2	Repay $5 (+)	$0	$5
	3	Borrow $5 (-)	$5	$10
	4	Repay $5 (+)	$0	$10

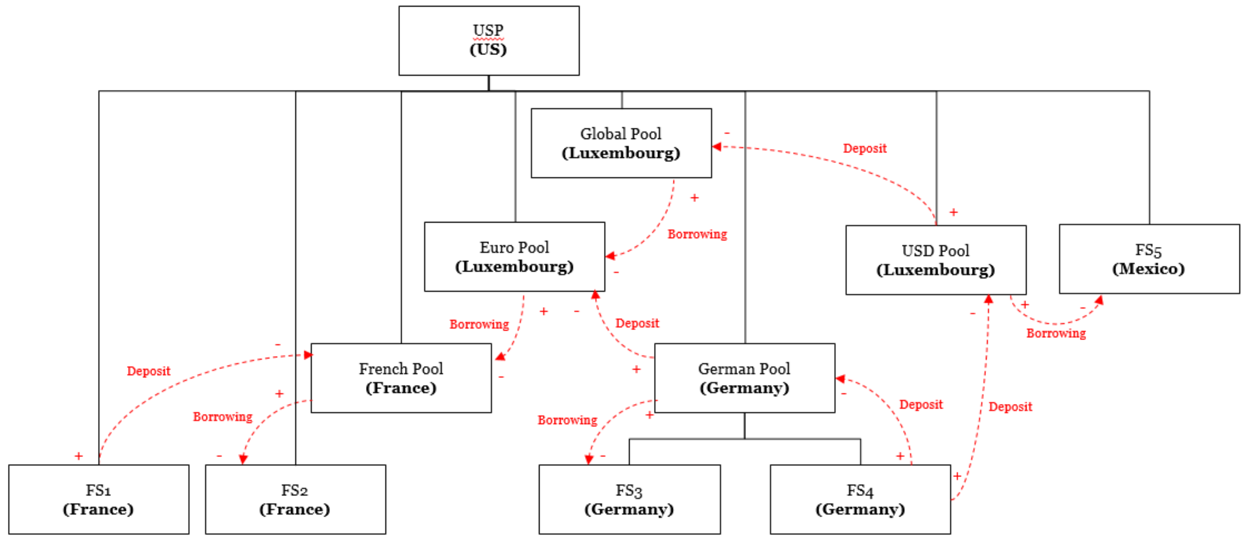
The cumulative effect on a cash pool's ability to engage in intercompany lending only worsens as the enterprise grows in size. The simple example described above consists of a single cash pool with only three participants. Many multinational enterprises, however, maintain a separate cash pool for each country in which they have multiple subsidiaries to minimize local tax issues such as withholding taxes. These local country cash pools then may participate in a currency-specific cash pool to minimize the impact of currency risks. Finally, the currency-specific cash pools may feed into a multi-currency global cash pool which centralizes both cash and currency risk.

In a common structure like this, if a cash pool participant engages in a proscribed transaction and thereby taints the local country cash pool head, this has the potential to successively infect the currency-specific cash pool (*i.e.*, if the local country cash pool head borrows from the currency-specific cash pool during the 72-month period) and the global cash pool (*i.e.*, if the currency-specific cash pool head borrows from the global cash pool during the 72-month period). As discussed above, these effects accumulate as balances fluctuate, eventually magnifying a small foot fault by one participant into a systemic problem that recharacterizes funding transactions across the global cash management system.

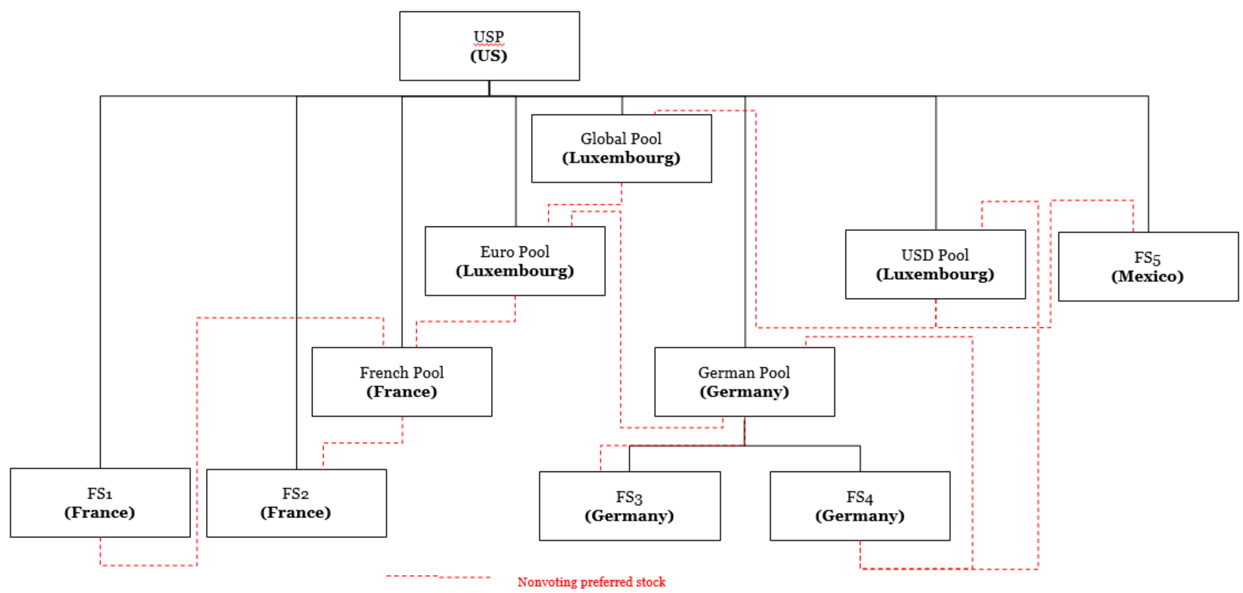
58 Prop. Reg. § 1.385-3(b)(3)(ii)(B); *see also* Prop. Reg. § 1.385-3(g)(3) Ex. 1 (applying the Funding Rule to a debt instrument based on the General Rule recharacterizing a different debt instrument).

59 Prop. Reg. § 1.385-3(b)(3)(ii)(B). The deposits are recharacterized in the order in which they were issued. Prop. Reg. § 1.385-3(b)(3)(iv)(B)(3).

For example, consider the following simplified global cash pool structure:



After one retroactive transfer pricing adjustment to one borrower and a sufficient period of fluctuating balances, the global cash pool structure instead would look like this:



The consequences of the potential systemic recharacterization described above are severe. With extensive cross-chain equity interests being issued and repaid on a daily basis, a multinational enterprise's global operations could experience (i) widespread loss of foreign tax credits; (ii) inability to effectuate tax-free capitalizations, reorganizations, and liquidations; (iii) non-economic subpart F income from mismatched foreign currency exposures; (iv) concerns of fast-pay stock and listed transactions; and (v) unmanageable complexity and uncertainty associated with a structure for U.S. tax purposes that is completely disconnected from the enterprise's structure for commercial, financial accounting, and foreign tax purposes.[60]

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60 The above discussion has focused on physical cash pooling and intercompany financing. Some companies use notional cash pooling to manage cash deployment and foreign currency exposures. Instead of actual cash transfers

VI. Observations

The dire effects of Prop. Reg. §§ 1.385-3 and -4 on cash pooling and treasury operations described above could not have been intended. The approach of the Proposed Regulations needs to be reconsidered, and significant work needs to be done to determine whether the stated policy goals of the Proposed Regulations can be achieved without fundamentally disrupting the day-to-day treasury operations of multinational groups.

Moreover, taxpayers should not be required to anticipate the potential unintended consequences of the Proposed Regulations on transactions entered into today while the operation of these rules is being reconsidered. Accordingly, the proposed retroactive transition rule under Prop. Reg. § 1.385-3(h) should be withdrawn. Cash pooling and treasury funding operations are not tax advantaged transactions that can be discontinued on short notice – they are how multinationals meet payrolls and fund the purchase of inventory.

VII. See also

April 7 PwC Tax Insight – Proposed Treasury Regulations under Section 385 would have profound impact on related party financings

April 28 PwC Webcast Recording – Section 385 Regulations

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between participants and a pool head, a third-party bank notionally nets participants' accounts to determine the aggregate interest to pay or charge based on the group's net cash position. As a result, cash-poor affiliates can borrow from the bank based on the strength of other affiliates' deposits at a reduced financing cost. Because each participant deposits or borrows in its functional currency, this system also effectively manages the foreign currency exposures that an internal cash pool head would otherwise need to manage.

Although notional cash pooling is conducted entirely through interactions with a third-party bank and generally does not include related-party transactions, consideration should be given to whether the bank could be treated as a conduit, resulting in the participants being treated as directly loaning to one another. For example, Rev. Rul. 87-89, 1987-2 C.B. 195 (*obsoleted in part by* Rev. Rul. 95-56), Rev. Rul. 76-192, 1976-1 C.B. 205, and Treas. Reg. § 1.881-3(c) address circumstances where, for purposes of sections 956 and 881, borrowings from a bank are treated as borrowings from a related party if the bank would not have made the loan on the same terms but for the related party's deposit with the bank. The Proposed Regulations provide no guidance with respect to notional cash pooling, but these (and other) conduit authorities arguably might support treating notional cash pool deposits and borrowings as deemed related-party debt instruments that are subject to potential recharacterization.