Follow-Up Discussion of the Final Section 385 Related-Party Debt Rules

Final and Temporary Regulations Limit and Clarify Proposed Documentation and Recharacterization Rules That Now Apply Mainly to “Inbound” Related-Party Debt Instruments

EXECUTIVE SUMMARY

On October 13, 2016, the Internal Revenue Service (the “IRS”) and the Treasury Department issued widely anticipated final regulations (the “Final Regulations”) and temporary regulations (the “Temporary Regulations,” and, together with the Final Regulations, the “Final and Temporary Regulations”) that in some circumstances treat debt issued by a U.S. corporation and held by a related party outside a U.S. consolidated group as equity for U.S. tax purposes. This memorandum follows up on our earlier memorandum that provided a summary overview of the Final and Temporary Regulations,1 and provides a more detailed description of the Final and Temporary Regulations.

These debt/equity regulations were first issued in proposed form on April 4, 2016 (the “Proposed Regulations”), and the new regulations generally retain the structure and general approach of the Proposed Regulations. Thus, the Final and Temporary Regulations continue to include: (i) rules that would recharacterize applicable related-party debt if it fails to meet certain documentation requirements (the “Documentation Requirements”) and (ii) rules that would recharacterize applicable related-party debt if it is in effect distributed, rather than issued for cash (and therefore effectively replaces equity capital) (the “Inbound Distributed Debt Rules”). However, the IRS and Treasury Department have significantly narrowed the Final and Temporary Regulations in response to feedback received from taxpayers and commentators.

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1 See IRS Significantly Narrows New Regulations Dealing with Related-Party Debt.
• **General Non-Application to U.S.-Parented Multinationals.**
  
  The Final and Temporary Regulations generally do not apply to debt instruments issued by foreign corporations, including foreign subsidiaries of U.S. multinationals. (Treasury and the IRS have reserved on the treatment of foreign corporations, so this matter might ultimately be revisited.)

  Since the Final and Temporary Regulations continue not to apply to debt between members of a U.S. consolidated group, the Final and Temporary Regulations apply to U.S. multinationals only in limited situations (e.g., if a U.S.-parented multinational owns a controlled RIC or REIT, if a U.S.-parented multinational owns a foreign subsidiary that in turn owns domestic subsidiaries or makes loans to U.S. affiliates, or for debt issued between members that may not be part of the same consolidated group, such as debt issued by some life insurance companies).

  The treatment of U.S. multinationals is further discussed on page 2 of this publication.

• **Exceptions for Inbound Loans to U.S. Regulated Financial and Insurance Company Subsidiaries.**

  The Inbound Distributed Debt Rules do not apply to debt instruments issued by U.S. “regulated financial companies” or their direct or indirect subsidiaries (other than loans issued by subsidiaries engaged in a non-financial business). “Regulated financial companies” are broadly defined to include (among other things) banks and bank holding companies, U.S. intermediate holding companies of foreign banking organizations, nonbank financial companies designated by the Financial Stability Oversight Council for enhanced supervision by the Federal Reserve, brokers and dealers registered under the Securities Exchange Act of 1934, futures commissions merchants and swap dealers. Moreover, the regulations do not specifically prohibit a U.S. group member that has issued debt qualifying for this exception from lending or contributing funds to a member that does not qualify. The Final and Temporary Regulations generally do not apply to debt issued by the U.S. branch of a foreign financial institution, because such debt is deemed issued by a foreign corporation for U.S. tax purposes.

  The Inbound Distributed Debt Rules also do not apply to debt instruments issued by qualifying “regulated insurance companies” domiciled or organized in any U.S. state or the District of Columbia.

  These companies continue to be subject to the Documentation Requirements in the Final Regulations. However, the Documentation Requirements provide a special rule for debt instruments issued by regulated financial companies with terms required by a regulator to satisfy regulatory capital or similar requirements. Such instruments generally will be deemed to meet the Documentation Requirements notwithstanding that such terms are inconsistent with the general prescriptions of the Documentation Requirements. Moreover, Treasury and the IRS are considering issuing additional guidance addressing the debt-equity issues raised by such securities under common law. Presumably any such guidance would speak to the circumstances under which so-called TLAC securities would be clearly respected as debt for U.S. tax purposes.

  This memorandum discusses the treatment of inbound loans to regulated financial and insurance companies under the Documentation Requirements starting on page 10, and under the Inbound Distributed Debt Rules starting on page 3.

• **Postponement and Relaxation of Documentation Requirements for Inbound Loans.**

  The Documentation Requirements have been postponed and modified in a manner that should make them easier to comply with. In particular, although the general structure of the Documentation Requirements in the Proposed Regulations has been maintained, the substantive rules in the Documentation Requirements are now more accommodating of...
practices (such as the use of “industry standard” legal documentation and considering an issuer’s ability to refinance indebtedness when evaluating that issuer’s creditworthiness) that are generally accepted by unrelated lenders.

- The revised Documentation Requirements do not apply to debt instruments issued by partnerships, and they generally allow a group of related corporations to evaluate each borrower’s creditworthiness on an annual basis.

- The final Documentation Requirements will not apply to debt instruments issued before January 1, 2018. In addition, the required materials generally may be prepared prior to the timely filing (including extensions) of the issuer’s tax return for the relevant taxable year (rather than within 30 days of when the relevant instrument is issued).

- Failure to satisfy the Documentation Requirements with respect to a debt instrument will merely create a presumption that the indebtedness is equity for U.S. federal income tax purposes, rather than causing the debt to be treated as equity per se, so long as the issuer’s group is otherwise “highly” compliant with the Documentation Requirements.

- We discuss the revised Documentation Requirements in additional detail starting on page 5.

- **No Bifurcation Authority.** The Proposed Regulations would have expressly permitted the IRS to bifurcate an instrument by treating it as partly indebtedness and partly equity for U.S. federal income tax purposes. This feature is not included in the Final and Temporary Regulations.

- **Short-Term/Cash Pooling Exception for Inbound Lenders.**
  
  - The Temporary Regulations provide an exception to the per se “funding rule” (as described below) for short-term loans among affiliates to cover cash pooling, cash sweeping and similar arrangements. In particular, the Temporary Regulations provide that certain demand deposits made with a “qualified cash pool header” (i.e., an entity principally serving a cash management function for the depositor’s group) are not subject to the Funding Rule.
  
  - Subject to certain detailed tests in the Temporary Regulations, qualifying short-term borrowings are also exempted from the Funding Rule to the extent that the issuer is not a “net borrower” from related parties for more than 270 days of the taxable year (or, alternatively, to the extent that the interest rate and aggregate outstanding balance meets certain tests reflecting that such borrowings are consistent with the funding needs of the issuer for its “normal operating cycle”).
  
  - The Temporary Regulations also exempt interest-free loans without original issue discount from the Funding Rule.
  
  - Finally, under the Documentation Requirements in the Final Regulations, revolving, cash pooling and similar arrangements generally must be documented at least annually.
  
  - The short-term/cash pooling exception is discussed further on page 17.

- **Elimination of the “Cliff Effect” of the “Threshold Exception” to the Inbound Distributed Debt Rules.** Under the Proposed Regulations, a group that exceeded a $50 million de minimis “threshold exception” under the Inbound Distributed Debt Rules would have lost this exception entirely (meaning that previously exempted instruments would have been recharacterized as equity once the limitation was exceeded). The Final and Temporary Regulations remove this rule (so that if a group breaches the “threshold exception”, only the amount in excess of $50 million is recharacterized). This is discussed in further detail starting on page 19 of this publication.
Addeional Exceptions to the Inbound Distributed Debt Rules. Although the Final and Temporary Regulations generally retain the per se “Funding Rule” of the Proposed Regulations (which automatically aggregates transactions, over up to a six-year period, for purposes of applying the Inbound Distributed Debt Rules), the Final and Temporary regulations generally broaden exceptions to the Distributed Debt Rules as a whole, particularly by:

- **Netting Distributions and Contributions** – Allowing distributions to be netted against capital contributions;
- **Providing an Accumulated Earnings Exception** – Replacing an exception for distributions and acquisitions not in excess of current earnings with an exception generally based on earnings accumulated from taxable years ended after April 4, 2016; and
- **Providing Ordinary Course/Employee Compensation Plan Exceptions** – Expanding exceptions for ordinary course transactions, including certain acquisitions of stock in connection with employee compensation plans.

These exceptions are discussed in greater detail starting on page 14 of this publication.

**RICs, REITs and S Corporations.**

- The Final and Temporary Regulations do not apply to groups parented by RICs or REITs. However, RICs and REITs may continue to be subject to the Final and Temporary Regulations if they are subsidiaries of a common parent that is not a RIC or a REIT.
- S corporations are exempted from the Final and Temporary Regulations entirely.

**Effective Date of Inbound Distributed Debt Rules.**

- The Inbound Distributed Debt Rules generally will still apply to debt instruments issued after April 4, 2016, except that a debt instrument generally will not be recharacterized as equity under the Inbound Distributed Debt Rules until 90 days after October 21, 2016 (when the Final and Temporary Regulations are intended to be published in the Federal Register).
- For debt instruments issued on or before October 12, 2016, the Final Regulations contain a grandfathering rule generally permitting the Inbound Distributed Debt Rules in the Proposed Regulations to be applied in lieu of those in the Final and Temporary Regulations, subject to certain consistency requirements.

As noted above, these changes mean that the principal effect of the Final and Temporary Regulations will be on foreign-parented multinationals, and this effect will be particularly pronounced (given the exception from the Distributed Debt Rules for regulated financial groups) on non-financial multinationals. However, the preamble to the Final and Temporary Regulations states that certain elements of the Proposed Regulations that were not included in the Final and Temporary Regulations remain under study. These aspects include: (i) the potential application of the Final and Temporary Regulations to debt instruments

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While the Final and Temporary Regulations generally target foreign-parented multinationals, it should be noted that some cases remain in which the Final and Temporary Regulations, including both the Documentation Requirements and what this memorandum describes as the “Inbound” Distributed Debt Rules, may apply in transactions between U.S. issuers that are not members of the same consolidated group.
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issued by foreign corporations and (ii) the potential adoption of a rule that would allow the IRS to bifurcate a single instrument into debt and equity components.
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BACKGROUND

The Final Regulations were issued under Section 385 of the U.S. Internal Revenue Code (the “Code”), which authorizes the U.S. Treasury Department to promulgate regulations setting forth factors for determining whether an interest in a corporation constitutes debt or equity and provides a non-exclusive list of factors that could be included in such regulations. Although regulations were previously issued under this provision in 1980, the 1980 regulations were withdrawn (after several revisions) in 1983.

On April 4, 2016, the IRS and Treasury Department issued the Proposed Regulations. Although the Proposed Regulations were issued concurrently with temporary regulations intended to limit the benefits of so-called “inversion” transactions, the Proposed Regulations were not limited to “inverted” groups and had a much broader scope. For example, the Proposed Regulations would have potentially affected U.S.-parented groups that owned foreign subsidiaries. Certain purely domestic groups (such as groups that included regulated investment companies, real estate investment trusts and certain insurance companies) that are ineligible to file consolidated returns were also within the scope of the Proposed Regulations. As discussed below, the Final and Temporary Regulations generally apply only to REITs, RICs and insurance companies that are subsidiaries of a larger affiliated group. Moreover, the Proposed Regulations did (and as discussed below, the Final and Temporary Regulations still do) potentially affect all foreign-parented groups with U.S. subsidiaries (without regard to whether the group had participated in an inversion transaction).

Broadly speaking, the Proposed Regulations consisted of three main elements. The first of these—the “Documentation Requirements”—introduced new recordkeeping and similar rules for issuers and holders of related-party debt. The second—the “Distributed Debt Rules”—was intended to modify the tax treatment of transactions that can create related-party leverage without an investment of new capital, and this set of rules generally applied to debt instruments that are distributed to a related party, issued in exchange for stock of a related party, or issued in other transactions (including certain asset reorganizations and transactions that may fund distributions) that the IRS and Treasury believed could be used for similar purposes. The third set of rules within the Proposed Regulations—the so-called “bifurcation authority”—would have permitted the IRS to characterize an instrument as partly indebtedness and partly equity for U.S. federal income tax purposes. The Proposed Regulations generally would have applied the Documentation Requirements and bifurcation authority to instruments issued (or deemed issued) on or after the regulations were finalized, and generally would have applied the Distributed Debt Rules to instruments issued (or deemed issued) on or after April 4, 2016, except that instruments issued before the date the regulations were finalized would not have been subject to recharacterization until 90 days after finalization.

3 The Proposed Regulations were published in the Federal Register at 81 FR 40226.
A. SCOPE OF THE FINAL AND TEMPORARY REGULATIONS

Although the Final and Temporary Regulations retain the general structure of the Proposed Regulations, the scope of the Final and Temporary Regulations has been significantly narrowed. As a result (and as discussed more fully below), the Final and Temporary Regulations are likely to be most relevant to foreign-parented multinational groups that are not in regulated financial sectors and that hold “inbound” debt of U.S. subsidiaries.

1. Limited Application to U.S.-Parented Groups

The Final and Temporary Regulations currently have only a limited relevance to U.S.-parented groups, because the regulations do not apply to obligations that (i) are issued by a foreign corporation or (ii) are between members of a U.S. consolidated group.

a. Non-Application to Consolidated Groups

In general, the Final and Temporary Regulations, like the Proposed Regulations, are relevant only to related-party debt (i.e., obligations that exist between members of what the Final Regulations refer to as an “expanded group”).4 However, Final and Temporary Regulations generally do not affect debt instruments that exist entirely between members of a U.S. consolidated group.5 Moreover, the

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4 An “expanded group” generally includes a parent corporation, together with any corporation that is at least 80% owned (by either vote or value, and directly or indirectly) by that parent corporation. More technically, the Final Regulations define an “expanded group” to mean one or more chains of corporations (excluding S corporations) connected through stock ownership with a common parent (other than a REIT, RIC or S corporation) (the “expanded group parent”), but only if (i) the expanded group parent owns, directly or indirectly, at least 80% of the voting power or value in at least one of the other corporations and (ii) 80% of the voting power or value in each of the other corporations is owned directly or indirectly by one or more of the other corporations. See Treas. Reg. § 1.385-1(c)(4). For this purpose, indirect ownership is generally determined under the attribution rules of Section 318 of the Code with certain modifications including by (i) increasing the ownership threshold from 5% to 50% in the case of “upward attribution” from corporations and (ii) limiting “option attribution” to options reasonably certain to be exercised (unlike the Proposed Regulations). Importantly, the Final Regulations reserve pending further study on the application of the “downward attribution” rules, which could have caused anomalous results—for example, under the Proposed Regulations, if otherwise unrelated corporations were partners in a joint venture, each of one partner’s subsidiaries could have been treated as owning the other partners’ subsidiaries such that all of the subsidiaries would have been treated as an expanded group. Similarly, under the Proposed Regulations, portfolio companies of a fund treated as a partnership could have been treated as owning each other’s stock, resulting in overlapping “brother/sister” expanded groups with each portfolio being a common parent of one such group.

5 Both the Documentation Rules and the Inbound Distributed Debt Rules reach this result, but under somewhat different approaches. In particular, the Inbound Distributed Debt Rules generally treat all corporations within a consolidated group as a single entity. See Treas. Reg. § 1.385-4T(b)(1). The Documentation Requirements generally do not treat a consolidated group as a single entity, but exclude obligations existing within a consolidated group by not treating intercompany obligations as (continued . . .)
partnership rules in the Final and Temporary Regulations apply on a look-through basis, so in effect, the partnership rules also do not apply to members of a consolidated group.

b. Exclusion of Foreign Issuers

The Final and Temporary Regulations do not apply at all to obligations of foreign corporations, including foreign subsidiaries of U.S. multinationals. More specifically, the Final and Temporary Regulations apply only to debt instruments issued by “covered members” of an expanded group.\(^6\) Entities other than domestic corporations are excluded from the definition of a “covered member.” Notwithstanding this change, the Final and Temporary Regulations reserve on such instruments, and the preamble to the Final and Temporary Regulations states that whether rules similar to the Final and Temporary Regulations should apply to foreign issuers in the future is a question that remains under study.

c. Exception for Certain Regulated Financial and Insurance Companies

The preamble to the Final and Temporary Regulations recognizes that certain financial and insurance companies are subject to federal and state regulation that prevent them from engaging in the type of transactions with which the regulations are concerned. Accordingly, the Final Regulations provide a new exception from the Inbound Distributed Debt Rules for debt instruments issued by “regulated financial companies.” However, the Documentation Requirements continue to apply to such instruments that are issued on or after January 1, 2018. “Regulated financial companies” are broadly defined to include (among other things) banks and bank holding companies, U.S. intermediate holding companies of foreign banking organizations, non-bank financial companies designated by the Financial Stability Oversight Council for enhanced supervision by the Federal Reserve, brokers and dealers registered under the Securities Exchange Act of 1934 (the “Exchange Act”), futures commissions merchants and swap dealers.\(^7\)

The debt instruments of a subsidiary within an expanded group headed by a regulated financial company (a “regulated financial group”) are also generally excepted from the Inbound Distributed Debt Rules, even if the subsidiary is not itself a regulated financial company. However, subsidiaries engaged in certain merchant banking and other non-financial activities do not qualify for the exception from the Inbound Distributed Debt Rules, even if other subsidiaries within the group qualify for the exception.\(^8\) In addition, a regulated financial group does not include an expanded group headed by certain types of regulated

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\(^6\) See Treas. Reg. § 1.385-1(c)(2).

\(^7\) See Treas. Reg. § 1.385-3(g)(3)(iv).

financial companies — specifically, a broker or dealer registered under the Exchange Act, a futures commissions merchant, a swap dealer, a security-based swap dealer, a Federal Home Loan Bank, a Farm Credit System Institution or a small business investment company. Accordingly, for groups parented by these types of regulated financial companies (even though the parent of such the group is a “regulated financial company” whose debt instruments are excepted from the Inbound Distributed Debt Rules)—the parent’s status as a regulated financial company does not qualify its subsidiaries for the exception. However, no specific rule appears to prevent a group parent that issues debt to a related foreign parent qualifying for this exception from also lending or contributing funds to a member that could not issue qualifying debt.9 (The Final and Temporary Regulations generally do not apply to debt issued by the U.S. branch of a foreign financial institution, because such debt is deemed issued by a foreign corporation for U.S. tax purposes.)

Similarly, the Inbound Distributed Debt Rules also do not apply to debt instruments issued by qualifying “regulated insurance companies.” However, the Documentation Requirements continue to apply to such instruments that are issued on or after January 1, 2018. “Regulated insurance companies” generally are defined as corporations that (i) are subject to tax under Subchapter L of the Code (i.e., as an insurance company), (ii) are domiciled or organized in any U.S. state or the District of Columbia, (iii) are licensed, authorized or regulated by one or more states or the District of Columbia to sell insurance, reinsurance or annuity contracts to persons (other than related persons) in such jurisdiction and (iv) are engaged in regular issuance of (or subject to ongoing liability with respect to) insurance, reinsurance or annuity contracts with unrelated persons.10 Accordingly, captive insurance companies servicing only related persons do not qualify for the exception. In addition, unlike the exception for regulated financial groups, there is no exception for non-insurance company subsidiaries of an insurance company parent.

2. Circumstances in Which U.S. Multinationals May Be Affected by the Final and Temporary Regulations

Notwithstanding the discussion above, the Final and Temporary Regulations can apply to U.S.-based multinationals in certain limited circumstances. For example, the Final and Temporary Regulations continue to apply to transactions between related U.S. corporations that are not members of the same consolidated group, even if they are members of the same affiliated group.11 Additional situations in

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9 There is, however, a general anti-abuse rule if a transaction is entered into with a principal purpose of avoiding the purposes of the Inbound Distributed Debt Rules.

10 See Treas. Reg. § 1.385-3(g)(3)(v).

11 For example, the Final and Temporary Regulations would continue to apply to transactions between corporations that are part of the same “expanded group” (as defined below) but involve (i) corporations that cannot be members of a consolidated group (such as certain insurance companies, whose debt instruments remain subject to the Documentation Requirements), (ii) corporations that do not meet the ownership requirements for consolidation (for example, corporations that meet an 80% (continued . . .)
which a U.S. multinational could be affected by the Final and Temporary Regulations include (i) if a U.S.-parented group owns a controlling interest in a RIC or REIT, (ii) if a U.S. multinational owns a domestic subsidiary through an intervening foreign subsidiary or (iii) if a foreign subsidiary makes significant loans to U.S. affiliates.

3. Debt Instruments of Entities Parented by RICs and REITs

An “expanded group” does not include groups with a RIC or a REIT as a common parent. Accordingly, debt instruments issued by non-controlled RICs and REITs are not subject to the Final and Temporary Regulations (including both the Documentation Requirements and the Inbound Distributed Debt Rules).

4. Application to “Brother-Sister” Corporations That Lack a Corporate Parent

In general, the Final and Temporary Regulations do not apply to “brother-sister” corporations with a common non-corporate parent. However, the preamble to the Final and Temporary Regulations states that the IRS and Treasury Department are continuing to evaluate whether rules similar to the Final and Temporary Regulations should apply to “brother-sister” corporations.

B. DOCUMENTATION REQUIREMENTS

1. Background on the Documentation Requirements

Under the Documentation Requirements, U.S. issuers and holders of covered related-party debt generally must prepare and maintain records to substantiate the characterization of certain interests as debt for federal income tax purposes. At a high level, the structure and nature of the Documentation Requirements is unchanged from the Proposed Regulations, although—as discussed further below—significant aspects of the Documentation Requirements have been relaxed.

An instrument that does not comply with the Documentation Requirements is generally recharacterized as equity for U.S. federal income tax purposes. However, under a new exception included in the Final Regulations that is discussed further below, if the issuer’s group is otherwise “highly compliant” with the Documentation Requirements, then the failure to meet the requirements with respect to an instrument will only create a rebuttable presumption that the instrument should be treated as equity, rather than an automatic recharacterization of the instrument as equity per se.

(continued)

ownership test by vote or value (but not both) or by certain attribution rules) or (iii) affiliated corporations that do not elect to file consolidated returns.

12 See Treas. Reg. § 1.385-1(c)(4)(i); Code Section 1504(b)(6).

13 The Proposed Regulations included a “no affirmative use” rule that would have prevented expanded groups relying on a failure to satisfy the Documentation Requirements to establish that an instrument is treated as equity for U.S. tax purposes. The Final and Temporary Regulations do not include such a rule, and instead reserve on this subject.
2. Applicability

Consistent with the Proposed Regulations, the Documentation Requirements only apply to “expanded group interests” (EGIs)\(^{14}\) that are issued by a member of an “expanded group.” In general, an EGI is an “applicable interest” (as discussed below) that is issued by a U.S. corporation and is held by one of the following:

- a corporation within the issuer’s expanded group;
- a disregarded entity of a regarded corporation within the issuer’s expanded group; or
- a partnership whose partners include a corporation in the issuer’s expanded group.\(^{15}\)

The Documentation Requirements also will not apply to either (i) an EGI existing within an expanded group that does not meet the “threshold” limitations discussed below or (ii) an EGI that is issued prior to the effective dates discussed below.

a. Threshold

The Documentation Requirements only apply to an EGI if, on the date the instrument first becomes an EGI, the relevant expanded group meets certain “threshold limitations.” An expanded group meets these threshold limitations if: (i) the stock of any member of the group is publicly traded; (ii) the total assets of the expanded group exceed $100 million; or (iii) the annual total revenue of the expanded group exceeds $50 million.\(^{16}\) This exemption is unchanged from its counterpart in the Proposed Regulations.

b. Applicable Interests

As noted above, an instrument cannot be an EGI unless that instrument is an “applicable interest.” In general, an “applicable interest” is any instrument issued by a domestic corporation that takes the form of debt (including an intercompany receivable),\(^{17}\) unless that instrument:

- exists entirely within a consolidated group of U.S. corporations;\(^ {18}\) or
- is a special type of debt instrument (including certain production payments, REMIC regular interests and certain debt instruments that are deemed to arise from a transfer pricing

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\(^{15}\) See Treas. Reg. § 1.385-2(d)(3).


\(^{17}\) As was the case in the Proposed Regulations, the Documentation Requirements in the Final and Temporary Regulations reserve on the treatment of other interests that, by their form, are not denominated as debt (such as sale/repurchase transactions), and therefore do not apply to such interests at present.

\(^{18}\) The Documentation Requirements continue to apply to debt instruments between non-consolidated U.S. corporations – for example, if either of the corporations cannot be a member of a consolidated group (such as an insurance company), if the corporations are not related by 80% vote and value as required for consolidation or if the corporations do not elect to file consolidated returns.
Although the Proposed Regulations used a different drafting approach to reach this result, a similar intra-consolidated group exception existed within the Proposed Regulations.\textsuperscript{20} However, the exception within the Final and Temporary Regulations for special types of instruments that are treated as indebtedness under certain rules is new.

Unlike the approach taken by the Proposed Regulations (which treated “controlled partnerships” as members of an expanded group), the Final and Temporary Regulations further provide that a debt instrument issued by a partnership (including a “controlled partnership”) is not treated as an EGI (and therefore is generally not subject to the Documentation Requirements).\textsuperscript{21} Additionally, as noted above, a debt instrument issued by a foreign corporation is outside the current scope of the Final and Temporary Regulations, including the Documentation Requirements.

c. Transactional Effective Dates

The Documentation Requirements do not apply to any interests issued or deemed issued before January 1, 2018. This represents a significant postponement of the effective date of the Documentation Requirements in the Proposed Regulations, which were proposed to take effect immediately for instruments issued on or after the date when the Proposed Regulations were finalized. Moreover, as discussed further below, the Final and Temporary Regulations provide extended deadlines for satisfying the Documentation Requirements.

3. Information to Be Documented

The Final and Temporary Regulations generally retain the four major “indebtedness factors” set forth in the Proposed Regulations, but make significant modifications to the way in which these factors are implemented. In general, these changes make the revised Documentation Requirements more straightforward to comply with, or at least more closely aligned with “industry standard” practices for lending to unrelated parties. However, in some cases, the revised Documentation Requirements may impose new substantiation rules that were not included in the Proposed Regulations. Each of these factors is discussed below.

\textsuperscript{19} See Treas. Reg. § 1.385-2(d)(2).

\textsuperscript{20} Instead of excluding debt instruments that exist within a consolidated group from the definition of “applicable interests”, the Proposed Regulations treated a consolidated group as a single corporation for purposes of the Documentation Requirements.

\textsuperscript{21} An instrument issued by a partnership could, however, still be recharacterized as equity if that instrument were issued “with a principal purpose of avoiding” the Documentation Requirements. See Treas. Reg. § 1.385-2(f). This anti-avoidance rule could also apply to other types of instruments that are generally outside the scope of the Documentation Requirements.
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October 20, 2016

SULLIVAN & CROMWELL LLP

a. Obligation to Pay a Sum Certain

The first “indebtedness factor” in the Final and Temporary Regulations is that the issuer of an EGI must have a documented and legally binding obligation to repay a certain amount on demand, or on certain dates.\(^\text{22}\) This requirement is substantively unchanged from its counterpart in the Proposed Regulations.

b. Creditors’ Rights

To satisfy this second requirement, an EGI generally must provide its owner with rights superior to those of shareholders to receive assets if the issuer is dissolved, a requirement that is consistent with the Proposed Regulations.\(^\text{23}\) In addition, the Documentation Requirements state that creditors “typically” have the right to accelerate debt interests in the event of default, and to sue the issuer for repayment. Although this second requirement is similar to a provision in the Proposed Regulations, the Final and Temporary Regulations clarify that the mere fact that an instrument is nonrecourse will not prevent the Documentation Requirements from being satisfied, so long as “sufficient remedies against a specified subset of the issuer's assets” are available. Additionally, the Proposed and Final Regulations specifically provide that, if creditors’ rights arise as a matter of law, such rights need not be included in the terms of an EGI. However, such rights must be specifically referenced in the written documentation prepared for an EGI.

c. Reasonable Expectation of Ability to Repay

The third factor that must be substantiated under the Documentation Requirements is that, at the time when an EGI was issued, the issuer was in a financial position that would support a reasonable expectation that the issuer could meet its obligations to pay principal and interest. This position may be evidenced by, among other things, third-party reports, cash flow projections, evidence that a third-party lender would have advanced funds on terms similar to the terms of an EGI, financial statements, business forecasts, asset appraisals, and computations of debt-to-equity and other relevant financial ratios.\(^\text{24}\) Although the general principle of this requirement is largely unchanged from the Proposed Regulations, the Final and Temporary Regulations make significant changes to the manner in which this requirement is implemented, including the following:

i. Authority to Rely on a Reasonable Assumption That a Liability Can Be Refinanced

Importantly, the Final and Temporary Regulations acknowledge that in determining an issuer’s creditworthiness, an expanded group “may assume that the principal amount of an EGI may be satisfied

\(^{22}\) See Treas. Reg. § 1.385-2(c)(2)(i).

\(^{23}\) See Treas. Reg. § 1.385-2(c)(2)(ii).

\(^{24}\) See Treas. Reg. § 1.385-2(c)(2)(iii).
with the proceeds of another borrowing by the issuer, provided that such assumption is reasonable.”

This clarification is significant because borrowers often repay (and expect to repay, when financing is established) significant amounts of the principal on third-party debt with refinancing proceeds (rather than out of earnings or with the proceeds of asset dispositions), and without such a rule, issuers of EGIs might have been treated as not satisfying the “ability to repay” requirement notwithstanding the clear availability of financing from unrelated parties. This rule does not, however, appear to extend to amounts other than principal that are due with respect to an EGI (meaning that an issuer of an EGI may be treated as lacking a “reasonable expectation” under the Documentation Requirements if projections indicate that an EGI issuer intends to meet interest or similar obligations by refinancing an EGI).

ii. Optional Annual Testing of “Ability to Repay”

Additionally, the Final and Temporary Regulations allow taxpayers to examine the creditworthiness of an EGI issuer on an annual basis (unless a “material event,” such as the bankruptcy or insolvency of the issuer, a material change in the issuer’s line of business or a sale or lease of 50% or more of the issuer’s “included assets”—has occurred). This is in contrast to the approach taken in the Proposed Regulations, which generally required an EGI issuer’s ability to repay to be evaluated separately for each new EGI issuance.

iii. Special Rules for Nonrecourse Debt

Under a new rule in the Final and Temporary Regulations for nonrecourse EGIs, an issuer’s “ability to repay” documentation must also include information relating to the property securing the EGI. This information must include: (i) the fair market value of any collateral that is publicly traded and (ii) an appraisal for non-traded property, if—one has been prepared for any collateral that is not publicly traded during the three years preceding the issuance of an EGI.

iv. Creditworthiness in the Context of “Disregarded Entity” Issuers and Issuers Within a Consolidated Group

If an EGI is issued by a “disregarded entity” with limited liability, the Final Regulations (in a manner consistent with the Proposed Regulations) provide that only the assets and liabilities of that “disregarded entity” will be taken into account in assessing an EGI issuer’s ability to repay its obligations. Additionally, because the Documentation Requirements in the Final and Temporary Regulations (unlike their


26 See Treas. Reg. § 1.385-2(d)(5). It is noteworthy that under this definition, a sale/leaseback or similar transaction with respect to an EGI issuer’s core assets could potentially create a “material event.”

27 “Included assets” are defined as all of the issuer’s assets, other than: (i) inventory, (ii) assets contributed to another entity in exchange for equity in that entity and (iii) investment assets (such as portfolio stock) if those assets are replaced with cash or other investment assets of equivalent value. See Treas. Reg. § 1.385-2(d)(6).
counterpart in the Proposed Regulations) do not treat members of a consolidated group as a single entity, the repayment capacity of an issuer within a consolidated group will be evaluated on a standalone basis.

d. Actions Evidencing a Debtor-Creditor Relationship

Under the final “indebtedness factor”, issuers and holders of EGIs must maintain records of behavior that is consistent with a debtor-creditor relationship. As in the Proposed Regulations, payments of principal and interest can only be used to support compliance with this requirement if such payments are reflected in written documentation, although the Proposed and Final Regulations clarify that such documentation is not limited to bank statements and wire transfers (and can include, for example, the netting of receivables between the issuer and holder of an EGI, together with journal entries in an expanded group’s accounting or cash management system). In the event of a default, EGI holders must document their “reasonable exercise of the diligence and judgment of a creditor,” which may include evidence of attempts to assert creditors’ rights or of a renegotiation of the terms of an EGI.28 Conversely, if a holder of an EGI refrains from enforcing the terms of an EGI, that holder must maintain evidence that any such decision was being consistent with the reasonable exercise of the diligence and judgment of a creditor.

e. Credit Facilities and Cash Pooling Arrangements

With respect to agreements that cover multiple EGIs, such as revolving credit and cash pooling facilities, the factors regarding the issuer’s unconditional obligation to repay a sum certain and creditors’ rights may be evidenced by the “relevant enabling documents,” such as resolutions of the board of directors or security agreements.29 In documenting a reasonable expectation of an EGI issuer’s ability to repay, an expanded group that operates a multiple-EGI arrangement may generally similarly rely on an “annual credit analysis” approach (unless a “material event” occurs).

f. Additional Exceptions

In addition to the above, the Documentation Requirements include several new exceptions, including the following:

- **First**, a new “market standard safe harbor” provides that documentation that is “customarily used in comparable third-party transactions treated as indebtedness for federal tax purposes” is sufficient to satisfy the Documentation Requirements that relate to legal rights (i.e., the requirement that an EGI provide for payment of a “sum certain” and for creditors’ rights), even if such documentation does not meet the criteria discussed above.30

- **Second**, EGIs issued by “regulated financial companies” or their direct or indirect subsidiaries (with some exceptions) that contain terms required by a regulator of that company in order for the EGI to satisfy regulatory capital or similar rules (such as some terms of “total loss absorbing capacity” or “TLAC” securities) are deemed to meet the requirement to satisfy the

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29 See Treas. Reg. § 1.385-2(c)(3).
four “indebtedness factors” discussed above notwithstanding any such terms, provided that at the time of issuance it is expected that the EGI will be paid in accordance with its terms. A similar exception applies to instruments issued by “regulated insurance companies” that are required to receive approval or consent of an insurance regulatory authority prior to making payments of principal or interest on the EGI (such as “surplus notes”). Regulated financial companies include bank holding companies, insured depository institutions, registered brokers or dealers and certain insurance companies domiciled or organized in one of the 50 states or the District of Columbia, among others.\textsuperscript{31} Moreover, Treasury and the IRS are considering issuing additional guidance addressing the debt-equity issues raised by such securities under common law. Presumably, any such guidance would speak to the circumstances under which so-called TLAC securities would be clearly respected as debt for U.S. tax purposes.

4. Timely Preparation and Recordkeeping Requirements

The Final and Temporary Regulations provide that materials used to satisfy the Documentation Requirements must be prepared by the time the issuer is required to file its federal income tax return, taking into account any extensions, for the year in which the “relevant date”\textsuperscript{32} for such documentation occurred. This represents a significant relaxation of the deadlines included in the Proposed Regulations, which generally required that the issuer prepare documentation within 30 days (or, in the case of evidence supporting the presence of a debtor/creditor relationship, 120 days) of a “relevant date.” Documentation must be maintained for all years that the relevant EGI is outstanding, and until the statute of limitations expires with respect to the federal tax returns concerning the EGI.

5. Consequences of Issuing and Maintaining Undocumented EGIs

As was the case under the Proposed Regulations, the Final and Temporary Regulations provide that an EGI that is not memorialized in a manner consistent with the Documentation Requirements is generally treated as equity for U.S. tax purposes, without regard to whether that instrument would be treated as debt or equity under general U.S. tax principles.\textsuperscript{33} However, the Final and Temporary Regulations relax

\textsuperscript{31} See Treas. Reg. §§ 1.385-2(c)(1)(iii) and 1.385-3(g)(3)(iv).

\textsuperscript{32} Generally, the “relevant date” for the first three “indebtedness factors” (\textit{i.e.}, the requirement to pay a “sum certain,” the presence of creditors’ rights and the issuer’s ability to repay) is the date on which the EGI is issued. For interests that become EGIs subsequent to issuance—for instance, when the holder or issuer joins the expanded group—the relevant date for these factors is generally the date that the instrument becomes an EGI. The relevant date for actions evidencing a debtor-creditor relationship, such as payments of principal or interest, is the date on which such payments occurred. Likewise, each date on which an event of default or an event triggering acceleration occurs is also a relevant date. For agreements covering multiple EGIs, the date of the execution of the documents governing the overall arrangement is a relevant date, as are the dates of any amendments to the governing documents that would permit an increase in the amount of principal or the addition of borrowers. See Treas. Reg. § 1.385-2(c)(4)(ii).

\textsuperscript{33} In cases where an undocumented EGI is issued by a “disregarded entity,” the Final and Temporary Regulations provide that this equity is deemed issued by the regarded owner of the “disregarded entity.” This represents a change from the approach taken by the Proposed Regulations, which would have treated an undocumented EGI issued by a “disregarded entity” as issued by the (continued . . .)
this \textit{per se} rule for expanded groups that are “highly compliant” with the Documentation Requirements during a year when an EGI does not meet the Documentation Requirements, and replacing this rule with a rebuttable presumption that an undocumented EGI is to be treated as equity for U.S. tax purposes (which can be overcome if the expanded group “clearly establishes that there are sufficient common law factors present to treat the EGI as indebtedness, including that the issuer intended to create indebtedness when the EGI was issued”).\textsuperscript{34} An expanded group is considered “highly compliant” for a year if the “undocumented EGIs” within the group:

- represent less than $10\%$ of all EGIs within the group (measured by adjusted issue price) at the close of each calendar quarter of that year;
- each have an issue price of \$100 million or less, and—at the end of each calendar quarter of that year—amount to less than $5\%$ of the average total number of EGIs outstanding at the close of each calendar quarter; or
- each have an issue price of \$25 million or less, and—at the end of each calendar quarter of that year—amount to less than $10\%$ of the average total number of EGIs outstanding at the close of each calendar quarter.

In addition to the exception for “highly compliant” taxpayers, the Final and Temporary Regulations provide that the \textit{“per se”} equity recharacterization rule does not apply to: (i) situations where the taxpayer had “reasonable cause” for not complying with the Documentation Requirements\textsuperscript{35} and (ii) circumstances in which a ministerial or “non-material” failure or error occurs and is corrected prior to discovery by the IRS.\textsuperscript{36} These new exceptions—if they apply—will cause noncompliance with the Documentation Requirements to be disregarded. Whether “reasonable cause” exists under these rules is to be determined under “principles of” the Treasury Regulations that allow penalties to be waived if a taxpayer has “reasonable cause” for not complying with an information reporting requirement.

C. **INBOUND DISTRIBUTED DEBT RULES**

1. **General Description of the Inbound Distributed Debt Rules**

The Inbound Distributed Debt Rules provide, subject to certain exceptions, that a debt instrument will be treated as equity for U.S. federal income tax purposes if the instrument is covered either by the “general rule” or the “funding rule” as described in the Final Regulations under the same general framework as existed in the Proposed Regulations.

\textit{(\ldots continued)}

\textit{“disregarded entity”} itself (meaning that such a “disregarded entity” would generally have turned into a partnership for U.S. tax purposes).

\textsuperscript{34} See Treas. Reg. § 1.385-2(b)(2)(i).


\textsuperscript{36} See Treas. Reg. § 1.385-2(b)(2)(iii).
a. General Rule

Under the “general rule,” a debt instrument will ordinarily be characterized as equity if the instrument is issued by a U.S. corporation (or treated as issued by a U.S. corporation) to a foreign (or non-consolidated) member of the issuer’s “expanded group” and the instrument is issued: (i) in a distribution with respect to stock; (ii) in exchange for “expanded group” stock (subject to a limited exception for “exempt exchanges”), or (iii) in exchange for property in an internal restructuring that is treated as an asset reorganization for U.S. federal income tax purposes (including an “A,” “C,” “D,” “F” or “G” reorganization). Therefore, for example, if a U.S. subsidiary were to issue a note to its foreign parent as a distribution, that note would typically be treated as equity under the general rule, as would a debt instrument issued by a U.S. corporation to a foreign affiliate as consideration for a “brother / sister” stock acquisition or a debt instrument issued by a U.S. corporation to a foreign affiliate as consideration in an internal restructuring (e.g., an internal Section 304 transaction or “D” reorganization) that occurs within an “expanded group.”

b. Funding Rule

Under the “funding rule”, a debt instrument will generally be regarded as equity to the extent the instrument was issued by a U.S. corporation (the “funded member”—a term that includes both the member itself and any predecessor or successor) to a foreign (or non-consolidated) member of the funded member’s “expanded group” in exchange for cash or other property to fund a distribution or acquisition that, if aggregated with the debt issuance, is similar to a transaction covered by the “general rule.” A debt instrument issued by a U.S. corporation to a foreign (or non-consolidated affiliate) is treated as funding such a distribution or acquisition if the debt instrument is issued with a “principal purpose” of funding the distribution or acquisition. The Final Regulations also include a “per se” rule that (subject to exceptions described further below) treats any debt instrument issued by a U.S. corporation to a foreign (or non-consolidated) affiliate as funding a relevant distribution or acquisition if the debt instrument is issued during the period beginning 36 months before the date of the distribution or acquisition.

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37 An “exempt exchange” includes many asset reorganizations. However, such “exempt exchanges” may nevertheless be reorganizations that are subject to the “asset reorganization” rule (which does not contain a similar allowance for “exempt exchanges”).

38 See Treas. Reg. § 1.385-3(b)(2).

39 The Final Regulations provide additional clarity to the application of the funding rule to predecessors and successors. Among other rules, the Final Regulations provide that, for the funding rule to apply to a distribution or acquisition by a funded member with respect to a debt instrument issued to a predecessor or successor, the issuance of the debt instrument and the distribution or acquisition must occur during the 36-month periods before and after the transaction that established the predecessor-successor relationship. See Treas. Reg. § 1.385-3(b)(3)(v).


acquisition, and ending 36 months after the date of a relevant distribution or acquisition. Accordingly, if a U.S. subsidiary were to distribute cash to its foreign parent and the U.S. subsidiary had issued a debt instrument to a foreign affiliate within the preceding or succeeding 36 months, the debt instrument generally would be within the scope of the “funding rule,” even if the distribution and borrowing were undertaken for significant (and unrelated) non-tax business reasons.

For purposes of the funding rule, to the extent that two or more debt instruments could be treated as funding a distribution or acquisition, and therefore be subject to recharacterization, the instruments are tested based on the order in which they are issued. Similarly, to the extent that a debt instrument could be treated as funding more than one distribution or acquisition, the instrument is treated as funding distributions or acquisitions in the order in which they occur.

2. Recharacterization “Reductions” for General Rule and Funding Rule Transactions
   a. Reduction for Expanded Group Earnings

The Proposed Regulations would have “reduced” the aggregate amount of distributions or acquisitions to be taken into account for purposes of the general rule or the funding rule by an amount equal to the current-year "earnings and profits" of the relevant member of an expanded group (in order to prevent ordinary course distributions from triggering recharacterization under the Inbound Distributed Debt Rules). Commenters raised a number of issues with the current-year earnings and profits reduction, including that current earnings and profits typically cannot be determined until after the close of the taxable year of the relevant distribution or acquisition, and the single taxable year approach created a “use it or lose it” incentive to make debt distributions to “use up” current earnings and profits.

The Final Regulations replace the current earnings and profits reduction with a new “expanded group earnings” reduction, which generally looks to accumulated earnings and profits (but only prospectively for taxable years ending after the issuance of the Proposed Regulations), rather than a single-year approach. Under this reduction, the aggregate amount of distributions or acquisitions subject to the general rule or the funding rule for a taxable year is reduced by the member’s “expanded group earnings account” as of the close of the taxable year, which generally includes the member’s earnings and profits

42 See Treas. Reg. § 1.385-3(b)(3)(iii). Under existing Treasury Regulations, the modification of a debt instrument that is considered a “significant modification” is deemed to be an exchange of the unmodified debt instrument for the modified debt instrument. The Final Regulations clarify the application of the 72-month presumption in the per se funding rule to such deemed exchanges by providing that the issue date of the modified debt instrument is generally backdated to the issue date of the unmodified debt instrument (except for any portion of the modified instrument representing an additional principal amount), unless the modification involves the substitution of an obligor, the addition or deletion of a co-obligor or the material deferral of scheduled payments, in which case the instrument is treated as issued on the date of the deemed exchange. See Treas. Reg. § 1.385-3(b)(3)(iii)(E).

accumulated in taxable years ending after April 4, 2016 during the period that the member is a member of the relevant expanded group.\textsuperscript{44} To the extent that the expanded group earnings account exceeds the aggregate amount of distributions or acquisitions subject to the general rule or the funding rule, the excess expanded group earnings account remains available to reduce such distributions or acquisitions in future years. On the other hand, to the extent that the aggregate amount of distributions and acquisitions is greater than the expanded group earnings account, the available reduction is applied first to earlier distributions and acquisitions\textsuperscript{45}—and the expanded group earnings account is not reduced by distributions that are not covered by expanded group earnings.

\textit{Alert:} The Final and Temporary Regulations eliminate certain planning opportunities that existed under the Proposed Regulations by greatly reducing the importance of the sequencing of note distributions and cash distributions that was present in the Proposed Regulations. For example, under the Proposed Regulations, if a corporation made a $50x note distribution (a general rule transaction) to the corporation’s foreign parent followed by a $50x cash distribution (a potentially funded transaction) within a taxable year in which the member had $50x of current earnings and profits, those earnings and profits would be paired to the first-in-time note distribution. Even though the $50x cash distribution was in excess of current earnings and profits, the distributed note would never be recharacterized, and further notes could have been distributed to a foreign parent in later years (as long as such later notes were issued by distribution rather than in exchange for cash or other property) up to current earnings and profits in the distribution year (even if within 36 months of excess cash distributions).

Under the Final Regulations, however, a debt instrument issued in a general rule transaction (\textit{e.g.}, a note distribution) that is covered by expanded group earnings can nevertheless be paired under the funding rule to a distribution or acquisition subject to the funding rule (\textit{e.g.}, a cash distribution) that is not covered by expanded group earnings.\textsuperscript{46} Thus, in the example above, if the member’s expanded group earnings account at the close of the taxable year is $50x (even though the initial $50x note distribution is paired with such earnings), the note is treated as funding the subsequent $50x cash distribution in excess of expanded group earnings, and is therefore recharacterized.

\textsuperscript{44} To avoid circularity, the Final Regulations clarify that if a debt instrument is recharacterized during a taxable year, any interest deductions disallowed due to such recharacterization still reduce expanded group earnings for that year, but the reduction for the disallowed deductions is reversed through an offsetting addition to expanded group earnings in the following year. \textit{See} Treas. Reg. § 1.385-3(c)(3)(i)(C)(4).

\textsuperscript{45} The Final Regulations also clarify explicitly that the reduction is applied to a distribution or acquisition, even if the distribution or acquisition is not paired with any debt instrument under the funding rule.

\textsuperscript{46} \textit{See} Treas. Reg. § 1.385-3(d)(6).
The Final Regulations provide a special “look-thru” rule preventing an expanded group member from taking into account earnings received as a dividend that are attributable to earnings that are not eligible for the expanded group earnings reduction (e.g., earnings accumulated in a taxable year ending before issuance of the Proposed Regulations, or while the distributing member was not an expanded group member). 47

b. Netting for Qualified Contributions

The Final and Temporary Regulations allow distributions and acquisitions by an expanded group member subject to the general rule or funding rule to be netted against the aggregate fair market value of stock issued by that member in “qualified contributions” to another expanded group member within the 36-month periods before and after the relevant distribution or acquisition. The netting only applies to distributions or acquisitions made during the relevant “expanded group period” (i.e., an intervening change in the member’s expanded group between the distribution/acquisition and contribution prevents netting). In addition, a distribution or acquisition can only be netted against contributions made before the close of the taxable year in which the distribution or acquisition would result in recharacterization of a debt instrument as equity under the Inbound Distributed Debt Rules—meaning that a contribution cannot “cure” a previously recharacterized debt instrument, unless the recharacterization occurred during the taxable year of the distribution or acquisition. 48

The netting does not apply to contributions of “excluded property,” including (among other things) stock of an expanded group member, property acquired by the contributee member in certain asset reorganizations, a debt instrument of an expanded group member subject to the Inbound Distributed Debt Rules and property acquired by the contributee in exchange for a debt instrument recharacterized under the Inbound Distributed Debt Rules.

3. Excepted Debt Instruments

Under the Final and Temporary Regulations, debt instruments that may be recharacterized as equity under the Inbound Distributed Debt Rules are limited to “covered debt instruments.” The Final and Temporary Regulations provide several carve-outs from the definition of “covered debt instrument” (which are much expanded from exceptions in the Proposed Regulations) in addition to a new exception from the funding rule for “qualified short-term debt instruments,” thereby limiting the scope of the Inbound Distributed Debt Rules.

47 More specifically, dividends received from another member of an expanded group are not taken into account in determining the recipient member’s expanded group earnings, except to the extent that they represent earnings accumulated by the distributing member in a taxable period ending after April 4, 2016 while the distributing member was a member of the expanded group. See Treas. Reg. § 1.385-3(c)(3)(i)(C)(3).

The Temporary Regulations provide a new exception from the funding rule (but not the general rule) for “qualified short-term debt instruments,” which generally covers debt issued pursuant to cash pooling, cash sweeping and similar arrangements among affiliates, including the following debt instruments:\textsuperscript{49}

- **Qualified Cash Pool Header.** *First*, certain demand deposits made with a “qualified cash pool header.” A “qualified cash pool header” is a member of an expanded group (or a controlled partnership or qualified business unit) that has as its principal purpose the management of a cash management arrangement for participating expanded group members. Any excess balance of deposits over the outstanding balance of loans made by the header must be held in cash or cash equivalents or invested through deposits with, or in the acquisition of instruments or portfolio securities of, persons unrelated to the header. Since the ability of a qualified cash pool header to invest in deposits appears to be limited to deposits with unrelated persons, U.S. cash pooling vehicles may not be able to place deposits with another cash pooling vehicle and satisfy the requirements of a qualified cash pool header.\textsuperscript{50} In addition, since the qualified cash pool header exception only covers deposits placed with a header, the exception does not apply to draws by expanded group members from a header, which must satisfy one of the other short-term exceptions described below.

- **Specified Current Assets / 270-Day Tests.** *Second*, debt instruments satisfying alternatively the “specified current assets test” or the “270-day test.” However, an issuer may rely on only one of these tests with respect to the debt instruments issued within the same taxable year.
  - **Specified Current Assets Test.** A debt instrument satisfies the “specified current assets test” if the rate of interest on the instrument, and the aggregate amount of the issuer’s qualified short-term debt instruments to expanded group members, are consistent with a borrowing of no more than the longer of 90 days or the issuer’s “normal operating cycle.”\textsuperscript{51}
  - **270-Day Test.** A debt instrument satisfies the alternate “270-day test” if the instrument has a term of no more than 270 days (or is issued under a revolver), provided that the instrument’s

\textsuperscript{49} See Treas. Reg. § 1.385-3T(b)(3)(vii).

\textsuperscript{50} As a result, it may be necessary for multinationals with both U.S. and foreign cash pool entities transacting with each other to sweep cash from the foreign vehicle (whose deposits are debt instruments of a foreign issuer outside the scope of the regulations) into the U.S. vehicle rather than the other way around.

\textsuperscript{51} More specifically, a debt instrument satisfies the current assets test if: (i) the rate of interest does not exceed an arm’s-length rate under transfer pricing principles that would be charged for a comparable debt instrument of the issuer with a term not exceeding the longer of 90 days or the issuer’s normal operating cycle and (ii) the aggregate amount of the issuer’s debt instruments owed to expanded group members treated as qualified short-term debt instruments (excluding deposits owed where the issuer is a qualified cash pool header; and netted against any of the issuer’s deposits made with a qualified cash pool header) does not exceed the amount of current assets (other than cash, cash equivalents and assets reflected on the books and records of a qualified cash pool header) reasonably expected to be reflected on the issuer’s balance sheet as a result of transactions in the ordinary course of business within the longer of the 90-day period following issuance or the issuer’s normal operating cycle. The issuer’s “normal operating cycle” is determined under applicable accounting principles (or if the issuer has no normal operating cycle under applicable accounting principles, the normal operating cycle is determined based on a reasonable analysis of the operating cycles of the issuer’s businesses and their relative sizes).
interest rate is consistent with a borrowing of 270 days or less and the issuer passes certain tests ensuring that the issuer is not a “net borrower” for more than 270 days in a year.\textsuperscript{52}

- \textbf{Ordinary Course Instruments.} \textit{Third}, instruments issued as consideration for property in the ordinary course of the issuer’s trade or business that are reasonably expected to be repaid within 120 days of issuance.

- \textbf{Interest-Free Loans.} \textit{Fourth}, interest-free loans issued without discount (excluding certain deferred payment and below-market interest loans for which interest is imputed for U.S. tax purposes).

\section*{b. Certain Majority Acquisitions of Subsidiary Stock}

Under the Final Regulations, an acquisition of stock (whether by contribution or purchase) of an expanded group member is not treated as an acquisition of stock to which the general rule or funding rule applies if immediately after the acquisition, the member that acquires the stock holds more than 50% of the voting power and value of the stock issuer.\textsuperscript{53} This exception allows one member of an expanded group to lend cash to another member to subscribe for shares in a subsidiary. For this exception to apply, the acquirer must not lose such 50% control pursuant to a plan in existence on the date of the acquisition, other than in a transaction in which the seller of the stock ceases to be a member of the expanded group (other than by reason of a complete liquidation). The Final Regulations provide a rebuttable presumption that a loss of control was pursuant to a plan if the control is lost within the 36-month period following the date of the acquisition—unlike the Proposed Regulations, which contained an irrebuttable three-year presumption).

There is also a special rule designed to prevent taxpayers from using the 50% control exception to avoid the funding rule by separating funding and funded transactions between different corporations. For example, suppose (a) S1 subscribes for a 51% interest in its sister company S2 for cash (qualifying for the 50% control exception), (b) S2 uses this cash to make a distribution to P and, (c) within 36 months, P loans cash to S1—thus resulting in the aggregate in a transaction that is substantially similar to a prototypical funding rule transaction in which S1 distributed cash to P with funds borrowed from P. To be sure this is picked up, the Final Regulations (like the Proposed Regulations) contain a special “successor” rule allowing cash or other property received in the contribution or purchase to be treated as a funding transaction to the extent attributable to transactions funding the stock acquirer—in the example above,

\begin{quote}
\textsuperscript{52} More specifically, a debt instrument satisfies the 270-day test if: (i) the instrument has a term of no more than 270 days or is under a revolving credit agreement, and the interest rate does not exceed an arm’s-length rate of interest for a comparable instrument of the issuer with a term of more than 270 days, (ii) the issuer is not a “net borrower” under such short-term instruments from the specific lender for more than 270 days during the issuer’s taxable year (and for instruments straddling two taxable years, more than 270 consecutive days) and (iii) the issuer is not a net borrower under such short-term instruments from all members of the expanded group for more than 270 days of the taxable year. A special rule permits the 270-day test to be satisfied notwithstanding reasonable failures to comply with the test if due diligence procedures were adequate and the failure is cured promptly upon discovery.
\end{quote}

\begin{quote}
\textsuperscript{53} See Treas. Reg. § 1.385-3(c)(2)(i).
\end{quote}
the loan from P to S1 could be paired, to the extent of the cash paid from S1 to S2, to the distribution by S2 to P.  

**c. Compensatory Stock Acquisitions**

Under a new exception in the Final Regulations, an acquisition of stock of an expanded group member is not treated as an acquisition to which the general rule or funding rule applies if such stock is delivered to individuals that are employees, directors or independent contractors in consideration for services rendered to a member of the expanded group (or a controlled partnership thereof).

**d. Dealers in Securities**

The Final Regulations provide a new ordinary course exception for dealers in securities. Acquisitions of stock of an expanded group member in the ordinary course of a dealer's business are not treated as acquisitions to which the general rule or funding rule apply, and debt instruments issued to or acquired by a dealer are not subject to the Inbound Distributed Debt Rules, if (i) the dealer accounts for the stock or instrument as securities held primarily for sale to customers in the ordinary course of business, (ii) the dealer disposes of the stock or instrument within a period of time consistent with holding the stock for sale to customers in the ordinary course of business and (iii) the dealer does not transfer the stock or instrument to another expanded group member (other than to another dealer that satisfies the requirements of the exception).

**e. Threshold Exception**

Under the Final Regulations, a debt instrument is not recharacterized as stock under the Inbound Distributed Debt Rules to the extent that, at the time the instrument would otherwise be recharacterized, the aggregate amount of debt instruments of expanded group members that would be so recharacterized is not more than $50 million. This eliminates the “cliff effect” that existed in the Proposed Regulations. More specifically, once the $50 million threshold is exceeded, debt instruments previously benefiting from the exception are not recharacterized and, in the case of a debt instrument that causes the $50 million threshold to be exceeded, only the portion of the instrument in excess of the threshold is subject to recharacterization.

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54 More specifically, when the 50% control exception applies, distributions or acquisitions (excluding distributions to, and acquisitions from, the acquirer) by the seller (if the exception applies to a purchase) or issuer (if the exception applies to a contribution) can be paired under the funding rule to expanded group debt instruments funding the acquirer made within the 36 months before and after the acquisition of stock to which the exception applies, to the extent of that stock’s value. See Treas. Reg. § 1.385-3(g)(24).

55 See Treas. Reg. § 1.385-3(c)(2)(ii).


57 See Treas. Reg. § 1.385-3(c)(4).
f. **Transfer Pricing Adjustments**

Under a new exception in the Final Regulations, a distribution or acquisition that is deemed to occur due to transfer pricing adjustments is not treated as a distribution of property or acquisition of stock subject to the *per se* funding rule.\(^{58}\)

4. **Operating Rules**

a. **Controlled Partnerships**

The Inbound Distributed Debt Rules provide that in applying the “general rule” and the “funding rule,” a “controlled partnership” generally is treated (subject to detailed rules in the Temporary Regulations) as an aggregate of its partners, so that each corporate partner that is a member of the expanded group that controls the partnership (i) is treated as having issued a portion of the debt actually issued by the partnership and (ii) in the case that the controlled partnership acquires property from a member of the expanded group, is treated as acquiring the partner’s share of the property acquired by the partnership (or, if an expanded group member acquires an interest in the controlled partnership, the partner is treated as acquiring its share of the property held by the partnership).\(^{59}\) The Temporary Regulations clarify that a partner’s share of indebtedness of the partnership is based on the partner’s reasonably anticipated percentage share of all the partnership’s interest expense over a “reasonable period” (rather than partner’s share of partnership profits as provided in the Proposed Regulations) as of the date of the relevant distribution or acquisition to which the general rule or funding rule applies. The Temporary Regulations also clarify that a partner’s share of property acquired by a controlled partnership is determined in accordance with the partner’s liquidation value percentage (rather than partner’s share of partnership profits as provided in the Proposed Regulations) as of the date that the expanded group member acquires the property (or the date the expanded group member acquires its interest in the controlled partnership). If indebtedness issued by a “controlled partnership” is recharacterized and deemed issued by a corporate partner, the holder of the recharacterized instrument is treated as holding stock in that partner.\(^{60}\)

b. **Funding Across Expanded Groups**

Under a new exception to the *per se* funding rule, the Final Regulations provide that when (i) an expanded group member makes a distribution or acquisition that occurs before the member is funded by an expanded group debt instrument, (ii) the distribution or acquisition occurs when the funded member’s expanded group parent is different from its parent at the time that the funding occurs and (iii) the funded member and the counterparty to the distribution or acquisition are not members of the same expanded

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\(^{58}\) See Treas. Reg. § 1.385-3(c)(2)(iii).

\(^{59}\) See Treas. Reg. § 1.385-3T(f).

\(^{60}\) Similarly, a debt instrument that is both recharacterized by the Inbound Distributed Debt Rules and issued by a “disregarded entity” is treated as stock in the regarded owner of the disregarded entity.
group on the date that the covered member is funded, the debt instrument is not treated as issued within the *per se* period with respect to the earlier distribution or acquisition.\(^{61}\) For example, if a subsidiary made a distribution to its parent, the parent subsequently sold the stock of the subsidiary to a new unrelated corporation and the new parent made a loan to the subsidiary, the loan would not be subject to recharacterization under the funding rule (unless a principal purpose of the loan was to fund the distribution).

c. **Cascading**

Under the Proposed Regulations, recharacterization of a debt instrument as equity could result in “cascading” recharacterizations under certain circumstances.

As one example, if a debt instrument was treated as equity, payments of interest and principal repayments on the instrument would be treated as distributions that could cause another expanded group debt instrument of the payor to be recharacterized under the *per se* funding rule if issued within the 36-month periods before and after the payment of interest or principal. The Final and Temporary Regulations do not alter this result, and repayments on a recharacterized debt instrument will continue to be treated as distributions subject to the funding rule that can result in recharacterization.

As a second example, however, under the Proposed Regulations, when a debt instrument is recharacterized as stock, the holder would be treated as acquiring stock of an expanded group member, and this transaction could itself be treated as funded by another expanded group debt instrument. The Final Regulations provide that a deemed acquisition of expanded group stock pursuant to the funding rule (but not a deemed acquisition of expanded group stock under the general rule upon receipt of a recharacterized debt instrument in exchange for other expanded group stock) is not treated as an acquisition within the scope of the funding rule.\(^{62}\)

In a third example under the Proposed Regulations, if a debt instrument is recharacterized as a result of a distribution and thereafter repaid, both the original distribution and the repayment (deemed to be a distribution on equity) could have been duplicatively treated as funded distributions. For example, if (a) S distributed $100x cash to P funded by a $100x note from P (“Note 1”) that was recharacterized as equity under the funding rule, (b) S thereafter repaid Note 1 and (c) within 36 months of the distribution, S issued a new $200x note to P (“Note 2”), Note 2 could potentially have been recharacterized in its entirety as a result of the distribution plus the repayment (even though, in effect, P only received the equivalent of a $100x cash distribution from S). The Final Regulations address this situation by providing that once a distribution or acquisition is treated as funded by a debt instrument: (i) the same distribution or acquisition is not treated as funded by another debt instrument and (ii) the same debt instrument cannot be treated

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\(^{62}\) See Treas. Reg. § 1.385-3(c)(2)(v).
as funding a different distribution or acquisition. Accordingly, in the example above, since the original distribution was originally treated as funded by Note 1, only $100x of Note 2 is recharacterized (the amount matched to the deemed distribution upon repayment of Note 1).

d. Timing of Recharacterization; Treatment of Deemed Exchanges

In general, if a debt instrument is recharacterized under the Inbound Distributed Debt Rules, that debt instrument is treated as equity from the instrument's original issue date. However, in cases where a debt instrument is treated as funding a distribution or acquisition that takes place in a taxable year of the issuer following the taxable year during which the instrument is issued, the instrument is initially respected as debt and then deemed exchanged for equity on the date of the acquisition or distribution treated as funded by the instrument. Under a new provision of the Final Regulations, to the extent that a debt instrument is treated as equity because the funded member is treated as the predecessor or successor of another expanded group member, the instrument is deemed to be exchanged for the stock no earlier than the date of the transaction that establishes the predecessor-successor relationship. In the case of a deemed exchange of a debt instrument for equity under the Inbound Distributed Debt Rules, a holder’s amount realized is deemed to be equal to the holder’s adjusted basis in the instrument, and the issuer is treated as retiring the instrument for its adjusted issue price (i.e., generally, no gain or loss, other than foreign exchange gain or loss, will be recognized).

If a debt instrument that is recharacterized under the Inbound Distributed Debt Rules leaves an expanded group (either because the instrument is transferred to a nonmember or because the issuer and holder cease to be members of the same expanded group), the issuer is deemed, immediately prior to the event, to issue a new debt instrument in exchange for the debt instrument previously treated as stock. In contrast to the rules discussed above that govern deemed conversions of debt instruments to equity, the Final and Temporary Regulations do not contain a rule that limits the recognition of gain, loss or income when an instrument recharacterized as equity under the Inbound Distributed Debt Rules is deemed to be exchanged for a debt instrument.

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63 See Treas. Reg. § 1.385-3(b)(6).
64 See Treas. Reg. § 1.385-3(d)(1)(i).
67 See Treas. Reg. § 1.385-1(d)(1). The Final Regulations also clarify that the issuer’s deduction of unpaid qualified stated interest accruing before the deemed exchange is unaffected by the deemed exchange.
68 See Treas. Reg. § 1.385-1(d)(2).
e. Anti-Abuse and Anti-Affirmative Use

Similar to the Proposed Regulations, the Inbound Distributed Debt Rules include an anti-abuse provision, which treats a debt instrument (or another interest)\(^{69}\) as stock in the case of transactions entered into with a principal purpose of avoiding the Inbound Distributed Debt Rules.\(^{70}\)

The Proposed Regulations also contained a rule providing that the Inbound Distributed Debt Rules would not apply to the extent that a person entered into a transaction that would effect recharacterization with a principal purpose of reducing federal tax liability. Commenters noted that the rule was contradictory to an objective factor-based analysis and created unnecessary uncertainty. Accordingly, the Final Regulations reserve on affirmative use, pending continued study.

5. Transition Rules

The Inbound Distributed Debt Rules generally will apply to debt instruments issued after April 4, 2016,\(^{71}\) except that a debt instrument generally will not be recharacterized as equity under the Inbound Distributed Debt Rules until January 19, 2017.\(^{72}\) Upon recharacterization, a debt instrument that would have been recharacterized as equity is deemed exchanged for equity in a transaction in which no gain or loss is generally recognized (other than foreign currency gain or loss), as described further above.

Under the Final Regulations, if a debt instrument issued after April 4, 2016 would have been recharacterized as stock before January 19, 2017 but for the transition rule described above, payments with respect to the debt instrument are treated as distributions for purposes of the funding rule.\(^{73}\) The funding rule applies with respect to distributions or acquisitions made after April 4, 2016.\(^{74}\)

For debt instruments issued on or before October 12, 2016, the Final Regulations contain a grandfathering rule permitting the Inbound Distributed Debt Rules in the Proposed Regulations to be

\(^{69}\) Such instruments may include, for example, deferred payment contracts to which Section 483 of the Code applies, nonperiodic swap payments, debt instruments initially issued to a nonmember of the issuer’s expanded group that are subsequently acquired by a member of the issuer’s expanded group (or if the holder subsequently becomes a member of the issuer’s expanded group), debt instruments issued to entities not taxable as corporations for federal tax purposes and debt instruments issued in connection with a reorganization or similar transactions.

\(^{70}\) See Treas. Reg. § 1.385-3(b)(4).

\(^{71}\) In contrast to the Proposed Regulations, the Inbound Distributed Debt Rules do not apply to debt instruments issued on April 4, 2016. See Treas. Reg. § 1.385-3(g)(3)(i).

\(^{72}\) See Treas. Reg. § 1.385-3(j)(2)(i)-(ii).

\(^{73}\) See Treas. Reg. § 1.385-3(j)(2)(iii).

\(^{74}\) See Treas. Reg. § 1.385-3(b)(3)(viii).
applied in lieu of those in the Final and Temporary Regulations, solely for purposes of determining whether such instruments are treated as stock, and subject to a consistent treatment requirement.  \footnote{See Treas. Reg. § 1.385-3(j)(2)(v).}
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**CONTACTS**

<table>
<thead>
<tr>
<th>New York</th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Ronald E. Creamer Jr.</td>
<td>+1-212-558-4665</td>
<td><a href="mailto:creamerr@sullcrom.com">creamerr@sullcrom.com</a></td>
</tr>
<tr>
<td>David P. Hariton</td>
<td>+1-212-558-4248</td>
<td><a href="mailto:haritond@sullcrom.com">haritond@sullcrom.com</a></td>
</tr>
<tr>
<td>Jeffrey D. Hochberg</td>
<td>+1-212-558-3266</td>
<td><a href="mailto:hochbergj@sullcrom.com">hochbergj@sullcrom.com</a></td>
</tr>
<tr>
<td>Andrew S. Mason</td>
<td>+1-212-558-3759</td>
<td><a href="mailto:masona@sullcrom.com">masona@sullcrom.com</a></td>
</tr>
<tr>
<td>David C. Spitzer</td>
<td>+1-212-558-4376</td>
<td><a href="mailto:spitzerd@sullcrom.com">spitzerd@sullcrom.com</a></td>
</tr>
<tr>
<td>S. Eric Wang</td>
<td>+1-212-558-3328</td>
<td><a href="mailto:wang@sullcrom.com">wang@sullcrom.com</a></td>
</tr>
<tr>
<td>Davis J. Wang</td>
<td>+1-212-558-3113</td>
<td><a href="mailto:wangd@sullcrom.com">wangd@sullcrom.com</a></td>
</tr>
<tr>
<td>Jameson S. Lloyd</td>
<td>+1-212-558-4464</td>
<td><a href="mailto:lloydj@sullcrom.com">lloydj@sullcrom.com</a></td>
</tr>
<tr>
<td>Isaac J. Wheeler</td>
<td>+1-212-558-7863</td>
<td><a href="mailto:wheeleri@sullcrom.com">wheeleri@sullcrom.com</a></td>
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<table>
<thead>
<tr>
<th>Washington, D.C.</th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Donald L. Korb</td>
<td>+1-202-956-7675</td>
<td><a href="mailto:korbd@sullcrom.com">korbd@sullcrom.com</a></td>
</tr>
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<table>
<thead>
<tr>
<th>London</th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Michael Orchowski</td>
<td>+44-20-7959-8504</td>
<td><a href="mailto:orchowskim@sullcrom.com">orchowskim@sullcrom.com</a></td>
</tr>
</tbody>
</table>