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# **Final Section 385 Regulations: Impacts on Debt / Equity Rules**

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# Agenda

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# Section 385: Debt or Equity – Why Does it Matter?

- Interest vs. Dividends: Payment / Receipt
  - Generally interest expenses deductible while dividend distributions are not
  - Debt repaid without tax consequences but dividend taxable to recipient
  - Dividends may have Foreign Tax Credits on underlying earnings
- Bad Debt vs. Worthless Stock
  - Character issue (ordinary loss vs. capital loss)
- S Corp
  - Debt re-characterized as second class of stock or foreign shareholder
- Section 368 Transactions
  - “Control” requirement – reclassified debt presumably is non-voting equity
- Withholding Taxes, Etc. Etc.

# IRC Section 385

## Treatment of certain corporate interests as stock or indebtedness

- **Sec. 385(a):** The Secretary is authorized 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).
- **Sec. 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. Factors:
  - Written unconditional promise
  - Whether there is subordination
  - Ratio of debt to equity
  - Whether convertible into equity
  - Relationship of holdings of stock to holdings of interest in question

# History of Section 385 Regulations / Court Cases

- Although IRC Section 385 gives Treasury and the IRS authority to promulgate regulations to determine whether an instrument is debt or equity, the only regulations ever issued before now were subsequently withdrawn in 1983, so the determination has been derived instead from federal tax common law.
- Cases employ a facts and circumstances approach, and decisions are typically “all or nothing,” not part equity / party debt. Approximately a dozen factors (9<sup>th</sup> Circuit – 11 factors; *Hardman v. US*) are typically used, including:
  - (1) Name given to the documents
  - (2) Source of the payments
  - (3) Participation in management
  - (4) Intent of the parties
  - (5) Identity of interest
  - (6) Ability to obtain loans
  - (7) Failure to repay on due date
  - (8) Source of payments / Payment of interest out of “dividend” money
  - (9) Presence of a fixed maturity date
  - (10) Right to enforce payments
  - (11) Status equal to/inferior to creditors
  - (12) “Thin” or adequate capitalization
  - (13) Advance used to acquire capital assets

# Proposed Debt-Equity Regulations

- On April 8, 2016, the Treasury Department published the **proposed regulations** under Section 385, which suggested disposing of decades of established rules and guidance in favor of a completely new set of rules and tests.
- The proposed regulations under Section 385 were very broad, potentially applying both to U.S. and foreign entities, S corporations, partnerships, disregarded entities, RICs, REITs and other regulated entities.
- Rather than adopting common law principles included in Section 385, the Proposed Regulations would treat debt that is clearly debt under common law principles as equity based solely on the common ownership of the issuer and holder.
- The proposed rules served the purpose of curtailing inversions and earnings stripping rather than the legislative purpose of Sec. 385 – to distinguish debt from equity.
- The IRS and the Treasury received **29,780 comments** on the Proposed Regulations.
  - And one FOIA lawsuit from Baker & McKenzie (related to the 1980s-era documents regarding proposed and final section 385 regulations).



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# Main Areas of Pushback on the Proposed Regulations

- Application to certain types of pass-through entities such as RICs, REITs, S corporations, partnerships and disregarded entities
- Application to certain types of debt instruments
- Documentation requirements
- Attempts to narrow the effects of the re-characterization rules
- General attempts to clarify certain definitions in the Proposed Regulations to avoid unintended consequences.
- Various arguments that the proposed regulations were not valid
  - Continuing debate on validity?

# Final Regulations – In General

- The Final Section 385 Regulations re-characterize certain debt instruments between members of an “expanded group” as stock where a member of an expanded group:
  - Distributes a debt instrument to another expanded group member as a dividend,
  - Issues a debt instrument to another expanded group member in exchange for stock of an expanded group member
  - Issues a debt instrument to an expanded group member in exchange for assets in certain tax-free reorganizations.
- Principal purpose (*per se*) rule: any debt instrument issued within 36 months before or after a distribution or acquisition described above is treated as being issued for a principal purpose of funding such distribution or acquisition.



# Fundamental Changes Under Final Regulations

On October 13, 2016, the Treasury released the final and temporary regulations under Section 385 (“final 385 regulations”). The final 385 regulations incorporated many comments received by the IRS and substantially revised the initial set of very rigid re-characterization rules.

- The final 385 regulations **do not apply** to
  - Debt issued by foreign issuers,
  - S corporations,
  - Non-controlled RICs and REITs .
- Common law factors analysis is preserved in the regulations, except where the Final Regulations would automatically treat a debt instrument as stock.
- The final 385 regulations significantly **soften the documentation requirements**.
- The final 385 regulations **do not apply** to debt instruments issued by regulated financial groups and insurance entities, as well as deposits pursuant to a cash management arrangements and certain advances to finance short-term liquidity needs.
- **All taxpayers will be able to exclude the first \$50 million of indebtedness** that otherwise would be re-characterized.
- Blocker entities are not addressed in the final 385 regulations.



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# Expanded Group – Generally

- The proposed regulations defined the term “expanded group” by reference to the term “affiliated group” as defined in section 1504(a), with several modifications expanding the potential reach of the proposed regulations.
- **Expanded Group Definition.** In response to the comments, the Treasury significantly modified the definition of the “expanded group”.
  - The definition still refers to section 1504(a) “affiliated group”, but it now exempts S corporations and non-controlled RICs and REITs from its scope. “Expanded group” does not cover entities which are not domestic corporations.
  - If a non-controlled partnership is the parent of the expanded group, it is excluded from the definition too.
  - Federal tax principles that are applicable in determining whether a corporation is a member of an affiliated group under section 1504(a)(1) and (a)(2) are generally applicable in determining whether a corporation is a member of an expanded group.
  - Indirect ownership for purposes of determining an expanded group is defined by cross reference to section 318 and the regulations thereunder with modifications.
- **Snapshot approach.** the determination of whether a corporation is a member of an expanded group at the time of a distribution or acquisition described in §1.385-3(b)(2) or (b)(3)(ii) is made immediately before such distribution or acquisition.
- **Overlapping expanded groups.** The expanded group parents of overlapping expanded groups are not themselves members of the same expanded group. See §1.385-1(c)(4)(vii), Ex. 1.

# Instruments Treated as Partly Debt, Partly Stock

- Section 385(a) authorizes the Secretary to treat an interest in a corporation as in part debt and in part stock.
  - Proposed Reg. § 1.385-1(d) would have allowed the IRS to treat a debt instrument as part debt, part stock to the extent an analysis of the relevant facts and circumstances under general tax principles at the time of issuance resulted in a determination that such treatment were proper. (“Bifurcation Rule.”)
  - The proposed rule offered no standards for determining when an instrument would be so treated, and as a result, substantial discretion would rest with IRS examining agents.
- In response to comments, **the Final Regulations eliminated the Bifurcation Rule.** Treasury will continue to study the issue.



# Deemed Exchanges

- Under the Proposed Treas. Reg. § 1.385-1(c), the re-characterization of an interest that was treated as debt when issued and then later characterized under the proposed regulations as stock gave rise to a deemed exchange of that interest for stock.
- The Final Regulations generally follow the deemed exchange approach, but clarify certain issues.
- The final rules generally prevent the holder from recognizing gain or loss and prevent the issuer from recognizing cancellation of debt income.
  - The holder is treated as having realized an amount equal to its adjusted basis in the portion of the debt to be treated as stock, and
  - The issuer is treated as having retired that portion for an amount equal to its adjusted issue price.
  - Neither the issuer nor the holder would account for any accrued but unpaid qualified stated interest.
  - But note that any interest that is not qualified stated interest (e.g., OID) may need to be taken into account.



## Effective Dates

- The re-characterization rules generally apply to tax years ending on or after January 19, 2017
  - Generally do not apply to debt instruments issued prior to April 5, 2016
- The documentation rules generally apply to debt instruments issued on or after January 1, 2018.



# Documentation Requirements and Compliance






# Documentation Rules

## Key Points

- Applies only to debt issued by U.S. corporations
- Effective Date: January 1, 2018
- Deadline: due date of federal tax return (including extensions)
- Highly compliant exception from Per Se treatment
- Easier compliance for cash pooling arrangements, internal banks (not exempted)
- Additional consideration possibly beyond documentation:
  - Modifies common law factor weighting

# Documentation Requirements: Who?

*APPLIES TO MID-SIZE AND LARGE COMPANIES*

IF	PUBLICLY TRADED		<b>EXEMPTED</b> <ul style="list-style-type: none"><li>■ S-Corporations</li><li>■ non-controlled REITs</li><li>■ Regulated investment companies</li><li>■ Controlled partnerships (generally)</li></ul>
OR	ASSETS EXCEED \$100M		
OR	REVENUE EXCEEDS \$50M		

**Documentation not needed for members of a consolidated group**



# Documentation Requirements In General

- Reg. §1.385-2 sets forth minimum threshold documentation, timing, and maintenance requirements that must be satisfied for EGIs
- Intended to enable IRS to analyze whether an EGI is appropriately treated as debt or stock for federal tax purposes
- As a general rule, failure to satisfy the documentation requirements means an EGI is stock
  - The type of stock (e.g., common or preferred) is based on the EGI's terms and conditions
  - An EGI that qualifies as debt at inception can lose debt status if documentation requirements are not satisfied later in its life



# Highly Compliant Exception from Per Se Treatment

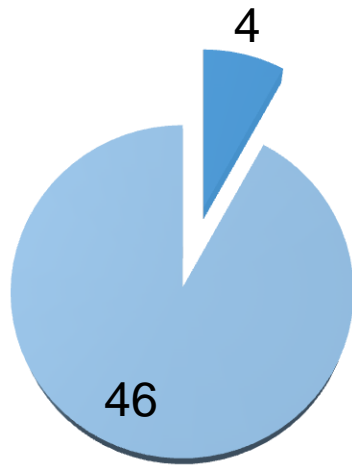
- Rebuttable Presumption as stock:
  - If otherwise “highly compliant”
  - Overcome presumption: sufficient common law factors to treat as debt
- Highly Compliant:
  - Must meet one of the tests:
    1. More than 90% of average of the aggregate adjusted issue price of all outstanding EGIs compliant with documentation rules, or
    2. Undocumented EGI issue price no greater than \$100 million and more than 95% of average total of all EGIs outstanding at quarter end are compliant; or
    3. Undocumented EGI issue price no greater than \$25 million and more than 90% of average total of all EGIs outstanding at quarter end are compliant



# Highly Compliant Exception from Per Se Treatment

## Pass

- Undocumented EGI - \$25M or under
- Documented EGI

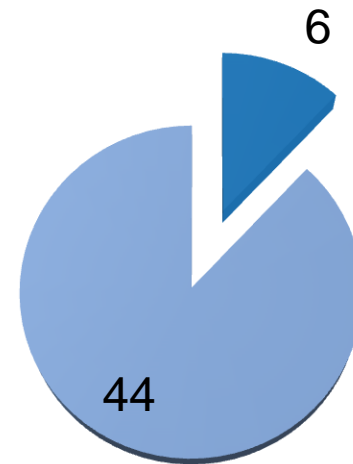


**92% EGI documented**

**Rebuttable presumption applies**

## Fail

- Undocumented EGI - \$25M or under
- Documented EGI



**88% EGI documented**

**Undocumented EGI treated as stock**

# Other Exceptions

- **Reasonable Cause**
  - Significant mitigating factors
  - Failure due to events beyond EG members' control
  - EG members must act in a responsibly, before and after the time that the failure occurred.
  - Requirement to document and maintain EGI documentation once reasonable cause is established.
- **Taxpayer Discovery and Correction**
  - But only if ministerial or non-material

# Documentation Required Generally

## Unconditional Obligation to Pay

- Unconditional and legally binding obligation to pay
- Fixed or determinable sum
- On demand or at one or more fixed dates

## Creditor's Rights

- Creditor has right to enforce obligation
- Typically includes right to cause or trigger default or acceleration in case of failure to pay
- Non-subordination to equity holders
- Provisions applicable to nonrecourse obligations
- Contained within document or reference to local law

## ■ Ability to Repay

- As of date of issuance, issuer's financial position supports reasonable expectation of repayment
- Taking into account all relevant circumstances (and ability to refinance may be taken into account)
- Certain provisions applicable to nonrecourse obligations
- Annual credit analysis may be required if the issuer issues more than one instrument on any day within the 12-month period
- Additional documentation required for material events

## ■ Debtor-Creditor Relationship

- Written documentation of payments with respect to interest or principal (if relied upon to support debt treatment)
- Evidence of holder exercising rights under event of default
- Written documentation of decision not to exercise such rights

# Documentation Requirements – Multiple EGIs

- If each borrowing is not documented by a separate note or writing, then:

- **Obligation to Pay & Creditor's Rights**

- Enabling documents. Must be prepared in accordance with the unconditional obligation to pay and creditor's rights provisions.
- Creditor's Rights. Documents may include, for example, board resolutions, credit agreements, omnibus agreements, security agreements, or other agreements with respect to the legal execution of the original principal balance or increase in principal balance.

- **Ability to Repay**

- Debt Capacity. Ability to repay documentation must be prepared with respect to the original borrowing and must be prepared upon execution of master agreement and updated at least **annually** for any further issuances.

- **Debtor-Creditor Relationship**

- Consistent Actions. Requirements with regard to issuer's and holder's actions evidencing a debtor-creditor relationship are unchanged with respect to cash pools and similar arrangements.

Cash Pooling: notional cash pools are subject to the same rules to the extent the bank deposits and borrowings are treated as issued directly between expanded group members.

# Market Standard Safe Harbor

- Allows documentation meeting typical third party transactions standards
  - Comparables – e.g., documentation used for third party trade payables.
- Safe harbor only pertains to the first two categories of disclosure
  - (1) Obligation and (2) Creditor Rights
  - But not to (3) reasonable expectation of ability to repay



# Material Event of Issuer

- Credit analysis must be prepared as of the “analysis date” – typically date EGI is issued
- If a material event occurs with respect to issuer within the year beginning on the analysis date, the credit analysis prepared as of the analysis date cannot be relied upon to satisfy the “ability to pay” requirement.
- An updated credit analysis must be prepared taking into account the material event.
- Material events include:
  1. Chapter 11 bankruptcy
  2. Foreclosure/receivership
  3. Section 108(d)(3) insolvency
  4. Material change in business line
  5. Disposal 50% of assets
  6. Merger/consolidation where EGI not assumed.



# Reg. §1.385-2: Minimum Standards for Debt Treatment

- Even if the documentation requirements are satisfied, the EGI can still be re-characterized as stock under case law or the transaction rules.
- The issuer and the holder are bound by debt treatment if the issuer treats the EGI as debt.



# Reg. §1.385-2: Due Dates for Documentation

- Completed by due date of Federal tax return (including extensions)
- Effective date: instruments on/after January 1, 2018
- Maintained for all years through final statute close



# Anti-Avoidance and No Affirmative Use Rules

- No Affirmative Use: Reserved
- Anti-Avoidance: non-EGI issued with a principal purpose of avoiding the documentation requirements treated as an EGI



# Recharacterization Rules



# General Rule

A “covered debt instrument” (that is not a qualified short-term debt instrument) is treated as stock if it is issued by a covered member to a member of the issuer’s expanded group in one or more of the following “prohibited/disfavored transactions”

- Distribution of a debt instrument to another expanded group member as a dividend,
  - Issuance of a debt instrument to another expanded group member in exchange for stock of an expanded group member
  - Issuance a debt instrument to an expanded group member in exchange for assets in certain tax-free reorganizations, but only to the extent that, pursuant to the plan of reorganization, a shareholder that is a member of the issuer’s expanded group immediately before the reorganization receives the debt instrument with respect to its stock in the transferor corporation.
- **Covered Debt Instrument:** Excludes debt instruments which are (1) issued before April 5, 2016; (2) issued by a dealer in securities; (3) certain excluded statutory or regulatory debt instruments; or (4) issued by certain exempted regulated financial companies or by a regulated insurance company.

# Funding Rule

**Principal Purpose Rule.** A covered debt instrument (that is not a qualified short-term debt instrument) is treated as stock if it is issued by a covered member (the “funded member”) to a member of the issuer’s expanded group with a principal purpose of engaging in one of the following transactions:

- A distribution of property by the funded member to another member of its expanded group (with certain exceptions);
- An acquisition of expanded group stock by the funded member from another member of its expanded group in exchange for property; or
- An acquisition of property by the funded member in an asset reorganization to the extent a shareholder that is another member of the funded member’s expanded group immediately before the reorganization receives boot.

**Per se rule.** A covered debt instrument is treated as funding a prohibited transaction if it is issued during the period beginning 36 months before or after a prohibited transaction.

- Modifications of covered debt instruments generally do not “reset” the issuance date of the debt instrument unless substituting obligors, adding or deleting a co-obligor, or having a material deferral.
- Certain qualified short-term debt instruments are not covered by the funding rule.



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# Exclusions & Reductions

- **Exclusions (§1.385-3(c)(2)):**
  - the subsidiary stock acquisition exception (the subsidiary stock issuance exception in the Proposed Regulations),
  - the compensatory stock acquisition exception, and
  - the exception to address the potential iterative application of the funding rule.
- **Reductions (§1.385-3(c)(3))**
  - the expanded group **earnings and profits reduction**
    - takes into account all accumulated earnings and profits by a corporation during its membership in an expanded group (as opposed to current year E&P in the Proposed Regulations), provided that the earnings and profits were accumulated in taxable years ending after April 4, 2016.
  - the qualified contribution reduction.
- **The \$50 million threshold exception (§1.385-3(c)(4)).**
  - The threshold exception overrides the general consequences of §1.385-3(b) **for the first \$50 million of debt instruments that otherwise would be treated as stock under the general rule and funding rule.**
  - Broader than the original exception in the Proposed Regulations.

# Exceptions for Certain Debt Instruments

Final Regulations do not apply to:

- Qualified Dealer Debt Instruments
- Instruments That Are Not In Form Debt:
  - production payments under section 636;
  - REMIC regular interests (as defined in section 860G(a)(1));
  - instruments described in section 1286 (relating to coupon stripping transactions) unless such an instrument is issued with a principal purpose of avoiding the purposes of §1.385-3 or §1.385-3T; and
  - leases treated as loans under section 467.
- Significant modifications and refinancing
- Debt instruments issued by certain issuers:
  - Regulated financial companies
  - Regulated insurance companies





# Application to Passthrough Entities

- The final regulations use the aggregate approach to passthrough entities despite concerns that non-corporate entities are outside the scope of section 385 and collateral consequences of treating a partnership instrument as stock of the expanded group partners.
- The **documentation rules** in Treas Reg. 1.385-2 with respect to **disregarded entities** are modified to conform to the recharacterization rules.
  - The covered member that is a regarded owner of the disregarded entity is deemed to issue its stock in exchange for the EGI to the actual holder of the EGI. The stock deemed issued is deemed to have the same terms as the EGI issued by the disregarded entity, other than the identity of the issuer, and payments on the stock are determined by reference to payments made on the EGI issued by the disregarded entity.
- Under the **recharacterization rules**, the holder of a debt instrument issued by a partnership that otherwise would be subject to recharacterization (based on an application of the factors in §1.385-3 to the expanded group partners under the aggregate approach) is treated as having transferred the debt instrument to the expanded group partner or partners in exchange for stock in the expanded group partner or partners.
- The final 385 regulations do not cover many passthrough entities (S-corporations, non-controlled RICs and REITs)



# Anti-Abuse Rules

- The anti-abuse rule in §1.385-3(b)(4) applies if a member of an expanded group enters into a transaction with a principal purpose of avoiding the purposes of §1.385-3 or §1.385-3T. The result is that a debt instrument is automatically characterized as stock.
  - The Treasury and the IRS refused to narrow the rule down by using “the” instead of “a” or excluding debt between related parties and transactions qualifying under the existing exceptions.
- No affirmative use rule: reserved pending continued study after the applicability date.

# Illustrative Transactions Impacted by the Regulations



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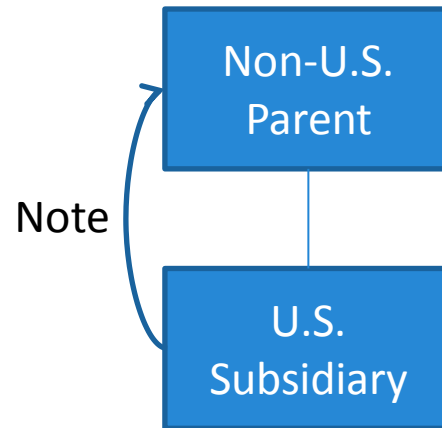


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# Leveraged Distributions by U.S. Subsidiary



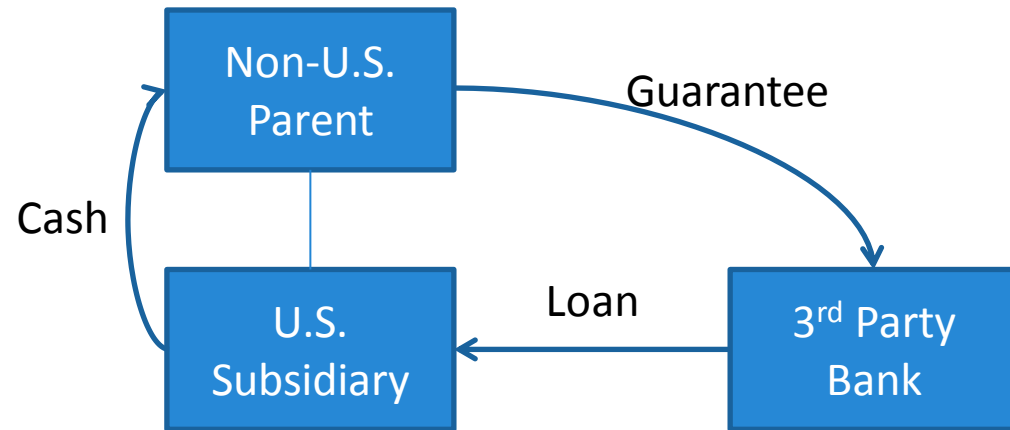
- **Pre-Regulations**

- Distribution of note by U.S. Subsidiary constitutes a dividend distribution (potentially subject to withholding tax)
- Interest on the note is deductible (subject to existing limitations – generally 50% of “adjusted taxable income” – a proxy for EBITDA)
- Repayment of note not taxable

- **Post-Regulations**

- Distribution of note in excess of expanded group earnings by U.S. Subsidiary constitutes a non-taxable recapitalization (not subject to withholding tax)
- Interest payments on the note are non-deductible dividends (potentially subject to withholding tax of 30% under U.S. domestic law, subject to reduction under an applicable tax treaty); likely still subject to tax as interest income in Non-U.S. jurisdiction)
- Repayment of note would be a dividend-equivalent redemption (potentially subject to withholding tax; note could be capitalized without adverse U.S. tax consequences)

# Leveraged Distributions by U.S. Subsidiary - Alternative



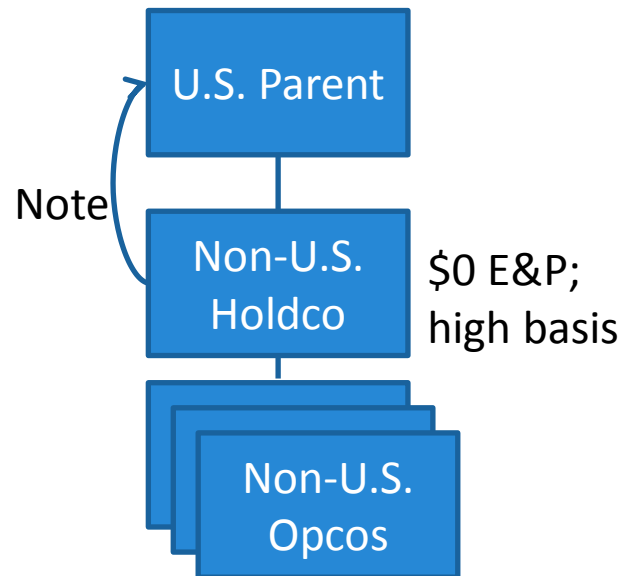
- **Pre-Regulations**

- Cash dividend (potentially subject to withholding tax)
- U.S. subsidiary's status as debtor tested under *Plantation Patterns* et. al.
- Interest on the note is deductible (subject to existing limitations – generally 50% of “adjusted taxable income” – a proxy for EBITDA)

- **Post-Regulations**

- Form is respected (unless “funding” rules are implicated), even in excess of expanded group earnings
- By introducing 3<sup>rd</sup> party bank, results are improved relative to prior structure; however, interest payments are no longer retained by the group

# Leveraged Distributions by a Non-U.S. Subsidiary



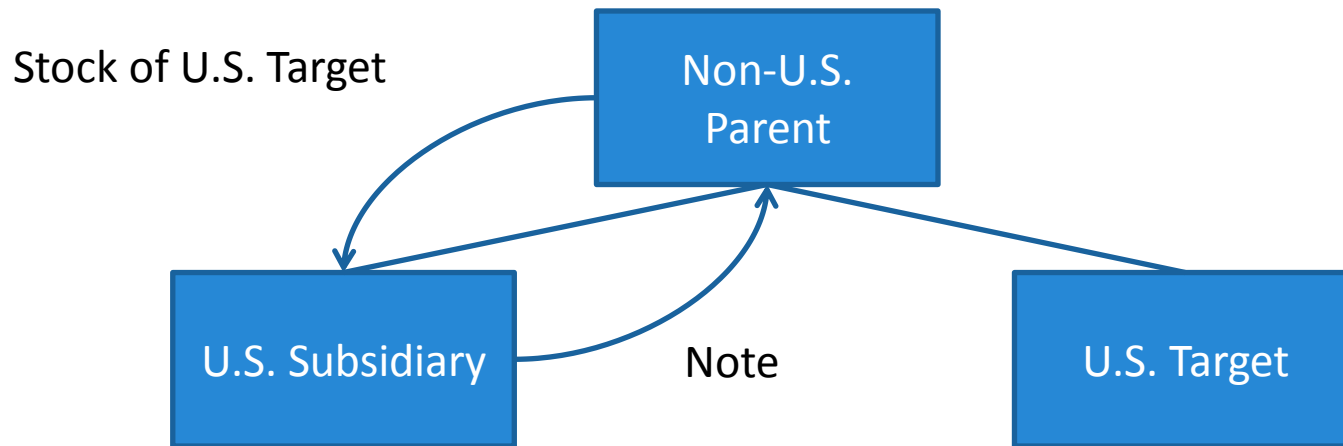
- **Pre-Regulations**

- Distribution of note by Non-U.S. Subsidiary constitutes a distribution that would be a non-taxable return of basis distribution (i.e., no taxable income to U.S. Parent because Non-U.S. Holdco has no E&P at the time of the note distribution)
- Repayment of note not taxable to U.S. Parent (regardless of Non-U.S. Holdco's E&P position at the time of repayment)

- **Proposed Regulations**

- Distribution of note constitutes a recapitalization (potentially non-taxable)
- Repayment of note is a dividend-equivalent redemption that would be taxable to U.S. Parent to the extent Non-U.S. Holdco has E&P at that time

# Integration of U.S. Subsidiaries via Leveraged Sales Section 304 Transaction



- **Transactions**

- Non-U.S. Parent wishes to integrate a newly-acquired U.S. target corporation into its pre-existing U.S. group
- Non-U.S. Parent transfers stock of U.S. Target to U.S. Subsidiary in exchange for a note (in excess of expanded group earnings)

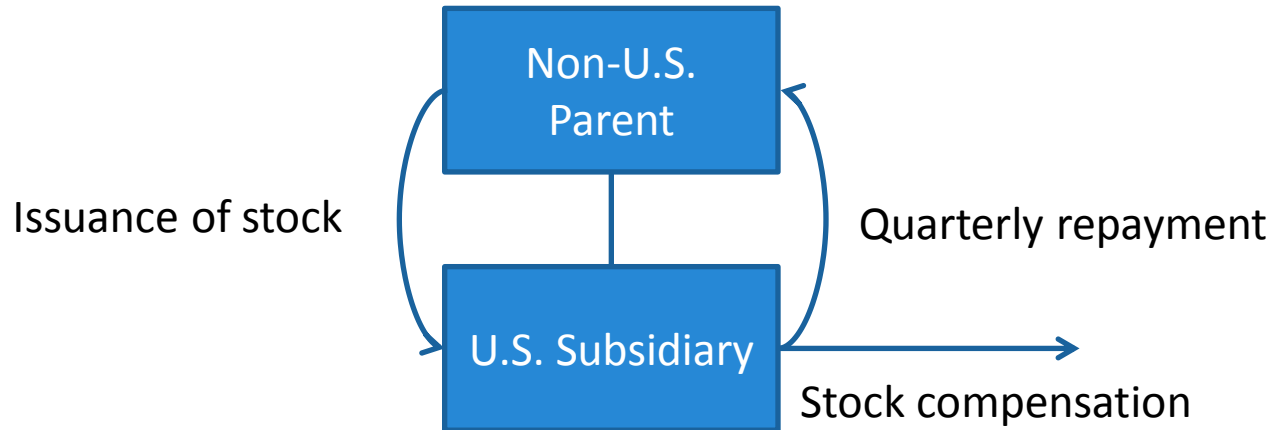
- **Pre-Regulations**

- Note issuance potentially treated as dividend from U.S. Subsidiary and/or U.S. Target, potentially subject to withholding tax
- Note respected as debt; interest deductible (subject to 163(j) limitations); repayment of note not taxable

- **Post-Regulations**

- Issuance of note by U.S. Subsidiary recharacterized as equity issuance (not subject to withholding tax)
- Interest payments are non-deductible dividends, potentially subject to withholding tax and likely still subject to tax as interest income in Non-U.S. jurisdiction
- Repayment of note is a dividend-equivalent redemption, potentially subject to withholding tax.

# Equity Recharge Arrangement



- **Transactions**

- Non-U.S. Parent stock is used as partial compensation for officers and employees throughout its worldwide group
- U.S. Subsidiary has RSU or other equity awards that vest upon employment anniversaries; as a result, Non-U.S. Parent shares are issued to U.S. Subsidiary to be used to satisfy such awards on a frequent basis
- U.S. Subsidiary pays Non-U.S. Parent fair market value for these shares, computed at the end of each quarter

- **Pre-Regulations**

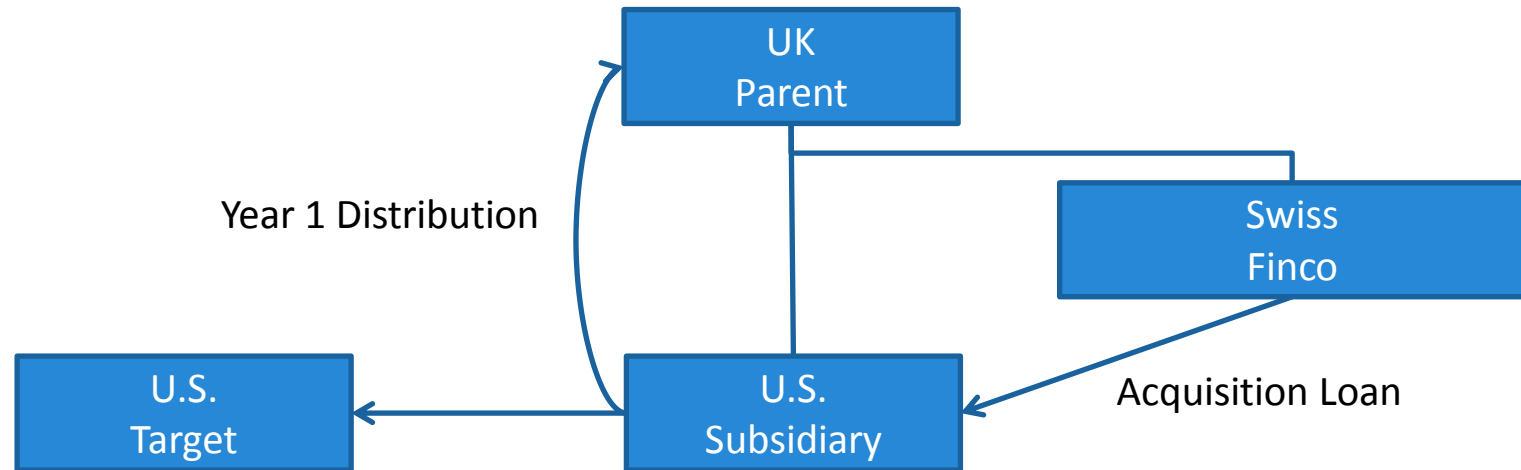
- Non-U.S. Parent not taxed (for U.S. purposes) upon receipt of payment under Section 1032
- U.S. Subsidiary claims a compensation deduction

- **Post-Regulations**

- Is obligation to pay at quarter-end indebtedness? If so, debt used to acquire “expanded group stock”
- But, see exception for compensatory stock acquisitions



# The Funding Rule



- **Transaction**

- In year 1, U.S. Subsidiary pays a distribution to UK parent that is not sourced from expanded group earnings
- In year 3, in a transaction completely unrelated to and unanticipated at the time of the year 1 distribution, U.S. subsidiary acquires U.S. Target in an all cash transaction
- Swiss Finco loans acquisition cash to U.S. Subsidiary

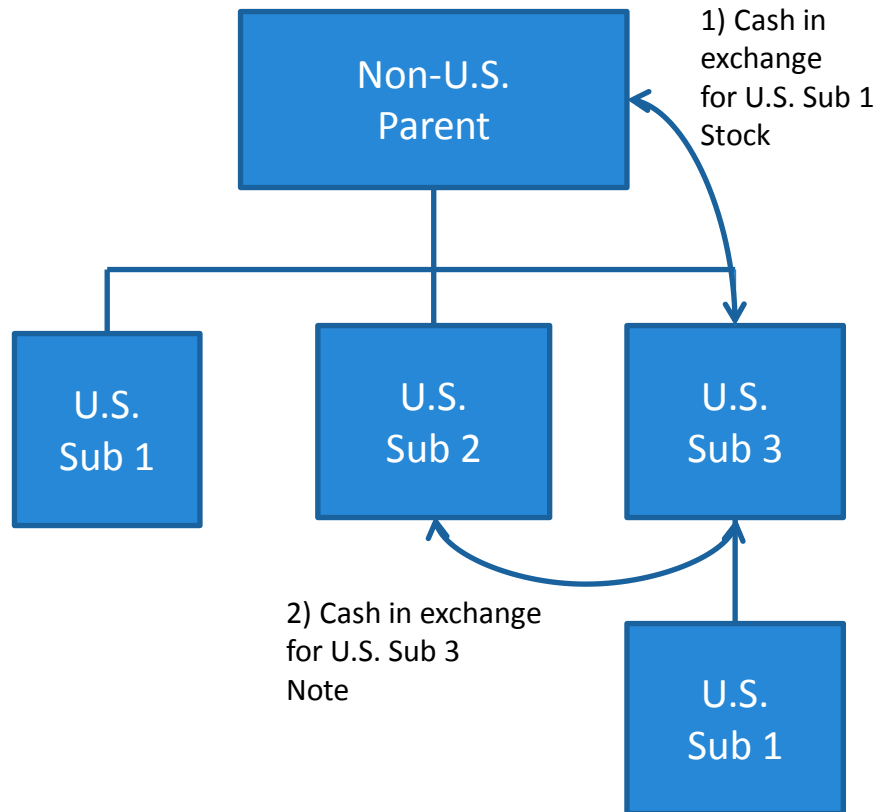
- **Pre-Regulations**

- Acquisition loan is respected as debt for tax purposes
- Interest payments by U.S. Subsidiary to Swiss Finco exempt from withholding tax under the U.S.-Swiss treaty

- **Post-Regulations**

- Acquisition loan is recharacterized as equity of U.S. Subsidiary under the funding rule
- Interest payments by U.S. Subsidiary are treated as distributions on equity, not interest, subject to 15% withholding tax under the U.S.-Swiss treaty

# The Funding Rule



## Transaction

- U.S. Sub 3 acquires the stock of U.S. Sub 1 from Non-U.S. Parent in exchange for \$100 cash
- In the same year, U.S. Sub 3 borrows \$100 from U.S. Sub 2 in exchange for a note (the “U.S. Sub 3 Note”)
- Assume that neither U.S. Sub 1 nor U.S. Sub 2 has any current or accumulated E&P

## Result under Funding Rule

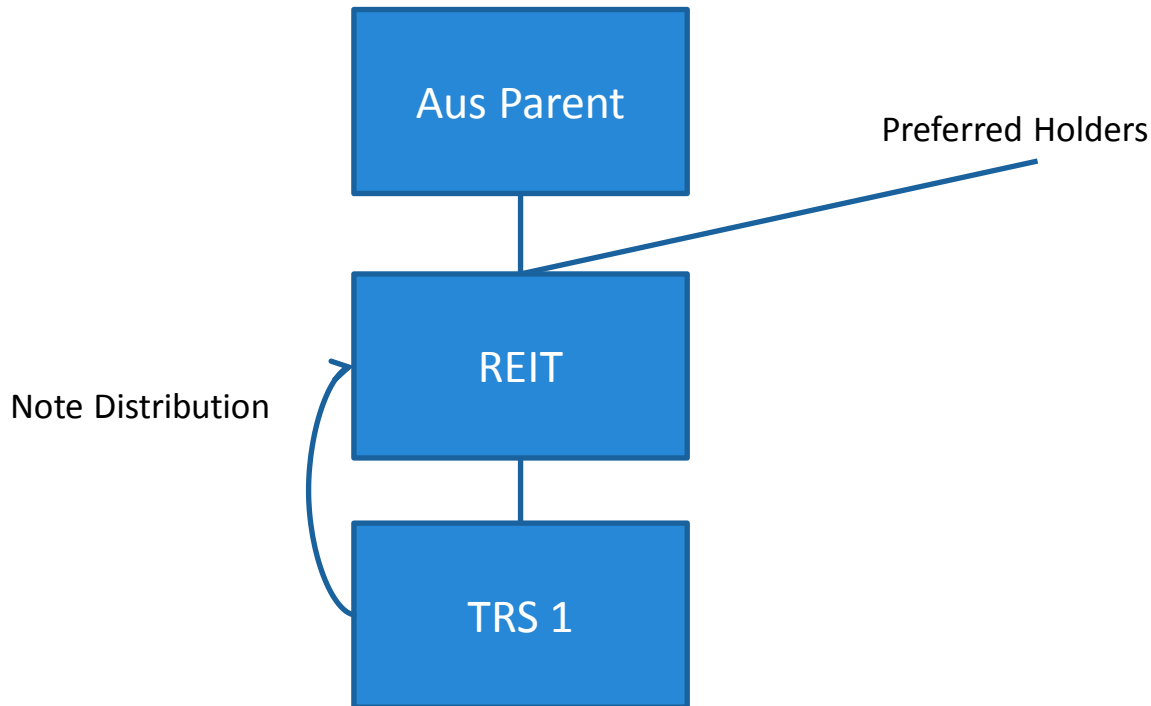
- The U.S. Sub 3 note issued to U.S. Sub 2 is treated as equity in U.S. Sub 3, and the transaction constitutes a dividend-equivalent Section 304(a)(1) transaction that is not taxable (Section 301(c)(3) gain, if any, would not be subject to U.S. tax, so long as U.S. Sub 3 is not a USRPHC).

## Alternative Transaction

- If U.S. Sub 3 purchases the U.S. Sub 1 stock in exchange for its own note, Section 304 does not apply to the transaction because the U.S. Sub 3 note would be recharacterized as U.S. Sub 3 stock.
- What is the policy rationale for the different treatment of these two similar transactions?

Assumption: No exceptions to the general rule or funding rule are applicable

# REIT Considerations



- “Captive” REIT conducts certain activities through TRS 1
- TRS 1 appreciates in value; REIT causes TRS 1 to distribute out a note (secured by real property) reflecting this unrealized appreciation so as to “skinny down” TRS 1 and comply with REIT limitations
- Under Regulations, note recharacterized as equity and value of TRS undiminished
- Compare result for a widely-held REIT - - no “expanded group” due to lack of an eligible parent

Thank you!



**Deloitte.**



McDermott  
Will & Emery

**Skadden**

