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June 29, 2016

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Assistant Secretary (Tax Policy)
Department of the Treasury
1500 Pennsylvania Avenue, NW
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The Honorable John Koskinen
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The Honorable William J. Wilkins
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Re: *Report No. 1351 on Proposed Regulations under Section 385*

Dear Messrs. Mazur, Koskinen, and Wilkins:

I am pleased to submit the attached report of the Tax Section of the New York State Bar Association. The report comments on proposed regulations issued by the Treasury Department ("**Treasury**") and the Internal Revenue Service (the "**IRS**," and together with Treasury, the "**government**") on April 4, 2016, under Section 385, concerning the tax treatment of debt instruments issued between related parties (the "**Proposed Regulations**").

The Proposed Regulations were issued simultaneously with a package of regulations under Sections 367, 956, 7701(l) and 7874 addressing inversions. We understand the primary aims of the Proposed Regulations include (i) curtailing earnings stripping transactions by inverted corporations, and other taxpayers, and (ii) limiting the ability of U.S. multinationals to use intercompany debt in transactions designed to repatriate foreign earnings without current U.S. tax. While we appreciate the interests of the government in limiting these types of transactions, we nevertheless have significant concerns about several aspects of the Proposed Regulations.

The Proposed Regulations represent a substantial change from settled law, with far-reaching implications, the full breadth of which may not be grasped by taxpayers, or the government, for some time to come. For well-advised taxpayers, the Proposed Regulations in their current form would have significant and disruptive effects on ordinary commercial activities and on other transactions that may not implicate tax policy concerns. For other taxpayers, the Proposed Regulations— and, in particular, Prop. Treas. Reg. § 1.385-3—will often operate as a trap for the unwary, in which taxpayers may learn only after the fact that an intercompany loan with customary debt terms can cause adverse tax consequences, even if the loan would (absent the Proposed Regulations) clearly constitute debt for U.S. federal income tax purposes. The fact that the Proposed Regulations raise these issues may to some extent be unavoidable, since Section 385 appears designed to distinguish between debt and equity based on a variety of factors germane to that analysis, rather than drawing the debt-equity distinction in a manner designed to achieve other tax policy goals.

We recognize the importance of the government's policy objectives in issuing the Proposed Regulations. However, we are concerned that Prop. Treas. Regs. §§ 1.385-1 and 1.385-2 both need to be substantially revised in order to operate properly. In addition, we strongly recommend that Prop. Treas. Reg. § 1.385-3 not be issued as a final regulation, due to the deep problems inherent in the proposed rule. We urge that the government instead put forward alternative guidance for taxpayers' and practitioners' review and comment.

A. Key Considerations

Section 385 was adopted in response to the lack of clear, consistent common law principles for drawing distinctions between debt and equity, a condition which provided grounds for frequent disputes between taxpayers and the government. Congress expected that Treasury and the IRS would promote the orderly administration of the tax laws, by providing "regulatory guidelines" for determining whether an interest in a corporation constitutes equity or debt. It appears these guidelines were anticipated to be based on factors concerning the characteristics of an instrument issued by a corporation, and other facts related to the overall bundle of economic and legal rights and obligations that together compose the holder's relationship with the issuer.

In this regard, there is a tension in how different provisions of the Proposed Regulations identify interests not appropriately treated as debt. Prop. Treas. Regs. §§ 1.385-1 and 1.385-2 both appear to begin with the basic premise that, if an intercompany instrument has the proper form, legal rights and economic characteristics, it is appropriately viewed as debt, even though it is issued between related parties. Prop. Treas. Regs. §§ 1.385-1 and 1.385-2 seek to impose discipline on a corporate group in ensuring that an instrument issued within the group is treated as debt only if it has the appropriate characteristics. By comparison, Prop. Treas. Reg. § 1.385-3 in significant respects departs from this premise. It takes the view that even classic debt, if issued by means of a distribution by a subsidiary to a parent, or other transactions the regulation identifies as similar, should be automatically classified as equity for tax purposes, notwithstanding that the same instrument entered into between third parties would be treated as debt and that the parties comply with its terms fully. Prop. Treas. Reg. § 1.385-3 thus is a substantial departure from the type of regulatory guidelines that Congress, Treasury and the IRS had, until now, anticipated would be adopted under Section 385.

1. Prop. Treas. Regs. §§ 1.385-1 and 1.385-2

Prop. Treas. Reg. § 1.385-1(d) (the "**Part-Stock Rule**") authorizes the IRS to bifurcate a debt instrument issued within a group. Although bifurcation is an approach to the tax treatment of debt that is expressly contemplated as a possibility by Section 385, the government and taxpayers have found it difficult in the past to apply bifurcation. Among other challenges, it often may be hard to determine what the separate components of an instrument should be, how to value them, and, in the case of the non-debt component of the bifurcated instrument, how it should be treated for tax purposes. The Proposed Regulations do not articulate any principles of general application (including in transactions between unrelated parties) that would address these issues. Nor do they indicate what special considerations, if any, apply in the related-party context that would shape the bifurcation analysis and make it an effective tool to produce appropriate tax results. Consistent with an apparent basic motivation for the Proposed Regulations overall, it appears the Part-Stock Rule may be concerned largely with the overleveraging of a group member, which may result where there is not a third party to impose financial discipline. Assuming that is the case, the Part-Stock Rule should be expressly narrowed, at least for now, to apply only to that case. In its present form, it creates uncertainty that impedes orderly administration of the tax laws.

Prop. Treas. Reg. § 1.385-2, by comparison, does provide some specific guidance for taxpayers about prerequisites for treating an instrument issued within a corporate group as debt (the "**Documentation Rules**"). The rules mandate that a corporate group must maintain four types of contemporaneous documentation relating to an intragroup debt instrument, to establish that (1) the instrument provides for payment of a sum certain; (2) it provides for traditional creditor's rights; (3) there is a reasonable expectation the issuer will pay off the debt in full; and (4) amounts due under the instrument are timely paid or, in the event of non-payment, the holder exercises the reasonable diligence of a creditor. So long as some suggested clarifications are made, the first two of these requirements are reasonable and, to a significant extent, are familiar concepts grounded in prior law. The remaining two types of required documentation (establishing a reasonable expectation that the debt will be paid in full, and that the holder exercises reasonable diligence of a creditor in the event of non-payment) are also based on familiar concepts from prior law; but the rules do not give clear recognition to the reality that, if the issuer of an intragroup debt instrument becomes financially distressed after the time the debt is issued, the related lender may have only limited practical ability to pursue a creditor's remedies and, even though acting in the same manner a reasonable third-party creditor would, may nonetheless refrain from exercising its rights to the fullest. We believe Prop. Treas. Reg. § 1.385-2 is not meant to say that this reality will prevent intragroup debt from being respected as debt; and the regulation should be clarified to avoid doubt on the point.

However, the principal problems raised by the Documentation Rules are administrative, rather than substantive. The rules should generally require that documentation be prepared supporting the status of intercompany debt as true debt only upon issuance, repayment according to its terms, or events of default, rather than the broader range of dates that are specified in Prop. Treas. Reg. § 1.385-2. Also, it should be required that these documents be prepared by the time the tax return is due for the year in which a relevant event occurs, rather than within 30 or 120 days after the date of issuance or other relevant events provided in the Proposed Regulations. Moreover, the general requirements of the Documentation Rules should be relaxed to fit normal commercial practice for short-term intragroup financings, including loans under cash pooling arrangements and trade payables for property and services provided by affiliates.

As currently drafted, the Documentation Rules would apply to instruments issued on or after the date the rules are published in final form. We recommend that the rules instead apply only to instruments issued at least a few months after the rules are finalized. Particularly if the large number of potential testing dates is retained, and the deadline for preparing at least some of the necessary documentation is kept at 30 days after a relevant event, it may realistically be difficult for taxpayers to implement the Documentation Rules in a timely fashion. Although the reasonable cause exception in the Documentation Rules might provide some relief, it would seem preferable to choose an effective date that is less likely to cause frequent reliance on that exception. In addition, even if the rules are modified in the manner we have recommended, groups may still often need lead time to assess the final rules and coordinate their internal tax, finance and legal functions in order to be able to generate appropriate documentation and ensure the terms of instruments are consistent with the final Documentation Rules.

2. Prop. Treas. Reg. § 1.385-3

As noted, Prop. Treas. Reg. § 1.385-3 recharacterizes debt issued within a corporate group as equity, if the debt is issued by means of a distribution by a subsidiary corporation to its parent or other specified types of transactions (the "**Per Se Stock Rules**"). Prop. Treas. Reg. § 1.385-3 is meant to limit earnings stripping, E&P repatriation and other types of planning opportunities of concern to the government. We have serious concerns regarding the Per Se Stock Rules, and we strongly recommend against issuing this proposed regulation in final form.

For many of us, the problems with Prop. Treas. Reg. § 1.385-3 are rooted in the choice of Section 385 as the statutory provision under which to issue rules curbing the types of planning that are of concern to the government. First, it does not appear that Congress (or, in their prior proposed regulations under Section 385, Treasury and the IRS) envisioned that the overall tax planning strategies of the borrower or lender would drive the analysis under Section 385 or the factors to determine whether an instrument issued by a corporation is debt or equity. Prop. Treas. Reg. § 1.385-3 is drafted in a manner that appears, at least implicitly, to acknowledge this point. By its terms, the regulation seeks to identify in a neutral fashion (*i.e.*, not expressly limited to cases involving earnings stripping, E&P repatriation or other specific tax planning strategies) certain cases where intragroup debt should not be respected as debt for tax purposes.

However, the circumstance that triggers recharacterization of debt as equity under Prop. Treas. Reg. § 1.385-3—*i.e.*, the fact that the debt was created in a particular type of transaction between group members, without reference to other factors—represents, to many of us, a second significant departure from the types of debt/equity factors that Congress and, until now, Treasury and the IRS appear to have assumed would be used in regulations under Section 385. In contrast with current law, Prop. Treas. Reg. § 1.385-3 treats otherwise identical instruments, with the economic characteristics and legal terms of traditional debt, differently solely because they were issued in different types of transactions. Moreover, to the extent transaction types are chosen as a proxy for cases where policy concerns related to particular types of tax planning are employed, the resulting rule will easily, perhaps inevitably, be over- or underinclusive (or both).

Because Prop. Treas. Reg. § 1.385-3 attempts in a single provision to address a variety of tax issues (*e.g.*, earnings stripping by foreign-parented multinational groups and repatriation planning by U.S.-parented multinational groups), the over- and under-inclusiveness problems noted above are exaggerated. A given transaction type may facilitate one kind of tax planning but not another.

Third, in the cases where Prop. Treas. Reg. § 1.385-3 applies, it treats an intragroup instrument as stock—even though this treatment in many cases does not appear to provide a more fitting explanation of the parties' transaction than treatment as debt, and even though many of the tax consequences that flow from equity treatment may not be logical or appropriate consequences in view of the basic nature of the parties' transaction. This appears to be an inevitable result of the decision to deem an instrument to be stock without regard to the economic and legal features of the instrument, and also of the fact that application of Section 385 to an instrument causes it to treated as debt or equity for all purposes of the Code. While the Code includes numerous provisions that treat debt-like equity as debt (*e.g.*, Sections 351(g) and 1504) and treat equity-like debt as equity (*e.g.*, Section 163(i), Section 163(l)), each such provision applies for the limited purposes under the Code that are necessary to further the particular goals of the provision. Notably, no provision of the Code that limits interest deductions does so by treating an instrument as equity for all purposes.

Although we believe that Section 385 is not an ideal statutory provision for issuing guidance to address earnings stripping and the other planning techniques that motivated the government in issuing Prop. Treas. Reg. § 1.385-3, many of us allow for the possibility that an appropriately targeted regulation could be issued under Section 385 to address at least some of these concerns. However, Prop. Treas. Reg. § 1.385-3 is a deeply problematic rule, due to its overbreadth and the often arbitrary results it produces. The proposed regulation identifies a corporation's distribution of a debt instrument to a closely related shareholder as the paradigmatic case where the form of the debt instrument should not be respected, based on the proposition that such a distribution typically lacks real-world significance. That proposition is debatable, if the debt has economic terms that would be acceptable to an unrelated party (indeed, the proposed regulation can apply even when a large portion of an issuance of debt is actually held by third parties). However, even if this argument is accepted, the proposed regulation sweeps in a wide range of other trigger transactions that have economic and practical consequences that are substantially different from a subsidiary's distribution of debt to a parent and do not fairly resemble such a distribution.

For example, an intragroup loan made to a highly creditworthy entity to provide short-term working capital, or to satisfy a regulatory requirement, will often be recharacterized as equity under Prop. Treas. Reg. § 1.385-3, if the borrower happens coincidentally to engage in a proscribed transaction during the relevant 6-year window of time (say, an acquisition of an affiliate's assets in a tax-free reorganization). This is true notwithstanding that the loan may have none of the economic or legal features typically associated with stock; the transaction in which the loan is issued may clearly have substance, and may bear no economic resemblance to a debt distribution by a subsidiary to its parent; and none of the policy concerns underlying Prop. Treas. Reg. § 1.385-3, or other tax policy concerns, may be present in such a case. This overbreadth is particularly troubling because, as noted above, the recharacterization of the instrument as stock is for all purposes of the Code—the result may be not just a conversion of interest, and principal, payments into dividends, but a far-reaching chain of collateral tax consequences, including creation of tax liability for third parties that have not participated in (and, for that matter, may not be aware of) the transactions in which the debt that is recharacterized was created.

We thus strongly urge that Prop. Treas. Reg. § 1.385-3 not be adopted. We appreciate, as noted, the government's significant concerns leading to its proposal of the rule, and we offer below several possible approaches the government could pursue in order to address those concerns.

B. Possible Alternatives to Prop. Treas. Reg. § 1.385-3

1. First Option: Rules Expressly Targeting Inverted Corporations and Other Problem Cases

One possibility would be to issue guidance under Section 385 that expressly targets debt issued as part of particular types of tax planning identified as problematic. The most obvious would be debt issued by an inverted U.S. corporation to its foreign parent or a foreign affiliate, where the debt is not issued as part of a transaction that increases the total assets of the group in U.S. corporate solution. Another specific target might be debt issued by a first-tier CFC to U.S. affiliates, in a transaction that does not result in an increase in the CFC's asset base. This approach would, clearly, be a departure from the historic approach under Section 385 above of not looking to the parties' tax planning as a factor in debt/equity analysis. Treasury and the IRS however could consider whether the seriousness of the policy issues they now confront, in a contemporary context, merits breaking new ground. Such an approach would have the considerable advantage of applying only to the precise cases that raise the policy concerns which have motivated the government to act.

2. Second Option: Guidance Based on the Group's Third-Party Debt:Equity Ratio

A second alternative would be to adopt rules under Section 385 that, consistent with Section 385(b)(3), focus on the debt:equity ratio of a corporation issuing debt within a worldwide group. For example, the regulation could provide that debt will not be recast as equity where both: (a) immediately following the issuance of the debt being tested, the issuer has a debt:equity ratio that is no higher than the worldwide group's third-party debt:equity ratio; and (b) the yield on the issuer's debt being tested does not exceed the blended yield on the group's third-party debt. This approach would be somewhat similar to the Administration's recent proposals on group excess interest expense, although the metrics that are used (debt:equity ratio, and reasonableness of the interest rate) would be traditional ones for a debt-equity analysis under general tax principles. Under such an approach, a group member would be free to issue internal debt that represented a reasonable portion of its capital structure; although this debt would not be loaned directly by third parties, it would represent a broadly sensible allocation of the economic burden of the group's third-party borrowing.

This approach would represent significantly less of a departure from the historic approach to debt:equity analysis, than Prop. Treas. Reg. § 1.385-3 does. This approach also would tend to mitigate the wide-ranging collateral consequences of characterizing an instrument as stock under Section 385, by allowing a corporation to incur intragroup debt up to a logical limit.

We note that because Prop. Treas. Reg. § 1.385-3 does not incorporate any type of exception based on the corporate group's debt:equity ratio, it tends to create incentives that might be viewed as in tension with the basic goal of preventing inappropriate earnings stripping, and that conceivably may not have been intended. First, a foreign-parented group will have an incentive to load up a newly formed U.S. subsidiary with the maximum possible amount of intercompany debt that can plausibly be respected as debt under general U.S. tax principles, due to the difficulty under Prop. Treas. Reg. § 1.385-3 of inserting additional leverage into the U.S. subsidiary after it is initially formed and capitalized. Second, a foreign-parented group also will have an incentive, where commercially feasible, to push down the maximum possible amount of third-party debt to U.S. subsidiaries, with a guarantee from the parent if requested by the lenders. A U.S.-parented group will also have somewhat similar incentives (subject to maximizing the tax benefit of interest deductions) in the case of a newly formed CFC.

Treasury and the IRS logically would need to address a series of choices if they design a rule under Section 385 that is based on a group's debt:equity ratio. We would be pleased to assist the government in analyzing these issues and developing guidance. Among other matters, guidance would need to address how debt and equity would be computed (*e.g.*, based on audited financial statements); whether the debt:equity ratio would be the only test used, or whether it would be appropriate to provide an additional test using a coverage ratio; and whether departures from the results dictated by the ratio tests would be appropriate in any cases, as well as whether any special rules should apply for particular industries.

It would appear that rules based on a corporate group's third-party debt:equity ratio, if properly constructed, could provide a logical response to concerns about earnings stripping. The analysis is more complicated, however, in the case of concerns about repatriation planning, or transactions otherwise seen to inappropriately shift CFCs' E&P. An approach based on a debt:equity ratio would prevent excessive, non-economic leveraging of a CFC to repatriate E&P (or otherwise manipulate E&P). Such an approach would, however, allow CFCs to issue intragroup debt freely up to formulaic limits. As the report explains, Prop. Treas. Reg. § 1.385-3 is a not particularly effective means of limiting this planning. That is true regardless of how heavily levered a CFC may be; and, in that respect, a test based on a CFC's debt:equity ratio might be seen as an incremental improvement on the proposed regulation. However, at a more basic level, the concept of dealing with CFC repatriation structures and other CFC planning through a single, uniformly applicable set of rules that also is meant to address earnings stripping, may simply not be an effective one in addressing issues pertaining to CFCs. Instead, the government could consider issuing other types of guidance, potentially under Sections 301, 956 or 7701(l), to address CFC planning techniques. For example, the possibility could be explored of guidance to treat an upstream loan by a lower-tier CFC to a first-tier CFC, when made with a principal purpose of funding a distribution by the first-tier CFC to a U.S. shareholder, as an investment in U.S. property under Section 956. Alternatively, or in addition, guidance might be considered under Sections 301 or 7701(l) to address cases where a first-tier CFC incurs intragroup debt to fund a distribution by it to a U.S. parent and, as part of a plan, the first-tier CFC later receives distributions from a lower-tier CFC in order to fund repayment of that debt; in these cases, the transaction might be recharacterized in a manner that causes the upper-tier CFC's distribution to its U.S. parent to be treated as not occurring, until the debt is repaid.

3. Third Option: Put Forward a Substantially Narrower Rule that Retains Elements of Prop. Treas. Reg. § 1.385-3 for Public Review and Comment

A third possibility would be to continue with some of the elements of Prop. Treas. Reg. § 1.385-3, but to significantly reduce the reach of the proposed regulation, and to better tailor it to curtailing the types of planning that have motivated the government to issue it. We offer a series of detailed proposals for doing so in the report; the key ones are summarized below. This approach would lack advantages of the two possibilities described above: even if narrowed in the manner we suggest, it still would not expressly target the precise types of tax planning of concern to the government and, thus, would have a significantly broader scope than the first approach we have described; and it also would continue to recast debt as equity based solely on a single factor (the type of transaction in which the debt is issued) that is not tied to the economics of the instrument, thus departing from previously understood Section 385 principles, and would seek to address all the policy concerns that the government is facing by means of a single, uniform mechanical set of rules rather than differentiated rules to deal with (on the one hand) earnings stripping and (on the other hand) repatriation and other CFC planning, by contrast to the second approach.

Our key recommendations under this approach would be:

First, transactions between foreign corporations should be excluded from Prop. Treas. Reg. § 1.385-3. A loan between two foreign corporations that are not CFCs, almost by definition, should not lead to the type of planning that apparently has motivated Prop. Treas. Reg. § 1.385-3. In addition, disapplying Prop. Treas. Reg. § 1.385-3 to transactions between a CFC and another foreign corporation (CFC, or non-CFC) will not cause corporate groups to gain meaningful additional opportunities to repatriate E&P (or manipulate CFC's E&P) beyond those available to them under the proposed regulation as currently drafted. As noted above, in order to address E&P planning techniques involving CFCs, the government could consider a separate set of rules that is designed specifically to achieve that purpose.

Second, although the government's stated focus in Prop. Treas. Reg. § 1.385-3 is on note distributions and other intercompany debt created in transactions in which the equity capital of EG members is reduced, Prop. Treas. Reg. § 1.385-3 does not exclude transactions where, in connection with an issuance of intragroup debt, the borrower receives an infusion of equity capital from a member of the group that offsets any distribution or other capital reduction. Prop. Treas. Reg. § 1.385-3 should take contributions of equity capital into account.

Third, Prop. Treas. Reg. § 1.385-3 has two prongs. A general rule (the "**General Per Se Rule**") recharacterizes debt as stock if the debt is issued as a distribution by a subsidiary to a parent, as consideration for an acquisition of stock of another group member, or as consideration for an acquisition of assets of another group member in a tax-free reorganization. In addition, a second rule (the "**Funding Rule**") recharacterizes debt issued for cash or other property as equity, if the debt is issued with a principal purpose of funding a distribution by the issuing corporation to its shareholder, or funding payments by the issuing corporation of consideration for the acquisition of stock or a group member or of assets of a group member in a tax-free reorganization. For purposes of the Funding Rule, if a corporation makes a distribution or engages in any of the other types of trigger transactions, then debt issued by that corporation within the 72-month period beginning 36 months before, and ending 36 months after, the date of a distribution or acquisition, is irrebuttably presumed to have been issued with a principal purpose of funding the relevant transaction (the "**72-Month Per Se Rule**"). The Funding Rule—although ostensibly an anti-avoidance rule to bolster the General Per Se Rule—in fact is responsible for a disproportionate share of the issues created by the regulation. It applies to a wide range of transactions which are economically dissimilar to the distribution of a note and the other transactions covered by the General Per Se Rule; and typically, the Funding Rule applies automatically whenever one of the transactions described in the rule occurs, even though there appears to be no policy reason for recharacterizing debt as equity in many of these transactions.

We strongly recommend that the Funding Rule be significantly scaled back. It should no longer contain any provision which automatically requires recharacterization, like the 72-Month Per Se Rule. Instead, the Funding Rule should apply only when an intragroup loan is made with a principal purpose of achieving substantially the same economic result as a distribution or other transaction that is subject to the General Per Se Rule. (As a very simple example, the Funding Rule would apply where, pursuant to a plan, a parent makes a loan to a subsidiary, which then makes a distribution in the same amount to the parent.) This change would limit the scope of the Funding Rule to transactions that are economically similar to the paradigmatic cases that the General Per Se Rule is meant to capture. Although this would be our preferred approach, a workable alternative could be to replace the 72-Month Per Se Rule with a rebuttable presumption, which would apply where an intragroup loan is made within one to two years before or after a distribution or other triggering transaction. That rebuttable presumption in favor of recharacterizing a loan as equity, would be accompanied by rebuttable presumptions in favor of not recharacterizing a loan as equity, if it is made within one to two years before or after a distribution or other triggering transaction, but is made pursuant to common types of transactions that present limited or no potential for abuse (*e.g.*, cash pooling arrangements; or purchases of an EG member's debt by an affiliate that is a securities dealer).

Fourth, to the extent Prop. Treas. Reg. § 1.385-3 contains any anti-avoidance rules, they should be precisely and clearly articulated so that they do not have the inadvertent effect of significantly broadening the regulation. In this connection, we note that the current combination of a mechanical operative rule for which purpose is irrelevant (the 72-Month Per Se Rule), and an anti-avoidance rule that is triggered when a taxpayer engages in a transaction to which the regulation applies with a purpose of reducing U.S. taxes, is likely to lead to arbitrary, one-sided results.

While the above would be key features of a narrower regulation that retains some basic elements of Prop. Treas. Reg. § 1.385-3, we stress that it would be critical to make many other changes, which are described in our report, in order to avoid replicating in the scaled-back rule significant technical problems and anomalous results produced under the existing proposal.

C. Effective Date Considerations

We have noted above our recommendation about the effective date for the Documentation Rules.

In addition, under any of the three options just described for issuing other guidance in place of Prop. Treas. Reg. § 1.385-3, the government inevitably would be producing complex, nuanced rules to deal with difficult technical and policy issues. Under the second and third of these approaches, the rules by their terms would apply not just to taxpayers that engage in behavior specifically identified by the government as having a significant potential for abuse, but a large number of other taxpayers as well that are engaged in commercial activities in the ordinary course of business or otherwise in transactions with limited potential for inappropriate results. In view of the difficulty of the issues, the novelty of the basic approach the government would be taking, and the potential for serious disruption of ongoing commercial activity due to (even seemingly minor) choices made in designing the rules, we strongly recommend that the government not issue such guidance in a form that would have current application, at least to the large majority of taxpayers. Rather, it would be important for taxpayers and practitioners to have an opportunity to review and comment on the guidance formulated by the government, before the guidance becomes effective. If Treasury and the IRS determine there are limited, clearly identified classes of taxpayers as to whom it is urgent to issue guidance with a current effective date in order to forestall potential abuse, such as inverted corporations, the government could make the new guidance currently effective only as to those taxpayers, in the form of temporary regulations, while either leaving the rules in proposed form for the large majority of affected taxpayers or, possibly, issuing the rules with an effective date for the large majority of affected taxpayers that is several years from now, with generous transition and grandfathering rules and with an expressly stated expectation that the rules may be further revised following comment by the public.

D. Specific Recommendations

The report makes a range of specific recommendations to implement the basic points discussed above and also to address a number of other technical issues related to the Proposed Regulations. The report's recommendations are listed in Part III and include proposals to:

- clarify the definitions of "expanded group" and "modified expanded group" and the attribution rules used in those definitions (recommendations 2–5, discussed in Part IV);
- narrow and clarify the operation of the Part-Stock Rule (recommendations 6–8, discussed in Part V);
- confirm the scope of the Documentation Rules and streamline their operation (recommendations 9–20, discussed in Parts VI and VII);
- not issue the Per Se Stock Rules in final form, and make a number of changes in any new guidance that retains basic elements of the Per Se Stock Rules as per the third option described above (recommendations 1 and 21–56, discussed in Parts I and VII–XIII);

- clarify how the rules concerning consolidated groups interact with other provisions with the Code, and make other technical changes to those rules (recommendations 57–59, discussed in Part XIV); and
- limit the application of the Proposed Regulations in the case of foreign corporations and investment partnerships (recommendations 60–61, discussed in Parts XV–XVI).

We appreciate your consideration of our recommendations. If you have any questions or comments on this report, please feel free to contact us and we would be happy to assist in any way.

Respectfully submitted,

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Chair

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