[4830-01-p]

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[TD 9897]

RIN 1545-BN68

The Treatment of Certain Interests in Corporations as Stock or Indebtedness

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations and removal of temporary regulations.

SUMMARY: This document contains final regulations regarding the treatment of certain interests in corporations as stock or indebtedness. The final regulations generally affect corporations, including those that are partners of certain partnerships, when those corporations or partnerships issue purported indebtedness to related corporations or partnerships.

DATES: Effective date: These regulations are effective on **[INSERT DATE OF PUBLICATION IN FEDERAL REGISTER]**.

Applicability dates: For dates of applicability, see §§1.385-3(j)(1) and (k) and 1.385-4(g).

FOR FURTHER INFORMATION CONTACT: Azeka J. Abramoff or D. Peter Merkel of the Office of Associate Chief Counsel (International) at (202) 317-6938 or Jeremy Aron-Dine of the Office of Associate Chief Counsel (Corporate) at (202) 317-6848 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background

I. Overview

Section 385 authorizes the Secretary of the Treasury (Secretary) to prescribe rules to determine whether an interest in a corporation is treated as stock or indebtedness (or as in part stock and in part indebtedness). On October 21, 2016, the Treasury Department and the IRS published T.D. 9790 in the **Federal Register** (81 FR 72858), which included final regulations under section 385 and temporary regulations under section 385 (2016 Final Regulations and Temporary Regulations, respectively, and together, the 2016 Regulations). On the same date, the Treasury Department and the IRS also published a notice of proposed rulemaking (REG-130314-16) in the **Federal Register** (81 FR 72751) (2016 Proposed Regulations) by cross-reference to the Temporary Regulations, which included §§1.385-3T and 1.385-4T. Technical corrections to the 2016 Regulations were published in the **Federal Register** (82 FR 8169) on January 24, 2017.

The 2016 Regulations and the 2016 Proposed Regulations address the classification of certain related-party debt as stock or indebtedness (or as in part stock and in part indebtedness) for U.S. Federal income tax purposes. The 2016 Final Regulations included documentation rules set forth in §1.385-2 (the Documentation Regulations). The 2016 Regulations also included §§1.385-3, 1.385-3T, and 1.385-4T, which treat certain indebtedness as stock that is issued by a corporation to a controlling shareholder in a distribution or in another related-party transaction that achieves an economically similar result (the Distribution Regulations). The Distribution Regulations apply to taxable years ending on or after January 19, 2017.

The Temporary Regulations set forth rules regarding the treatment under the Distribution Regulations of certain qualified short-term debt instruments, transactions involving controlled partnerships, and transactions involving consolidated groups. The Temporary Regulations apply to taxable years ending on or after January 19, 2017. The Temporary Regulations expired on October 13, 2019. See section 7805(e); §1.385-3T(l); §1.385-4T(h).

The 2016 Proposed Regulations are proposed to apply to taxable years ending on or after January 19, 2017. The preamble to the 2016 Regulations requested comments on all aspects of the Temporary Regulations, and the preamble to the 2016 Proposed Regulations requested comments on all aspects of the 2016 Proposed Regulations. REG-130314-16, 81 FR 72751, 72858 (October 21, 2016). The preamble to the 2016 Regulations also requested comments on certain aspects of the exception for qualified short-term debt instruments.

On October 28, 2019, the Treasury Department and the IRS issued Notice 2019-58, 2019-44 I.R.B. 1022, which announced that, following the expiration of the Temporary Regulations, a taxpayer may rely on the 2016 Proposed Regulations until further notice is given in the **Federal Register**, provided that the taxpayer consistently applies the rules in the 2016 Proposed Regulations in their entirety. On November 4, 2019, the Treasury Department and the IRS published an advance notice of proposed rulemaking in the **Federal Register** (84 FR 59318) (the ANPRM), which announced that the Treasury Department and the IRS intend to propose more streamlined and targeted Distribution Regulations. The ANPRM also obsoleted Notice 2019-58 and announced that a taxpayer may rely on the 2016 Proposed Regulations until further notice is given

in the **Federal Register**, provided that the taxpayer consistently applies the rules in the 2016 Proposed Regulations in their entirety. This Treasury decision finalizes the 2016 Proposed Regulations without any substantive change (the 2020 Final Regulations).

II. Executive Order 13789

Executive Order 13789 (E.O. 13789), issued on April 21, 2017, instructed the Secretary to review all significant tax regulations issued on or after January 1, 2016, and to take concrete action to alleviate the burdens of regulations that (i) impose an undue financial burden on U.S. taxpayers; (ii) add undue complexity to the Federal tax laws; or (iii) exceed the statutory authority of the IRS. E.O. 13789 further instructed the Secretary to submit to the President within 60 days a report (First Report) that identifies regulations that meet these criteria. The First Report, Notice 2017-38, 2017-30 I.R.B. 147, which was published on July 24, 2017, included the 2016 Regulations in a list of eight regulations identified by the Secretary in the First Report as meeting at least one of the first two criteria specified in E.O. 13789.

E.O. 13789 further instructed the Secretary to submit to the President a report (Second Report) that recommended specific actions to mitigate the burden imposed by regulations identified in the First Report. On October 16, 2017, the Secretary published in the **Federal Register** the Second Report (82 FR 48013), which stated that (i) the Treasury Department and the IRS were considering a proposal to revoke the Documentation Regulations as issued and (ii) the Treasury Department will reassess the distribution regulations in light of impending tax reform, and the Treasury Department and the IRS may then propose more streamlined and targeted regulations. On September 24, 2018, the Treasury Department and the IRS published proposed

regulations in the **Federal Register** that proposed removal of the Documentation Regulations from the Code of Federal Regulations. See 83 FR 48265 (September 24, 2018) (2018 Proposed Regulations). On November 4, 2019, the Treasury Department and the IRS published T.D. 9880 in the **Federal Register** (84 FR 59297), which finalized without change the proposed regulations removing the Documentation Regulations.

In response to E.O. 13789 and the 2018 Proposed Regulations, several comments recommended that the Treasury Department and the IRS revoke the Distribution Regulations in addition to the Documentation Regulations, while one comment recommended that the Treasury Department and the IRS issue more streamlined and targeted Distribution Regulations. The ANPRM stated that the Treasury Department and the IRS are cognizant that a complete withdrawal of the Distribution Regulations could restore incentives for multinational corporations to generate additional interest deductions without new investment. Accordingly, the Treasury Department and the IRS determined that the Distribution Regulations continue to be necessary at this time. The ANPRM also announced that the Treasury Department and the IRS intend to propose more streamlined and targeted Distribution Regulations.

The 2016 Proposed Regulations cross-reference the Temporary Regulations, a part of the Distribution Regulations, which expired on October 13, 2019. Because of the general determination that the Distribution Regulations continue to be necessary at this time, the Treasury Department and the IRS are issuing the 2020 Final Regulations, which finalize the 2016 Proposed Regulations, while the Treasury Department and the

IRS study the appropriate approach to revising the Distribution Regulations, as discussed in the ANPRM.

III. The Distribution Regulations

Under the Distribution Regulations' general rule, the issuance of a debt instrument by a member of an expanded group to another member of the same expanded group in a distribution, or an economically similar acquisition transaction, may result in the treatment of the debt instrument as stock. See §1.385-3(b)(2). The Distribution Regulations also include a funding rule that treats as stock a debt instrument that is issued as part of a series of transactions that achieves a result similar to a general rule transaction. See §1.385-3(b)(3)(i). Specifically, §1.385-3(b) treats as stock a debt instrument that was issued in exchange for property, including cash, to fund a distribution to an expanded group member or another acquisition transaction that achieves an economically similar result. Id. Furthermore, the Distribution Regulations include a per se rule, which treats a debt instrument as funding a distribution to an expanded group member or other acquisition transaction with a similar economic effect if it was issued in exchange for property during the period beginning 36 months before and ending 36 months after the issuer of the debt instrument made the distribution or undertook an acquisition transaction with a similar economic effect. See §1.385-3(b)(3)(iii). The Distribution Regulations also include several exceptions limiting their scope. See, e.g., §1.385-3(c).

The Distribution Regulations generally apply to transactions among members of an expanded group of corporations, which is generally defined by reference to the term “affiliated group” in section 1504(a), with several modifications, such as including foreign

corporations in the expanded group. See §1.385-1(c)(4). The Distribution Regulations also generally apply only to "covered debt instruments" that are issued by "covered members" other than certain regulated financial companies and regulated insurance companies. See §1.385-3(g)(3)(i). A covered member is a member of an expanded group that is a domestic corporation. See §1.385-1(c)(2). A covered debt instrument is generally a debt instrument that is issued after April 4, 2016, other than certain excluded specialized debt instruments. See §1.385-3(g)(3). In addition to these scope limitations, the funding rule also excludes qualified short-term debt instruments, as defined in §1.385-3(b)(3)(vii). See §1.385-3(b)(3)(i).

Summary of Comments

The Treasury Department and the IRS have not received any comments specifically in response to the Temporary Regulations or the 2016 Proposed Regulations. Accordingly, the 2016 Proposed Regulations are adopted as final regulations without any substantive change. In addition, the Temporary Regulations are withdrawn. Comments on the 2016 Regulations that are not specific to the particular matters addressed in the Temporary Regulations or the 2016 Proposed Regulations are beyond the scope of this rulemaking and are not addressed in this preamble.

Pursuant to E.O. 13789 and the ANPRM, the Treasury Department and the IRS intend to issue proposed regulations modifying the Distribution Regulations to make them more streamlined and targeted, including by withdrawing the per se rule. In connection with the intended revisions, the Treasury Department and the IRS continue to study all appropriate modifications to the Distribution Regulations.

Applicability Dates

The amendments to §1.385-3, other than §1.385-3(f)(4)(iii), apply to taxable years ending after January 19, 2017. Sections 1.385-3(f)(4)(iii) and 1.385-4 provide rules applicable to members of consolidated groups and are issued under section 1502. Section 1503(a) provides in general, that in any case in which a consolidated return is made or is required to be made, the tax shall be determined, computed, assessed, collected, and adjusted in accordance with the regulations under section 1502 prescribed before the last day prescribed by law for the filing of such return. Thus, §§1.385-3(f)(4)(iii) and 1.385-4 apply to taxable years for which the U.S. Federal income tax return is due, without extensions, after **[INSERT DATE OF PUBLICATION IN FEDERAL REGISTER]**.

The Temporary Regulations apply to taxable years ending on or after January 19, 2017, and before their expiration on October 13, 2019. For rules applying §§1.385-3T(f)(4)(iii) and 1.385-4T to taxable years ending on or after January 19, 2017 and for which the U.S. Federal income tax return was due, without extensions, on or before **[INSERT DATE OF PUBLICATION IN FEDERAL REGISTER]**, see §§1.385-3T and 1.385-4T (as contained in 26 CFR in part 1 revised as of April 1, 2019). The provisions in the Temporary Regulations and the corresponding provisions in the 2020 Final Regulations are substantially identical.

For certain taxable years for which the U.S. Federal income tax return was due, without extensions, on or before **[INSERT DATE OF PUBLICATION IN FEDERAL REGISTER]**, there may be a period after October 13, 2019, to which neither §§1.385-3T(f)(4)(iii) and 1.385-4T nor §§1.385-3(f)(4)(iii) and 1.385-4 apply. The 2020 Final Regulations allow a taxpayer to choose to apply §§1.385-3(f)(4)(iii), 1.385-4, or both to

such period, provided that all members of the expanded group apply that section or sections. Accordingly, a taxpayer can choose to apply the 2020 Final Regulations to the period, if any, to which neither the Temporary Regulations nor the 2020 Final Regulations apply.

Special Analyses

I. Regulatory Planning and Review -- Economic Analysis

These regulations are not subject to review under section 6(b) of Executive Order 12866 pursuant to the Memorandum of Agreement (April 11, 2018) between the Treasury Department and the Office of Management and Budget regarding review of tax regulations.

II. Paperwork Reduction Act

These regulations do not establish a new collection of information nor modify an existing collection that requires the approval of the Office of Management and Budget under the Paperwork Reduction Act (44 U.S.C. chapter 35).

III. Regulatory Flexibility Act

Pursuant to the Regulatory Flexibility Act (5 U.S.C. Chapter 6), it is hereby certified that the 2020 Final Regulations will not have a significant economic impact on a substantial number of small entities.

Section 1.385-3 provides that certain interests in a corporation that are held by a member of the corporation's expanded group and that otherwise would be treated as indebtedness for Federal tax purposes are treated as stock. The regulations under Section 1.385-3 finalized in the 2020 Final Regulations provide that for certain debt instruments issued by a controlled partnership, the holder is deemed to transfer all or a

portion of the debt instrument to the partner or partners in the partnership in exchange for stock in the partner or partners. Section 1.385-4 provides rules regarding the application of §1.385-3 to members of a consolidated group. Section 1.385-3 includes multiple exceptions that limit its application. In particular, the threshold exception provides that the first $50 million of expanded group debt instruments that otherwise would be reclassified as stock or deemed to be transferred to a partner in a controlled partnership under §1.385-3 will not be reclassified or deemed transferred under §1.385-3. Although it is possible that the classification rules in the 2020 Final Regulations could have an effect on small entities, the threshold exception of the first $50 million of debt instruments otherwise subject to recharacterization or deemed transfer under §§1.385-3 and 1.385-4 makes it unlikely that a substantial number of small entities will be affected by these provisions.

Pursuant to section 7805(f) of the Code, the proposed regulations preceding these final regulations were submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on their impact on small business. No comments were received concerning the economic impact on small entities from the Small Business Administration.

IV. Unfunded Mandates Reform Act

Section 202 of the Unfunded Mandates Reform Act of 1995 requires that agencies assess anticipated costs and benefits and take certain other actions before issuing a final rule that includes any Federal mandate that may result in expenditures in any one year by a state, local, or tribal government, in the aggregate, or by the private sector, of $100 million in 1995 dollars, updated annually for inflation. This rule does not

include any Federal mandate that may result in expenditures by state, local, or tribal governments, or by the private sector in excess of that threshold.

V. Executive Order 13132: Federalism

Executive Order 13132 (entitled “Federalism”) prohibits an agency from publishing any rule that has federalism implications if the rule either imposes substantial, direct compliance costs on state and local governments, and is not required by statute, or preempts state law, unless the agency meets the consultation and funding requirements of section 6 of the Executive order. This final rule does not have federalism implications and does not impose substantial direct compliance costs on state and local governments or preempt state law within the meaning of the Executive order.

Statement of Availability of IRS Documents

IRS Notices and other guidance cited in this preamble are published in the Internal Revenue Bulletin and are available from the Superintendent of Documents, U.S. Government Publishing Office, Washington, DC 20402, or by visiting the IRS website at http://www/irs.gov.

Drafting Information

The principal authors of these final regulations are Azeka J. Abramoff and D. Peter Merkel of the Office of Associate Chief Counsel (International). However, other personnel from the IRS and the Treasury Department participated in their development.

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1--INCOME TAXES

Paragraph 1. The authority citation for part 1 is amended by removing the entries for §§1.385-3T and 1.385-4T and adding an entry for §1.385-4 in numerical order to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

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Section 1.385-4 also issued under 26 U.S.C. 385 and 1502.

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§1.385-1 [Amended]

Par. 2. Section 1.385-1 is amended by:

1. In paragraph (c)(4)(vii), designating Examples 1 through 4 as paragraphs (c)(4)(vii)(A) through (D), respectively.

2. In newly designated paragraphs (c)(4)(vii)(A) through (D), redesignating the paragraphs in the first column as the paragraphs in the second column:

Old paragraphs	New paragraphs
(c)(4)(vii)(A)(i) and (ii)	(c)(4)(vii)(A)(1) and (2)
(c)(4)(vii)(B)(i) and (ii)	(c)(4)(vii)(B)(1) and (2)
(c)(4)(vii)(C)(i) and (ii)	(c)(4)(vii)(C)(1) and (2)
(c)(4)(vii)(D)(i) and (ii)	(c)(4)(vii)(D)(1) and (2)

3. Revise the last sentence of newly redesignated paragraph (c)(4)(vii)(B)(1).

4. In newly designated paragraphs (c)(4)(vii)(C)(2) and (c)(4)(vii)(D)(2), redesignating the paragraphs in the first column as the paragraphs in the second column:

Old paragraphs	New paragraphs
(c)(4)(vii)(C)(2)(A) and (B)	(c)(4)(vii)(C)(2)(i) and (ii)
(c)(4)(vii)(D)(2)(A) through (C)	(c)(4)(vii)(D)(2)(i) through (iii)

5. For each paragraph listed in the table, remove the language in the “Remove” column wherever it appears and add in its place the language in the “Add” column as set forth below:

Paragraph	Remove	Add
(a)	1.385-4T	1.385-4
(c) introductory text	1.385-4T(e)	1.385-4(e)
(c)(4)(i) introductory text	corporations described in section 1504(b)(8)	S corporations
(c)(4)(i) introductory text	not described in section 1504(b)(6) or (b)(8) (an expanded group parent)	that is not an S corporation or a regulated investment company or a real estate investment trust subject to tax under subchapter M of chapter 1 of the Internal Revenue Code (a RIC or a

		REIT, respectively) (such common parent corporation, an expanded group parent)
(c)(4)(vii) introductory text	described in section 1504(b)(6) or (b)(8)	an S corporation, a RIC, or a REIT
(c)(4)(vii)(B)(2)	P is a real estate investment trust described in section 1504(b)(6)	P is a REIT
(c)(4)(vii)(B)(2)	Although S2 is a corporation described in section 1504(b)(6), a corporation described in section 1504(b)(6) may	Although S2 is a corporation that is a REIT, a REIT may
(c)(4)(vii)(D)(1)	Example 3	paragraph (c)(4)(vii)(C)(1) of this section (Example 3)
(d)(1)(iv)(A)	1.385-3T(d)(4)	1.385-3(d)(4)
(d)(1)(iv)(B)	1.385-3T(f)(4)	1.385-3(f)(4)

The revision reads as follows:

§1.385-1 General provisions.

* * * * *

(c) * * *

(4) * * *

(vii) * * *

(B) * * *

(1) * * * Both P and S2 are REITs.

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Par. 3. Section 1.385-3 is amended by:

1. Revising the section heading.

2. For each paragraph listed in the table, remove the language in the “Remove” column wherever it appears and add in its place the language in the “Add” column as set forth below:

Paragraph	Remove	Add
(a)	1.385-4T	1.385-4
(b)(4) introductory text	1.385-3T	1.385-3
(b)(4)(i) introductory text	1.385-3T	1.385-3
(b)(4)(i)(E)	1.385-3T(k)(2)	1.385-3(k)(2)
(b)(4)(ii) introductory text	1.385-3T	1.385-3
(b)(4)(ii)(D)	1.385-4T	1.385-4
(c)(1)	1.385-3T(f)	1.385-3(f)
(c)(2)(i)(C)	1.385-3T	1.385-3
(c)(2)(iv)	1.385-3T(f)(2)	1.385-3(f)(2)

(c)(2)(v)(B)	1.385-3T(d)(4)	1.385-3(d)(4)
(c)(2)(v)(C)	1.385-3T(f)(4) or (5)	1.385-3(f)(4) or (5)
(c)(3)(i)(C)(4)	1.385-3T(f)(4)(i)	1.385-3(f)(4)(i)
(c)(3)(ii)(D)(6)	1.385-3T	1.385-3
(d)(2)(ii)(A)	1.385-4T(c)(2)	1.385-4(c)(2)
(d)(2)(ii)(B)	1.385-3T(f)(5)(i)	1.385-3(f)(5)(i)
(d)(7)(ii)	1.385-3T(d)(4)	1.385-3(d)(4)
(g) introductory text	1.385-3T and 1.385-4T	1.385-3 and 1.385-4
(g)(3)(iii)(D)	1.385-3T	1.385-3
(j)(2)(i)	1.385-1, 1.385-3T, and 1.385-4T	1.385-1, 1.385-3, and 1.385-4
(j)(2)(ii)	1.385-1, 1.385-3T, and 1.385-4T	1.385-1, 1.385-3, and 1.385-4
(j)(2)(v)	1.385-1, 1.385-3, 1.385-3T, and 1.385-4T	1.385-1, 1.385-3, and 1.385-4

3. Revising paragraphs (b)(3)(vii), (d)(4), (f), and (g)(5) through (8), (15) through (17), (22), and (23).

4. In paragraph (h)(3), designating Examples 1 through 19 as paragraphs (h)(3)(i) through (xix), respectively.

5. In newly designated paragraphs (h)(3)(i) through (xi), redesignating the paragraphs in the first column as the paragraphs in the second column:

Old paragraphs	New paragraphs
(h)(3)(i)(i) and (ii)	(h)(3)(i)(A) and (B)
(h)(3)(ii)(i) and (ii)	(h)(3)(ii)(A) and (B)
(h)(3)(iii)(i) and (ii)	(h)(3)(iii)(A) and (B)
(h)(3)(iv)(i) and (ii)	(h)(3)(iv)(A) and (B)
(h)(3)(v)(i) and (ii)	(h)(3)(v)(A) and (B)
(h)(3)(vi)(i) and (ii)	(h)(3)(vi)(A) and (B)
(h)(3)(vii)(i) and (ii)	(h)(3)(vii)(A) and (B)
(h)(3)(viii)(i) and (ii)	(h)(3)(viii)(A) and (B)
(h)(3)(ix)(i) and (ii)	(h)(3)(ix)(A) and (B)
(h)(3)(x)(i) and (ii)	(h)(3)(x)(A) and (B)
(h)(3)(xi)(i) and (ii)	(h)(3)(xi)(A) and (B)

6. In newly designated paragraphs (h)(3)(ii)(B), (h)(3)(iii)(B), (h)(3)(vi)(B), (h)(3)(vii)(B), (h)(3)(viii)(B), (h)(3)(ix)(B), and (h)(3)(x)(B), redesignating the paragraphs in the first column as the paragraphs in the second column:

Old paragraphs	New paragraphs
(h)(3)(ii)(B)(A) and (B)	(h)(3)(ii)(B)(1) and (2)
(h)(3)(iii)(B)(A) and (B)	(h)(3)(iii)(B)(1) and (2)
(h)(3)(vi)(B)(A) and (B)	(h)(3)(vi)(B)(1) and (2)
(h)(3)(vii)(B)(A) and (B)	(h)(3)(vii)(B)(1) and (2)

(h)(3)(viii)(B)(A) though (F)	(h)(3)(viii)(B)(1) though (6)
(h)(3)(ix)(B)(A) and (B)	(h)(3)(ix)(B)(1) and (2)
(h)(3)(x)(B)(A) though (C)	(h)(3)(x)(B)(1) through (3)

7. For each newly designated paragraph listed in the table, remove the language in the "Remove" column wherever it appears and add in its place the language in the "Add" column as set forth below:

Paragraph	Remove	Add
(h)(3)(v)(A)	Example 4 of this paragraph (h)(3)	paragraph (h)(3)(iv)(A) of this section (Example 4)
(h)(3)(v)(B)	Example 4 of this paragraph (h)(3)	paragraph (h)(3)(iv)(B) of this section (Example 4)
(h)(3)(vii)(A)	Example 6 of this paragraph (h)(3)	paragraph (h)(3)(vi)(A) of this section (Example 6)

8. Revising newly designated paragraphs (h)(3)(xii) through (xix) and paragraph (j)(1).

9. Adding paragraphs (j)(3) and (k).

The revisions and additions read as follows:

§1.385-3 Certain distributions of debt instruments and similar transactions.

* * * * *

(b) * * *

(3) * * *

(vii) Qualified short-term debt instrument. The term qualified short-term debt instrument means a covered debt instrument that is described in paragraphs (b)(3)(vii)(A) though (D) of this section.

(A) Short-term funding arrangement. A covered debt instrument is described in this paragraph (b)(3)(vii)(A) if the requirements of the specified current assets test described in paragraph (b)(3)(vii)(A)(1) of this section or the 270-day test described in paragraph (b)(3)(vii)(A)(2) of this section (the alternative tests) are satisfied, provided that an issuer may only claim the benefit of one of the alternative tests with respect to covered debt instruments issued by the issuer in the same taxable year.

(1) Specified current assets test—(i) In general. The requirements of this paragraph (b)(3)(vii)(A)(1) are satisfied with respect to a covered debt instrument if the requirement of paragraph (b)(3)(vii)(A)(1)(ii) of this section is satisfied, but only to the extent the requirement of paragraph (b)(3)(vii)(A)(1)(iii) of this section is satisfied.

(ii) Maximum interest rate. The rate of interest charged with respect to the covered debt instrument does not exceed an arm's length interest rate, as determined under section 482 and §§ 1.482-1 through 1.482-9, that would be charged with respect to a comparable debt instrument of the issuer with a term that does not exceed the longer of 90 days and the issuer's normal operating cycle.

(iii) Maximum outstanding balance. The amount owed by the issuer under covered debt instruments issued to members of the issuer's expanded group that satisfy the requirements of paragraph (b)(3)(vii)(A)(1)(ii), (b)(3)(vii)(A)(2) (if the covered debt instrument was issued in a prior taxable year), or (b)(3)(vii)(B) or (C) of this section

immediately after the covered debt instrument is issued does not exceed the maximum of the amounts of specified current assets reasonably expected to be reflected, under applicable accounting principles, on the issuer's balance sheet as a result of transactions in the ordinary course of business during the subsequent 90–day period or the issuer's normal operating cycle, whichever is longer. For purposes of the preceding sentence, in the case of an issuer that is a qualified cash pool header, the amount owed by the issuer shall not take into account deposits described in paragraph (b)(3)(vii)(D) of this section. Additionally, the amount owed by any issuer shall be reduced by the amount of the issuer's deposits with a qualified cash pool header, but only to the extent of amounts borrowed from the same qualified cash pool header that satisfy the requirements of paragraph (b)(3)(vii)(A)(2) (if the covered debt instrument was issued in a prior taxable year) or (b)(3)(vii)(A)(1)(ii) of this section.

(iv) Specified current assets. For purposes of paragraph (b)(3)(vii)(A)(1)(iii) of this section, the term specified current assets means assets that are reasonably expected to be realized in cash or sold (including by being incorporated into inventory that is sold) during the normal operating cycle of the issuer, other than cash, cash equivalents, and assets that are reflected on the books and records of a qualified cash pool header.

(v) Normal operating cycle. For purposes of paragraph (b)(3)(vii)(A)(1) of this section, the term normal operating cycle means the issuer's normal operating cycle as determined under applicable accounting principles, except that if the issuer has no single clearly defined normal operating cycle, then the normal operating cycle is determined based on a reasonable analysis of the length of the operating cycles of the multiple businesses and their sizes relative to the overall size of the issuer.

(vi) Applicable accounting principles. For purposes of paragraph (b)(3)(vii)(A)(1) of this section, the term applicable accounting principles means the financial accounting principles generally accepted in the United States, or an international financial accounting standard, that is applicable to the issuer in preparing its financial statements, computed on a consistent basis.

(2) 270-day test--(i) In general. A covered debt instrument is described in this paragraph (b)(3)(vii)(A)(2) if the requirements of paragraphs (b)(3)(vii)(A)(2)(ii) through (iv) of this section are satisfied.

(ii) Maximum term and interest rate. The covered debt instrument must have a term of 270 days or less or be an advance under a revolving credit agreement or similar arrangement and must bear a rate of interest that does not exceed an arm's length interest rate, as determined under section 482 and §§ 1.482-1 through 1.482-9, that would be charged with respect to a comparable debt instrument of the issuer with a term that does not exceed 270 days.

(iii) Lender-specific indebtedness limit. The issuer is a net borrower from the lender for no more than 270 days during the taxable year of the issuer, and in the case of a covered debt instrument outstanding during consecutive tax years, the issuer is a net borrower from the lender for no more than 270 consecutive days, in both cases taking into account only covered debt instruments that satisfy the requirement of paragraph (b)(3)(vii)(A)(2)(ii) of this section other than covered debt instruments described in paragraph (b)(3)(vii)(B) or (C) of this section.

(iv) Overall indebtedness limit. The issuer is a net borrower under all covered debt instruments issued to members of the issuer's expanded group that satisfy the

requirements of paragraphs (b)(3)(vii)(A)(2)(ii) and (iii) of this section, other than covered debt instruments described in paragraph (b)(3)(vii)(B) or (C) of this section, for no more than 270 days during the taxable year of the issuer, determined without regard to the identity of the lender under such covered debt instruments.

(v) Inadvertent error. An issuer's failure to satisfy the 270-day test will be disregarded if the failure is reasonable in light of all the facts and circumstances and the failure is promptly cured upon discovery. A failure to satisfy the 270-day test will be considered reasonable if the taxpayer maintains due diligence procedures to prevent such failures, as evidenced by having written policies and operational procedures in place to monitor compliance with the 270-day test and management-level employees of the expanded group having undertaken reasonable efforts to establish, follow, and enforce such policies and procedures.

(B) Ordinary course loans. A covered debt instrument is described in this paragraph (b)(3)(vii)(B) if the covered debt instrument is issued as consideration for the acquisition of property other than money in the ordinary course of the issuer's trade or business, provided that the obligation is reasonably expected to be repaid within 120 days of issuance.

(C) Interest-free loans. A covered debt instrument is described in this paragraph (b)(3)(vii)(C) if the instrument does not provide for stated interest or no interest is charged on the instrument, the instrument does not have original issue discount (as defined in section 1273 and §§ 1.1273-1 and 1.1273-2), interest is not imputed under section 483 or section 7872 and §§ 1.483-1 through 1.483-4 or §§ 1.7872-1 through

1.7872-16, respectively, and interest is not required to be charged under section 482 and §§ 1.482-1 through 1.482-9.

(D) Deposits with a qualified cash pool header--(1) In general. A covered debt instrument is described in this paragraph (b)(3)(vii)(D) if it is a demand deposit received by a qualified cash pool header described in paragraph (b)(3)(vii)(D)(2) of this section pursuant to a cash-management arrangement described in paragraph (b)(3)(vii)(D)(3) of this section. This paragraph (b)(3)(vii)(D) does not apply if a purpose for making the demand deposit is to facilitate the avoidance of the purposes of this section with respect to a qualified business unit (as defined in section 989(a) and § 1.989(a)-1) (QBU) that is not a qualified cash pool header.

(2) Qualified cash pool header. The term qualified cash pool header means an expanded group member, controlled partnership, or QBU described in §1.989(a)-1(b)(2)(ii), that has as its principal purpose managing a cash-management arrangement for participating expanded group members, provided that the excess (if any) of funds on deposit with such expanded group member, controlled partnership, or QBU (header) over the outstanding balance of loans made by the header is maintained on the books and records of the header in the form of cash or cash equivalents, or invested through deposits with, or the acquisition of obligations or portfolio securities of, persons that do not have a relationship to the header (or, in the case of a header that is a QBU described in §1.989(a)-1(b)(2)(ii), its owner) described in section 267(b) or section 707(b).

(3) Cash-management arrangement. The term cash-management arrangement means an arrangement the principal purpose of which is to manage cash for

participating expanded group members. For purposes of the preceding sentence, managing cash means borrowing excess funds from participating expanded group members and lending funds to participating expanded group members, and may also include foreign exchange management, clearing payments, investing excess cash with an unrelated person, depositing excess cash with another qualified cash pool header, and settling intercompany accounts, for example through netting centers and pay-on-behalf-of programs.

* * * * *

(d) * * *

(4) Treatment of disregarded entities. This paragraph (d)(4) applies to the extent that a covered debt instrument issued by a disregarded entity, the regarded owner of which is a covered member, would, absent the application of this paragraph (d)(4), be treated as stock under this section. In this case, rather than the covered debt instrument being treated as stock to such extent (applicable portion), the covered member that is the regarded owner of the disregarded entity is deemed to issue its stock in the manner described in this paragraph (d)(4). If the applicable portion otherwise would have been treated as stock under paragraph (b)(2) of this section, then the covered member is deemed to issue its stock to the expanded group member to which the covered debt instrument was, in form, issued (or transferred) in the transaction described in paragraph (b)(2) of this section. If the applicable portion otherwise would have been treated as stock under paragraph (b)(3)(i) of this section, then the covered member is deemed to issue its stock to the holder of the covered debt instrument in exchange for a portion of the covered debt instrument equal to the applicable portion. In each case, the

covered member that is the regarded owner of the disregarded entity is treated as the holder of the applicable portion of the debt instrument issued by the disregarded entity, and the actual holder is treated as the holder of the remaining portion of the covered debt instrument and the stock deemed to be issued by the regarded owner. Under Federal tax principles, the applicable portion of the debt instrument issued by the disregarded entity generally is disregarded. This paragraph (d)(4) must be applied in a manner that is consistent with the principles of paragraph (f)(4) of this section. Thus, for example, stock deemed issued is deemed to have the same terms as the covered debt instrument 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 covered debt instrument issued by the disregarded entity. See §1.385-4(b)(3) for additional rules that apply if the regarded owner of the disregarded entity is a member of a consolidated group. If the regarded owner of a disregarded entity is a controlled partnership, then paragraph (f) of this section applies as though the controlled partnership were the issuer in form of the debt instrument.

* * * * *

(f) Treatment of controlled partnerships--(1) In general. For purposes of this section and §1.385-4, a controlled partnership is treated as an aggregate of its partners in the manner described in this paragraph (f). Paragraph (f)(2) of this section sets forth rules concerning the aggregate treatment when a controlled partnership acquires property from a member of the expanded group. Paragraph (f)(3) of this section sets forth rules concerning the aggregate treatment when a controlled partnership issues a debt instrument. Paragraph (f)(4) of this section deems a debt instrument issued by a

controlled partnership to be held by an expanded group partner rather than the holder-in-form in certain cases. Paragraph (f)(5) of this section sets forth the rules concerning events that cause the deemed results described in paragraph (f)(4) of this section to cease. Paragraph (f)(6) of this section exempts certain issuances of a controlled partnership's debt to a partner and a partner's debt to a controlled partnership from the application of this section. For definitions applicable for this section, see paragraph (g) of this section. For examples illustrating the application of this section, see paragraph (h) of this section.

(2) Acquisitions of property by a controlled partnership--(i) Acquisitions of property when a member of the expanded group is a partner on the date of the acquisition--(A) Aggregate treatment. Except as otherwise provided in paragraphs (f)(2)(i)(C) and (f)(6) of this section, if a controlled partnership, with respect to an expanded group, acquires property from a member of the expanded group (transferor member), then, for purposes of this section, a member of the expanded group that is an expanded group partner on the date of the acquisition is treated as acquiring its share (as determined under paragraph (f)(2)(i)(B) of this section) of the property. The expanded group partner is treated as acquiring its share of the property from the transferor member in the manner (for example, in a distribution, in an exchange for property, or in an issuance), and on the date on which, the property is actually acquired by the controlled partnership from the transferor member. Accordingly, this section applies to a member's acquisition of property described in this paragraph (f)(2)(i)(A) in the same manner as if the member actually acquired the property from the transferor member, unless explicitly provided otherwise.

(B) Expanded group partner's share of property. For purposes of paragraph (f)(2)(i)(A) of this section, a partner's share of property acquired by a controlled partnership is determined in accordance with the partner's liquidation value percentage (as defined in paragraph (g)(17) of this section) with respect to the controlled partnership. The liquidation value percentage is determined on the date on which the controlled partnership acquires the property.

(C) Exception if transferor member is an expanded group partner. If a transferor member is an expanded group partner in the controlled partnership, paragraph (f)(2)(i)(A) of this section does not apply to such partner.

(ii) Acquisitions of expanded group stock when a member of the expanded group becomes a partner after the acquisition--(A) Aggregate treatment. Except as otherwise provided in paragraph (f)(2)(ii)(C) of this section, if a controlled partnership, with respect to an expanded group, owns expanded group stock, and a member of the expanded group becomes an expanded group partner in the controlled partnership, then, for purposes of this section, the member is treated as acquiring its share (as determined under paragraph (f)(2)(ii)(B) of this section) of the expanded group stock owned by the controlled partnership. The member is treated as acquiring its share of the expanded group stock on the date on which the member becomes an expanded group partner. Furthermore, the member is treated as if it acquires its share of the expanded group stock from a member of the expanded group in exchange for property other than expanded group stock, regardless of the manner in which the partnership acquired the stock and in which the member acquires its partnership interest. Accordingly, this section applies to a member's acquisition of expanded group stock described in this

paragraph (f)(2)(ii)(A) in the same manner as if the member actually acquired the stock from a member of the expanded group in exchange for property other than expanded group stock, unless explicitly provided otherwise.

(B) Expanded group partner's share of expanded group stock. For purposes of paragraph (f)(2)(ii)(A) of this section, a partner's share of expanded group stock owned by a controlled partnership is determined in accordance with the partner's liquidation value percentage with respect to the controlled partnership. The liquidation value percentage is determined on the date on which a member of the expanded group becomes an expanded group partner in the controlled partnership.

(C) Exception if an expanded group partner acquires its interest in a controlled partnership in exchange for expanded group stock. Paragraph (f)(2)(ii)(A) of this section does not apply to a member of an expanded group that acquires its interest in a controlled partnership either from another partner in exchange solely for expanded group stock or upon a partnership contribution to the controlled partnership comprised solely of expanded group stock.

(3) Issuances of debt instruments by a controlled partnership to a member of an expanded group--(i) Aggregate treatment. If a controlled partnership, with respect to an expanded group, issues a debt instrument to a member of the expanded group, then, for purposes of this section, a covered member that is an expanded group partner is treated as the issuer with respect to its share (as determined under paragraph (f)(3)(ii) of this section) of the debt instrument issued by the controlled partnership. This section applies to the portion of the debt instrument treated as issued by the covered member as described in this paragraph (f)(3)(i) in the same manner as if the covered member

actually issued the debt instrument to the holder-in-form, unless otherwise provided. See paragraph (f)(4) of this section, which deems a debt instrument issued by a controlled partnership to be held by an expanded group partner rather than the holder-in-form in certain cases.

(ii) Expanded group partner's share of a debt instrument issued by a controlled partnership--(A) General rule. An expanded group partner's share of a debt instrument issued by a controlled partnership is determined on each date on which the partner makes a distribution or acquisition described in paragraph (b)(2) or (b)(3)(i) of this section (testing date). An expanded group partner's share of a debt instrument issued by a controlled partnership to a member of the expanded group is determined in accordance with the partner's issuance percentage (as defined in paragraph (g)(16) of this section) on the testing date. A partner's share determined under this paragraph (f)(3)(ii)(A) is adjusted as described in paragraph (f)(3)(ii)(B) of this section.

(B) Additional rules if there is a specified portion with respect to a debt instrument--(1) An expanded group partner's share (as determined under paragraph (f)(3)(ii)(A) of this section) of a debt instrument issued by a controlled partnership is reduced, but not below zero, by the sum of all of the specified portions (as defined in paragraph (g)(23) of this section), if any, with respect to the debt instrument that correspond to one or more deemed transferred receivables (as defined in paragraph (g)(8) of this section) that are deemed to be held by the partner.

(2) If the aggregate of all of the expanded group partners' shares (as determined under paragraph (f)(3)(ii)(A) of this section and reduced under paragraph (f)(3)(ii)(B)(1) of this section) of the debt instrument exceeds the adjusted issue price of the debt,

reduced by the sum of all of the specified portions with respect to the debt instrument that correspond to one or more deemed transferred receivables that are deemed to be held by one or more expanded group partners (excess amount), then each expanded group partner's share (as determined under paragraph (f)(3)(ii)(A) of this section and reduced under paragraph (f)(3)(ii)(B)(1) of this section) of the debt instrument is reduced. The amount of an expanded group partner's reduction is the excess amount multiplied by a fraction, the numerator of which is the partner's share, and the denominator of which is the aggregate of all of the expanded group partners' shares.

(iii) Qualified short-term debt instrument. The determination of whether a debt instrument is a qualified short-term debt instrument for purposes of paragraph (b)(3)(vii) of this section is made at the partnership-level without regard to paragraph (f)(3)(i) of this section.

(4) Recharacterization when there is a specified portion with respect to a debt instrument issued by a controlled partnership--(i) General rule. A specified portion, with respect to a debt instrument issued by a controlled partnership and an expanded group partner, is not treated as stock under paragraph (b)(2) or (b)(3)(i) of this section. Except as otherwise provided in paragraphs (f)(4)(ii) and (iii) of this section, the holder-in-form (as defined in paragraph (g)(15) of this section) of the debt instrument is deemed to transfer a portion of the debt instrument (a deemed transferred receivable, as defined in paragraph (g)(8) of this section) with a principal amount equal to the adjusted issue price of the specified portion to the expanded group partner in exchange for stock in the expanded group partner (deemed partner stock, as defined in paragraph (g)(6) of this section) with a fair market value equal to the principal amount of the deemed transferred

receivable. Except as otherwise provided in paragraph (f)(4)(vi) of this section (concerning the treatment of a deemed transferred receivable for purposes of section 752) and paragraph (f)(5) of this section (concerning specified events subsequent to the deemed transfer), the deemed transfer described in this paragraph (f)(4)(i) is deemed to occur for all Federal tax purposes.

(ii) Expanded group partner is the holder-in-form of a debt instrument. If the specified portion described in paragraph (f)(4)(i) of this section is with respect to an expanded group partner that is the holder-in-form of the debt instrument, then paragraph (f)(4)(i) of this section will not apply with respect to that specified portion except that only the first sentence of paragraph (f)(4)(i) of this section is applicable.

(iii) Expanded group partner is a consolidated group member. This paragraph (f)(4)(iii) applies when one or more expanded group partners is a member of a consolidated group that files (or is required to file) a consolidated U.S. Federal income tax return. In this case, notwithstanding §1.385-4(b)(1) (which generally treats members of a consolidated group as one corporation for purposes of this section), the holder-in-form of the debt instrument issued by the controlled partnership is deemed to transfer the deemed transferred receivable or receivables to the expanded group partner or partners that are members of a consolidated group that make, or are treated as making under paragraph (f)(2) of this section, the regarded distributions or acquisitions (within the meaning of §1.385-4(e)(5)) described in paragraph (b)(2) or (b)(3)(i) of this section in exchange for deemed partner stock in such partner or partners. To the extent those regarded distributions or acquisitions are made by a member of the consolidated group that is not an expanded group partner (excess amount), the holder-in-form is deemed to

transfer a portion of the deemed transferred receivable or receivables to each member of the consolidated group that is an expanded group partner in exchange for deemed partner stock in the expanded group partner. The portion is the excess amount multiplied by a fraction, the numerator of which is the portion of the consolidated group's share (as determined under paragraph (f)(3)(ii) of this section) of the debt instrument issued by the controlled partnership that would have been the expanded group partner's share if the partner was not a member of a consolidated group, and the denominator of which is the consolidated group's share of the debt instrument issued by the controlled partnership.

(iv) Rules regarding deemed transferred receivables and deemed partner stock--(A) Terms of deemed partner stock. Deemed partner stock has the same terms as the deemed transferred receivable with respect to the deemed transfer, other than the identity of the issuer.

(B) Treatment of payments with respect to a debt instrument for which there is one or more deemed transferred receivables. When a payment is made with respect to a debt instrument issued by a controlled partnership for which there is one or more deemed transferred receivables, then, if the amount of the retained receivable (as defined in paragraph (g)(22) of this section) held by the holder-in-form is zero and a single deemed holder is deemed to hold all of the deemed transferred receivables, the entire payment is allocated to the deemed transferred receivables held by the single deemed holder. If the amount of the retained receivable held by the holder-in-form is greater than zero or there are multiple deemed holders of deemed transferred receivables, or both, the payment is apportioned among the retained receivable, if any,

and each deemed transferred receivable in proportion to the principal amount of all the receivables. The portion of a payment allocated or apportioned to a retained receivable or a deemed transferred receivable reduces the principal amount of, or accrued interest with respect to, as applicable depending on the payment, the retained receivable or deemed transferred receivable. When a payment allocated or apportioned to a deemed transferred receivable reduces the principal amount of the receivable, the expanded group partner that is the deemed holder with respect to the deemed transferred receivable is deemed to redeem the same amount of deemed partner stock, and the specified portion with respect to the debt instrument is reduced by the same amount. When a payment allocated or apportioned to a deemed transferred receivable reduces accrued interest with respect to the receivable, the expanded group partner that is the deemed holder with respect to the deemed transferred receivable is deemed to make a matching distribution in the same amount with respect to the deemed partner stock. The controlled partnership is treated as the paying agent with respect to the deemed partner stock.

(v) Holder-in-form transfers debt instrument in a transaction that is not a specified event. If the holder-in-form transfers the debt instrument (which is disregarded for Federal tax purposes) to a member of the expanded group or a controlled partnership (and therefore the transfer is not a specified event described in paragraph (f)(5)(iii)(F) of this section), then, for Federal tax purposes, the holder-in-form is deemed to transfer the retained receivable and the deemed partner stock to the transferee.

(vi) Allocation of deemed transferred receivable under section 752. A partnership liability that is a debt instrument with respect to which there is one or more deemed

transferred receivables is allocated for purposes of section 752 without regard to any deemed transfer.

(5) Specified events affecting ownership following a deemed transfer--(i) General rule. If a specified event (within the meaning of paragraph (f)(5)(iii) of this section) occurs with respect to a deemed transfer, then, immediately before the specified event, the expanded group partner that is both the issuer of the deemed partner stock and the deemed holder of the deemed transferred receivable is deemed to distribute the deemed transferred receivable (or portion thereof, as determined under paragraph (f)(5)(iv) of this section) to the holder-in-form in redemption of the deemed partner stock (or portion thereof, as determined under paragraph (f)(5)(iv) of this section) deemed to be held by the holder-in-form. The deemed distribution is deemed to occur for all Federal tax purposes, except that the distribution is disregarded for purposes of paragraph (b) of this section. Except when the deemed transferred receivable (or portion thereof, as determined under paragraph (f)(5)(iv) of this section) is deemed to be retransferred under paragraph (f)(5)(ii) of this section, the principal amount of the retained receivable held by the holder-in-form is increased by the principal amount of the deemed transferred receivable, the deemed transferred receivable ceases to exist for Federal tax purposes, and the specified portion (or portion thereof) that corresponds to the deemed transferred receivable (or portion thereof) ceases to be treated as a specified portion for purposes of this section.

(ii) New deemed transfer when a specified event involves a transferee that is a covered member that is an expanded group partner. If the specified event is described in paragraph (f)(5)(iii)(E) of this section, the holder-in-form of the debt instrument is

deemed to retransfer the deemed transferred receivable (or portion thereof, as determined under paragraph (f)(5)(iv) of this section) that the holder-in-form is deemed to have received pursuant to paragraph (f)(5)(i) of this section, to the transferee expanded group partner in exchange for deemed partner stock issued by the transferee expanded group partner with a fair market value equal to the principal amount of the deemed transferred receivable (or portion thereof) that is retransferred. For purposes of this section, this deemed transfer is treated in the same manner as a deemed transfer described in paragraph (f)(4)(i) of this section.

(iii) Specified events. A specified event, with respect to a deemed transfer, occurs when, immediately after the transaction and taking into account all related transactions:

(A) The controlled partnership that is the issuer of the debt instrument either ceases to be a controlled partnership or ceases to have an expanded group partner that is a covered member.

(B) The holder-in-form is a member of the expanded group immediately before the transaction, and the holder-in-form and the deemed holder cease to be members of the same expanded group for the reasons described in paragraph (d)(2) of this section.

(C) The holder-in-form is a controlled partnership immediately before the transaction, and the holder-in-form ceases to be a controlled partnership.

(D) The expanded group partner that is both the issuer of deemed partner stock and the deemed holder transfers (directly or indirectly through one or more partnerships) all or a portion of its interest in the controlled partnership to a person that neither is a covered member nor a controlled partnership with an expanded group

partner that is a covered member. If there is a transfer of only a portion of the interest, see paragraph (f)(5)(iv) of this section.

(E) The expanded group partner that is both the issuer of deemed partner stock and the deemed holder transfers (directly or indirectly through one or more partnerships) all or a portion of its interest in the controlled partnership to a covered member or a controlled partnership with an expanded group partner that is a covered member. If there is a transfer of only a portion of the interest, see paragraph (f)(5)(iv) of this section.

(F) The holder-in-form transfers the debt instrument (which is disregarded for Federal tax purposes) to a person that is neither a member of the expanded group nor a controlled partnership. See paragraph (f)(4)(v) of this section if the holder-in-form transfers the debt instrument to a member of the expanded group or a controlled partnership.

(iv) Specified event involving a transfer of only a portion of an interest in a controlled partnership. If, with respect to a specified event described in paragraph (f)(5)(iii)(D) or (E) of this section, an expanded group partner transfers only a portion of its interest in a controlled partnership, then, only a portion of the deemed transferred receivable that is deemed to be held by the expanded group partner is deemed to be distributed in redemption of an equal portion of the deemed partner stock. The portion of the deemed transferred receivable referred to in the preceding sentence is equal to the product of the entire principal amount of the deemed transferred receivable deemed to be held by the expanded group partner multiplied by a fraction, the numerator of which is the portion of the expanded group partner's capital account attributable to the interest

that is transferred, and the denominator of which is the expanded group partner's capital account with respect to its entire interest, determined immediately before the specified event.

(6) Issuance of a partnership's debt instrument to a partner and a partner's debt instrument to a partnership. If a controlled partnership, with respect to an expanded group, issues a debt instrument to an expanded group partner, or if a covered member that is an expanded group partner issues a covered debt instrument to a controlled partnership, and in each case, no partner deducts or receives an allocation of expense with respect to the debt instrument, then this section does not apply to the debt instrument.

(g) * * *

(5) Deemed holder. The term deemed holder means, with respect to a deemed transfer, the expanded group partner that is deemed to hold a deemed transferred receivable by reason of the deemed transfer.

(6) Deemed partner stock. The term deemed partner stock means, with respect to a deemed transfer, the stock deemed issued by an expanded group partner as described in paragraphs (f)(4)(i) and (iii) and (f)(5)(ii) of this section. The amount of deemed partner stock is reduced as described in paragraphs (f)(4)(iv)(B) and (f)(5)(i) of this section.

(7) Deemed transfer. The term deemed transfer means, with respect to a specified portion, the transfer described in paragraph (f)(4)(i) or (iii) or (f)(5)(ii) of this section.

(8) Deemed transferred receivable. The term deemed transferred receivable means, with respect to a deemed transfer, the portion of the debt instrument described in paragraph (f)(4)(i) or (iii) or (f)(5)(ii) of this section. The deemed transferred receivable is reduced as described in paragraphs (f)(4)(iv)(B) and (f)(5)(i) of this section.

* * * * *

(15) Holder-in-form. The term holder-in-form means, with respect to a debt instrument issued by a controlled partnership, the person that, absent the application of paragraph (f)(4) of this section, would be the holder of the debt instrument for Federal tax purposes. Therefore, the term holder-in-form does not include a deemed holder (as defined in paragraph (g)(5) of this section).

(16) Issuance percentage. The term issuance percentage means, with respect to a controlled partnership and an expanded group partner, the ratio (expressed as a percentage) of the partner's reasonably anticipated distributive share of all the partnership's interest expense over a reasonable period, divided by all of the partnership's reasonably anticipated interest expense over that same period, taking into account any and all relevant facts and circumstances. The relevant facts and circumstances include, without limitation, the term of the debt instrument; whether the partnership anticipates issuing other debt instruments; and the partnership's anticipated section 704(b) income and expense, and the partners' respective anticipated allocation percentages, taking into account anticipated changes to those allocation percentages over time resulting, for example, from anticipated contributions, distributions, recapitalizations, or provisions in the controlled partnership agreement.

(17) Liquidation value percentage. The term liquidation value percentage means, with respect to a controlled partnership and an expanded group partner, the ratio (expressed as a percentage) of the liquidation value of the expanded group partner's interest in the partnership divided by the aggregate liquidation value of all the partners' interests in the partnership. The liquidation value of an expanded group partner's interest in a controlled partnership is the amount of cash the partner would receive with respect to the interest if the partnership (and any partnership through which the partner indirectly owns an interest in the controlled partnership) sold all of its property for an amount of cash equal to the fair market value of the property (taking into account section 7701(g)), satisfied all of its liabilities (other than those described in §1.752-7), paid an unrelated third party to assume all of its §1.752-7 liabilities in a fully taxable transaction, and then the partnership (and any partnership through which the partner indirectly owns an interest in the controlled partnership) liquidated.

* * * * *

(22) Retained receivable. The term retained receivable means, with respect to a debt instrument issued by a controlled partnership, the portion of the debt instrument that is not transferred by the holder-in-form pursuant to one or more deemed transfers. The retained receivable is adjusted for decreases described in paragraph (f)(4)(iv)(B) of this section and increases described in paragraph (f)(5)(i) of this section.

(23) Specified portion. The term specified portion means, with respect to a debt instrument issued by a controlled partnership and a covered member that is an expanded group partner, the portion of the debt instrument that is treated under paragraph (f)(3)(i) of this section as issued on a testing date (within the meaning of

paragraph (f)(3)(ii) of this section) by the covered member and that, absent the application of paragraph (f)(4)(i) of this section, would be treated as stock under paragraph (b)(2) or (b)(3)(i) of this section on the testing date. A specified portion is reduced as described in paragraphs (f)(4)(iv)(B) and (f)(5)(i) of this section.

* * * * *

(h) * * *

(3) * * *

(xii) Example 12: Distribution of a covered debt instrument to a controlled partnership--(A) Facts. CFC and FS are equal partners in PRS. PRS owns 100% of the stock in X Corp, a domestic corporation. On Date A in Year 1, X Corp issues X Note to PRS in a distribution.

(B) Analysis. (1) Under §1.385-1(c)(4), in determining whether X Corp is a member of the FP expanded group that includes CFC and FS, CFC and FS are each treated as owning 50% of the X Corp stock held by PRS. Accordingly, 100% of X Corp's stock is treated as owned by CFC and FS, and X Corp is a member of the FP expanded group.

(2) Together CFC and FS own 100% of the interests in PRS capital and profits, such that PRS is a controlled partnership under §1.385-1(c)(1). CFC and FS are both expanded group partners on the date on which PRS acquired X Note. Therefore, pursuant to paragraph (f)(2)(i)(A) of this section, each of CFC and FS is treated as acquiring its share of X Note in the same manner (in this case, by a distribution of X Note), and on the date on which, PRS acquired X Note. Likewise, X Corp is treated as issuing to each of CFC and FS its share of X Note. Under paragraph (f)(2)(i)(B) of this section, each of CFC's and FS's share of X Note, respectively, is determined in accordance with its liquidation value percentage determined on Date A in Year 1, the date X Corp distributed X Note to PRS. On Date A in Year 1, pursuant to paragraph (g)(17) of this section, each of CFC's and FS's liquidation value percentages is 50%. Accordingly, on Date A in Year 1, under paragraph (f)(2)(i)(A) of this section, for purposes of this section, CFC and FS are each treated as acquiring 50% of X Note in a distribution.

(3) Under paragraphs (b)(2)(i) and (d)(1)(i) of this section, X Note is treated as stock on the date of issuance, which is Date A in Year 1. Under paragraph (f)(2)(i)(A) of this section, each of CFC and FS are treated as acquiring 50% of X Note in a distribution for purposes of this section. Therefore, X Corp is treated as distributing its stock to PRS in a distribution described in section 305.

(xiii) Example 13: Loan to a controlled partnership; proportionate distributions by expanded group partners--(A) Facts. DS, USS2, and USP are partners in PRS. USP is a domestic corporation that is not a member of the FP expanded group. Each of DS and USS2 own 45% of the interests in PRS profits and capital, and USP owns 10% of the interests in PRS profits and capital. The PRS partnership agreement provides that all items of PRS income, gain, loss, deduction, and credit are allocated in accordance with the percentages in the preceding sentence. On Date A in Year 1, FP lends $200x to PRS in exchange for PRS Note with stated principal amount of $200x, which is payable at maturity. PRS Note also provides for annual payments of interest that are qualified stated interest. PRS uses all $200x in its business and does not distribute any money or other property to a partner. Subsequently, on Date B in Year 1, DS distributes $90x to USS1, USS2 distributes $90x to FP, and USP distributes $20x to its shareholder. Each of DS's and USS2's issuance percentage is 45% on Date B in Year 1, the date of the distributions and therefore a testing date under paragraph (f)(3)(ii)(A) of this section.

(B) Analysis. (1) DS and USS2 together own 90% of the interests in PRS profits and capital and therefore PRS is a controlled partnership under §1.385-1(c)(1). Under §1.385-1(c)(2), each of DS and USS2 is a covered member.

(2) Under paragraph (f)(3)(i) of this section, each of DS and USS2 is treated as issuing its share of PRS Note, and under paragraph (f)(3)(ii)(A) of this section, DS's and USS2's share is each $90x (45% of $200x). USP is not an expanded group partner and therefore has no issuance percentage and is not treated as issuing any portion of PRS Note.

(3) The $90x distributions made by DS to USS1 and by USS2 to FP are described in paragraph (b)(3)(i)(A) of this section. Under paragraph (b)(3)(iii)(A) of this section, the portions of PRS Note treated as issued by each of DS and USS2 are treated as funding the distribution made by DS and USS2 because the distributions occurred within the per se period with respect to PRS Note. Under paragraph (b)(3)(i) of this section, the portions of PRS Note treated as issued by each of DS and USS2 would, absent the application of paragraph (f)(4)(i) of this section, be treated as stock of DS and USS2 on Date B in Year 1, the date of the distributions. See paragraph (d)(1)(ii) of this section. Under paragraph (g)(23) of this section, each of the $90x portions is a specified portion.

(4) Under paragraph (f)(4)(i) of this section, the specified portions are not treated as stock under paragraph (b)(3)(i) of this section. Instead, FP is deemed to transfer a portion of PRS Note with a principal amount equal to $90x (the adjusted issue price of the specified portion with respect to DS) to DS in exchange for deemed partner stock in DS with a fair market value of $90x. Similarly, FP is deemed to transfer a portion of PRS Note with a principal amount equal to $90x (the adjusted issue price of the specified portion with respect to USS2) to USS2 in exchange for deemed partner stock in USS2 with a fair market value of $90x. The principal amount of the retained receivable held by FP is $20x ($200x—$90x—$90x).

(xiv) Example 14: Loan to a controlled partnership; disproportionate distributions by expanded group partners--(A) Facts. The facts are the same as in paragraph (h)(3)(xiii)(A) of this section (Example 13), except that on Date B in Year 1, DS distributes $45x to USS1 and USS2 distributes $135x to FP.

(B) Analysis. (1) The analysis is the same as in paragraph (h)(3)(xiii)(B)(1) of this section (Example 13).

(2) The analysis is the same as in paragraph (h)(3)(xiii)(B)(2) of this section (Example 13).

(3) The $45x and $135x distributions made by DS to USS1 and by USS2 to FP, respectively, are described in paragraph (b)(3)(i)(A) of this section. Under paragraph (b)(3)(iii)(A) of this section, the portion of PRS Note treated as issued by DS is treated as funding the distribution made by DS because the distribution occurred within the per se period with respect to PRS Note, but under paragraph (b)(3)(i) of this section, only to the extent of DS's $45x distribution. USS2 is treated as issuing $90x of PRS Note, all of which is treated as funding $90x of USS2's $135x distribution under paragraph (b)(3)(iii)(A) of this section. Under paragraph (b)(3)(i) of this section, absent the application of paragraph (f)(4)(i) of this section, $45x of PRS Note would be treated as stock of DS and $90x of PRS Note would be treated as stock of USS2 on Date B in Year 1, the date of the distributions. See paragraph (d)(1)(ii) of this section. Under paragraph (g)(23) of this section, $45x of PRS Note is a specified portion with respect to DS and $90x of PRS Note is a specified portion with respect to USS2.

(4) Under paragraph (f)(4)(i) of this section, the specified portions are not treated as stock under paragraph (b)(3)(i) of this section. Instead, FP is deemed to transfer a portion of PRS Note with a principal amount equal to $45x (the adjusted issue price of the specified portion with respect to DS) to DS in exchange for stock of DS with a fair market value of $90x. Similarly, FP is deemed to transfer a portion of PRS Note with a principal amount equal to $90x (the adjusted issue price of the specified portion with respect to USS2) to USS2 in exchange for stock of USS2 with a fair market value of $90x. The principal amount of the retained receivable held by FP is $65x ($200x-$45x-$90x).

(xv) Example 15: Loan to partnership; distribution in later year--(A) Facts. The facts are the same as in paragraph (h)(3)(xiii)(A) of this section (Example 13), except that USS2 does not distribute $90x to FP until Date C in Year 2, which is less than 36 months after Date A in Year 1. On Date C in Year 2, DS's, USS2's, and USP's issuance percentages under paragraph (g)(16) of this section are unchanged at 45%, 45%, and 10%, respectively.

(B) Analysis. (1) The analysis is the same as in paragraph (h)(3)(xiii)(B)(1) of this section (Example 13).

(2) The analysis is the same as in paragraph (h)(3)(xiii)(B)(2) of this section (Example 13).

(3) With respect to the distribution made by DS, the analysis is the same as in paragraph (h)(3)(xiii)(B)(3) of this section (Example 13).

(4) With respect to the deemed transfer to DS, the analysis is the same as in paragraph (h)(3)(xiii)(B)(4) of this section (Example 13). Accordingly, the amount of the retained receivable held by FP as of Date B in Year 1 is $110x ($200x-$90x).

(5) Under paragraph (f)(3)(ii)(A) of this section, USS2's share of PRS Note is determined on Date C in Year 2. On Date C in Year 2, DS's, USS2's, and USP's respective shares of PRS Note under paragraph (f)(3)(ii)(A) of this section are $90x, $90x, and $20x. However, because DS is treated as the issuer with respect to a $90x specified portion of PRS Note, DS's share of PRS Note is reduced by $90x to $0 under paragraph (f)(3)(ii)(B)(1) of this section. No reduction to either of USS2's or USP's share of PRS Note is required under paragraph (f)(3)(ii)(B)(2) of this section because the aggregate of DS's, USS2's, and USP's shares of PRS Note as reduced is $110x (DS has a $0 share, USS2 has a $90x share, and USP has a $20x share), which does not exceed $110x (the $200x adjusted issue price of PRS Note reduced by the $90x specified portion with respect to DS). Under paragraph (f)(3)(i) of this section, USS2 is treated as issuing its share of PRS Note.

(6) The $90x distribution made by USS2 to FP is described in paragraph (b)(3)(i)(A) of this section. Under paragraph (b)(3)(iii)(A) of this section, the portion of PRS Note treated as issued by USS2 is treated as funding the distribution made by USS2, because the distribution occurred within the per se period with respect to PRS Note. Accordingly, the portion of PRS Note treated as issued by USS2 would, absent the application of paragraph (f)(4)(i) of this section, be treated as stock of USS2 under paragraph (b)(3)(i) of this section on Date C in Year 2. See paragraph (d)(1)(ii) of this section. Under paragraph (g)(23) of this section, the $90x portion is a specified portion.

(7) Under paragraph (f)(4)(i) of this section, the specified portion of PRS Note treated as issued by USS2 is not treated as stock under paragraph (b)(3)(i) of this section. Instead, on Date C in Year 2, FP is deemed to transfer a portion of PRS Note with a principal amount equal to $90x (the adjusted issue price of the specified portion with respect to USS2) to USS2 in exchange for stock in USS2 with a fair market value of $90x. The principal amount of the retained receivable held by FP is reduced from $110x to $20x.

(xvi) Example 16: Loan to a controlled partnership; partnership ceases to be a controlled partnership--(A) Facts. The facts are the same as in paragraph (h)(3)(xiii)(A) of this section (Example 13), except that on Date C in Year 4, USS2 sells its entire interest in PRS to an unrelated person.

(B) Analysis. (1) On date C in Year 4, PRS ceases to be a controlled partnership with respect to the FP expanded group under §1.385-1(c)(1). This is the case because DS, the only remaining partner that is a member of the FP expanded group, only owns 45% of the total interest in PRS profits and capital. Because PRS ceases to be a controlled partnership, a specified event (within the meaning of paragraph (f)(5)(iii)(A) of

this section) occurs with respect to the deemed transfers with respect to each of DS and USS2.

(2) Under paragraph (f)(5)(i) of this section, on Date C in Year 4, immediately before PRS ceases to be a controlled partnership, each of DS and USS2 is deemed to distribute its deemed transferred receivable to FP in redemption of FP's deemed partner stock in DS and USS2. The specified portion that corresponds to each of the deemed transferred receivables ceases to be treated as a specified portion. Furthermore, the deemed transferred receivables cease to exist, and the retained receivable held by FP increases from $20x to $200x.

(xvii) Example 17: Transfer of an interest in a partnership to a covered member--(A) Facts. The facts are the same as in paragraph (h)(3)(xiii)(A) of this section (Example 13), except that on Date C in Year 4, USS2 sells its entire interest in PRS to USS1.

(B) Analysis. (1) After USS2 sells its interest in PRS to USS1, DS and USS1 together own 90% of the interests in PRS profits and capital and therefore PRS continues to be a controlled partnership under §1.385-1(c)(1). A specified event (within the meaning of paragraph (f)(5)(iii)(E) of this section) occurs as result of the sale only with respect to the deemed transfer with respect to USS2.

(2) Under paragraph (f)(5)(i) of this section, on Date C in Year 4, immediately before USS2 sells its entire interest in PRS to USS1, USS2 is deemed to distribute its deemed transferred receivable to FP in redemption of FP's deemed partner stock in USS2. Because the specified event is described in paragraph (f)(5)(iii)(E) of this section, under paragraph (f)(5)(ii) of this section, FP is deemed to retransfer the deemed transferred receivable deemed received from USS2 to USS1 in exchange for deemed partner stock in USS1 with a fair market value equal to the principal amount of the deemed transferred receivable that is retransferred to USS1.

(xviii) Example 18: Loan to partnership and all partners are members of a consolidated group--(A) Facts. USS1 and DS are equal partners in PRS. USS1 and DS are members of a consolidated group, as defined in §1.1502-1(h). The PRS partnership agreement provides that all items of PRS income, gain, loss, deduction, and credit are allocated equally between USS1 and DS. On Date A in Year 1, FP lends $200x to PRS in exchange for PRS Note. PRS uses all $200x in its business and does not distribute any money or other property to any partner. On Date B in Year 1, DS distributes $200x to USS1, and USS1 distributes $200x to FP. If neither of USS1 or DS were a member of the consolidated group, each would have an issuance percentage under paragraph (g)(16) of this section, determined as of Date A in Year 1, of 50%.

(B) Analysis. (1) Pursuant to §1.385-4(b)(6), PRS is treated as a partnership for purposes of this section. Under §1.385-4(b)(1), DS and USS1 are treated as one corporation for purposes of this section, and thus a single covered member under §1.385-1(c)(2). For purposes of this section, the single covered member owns 100% of the PRS profits and capital and therefore PRS is a controlled partnership under §1.385-1(c)(1). Under paragraph (f)(3)(i) of this section, the single covered member is treated

as issuing all $200x of PRS Note to FP, a member of the same expanded group as the single covered member. DS's distribution to USS1 is a disregarded distribution because it is a distribution between members of a consolidated group that is disregarded under the one-corporation rule described in §1.385-4(b)(1). However, under paragraph (b)(3)(iii)(A) of this section, PRS Note, treated as issued by the single covered member, is treated as funding the distribution by USS1 to FP, which is described in paragraph (b)(3)(i)(A) of this section and which is a regarded distribution. Accordingly, PRS Note, absent the application of paragraph (f)(4)(i) of this section, would be treated as stock under paragraph (b) of this section on Date B in Year 1. Thus, pursuant to paragraph (g)(23) of this section, the entire PRS Note is a specified portion.

(2) Under paragraphs (f)(4)(i) and (iii) of this section, the specified portion is not treated as stock and, instead, FP is deemed to transfer PRS Note with a principal amount equal to $200x to USS1 in exchange for stock of USS1 with a fair market value of $200x. Under paragraph (f)(4)(iii) of this section, FP is deemed to transfer PRS Note to USS1 because only USS1 made a regarded distribution described in paragraph (b)(3)(i) of this section.

(xix) Example 19: Loan to a disregarded entity--(A) Facts. DS owns DRE, a disregarded entity within the meaning of §1.385-1(c)(3). On Date A in Year 1, FP lends $200x to DRE in exchange for DRE Note. Subsequently, on Date B in Year 1, DS distributes $100x of cash to USS1.

(B) Analysis. Under paragraph (b)(3)(iii)(A) of this section, $100x of DRE Note would be treated as funding the distribution by DS to USS1 because DRE Note is issued to a member of the FP expanded group during the per se period with respect to DS's distribution to USS1. Accordingly, under paragraphs (b)(3)(i)(A) and (d)(1)(ii) of this section, $100x of DRE Note would be treated as stock on Date B in Year 1. However, under paragraph (d)(4) of this section, DS, as the regarded owner, within the meaning of §1.385-1(c)(5), of DRE is deemed to issue its stock to FP in exchange for a portion of DRE Note equal to the $100x applicable portion (as defined in paragraph (d)(4) of this section). Thus, DS is treated as the holder of $100x of DRE Note, which is disregarded, and FP is treated as the holder of the remaining $100x of DRE Note. The $100x of stock deemed issued by DS to FP has the same terms as DRE Note, other than the issuer, and payments on the stock are determined by reference to payments on DRE Note.

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(j) * * *(1) In general. Except as provided in paragraph (j)(2) or (3) or (k) of this section, this section applies to taxable years ending on or after January 19, 2017.

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(3) Paragraph (f)(4)(iii) of this section. Paragraph (f)(4)(iii) of this section applies to taxable years for which the U.S. Federal income tax return is due, without extensions, after **[INSERT DATE OF PUBLICATION IN FEDERAL REGISTER]**. For taxable years ending on or after January 19, 2017, and for which the U.S. Federal income tax return is due, without extensions, on or before **[INSERT DATE OF PUBLICATION IN FEDERAL REGISTER]**, see §1.385-3T(f)(4)(iii), as contained in 26 CFR in part 1 in effect on April 1, 2019. In the case of a taxable year that ends after October 13, 2019, and on or before **[INSERT DATE OF PUBLICATION IN FEDERAL REGISTER]**, a taxpayer may choose to apply paragraph (f)(4)(iii) of this section to the portion of the taxable year that occurs after the expiration of §1.385-3T on October 13, 2019, provided that all members of the taxpayer's expanded group apply such paragraph.

(k) Additional transition rules. See transition rules in §1.385-3T(k)(2) as contained in 26 CFR in part 1 in effect on April 1, 2019.

§§1.385-3T and 1.385-4T [Removed]

Par. 4. Sections 1.385-3T and 1.385-4T are removed.

Par. 5. Section 1.385-4 is added to read as follows:

§1.385-4 Treatment of consolidated groups.

(a) Scope. This section provides rules for applying §1.385-3 to members of consolidated groups. Paragraph (b) of this section sets forth rules concerning the extent to which, solely for purposes of applying §1.385-3, members of a consolidated group that file (or that are required to file) a consolidated U.S. Federal income tax return are treated as one corporation. Paragraph (c) of this section sets forth rules concerning the treatment of a debt instrument that ceases to be, or becomes, a consolidated group

debt instrument. Paragraph (d) of this section provides rules for applying the funding rule of §1.385-3(b)(3) to members that depart a consolidated group. For definitions applicable to this section, see paragraph (e) of this section and §§1.385-1(c) and 1.385-3(g). For examples illustrating the application of this section, see paragraph (f) of this section.

(b) Treatment of consolidated groups--(1) Members treated as one corporation. For purposes of this section and §1.385-3, and except as otherwise provided in this section and §1.385-3, all members of a consolidated group (as defined in §1.1502-1(h)) that file (or that are required to file) a consolidated U.S. Federal income tax return are treated as one corporation. Thus, for example, when a member of a consolidated group issues a covered debt instrument that is not a consolidated group debt instrument, the consolidated group generally is treated as the issuer of the covered debt instrument for purposes of this section and §1.385-3. Also, for example, when one member of a consolidated group issues a covered debt instrument that is not a consolidated group debt instrument and therefore is treated as issued by the consolidated group, and another member of the consolidated group makes a distribution or acquisition described in §1.385-3(b)(3)(i)(A) through (C) with an expanded group member that is not a member of the consolidated group, §1.385-3(b)(3)(i) may treat the covered debt instrument as funding the distribution or acquisition made by the consolidated group. In addition, except as otherwise provided in this section, acquisitions and distributions described in §1.385-3(b)(2) and (b)(3)(i) in which all parties to the transaction are members of the same consolidated group both before and after the transaction are disregarded for purposes of this section and §1.385-3.

(2) One-corporation rule inapplicable to expanded group member determination. The one-corporation rule described in paragraph (b)(1) of this section does not apply in determining the members of an expanded group. Notwithstanding the previous sentence, an expanded group does not exist for purposes of this section and §1.385-3 if it consists only of members of a single consolidated group.

(3) Application of §1.385-3 to debt instruments issued by members of a consolidated group--(i) Debt instrument treated as stock of the issuing member of a consolidated group. If a covered debt instrument treated as issued by a consolidated group under the one-corporation rule described in paragraph (b)(1) of this section is treated as stock under §1.385-3, the covered debt instrument is treated as stock in the member of the consolidated group that would be the issuer of such debt instrument without regard to this section. But see §1.385-3(d)(7) (providing that a covered debt instrument that is treated as stock under §1.385-3(b)(2), (3), or (4) and that is not described in section 1504(a)(4) is not treated as stock for purposes of determining whether the issuer is a member of an affiliated group (within the meaning of section 1504(a)).

(ii) Application of the covered debt instrument exclusions. For purposes of determining whether a debt instrument issued by a member of a consolidated group is a covered debt instrument, each test described in §1.385-3(g)(3) is applied on a separate member basis without regard to the one-corporation rule described in paragraph (b)(1) of this section.

(iii) Qualified short-term debt instrument. The determination of whether a member of a consolidated group has issued a qualified short-term debt instrument for purposes

of §1.385-3(b)(3)(vii) is made on a separate member basis without regard to the one-corporation rule described in paragraph (b)(1) of this section.

(4) Application of the reductions of §1.385-3(c)(3) to members of a consolidated group--(i) Application of the reduction for expanded group earnings--(A) In general. A consolidated group maintains one expanded group earnings account with respect to an expanded group period, and only the earnings and profits, determined in accordance with §1.1502-33 (without regard to the application of §1.1502-33(b)(2), (e), and (f)), of the common parent (within the meaning of section 1504) of the consolidated group are considered in calculating the expanded group earnings for the expanded group period of the consolidated group. Accordingly, a regarded distribution or acquisition made by a member of a consolidated group is reduced to the extent of the expanded group earnings account of the consolidated group.

(B) Effect of certain corporate transactions on the calculation of expanded group earnings--(1) Consolidation. A consolidated group succeeds to the expanded group earnings account of a joining member under the principles of §1.385-3(c)(3)(i)(F)(2)(ii).

(2) Deconsolidation--(i) In general. Except as otherwise provided in paragraph (b)(4)(i)(B)(2)(ii) of this section, no amount of the expanded group earnings account of a consolidated group for an expanded group period, if any, is allocated to a departing member. Accordingly, immediately after leaving the consolidated group, the departing member has no expanded group earnings account with respect to its expanded group period.

(ii) Allocation of expanded group earnings to a departing member in a distribution described in section 355. If a departing member leaves the consolidated group by

reason of an exchange or distribution to which section 355 (or so much of section 356 that relates to section 355) applies, the expanded group earnings account of the consolidated group is allocated between the consolidated group and the departing member in proportion to the earnings and profits of the consolidated group and the earnings and profits of the departing member immediately after the transaction.

(ii) Application of the reduction for qualified contributions--(A) In general. For purposes of applying §1.385-3(c)(3)(ii)(A) to a consolidated group—

(1) A qualified contribution to any member of a consolidated group that remains a member of the consolidated group immediately after the qualified contribution from a person other than a member of the same consolidated group is treated as made to the one corporation described in paragraph (b)(1) of this section;

(2) A qualified contribution that causes a member of a consolidated group to become a departing member of that consolidated group is treated as made to the departing member and not to the consolidated group of which the departing member was a member immediately prior to the qualified contribution; and

(3) No contribution of property by a member of a consolidated group to any other member of the consolidated group is a qualified contribution.

(B) Effect of certain corporate transactions on the calculation of qualified contributions--(1) Consolidation. A consolidated group succeeds to the qualified contributions of a joining member under the principles of §1.385-3(c)(3)(ii)(F)(2)(ii).

(2) Deconsolidation--(i) In general. Except as otherwise provided in paragraph (b)(4)(ii)(B)(2)(ii) of this section, no amount of the qualified contributions of a consolidated group for an expanded group period, if any, is allocated to a departing

member. Accordingly, immediately after leaving the consolidated group, the departing member has no qualified contributions with respect to its expanded group period.

(ii) Allocation of qualified contributions to a departing member in a distribution described in section 355. If a departing member leaves the consolidated group by reason of an exchange or distribution to which section 355 (or so much of section 356 that relates to section 355) applies, each qualified contribution of the consolidated group is allocated between the consolidated group and the departing member in proportion to the earnings and profits of the consolidated group and the earnings and profits of the departing member immediately after the transaction.

(5) Order of operations. For purposes of this section and §1.385-3, the consequences of a transaction involving one or more members of a consolidated group are determined as provided in paragraphs (b)(5)(i) and (ii) of this section.

(i) First, determine the characterization of the transaction under Federal tax law without regard to the one-corporation rule described in paragraph (b)(1) of this section.

(ii) Second, apply this section and §1.385-3 to the transaction as characterized to determine whether to treat a debt instrument as stock, treating the consolidated group as one corporation under paragraph (b)(1) of this section, unless otherwise provided.

(6) Partnership owned by a consolidated group. For purposes of this section and §1.385-3, and notwithstanding the one-corporation rule described in paragraph (b)(1) of this section, a partnership that is wholly owned by members of a consolidated group is treated as a partnership. Thus, for example, if members of a consolidated group own all of the interests in a controlled partnership that issues a debt instrument to a member of the consolidated group, such debt instrument would be treated as a consolidated group

debt instrument because, under §1.385-3(f)(3)(i), for purposes of this section and §1.385-3, a consolidated group member that is an expanded group partner is treated as the issuer with respect to its share of the debt instrument issued by the partnership.

(7) Predecessor and successor--(i) In general. Pursuant to paragraph (b)(5) of this section, the determination as to whether a member of an expanded group is a predecessor or successor of another member of the consolidated group is made without regard to paragraph (b)(1) of this section. For purposes of §1.385-3(b)(3), if a consolidated group member is a predecessor or successor of a member of the same expanded group that is not a member of the same consolidated group, the consolidated group is treated as a predecessor or successor of the expanded group member (or the consolidated group of which that expanded group member is a member). Thus, for example, a departing member that departs a consolidated group in a distribution or exchange to which section 355 applies is a successor to the consolidated group and the consolidated group is a predecessor of the departing member.

(ii) Joining members. For purposes of §1.385-3(b)(3), the term predecessor also means, with respect to a consolidated group, a joining member and the term successor also means, with respect to a joining member, a consolidated group.

(c) Consolidated group debt instruments--(1) Debt instrument ceases to be a consolidated group debt instrument but continues to be issued and held by expanded group members--(i) Consolidated group member leaves the consolidated group. For purposes of this section and §1.385-3, when a debt instrument ceases to be a consolidated group debt instrument as a result of a transaction in which the member of the consolidated group that issued the instrument (the issuer) or the member of the

consolidated group holding the instrument (the holder) ceases to be a member of the same consolidated group but both the issuer and the holder continue to be members of the same expanded group, the issuer is treated as issuing a new debt instrument to the holder in exchange for property immediately after the debt instrument ceases to be a consolidated group debt instrument. To the extent the newly-issued debt instrument is a covered debt instrument that is treated as stock under §1.385-3(b)(3), the covered debt instrument is then immediately deemed to be exchanged for stock of the issuer. For rules regarding the treatment of the deemed exchange, see §1.385-1(d). For examples illustrating the rule in this paragraph (c)(1)(i), see paragraphs (f)(3)(iv) and (v) of this section (Examples 4 and 5).

(ii) Consolidated group debt instrument that is transferred outside of the consolidated group. For purposes of this section and §1.385-3, when a member of a consolidated group that holds a consolidated group debt instrument transfers the debt instrument to an expanded group member that is not a member of the same consolidated group (transferee expanded group member), the debt instrument is treated as issued by the consolidated group to the transferee expanded group member immediately after the debt instrument ceases to be a consolidated group debt instrument. Thus, for example, for purposes of this section and §1.385-3, the sale of a consolidated group debt instrument to a transferee expanded group member is treated as an issuance of the debt instrument by the consolidated group to the transferee expanded group member in exchange for property. To the extent the newly-issued debt instrument is a covered debt instrument that is treated as stock upon being transferred, the covered debt instrument is deemed to be exchanged for stock of the member of the

consolidated group treated as the issuer of the debt instrument (determined under paragraph (b)(3)(i) of this section) immediately after the covered debt instrument is transferred outside of the consolidated group. For rules regarding the treatment of the deemed exchange, see §1.385-1(d). For examples illustrating the rule in this paragraph (c)(1)(ii), see paragraphs (f)(3)(ii) and (iii) of this section (Examples 2 and 3).

(iii) Overlap transactions. If a debt instrument ceases to be a consolidated group debt instrument in a transaction to which both paragraphs (c)(1)(i) and (ii) of this section apply, then only the rules of paragraph (c)(1)(ii) of this section apply with respect to such debt instrument.

(iv) Subgroup exception. A debt instrument is not treated as ceasing to be a consolidated group debt instrument for purposes of paragraphs (c)(1)(i) and (ii) of this section if both the issuer and the holder of the debt instrument are members of the same consolidated group immediately after the transaction described in paragraph (c)(1)(i) or (ii) of this section.

(2) Covered debt instrument treated as stock becomes a consolidated group debt instrument. When a covered debt instrument that is treated as stock under §1.385-3 becomes a consolidated group debt instrument, then immediately after the covered debt instrument becomes a consolidated group debt instrument, the issuer is deemed to issue a new covered debt instrument to the holder in exchange for the covered debt instrument that was treated as stock. In addition, in a manner consistent with §1.385-3(d)(2)(ii)(A), when the covered debt instrument that previously was treated as stock becomes a consolidated group debt instrument, other covered debt instruments issued by the issuer of that instrument (including a consolidated group that includes the issuer)

that are not treated as stock when the instrument becomes a consolidated group debt instrument are re-tested to determine whether those other covered debt instruments are treated as funding the regarded distribution or acquisition that previously was treated as funded by the instrument (unless such distribution or acquisition is disregarded under paragraph (b)(1) of this section). Further, also in a manner consistent with §1.385-3(d)(2)(ii)(A), a covered debt instrument that is issued by the issuer (including a consolidated group that includes the issuer) after the application of this paragraph (c)(2) and within the per se period may also be treated as funding that regarded distribution or acquisition.

(3) No interaction with the intercompany obligation rules of §1.1502-13(g). The rules of this section do not affect the application of the rules of §1.1502-13(g). Thus, any deemed satisfaction and reissuance of a debt instrument under §1.1502-13(g) and any deemed issuance and deemed exchange of a debt instrument under this paragraph (c) that arise as part of the same transaction or series of transactions are not integrated. Rather, each deemed satisfaction and reissuance under the rules of §1.1502-13(g), and each deemed issuance and exchange under the rules of this section, are respected as separate steps and treated as separate transactions.

(d) Application of the funding rule of §1.385-3(b)(3) to members departing a consolidated group. This paragraph (d) provides rules for applying the funding rule of §1.385-3(b)(3) when a departing member ceases to be a member of a consolidated group, but only if the departing member and the consolidated group are members of the same expanded group immediately after the deconsolidation.

(1) Continued application of the one-corporation rule. A disregarded distribution or acquisition by any member of the consolidated group continues to be disregarded when the departing member ceases to be a member of the consolidated group.

(2) Continued recharacterization of a departing member's covered debt instrument as stock. A covered debt instrument of a departing member that is treated as stock of the departing member under §1.385-3(b) continues to be treated as stock when the departing member ceases to be a member of the consolidated group.

(3) Effect of issuances of covered debt instruments that are not consolidated group debt instruments on the departing member and the consolidated group. If a departing member has issued a covered debt instrument (determined without regard to the one-corporation rule described in paragraph (b)(1) of this section) that is not a consolidated group debt instrument and that is not treated as stock immediately before the departing member ceases to be a consolidated group member, then the departing member (and not the consolidated group) is treated as issuing the covered debt instrument on the date and in the manner the covered debt instrument was issued. If the departing member is not treated as the issuer of a covered debt instrument pursuant to the preceding sentence, then the consolidated group continues to be treated as issuing the covered debt instrument on the date and in the manner the covered debt instrument was issued.

(4) Treatment of prior regarded distributions or acquisitions. This paragraph (d)(4) applies when a departing member ceases to be a consolidated group member in a transaction other than a distribution to which section 355 (or so much of section 356 as relates to section 355) applies, and the consolidated group has made a regarded

distribution or acquisition. In this case, to the extent the distribution or acquisition has not caused a covered debt instrument of the consolidated group to be treated as stock under §1.385-3(b) on or before the date the departing member leaves the consolidated group, then--

(i) If the departing member made the regarded distribution or acquisition (determined without regard to the one-corporation rule described in paragraph (b)(1) of this section), the departing member (and not the consolidated group) is treated as having made the regarded distribution or acquisition.

(ii) If the departing member did not make the regarded distribution or acquisition (determined without regard to the one-corporation rule described in paragraph (b)(1) of this section), then the consolidated group (and not the departing member) continues to be treated as having made the regarded distribution or acquisition.

(e) Definitions. The definitions in this paragraph (e) apply for purposes of this section.

(1) Consolidated group debt instrument. The term consolidated group debt instrument means a covered debt instrument issued by a member of a consolidated group and held by a member of the same consolidated group.

(2) Departing member. The term departing member means a member of an expanded group that ceases to be a member of a consolidated group but continues to be a member of the same expanded group. In the case of multiple members leaving a consolidated group as a result of a single transaction that continue to be members of the same expanded group, if such members are treated as one corporation under

paragraph (b)(1) of this section immediately after the transaction, that one corporation is a departing member with respect to the consolidated group.

(3) Disregarded distribution or acquisition. The term disregarded distribution or acquisition means a distribution or acquisition described in §1.385-3(b)(2) or (b)(3)(i) between members of a consolidated group that is disregarded under the one-corporation rule described in paragraph (b)(1) of this section.

(4) Joining member. The term joining member means a member of an expanded group that becomes a member of a consolidated group and continues to be a member of the same expanded group. In the case of multiple members joining a consolidated group as a result of a single transaction that continue to be members of the same expanded group, if such members were treated as one corporation under paragraph (b)(1) of this section immediately before the transaction, that one corporation is a joining member with respect to the consolidated group.

(5) Regarded distribution or acquisition. The term regarded distribution or acquisition means a distribution or acquisition described in §1.385-3(b)(2) or (b)(3)(i) that is not disregarded under the one-corporation rule described in paragraph (b)(1) of this section.

(f) Examples--(1) Assumed facts. Except as otherwise stated, the following facts are assumed for purposes of the examples in paragraph (f)(3) of this section:

(i) FP is a foreign corporation that owns 100% of the stock of USS1, a covered member, and 100% of the stock of FS, a foreign corporation;

(ii) USS1 owns 100% of the stock of DS1 and DS3, both covered members;

(iii) DS1 owns 100% of the stock of DS2, a covered member;

(iv) FS owns 100% of the stock of UST, a covered member;

(v) At the beginning of Year 1, FP is the common parent of an expanded group comprised solely of FP, USS1, FS, DS1, DS2, DS3, and UST (the FP expanded group);

(vi) USS1, DS1, DS2, and DS3 are members of a consolidated group of which USS1 is the common parent (the USS1 consolidated group);

(vii) The FP expanded group has outstanding more than $50 million of debt instruments described in §1.385-3(c)(4) at all times;

(viii) No issuer of a covered debt instrument has a positive expanded group earnings account, within the meaning of §1.385-3(c)(3)(i)(B), or has received a qualified contribution, within the meaning of §1.385-3(c)(3)(ii)(B);

(ix) All notes are covered debt instruments, within the meaning of §1.385-3(g)(3), and are not qualified short-term debt instruments, within the meaning of §1.385-3(b)(3)(vii);

(x) All notes between members of a consolidated group are intercompany obligations within the meaning of §1.1502-13(g)(2)(ii);

(xi) Each entity has as its taxable year the calendar year;

(xii) No domestic corporation is a United States real property holding corporation within the meaning of section 897(c)(2);

(xiii) Each note is issued with adequate stated interest (as defined in section 1274(c)(2)); and

(xiv) Each transaction occurs after January 19, 2017.

(2) No inference. Except as otherwise provided in this section, it is assumed for purposes of the examples in paragraph (f)(3) of this section that the form of each

transaction is respected for Federal tax purposes. No inference is intended, however, as to whether any particular note would be respected as indebtedness or as to whether the form of any particular transaction described in an example in paragraph (f)(3) of this section would be respected for Federal tax purposes.

(3) Examples. The following examples illustrate the rules of this section.

(i) Example 1: Order of operations--(A) Facts. On Date A in Year 1, UST issues UST Note to USS1 in exchange for DS3 stock representing less than 20% of the value and voting power of DS3.

(B) Analysis. UST is acquiring the stock of DS3, the non-common parent member of a consolidated group. Pursuant to paragraph (b)(5)(i) of this section, the transaction is first analyzed without regard to the one-corporation rule described in paragraph (b)(1) of this section, and therefore UST is treated as issuing a covered debt instrument in exchange for expanded group stock. The exchange of UST Note for DS3 stock is not an exempt exchange within the meaning of §1.385-3(g)(11) because UST and USS1 are not parties to an asset reorganization. Pursuant to paragraph (b)(5)(ii) of this section, §1.385-3 (including §1.385-3(b)(2)(ii)) is then applied to the transaction, thereby treating UST Note as stock for Federal tax purposes when it is issued by UST to USS1. The UST Note is not treated as property for purposes of section 304(a) because it is not property within the meaning specified in section 317(a). Therefore, UST's acquisition of DS3 stock from USS1 in exchange for UST Note is not an acquisition described in section 304(a)(1).

(ii) Example 2: Distribution of consolidated group debt instrument--(A) Facts. On Date A in Year 1, DS1 issues DS1 Note to USS1 in a distribution. On Date B in Year 2, USS1 distributes DS1 Note to FP.

(B) Analysis. Under paragraph (b)(1) of this section, the USS1 consolidated group is treated as one corporation for purposes of §1.385-3. Accordingly, when DS1 issues DS1 Note to USS1 in a distribution on Date A in Year 1, DS1 is not treated as issuing a debt instrument to another member of DS1's expanded group in a distribution for purposes of §1.385-3(b)(2), and DS1 Note is not treated as stock under §1.385-3. When USS1 distributes DS1 Note to FP, DS1 Note is deemed satisfied and reissued under §1.1502-13(g)(3)(ii), immediately before DS1 Note ceases to be an intercompany obligation. Under paragraph (c)(1)(ii) of this section, when USS1 distributes DS1 Note to FP, the USS1 consolidated group is treated as issuing DS1 Note to FP in a distribution on Date B in Year 2. Accordingly, DS1 Note is treated as stock under §1.385-3(b)(2)(i). Under paragraph (c)(1)(ii) of this section, DS1 Note is deemed to be exchanged for stock of the issuing member, DS1, immediately after DS1 Note is transferred outside of the USS1 consolidated group. Under paragraph (c)(3) of this section, the deemed satisfaction and reissuance under §1.1502-13(g)(3)(ii) and the deemed issuance and

exchange under paragraph (c)(1)(ii) of this section, are respected as separate steps and treated as separate transactions.

(iii) Example 3: Sale of consolidated group debt instrument--(A) Facts. On Date A in Year 1, DS1 lends $200x of cash to USS1 in exchange for USS1 Note. On Date B in Year 2, USS1 distributes $200x of cash to FP. Subsequently, on Date C in Year 2, DS1 sells USS1 Note to FS for $200x.

(B) Analysis. Under paragraph (b)(1) of this section, the USS1 consolidated group is treated as one corporation for purposes of §1.385-3. Accordingly, when USS1 issues USS1 Note to DS1 for property on Date A in Year 1, the USS1 consolidated group is not treated as a funded member, and when USS1 distributes $200x to FP on Date B in Year 2, that distribution is a transaction described in §1.385-3(b)(3)(i)(A), but does not cause USS1 Note to be recharacterized under §1.385-3(b)(3). When DS1 sells USS1 Note to FS, USS1 Note is deemed satisfied and reissued under §1.1502-13(g)(3)(ii), immediately before USS1 Note ceases to be an intercompany obligation. Under paragraph (c)(1)(ii) of this section, when the USS1 Note is transferred to FS for $200x on Date C in Year 2, the USS1 consolidated group is treated as issuing USS1 Note to FS in exchange for $200x on that date. Because USS1 Note is issued by the USS1 consolidated group to FS within the per se period as defined in §1.385-3(g)(19) with respect to the distribution by the USS1 consolidated group to FP, USS1 Note is treated as funding the distribution under §1.385-3(b)(3)(iii)(A) and, accordingly, is treated as stock under §1.385-3(b)(3). Under §1.385-3(d)(1)(i) and paragraph (c)(1)(ii) of this section, USS1 Note is deemed to be exchanged for stock of the issuing member, USS1, immediately after USS1 Note is transferred outside of the USS1 consolidated group. Under paragraph (c)(3) of this section, the deemed satisfaction and reissuance under §1.1502-13(g)(3)(ii) and the deemed issuance and exchange under paragraph (c)(1)(ii) of this section are respected as separate steps and treated as separate transactions.

(iv) Example 4: Treatment of consolidated group debt instrument and departing member's regarded distribution or acquisition when the issuer of the instrument leaves the consolidated group--(A) Facts. The facts are the same as provided in paragraph (f)(1) of this section, except that USS1 and FS own 90% and 10% of the stock of DS1, respectively. On Date A in Year 1, DS1 distributes $80x of cash and newly-issued DS1 Note, which has a value of $10x, to USS1. Also on Date A in Year 1, DS1 distributes $10x of cash to FS. On Date B in Year 2, FS purchases all of USS1's stock in DS1 (90% of the stock of DS1), resulting in DS1 ceasing to be a member of the USS1 consolidated group.

(B) Analysis. Under paragraph (b)(1) of this section, the USS1 consolidated group is treated as one corporation for purposes of §1.385-3. Accordingly, DS1's distribution of $80x of cash to USS1 on Date A in Year 1 is a disregarded distribution or acquisition, and under paragraph (d)(1) of this section, continues to be a disregarded distribution or acquisition when DS1 ceases to be a member of the USS1 consolidated group. In addition, when DS1 issues DS1 Note to USS1 in a distribution on Date A in Year 1, DS1 is not treated as issuing a debt instrument to a member of DS1's expanded

group in a distribution for purposes of §1.385-3(b)(2)(i), and DS1 Note is not treated as stock under §1.385-3(b)(2)(i). DS1's issuance of DS1 Note to USS1 is also a disregarded distribution or acquisition, and under paragraph (d)(1) of this section, continues to be a disregarded distribution or acquisition when DS1 ceases to be a member of the USS1 consolidated group. The distribution of $10x cash by DS1 to FS on Date A in Year 1 is a regarded distribution or acquisition. When FS purchases 90% of the stock of DS1's from USS1 on Date B in Year 2 and DS1 ceases to be a member of the USS1 consolidated group, DS1 Note is deemed satisfied and reissued under §1.1502-13(g)(3)(ii), immediately before DS1 Note ceases to be an intercompany obligation. Under paragraph (c)(1)(i) of this section, for purposes of §1.385-3, DS1 is treated as issuing a new debt instrument to USS1 in exchange for property immediately after DS1 Note ceases to be a consolidated group debt instrument. Under paragraph (d)(4)(i) of this section, the departing member, DS1 (and not the USS1 consolidated group) is treated as having distributed $10x to FS on Date A in Year 1 (a regarded distribution or acquisition) for purposes of applying §1.385-3(b)(3) after DS1 ceases to be a member of the USS1 consolidated group. Because DS1 Note is reissued by DS1 to USS1 within the per se period (as defined in §1.385-3(g)(19)) with respect to DS1's regarded distribution to FS, DS1 Note is treated as funding the distribution under §1.385-3(b)(3)(iii)(A) and, accordingly, is treated as stock under §1.385-3(b)(3). Under §1.385-3(d)(1)(i) and paragraph (c)(1)(i) of this section, DS1 Note is immediately deemed to be exchanged for stock of DS1 on Date B in Year 2. Under paragraph (c)(3) of this section, the deemed satisfaction and reissuance under §1.1502-13(g)(3)(ii) and the deemed issuance and exchange under paragraph (c)(1)(i) of this section are respected as separate steps and treated as separate transactions. Under §1.385-3(d)(7)(i), after DS1 Note is treated as stock held by USS1, DS1 Note is not treated as stock for purposes of determining whether DS1 is a member of the USS1 consolidated group.

(v) Example 5: Treatment of consolidated group debt instrument and consolidated group's regarded distribution or acquisition--(A) Facts. On Date A in Year 1, DS1 issues DS1 Note to USS1. On Date B in Year 2, USS1 distributes $100x of cash to FP. On Date C in Year 3, USS1 sells all of its interest in DS1 to FS, resulting in DS1 ceasing to be a member of the USS1 consolidated group.

(B) Analysis. Under paragraph (b)(1) of this section, the USS1 consolidated group is treated as one corporation for purposes of §1.385-3. Accordingly, when DS1 issues DS1 Note to USS1 in a distribution on Date A in Year 1, DS1 is not treated as issuing a debt instrument to a member of DS1's expanded group in a distribution for purposes of §1.385-3(b)(2)(i), and DS1 Note is not treated as stock under §1.385-3(b)(2)(i). DS1's issuance of DS1 Note to USS1 is also a disregarded distribution or acquisition, and under paragraph (d)(1) of this section, continues to be a disregarded distribution or acquisition when DS1 ceases to be a member of the USS1 consolidated group. The distribution of $100x cash by DS1 to USS1 on Date B in Year 2 is a regarded distribution or acquisition. When FS purchases all of the stock of DS1 from USS1 on Date C in Year 3 and DS1 ceases to be a member of the USS1 consolidated group, DS1 Note is deemed satisfied and reissued under §1.1502-13(g)(3)(ii), immediately before DS1 Note ceases to be an intercompany obligation. Under

paragraph (c)(1)(i) of this section, for purposes of §1.385-3, DS1 is treated as issuing a new debt instrument to USS1 in exchange for property immediately after DS1 Note ceases to be a consolidated group debt instrument. Under paragraph (d)(4)(ii) of this section, the USS1 consolidated group (and not DS1) is treated as having distributed $100x to FP on Date B in Year 2 (a regarded distribution or acquisition) for purposes of applying §1.385-3(b)(3) after DS1 ceases to be a member of the USS1 consolidated group. Because DS1 has not engaged in a regarded distribution or acquisition that would have been treated as funded by the reissued DS1 Note, the reissued DS1 Note is not treated as stock.

(vi) Example 6: Treatment of departing member's issuance of a covered debt instrument--(A) Facts. On Date A in Year 1, FS lends $100x of cash to DS1 in exchange for DS1 Note. On Date B in Year 2, USS1 distributes $30x of cash to FP. On Date C in Year 2, USS1 sells all of its DS1 stock to FP, resulting in DS1 ceasing to be a member of the USS1 consolidated group.

(B) Analysis. Under paragraph (b)(1) of this section, the USS1 consolidated group is treated as one corporation for purposes of §1.385-3. Accordingly, on Date A in Year 1, the USS1 consolidated group is treated as issuing DS1 Note to FS, and on Date B in Year 2, the USS1 consolidated group is treated as distributing $30x of cash to FP. Because DS1 Note is issued by the USS1 consolidated group to FS within the per se period as defined in §1.385-3(g)(19) with respect to the distribution by the USS1consoldiated group of $30x cash to FP, $30x of DS1 Note is treated as funding the distribution under §1.385-3(b)(3)(iii)(A), and, accordingly, is treated as stock on Date B in Year 2 under §1.385-3(b)(3) and §1.385-3(d)(1)(ii). Under paragraph (d)(3) of this section, DS1 (and not the USS1 consolidated group) is treated as the issuer of the remaining portion of DS1 Note for purposes of applying §1.385-3(b)(3) after DS1 ceases to be a member of the USS1 consolidated group.

(g) Applicability date. This section applies to taxable years for which the U.S. Federal income tax return is due, without extensions, after **[INSERT DATE OF PUBLICATION IN FEDERAL REGISTER]**. For taxable years ending on or after January 19, 2017, and for which the U.S. Federal income tax return is due, without extensions, on or before **[INSERT DATE OF PUBLICATION IN FEDERAL REGISTER]**, see §1.385-4T, as contained in 26 CFR in part 1 in effect on April 1, 2019. In the case of a taxable year that ends after October 13, 2019, and on or before **[INSERT DATE OF PUBLICATION IN FEDERAL REGISTER]**, a taxpayer may choose to apply this section to the portion of the taxable year that occurs after the expiration of §1.385-4T on October 13, 2019, provided that all members of the taxpayer's expanded group apply this section in its entirety.

Sunita Lough

Deputy Commissioner for Services and Enforcement.

Approved: April 2, 2020

David J. Kautter

Assistant Secretary of the Treasury (Tax Policy).

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