Section 385 Regulations

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Agenda

- Background
- Overview of the Final Regulations
- Documentation Rules
- Transaction Rules
- State and Local Tax Issues
On April 4, 2016, the Treasury and IRS issued Proposed Regulations under section 385 that address the treatment of certain interests in corporations as stock or indebtedness.

The regulations proposed to:
- Allow the IRS to bifurcate debt instruments into part debt and part equity;
- Establish documentation requirements that must be satisfied in order for certain related-party debt to be respected as debt; and
- Automatically recharacterize certain related-party debt as equity.

Issued as part of inversion package intended to limit earnings stripping—but not limited to inverted companies.

Received thousands of pages of comments from practitioners, law professors, and businesses.
The Final Regulations

- Final and temporary regulations (the Final Regulations) were published in the Federal Register on October 21, 2016

- Broad exclusions from scope, including for foreign issuers and S-corps
  - Principally apply to foreign multinational corporations’ debt funding U.S. subsidiaries

- Some aspects still applicable to U.S. multinational corporations
  - Transactions with subsidiaries (upstream loans, purchase goods)
  - State and local tax
Revised Scope of the Final Regulations

US Consolidated Group

- US1
  - 100% to US2

- US2
  - 100% to US3

- US3
  - 100% to Non-US1

Expanded Group

- Non-US
  - 100% to US5

- US5
  - 60% to Non-US2
  - 40% to USP

- Non-US2
  - 100% to Non-US3

- Non-US3
  - 100% to Non-US2

- USP
  - 100% to US Consolidated Group

- US Consolidated Group
  - 100% to Expanded Group

- Expanded Group
  - 100% to US Consolidated Group

- CFC1

- USP
  - 40% to Non-US1

- Non-US1
  - 100% to US Consolidated Group

- US Consolidated Group
  - 80% to US3

- US3
  - 100% to US2

- US2
  - 100% to US1

- US1

- US5
  - 100% to USP

- USP
  - 100% to US Consolidated Group

- US Consolidated Group
  - 70% to Non-US2

- Non-US2

- Non-US2

- Non-US2

100% 100% 100% 70%
Revised Scope of the Final Regulations

**US Consolidated Group**
- US1
- US2
- US3
- US4

**Expanded Group**
- Non-US1
- Non-US2
- Non-US3
- Non-US4

100% Fully in scope
70% Fully out of scope

- **CFC Cash Pool**
- **Trade Payables**
- **§956 Loan**

Diagram arrows indicate flow and scope:
- **Red arrows** indicate fully in scope.
- **Blue arrows** indicate fully out of scope.
Structure of Final Regulations

- Reg. 1.385-1 General provisions
- Reg. 1.385-2 Documentation rules
- Reg. 1.385-3 Transaction rules
- Reg. 1.385-3T Exceptions / clarification to the Transaction rules
- Reg. 1.385-4T Consolidated groups
Overview of Final and Temporary Section 385 Regulations

- New general rule in Treas. Reg. § 1.385-1(b) that effectively implements the common law factors for classification as debt versus equity.
  - Under this rule, whether an interest is classified as debt or equity ordinarily will be determined based on common law, including the factors prescribed under common law.

- Treas. Reg. § 1.385-2 provides a minimum standard of documentation that must be met in order for an instrument to be treated as debt based on an application of the common law factors and adjusts the weighting of certain common law factors.

- Treas. Reg. § 1.385-3 elevates two particular common law factors (the lack of new investment in the operations of the issuer and relatedness) into determinative factors that, in specific situations, will result in the automatic reclassification of debt into equity.
Key Concepts

- **Covered member (CM)**
  - Domestic corporation that is a member of an expanded group

- **Expanded group (EG)**
  - One or more chains of corporations with a common parent corporation
    - Excludes S corporations (change from Proposed Regulations)
    - RICs, REITS & S corporations cannot be a common parent corporation
  - 80% vote or value (section 318 constructive ownership rules apply, with some modifications)

- **Controlled partnership (CP)**
  - A partnership in which 80% or more of the interests in partnership capital or profits are owned directly or indirectly by one or more EG members
Documentation rules

- Based on a concept of an expanded group instrument (EGI)
  - Instrument issued in debt form by a member of the EG and held by an EG member, a disregarded entity (DRE) owned by an EG member or a controlled partnership with respect to the EG
  - Excludes instruments held within a US consolidated group

- The documentation requirements only apply to certain expanded group instruments
  - Only EGIs issued by CMs or a DRE owned by a CM
  - Application to EGIs issued by other parties reserved
  - Exception for small privately held groups (assets < $100m, revenues < $50m)
Documentation rules

- For foreign-based multinationals, documentation requirements apply to:
  - Trade payables owed by U.S. group members to foreign affiliates
  - Debts between different consolidated groups

- For U.S.-based multinationals, documentation requirements apply to:
  - Trade payables owed by CM to foreign affiliates
  - Section 956 loans
Documentation - Four Key Requirements

- Obligation to Repay
- Creditor’s Rights
  - Default (acceleration), seniority / priority
  - Ability to reference governing Law
  - Market safe harbor
- Ability to Repay / Solvency
  - May prepare annual credit analysis
  - May use for multiple instruments
- On-Going Maintenance
  - Payments and non-payments of interest and principal
## Comparison of Documentation Rules

<table>
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<th>Proposed Regulations</th>
<th>Final Regulations</th>
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<td><strong>Effective date</strong></td>
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<tr>
<td><strong>Timely documentation</strong></td>
<td>Within 30 days of issuance for #1-3, within 120 days of #4 events</td>
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<td><strong>Implications of failure</strong></td>
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<td><strong>Recharacterized debt of a DRE</strong></td>
<td>Stock in the DRE – springing partnerships</td>
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The Transaction Rules

- Provides rules that automatically recharacterize Covered Debt Instruments (defined on next slide) issued by EG member as part of a transaction or series of transactions that does not result in new investment in the operations of the issuer.
  - If recast, then equity for all purposes, including withholding tax and subchapter C provisions, such as sections 305, 351, 355, and 368 (but not section 1504(a))
    - Generally contains the rules issued in Prop. Treas. Reg. §1.385-3 (with significant modifications) except for (1) expanded ordinary course exceptions (including cash pooling) and (2) treatment of disregarded entities and partnerships, both of which are located in Treas. Reg. section 1.385-3T.
The Transaction Rules

- **Covered debt instrument (CDI)**
  - Debt instrument issued by CMs or a DRE owned by a CM after April 4, 2016
  - Application to EGIs issued by other parties reserved
    - Treasury has indicated they are still studying reserved issues – impact of change in Administration?
  - Members of a U.S. consolidated group treated as one corporation

- **Generally applies to tax years ending on or after January 19, 2017**
  - Transition rules for CDIs issued between April 4, 2016 and January 19, 2017
Relevant transactions

- CDIs issued
  - In a corporate distribution
  - In exchange for stock of an affiliate
  - As boot in certain asset-reorganizations
  - In exchange for property and treated as funding one of the above-mentioned transactions (funding rule)

- Nonrebuttable presumption that a CDI funds a distribution or acquisition under the funding rule if the CDI is issued within a 72 month period beginning 36 months before the date of the distribution or acquisition
  - CDI issued outside the per se period with a principal purpose of funding a distribution or acquisition is treated as funding that distribution or acquisition
Facts

1) In Year 1, when US1 has no E&P, US1 distributes a note to FP (alternatively, US1 has E&P but FP is in a jurisdiction with a US tax treaty providing for no withholding tax on dividends).

Issues

• Absent the application of Treas. Reg. section 1.385-3, the Year 1 note distribution is not taxable (section 301(c)(3) gain, if any, is not subject to U.S. tax so long as US1 is not a USRPHC).

• Interest payments reduce the U.S. tax base and the principal can be repaid without U.S. tax.

Result under General Rule

• The note is recharacterized as equity under Treas. Reg. section 1.385-3(b)(2)(i).
Section 304 Transaction

Facts
1) US2 acquires the stock of US1 from FP in exchange for a note (assume that neither US1 nor US2 has any current or accumulated E&P).

Issues
- Absent the application of the section 385 regulations, the transaction would constitute a dividend-equivalent section 304(a)(1) transaction that may be treated as a section 301(c)(2) return of basis.

Result under General Rule
- The note is recharacterized as equity under Treas. Reg. section 1.385-3(b)(2)(ii).
- The transaction is no longer subject to section 304(a)(1) because US2 stock is not “property” under section 317(a). See also Treas. Reg. section 1.385-3(h)(3) Ex. 3.
All Boot D Reorganization

Facts
1) US1 transfers all of its assets and liabilities to US2 in exchange for a note in a transaction that qualifies as a reorganization under section 368(a)(1)(D).

2) Pursuant to the plan of reorganization, US1 distributes the note to FP in liquidation. FP has a tax basis in its US1 stock equal to fair market value.

Issues
• Absent the application of Treas. Reg. section 1.385-3(b)(2), the “dividend-within-gain” limitation of section 356(a)(2) prevents any of the note distribution from being treated as a dividend.

Result under General Rule
• The note is recharacterized as equity under Treas. Reg. section 1.385-3(b)(2)(iii).
Facts
1) In Year 1, when FS1 owns 100% of the single class of voting stock of US1, US1 issues a note to FS1 in a distribution.
2) In Year 2, USP contributes assets to US1 for use in US1’s business in exchange for stock which results in USP owning 80% of the actual vote and value of the stock of US1 (i.e., not including the note).

Conclusions
• The note is treated as equity under Treas. Reg. section 1.385-3(b)(2)(i).
• Assuming the note does not have voting power, it would presumably be treated as non-voting stock, which would cause USP’s contribution of property to fail section 368(c).
Dividends Received Deduction

**Facts**

1) USP wholly owns US1, which has significant E&P. USP and US1 are not consolidated.

2) In Year 1, US1 distributes a note to USP (the “US1 Note”).

3) US1 pays interest on the US1 Note.

**Analysis**

- The US1 Note is recharacterized as stock under Treas. Reg. section 1.385-3(b)(2)(i), and so the interest payments on the US1 Note would be characterized as dividend distributions.

- Section 246(c)(1)(A) requires a 45-day holding period of stock in order to qualify for the section 243 dividends-received deduction with respect to dividends paid on such stock.

- Section 246(c)(4) provides that the holding period is tolled for periods in which the risk of loss is diminished, and Rev. Rul. 94-28 provides that section 246(c)(4) applies to an instrument that affords the holder the rights of a creditor and is not stock for corporate law purposes but is stock for federal income tax purposes.

- Section 246(c)(4) may prevent payments of interest on the US1 Note from qualifying for the dividends-received deduction.

- This issue is less relevant under the Final Regulations due to the exclusion of foreign issuers.
Fast-Pay Stock

Facts
1) USP wholly owns US1 and CFC1; US1 wholly owns US2 and CFC1 wholly owns CFC2.
2) In Year 1, US2 purchases the stock of CFC2 from CFC1 in exchange for a note (the “US2 Note”)
3) The US2 Note has a 5-year term and is fully amortizing.

Analysis
• The US2 Note is recharacterized as stock under Treas. Reg. section 1.385-3(b)(2)(ii), and payments on the US2 Note would constitute dividends.
• Because the US2 Note is fully amortizing, the payments received are economically a return of the holder’s investment, potentially causing the US2 Note to be considered fast-pay stock under Treas. Reg. section 1.7701(l)-3.
• Treas. Reg. section 1.7701(l)-3 permits the IRS to recharacterize fast-pay stock where it determines that a principal purpose of the arrangement is the avoidance of tax.
• Can such a principal purpose be found here, given that the instrument is formally debt? The preamble to the Final Regulations notes but does not resolve the issue.
Funding rule with distribution

**Facts**

1) US3 acquires the stock of US1 from FP in exchange for $100 of cash.

2) In the same year, US3 borrows $100 from US2 in exchange for a note (the “US3 Note”).

3) Assume that neither US1 nor US2 has any current or accumulated E&P.

**Result under Funding Rule**

- The US3 Note is treated as equity in US3 pursuant to Treas. Reg. section 1.385-3(b)(3), and the transaction constitutes a dividend-equivalent section 304(a)(1) transaction.
Expanded group earnings

- **Proposed Regulations**
  - Funding rule will not apply to distributions or acquisitions to the extent of the issuer’s current year earnings & profits
    - Commentators noted several concerns with exception only covering current E&P

- **Final Regulations**
  - Aggregate distributions and acquisitions are reduced by CM’s “expanded group earnings account” which captures earnings & profits derived while the entity was a member of the EG in taxable years ending after April 6, 2016
Expanded group earnings (cont’d)

- Final Regulations implement the exception by introducing the concept of a member’s “EG earnings account”
  - The aggregate amount of a CM’s distributions or acquisitions described in the general rule or funding rule in a taxable year during an “EG period” is reduced by the member’s “EG earnings account” for the EG period
  - “EG period” is the period during which the covered member is a member of an EG with the same EG parent
  - “EG earnings account” with respect to an EG period is the CM’s EG earnings during the period minus the CM’s EG reductions during the period
  - “EG earnings” are the E&P accumulated by the CM during the EG period (but after April 4, 2016) without regard to any distributions or acquisitions by the Covered Member described in the Transaction Rules
  - “EG reductions” are the amounts by which acquisitions or distributions described in the Transaction Rules were reduced by reason of the EG earnings reduction during the portion of the EG period preceding the taxable year
Commentators to the Proposed Regulations had raised concerns regarding the sequencing rule that states that the reduction is applied to the distributions or acquisitions in the order of occurrence.

The Final Regulations provide that, to the extent an exception applies to exclude or reduce the amount of a distribution or acquisition described in the general rule, the debt instrument issued in the transaction is treated as issued by a member in exchange for property solely for purposes of applying the funding rule to the debt instrument and the member (the “funded member rule”).
Funded member rule

Facts
1) In Year 1, US1 has expanded group earnings of $50x
2) In Year 1, US1 distributes $50x cash and a note with a $50x principal amount to FP

Conclusions
• Under the funded member rule, if the general rule distribution is reduced by $50x under the expanded group earnings reduction, S is treated as having been funded by the issuance of the $50x note.
• As a result, the ordering of the distributions does not materially affect the consequences of the transactions – either (1) the funding rule distribution occurs first, the amount of the cash distribution is reduced by $50x, and the US1 note is recharacterized as stock under the general rule, or (2) the general rule distribution occurs first, the amount of the note distribution is reduced by $50x, US1 is treated as having been funded by the note, and the US1 note is recharacterized as stock under the funding rule by reason of the cash distribution.
• In either sequence of events, the US1 note is recharacterized as stock, whether by reason of the general rule or the funding rule.

Assumptions
• US1 makes no other distributions or acquisitions in Year 1
• US1 has not been funded by a debt instrument outstanding in Year 1
Qualified contribution

- Newly added to the Final Regulations
- Aggregate distributions and acquisitions are reduced by the aggregate fair market value of stock issued by a CM in a qualified contribution
- “Qualified contribution” is a contribution of certain property to a CM by a EG member
- Does not include (amongst other items) contributions of:
  - EG stock
  - Property acquired by CM in an asset reorganization
  - CDI of any EG member
  - Property from controlled subsidiaries
Qualified contribution (cont’d)

- Certain other contributions are not treated as qualified contributions:
  - A contribution from a corporation that the covered member controls (contribution by subsidiary to parent)
  - A contribution from a predecessor or successor or any corporation controlled by that predecessor or successor
  - A contribution that does not increase the fair market value of the stock of the contributee
Subsidiary stock exception

- Proposed Regulations
  - Funding rule will not apply to acquisitions that involve the transfer of property to a subsidiary in exchange for stock of that subsidiary if, for 3 years after the issuance, the transferor holds more than 50% vote and value of the subsidiary.

- Final Regulations
  - Transaction rule will not apply to acquisitions of stock of an EG member where the CM has, and does not relinquish pursuant to a plan that existed on date of acquisition, control of the seller.
    - Control equals more than 50% voting power and value
    - Rebuttable presumption where control is relinquished within 36 months
Subsidiary stock acquisition example

**Downstream contribution**

Non-US

US

Non-US2

Issuance of Note by US in exchange for cash

**US Qualifies for subsidiary stock exception**

- Proposed Regulations
- Final Regulations

**Upstream acquisition**

Non-US

US

Non-US2

US acquires stock of Non-US3 in exchange for cash

Issuance of Note by US in exchange for cash

20%

80%

Non-US3

**US Qualifies for subsidiary stock exception**

- Proposed Regulations
- Final Regulations
Qualified short-term funding debt

- Qualified short-term debt is not recharacterized under the funding rule
  - Short-term funding arrangement: issuer can claim 1 of 2 exceptions per year
    - 270 day test: generally, debt term ≤ 270 days and issuer is net borrower under all similar affiliate loans for ≤ 270 days/year
    - Specified current assets test: generally, debt up to issuer’s current assets other than cash or equivalents
  - Ordinary course loan: debt issued for acquisition of property in ordinary course of trade or business, if reasonably expected to be repaid within 120 days
  - Interest free loans: debt issued without stated interest or discount (including trade payables), where not subject to imputed interest
  - Cash pool deposits: generally, demand deposits with qualified cash pool header under cash management agreement that has principal purpose of managing cash for group
Other exceptions

- **Compensatory stock acquisitions:**
  - An acquisition of stock of an EG member is not treated as an acquisition to which the general rule or funding rule applies if such stock is delivered to individuals that are employees, directors or independent contractors in consideration for services rendered to a member of the EG (or a CP thereof).

- **Threshold exception:**
  - A debt instrument is only recharacterized under the Transaction Rule to the extent that the aggregate amount of otherwise recharacterizable indebtedness held by members of the expanded group exceeds $50 million.
    - The Final Regulations eliminate the “cliff effect” that existed in the proposed regulations, i.e. only the portion of such debt in excess of the threshold is subject to recharacterization.
State and local tax issues

- It is not clear whether the states will adopt identical or similar regulations.
- Although state taxable income is typically based on federal taxable income, the states maintain that they are not bound by IRS interpretation of the IRC, including Treasury regulations (even legislative regulations).
State and local tax issues

- The states could adopt regulations that incorporate the principles of the 385 regulations, modified to reflect differences in filing status or substantive law.
  - Example: Parent Corp. and Subsidiary Corp. file consolidated federal returns and separate state returns. They are exempt from a number of the 385 regulations’ provisions but may be made subject to comparable state rules because of their separate filing status.
  - Example: A debt issuer is a federal S corporation and, hence, is exempt from the federal rules but is a state C corporation and may be made subject to state rules.
  - Example: A state could adopt different minimum threshold rules that would pick up situations that are not subject to the federal rules.
State and local tax issues

- Corporations that are not subject to the federal documentation rules may find it prudent to comply with them because of the danger that they may be subject to similar state rules.

- This could happen if a corporation becomes taxable in a new state that has such rules by acquiring a corporation that does business in that state.
State and local tax issues

- Will the states base the application of the exception for distributions from E&P on E&P based on state tax principles?
- Treatment as stock can increase state taxes based on capital and not on net income.
Cascading Taint Under Proposed Regulations

US Parent

CFC Holdco

Cash Distribution

CFC Opco 3

Centralized Treasury Co

3-Year Revolver Note

Recast as Stock

Cash Pool Deposits Recast as Stock

CFC Opco 4

Revolver & Cash Pool Loans

CFC Opco 1

CFC Opco 2
Cascading Recharacterizations

In response to cascading consequences of recharacterization, the Final Regulations incorporate certain operating rules that avoid particular cascading and duplicative recharacterizations:

- When two or more Covered Debt Instruments may be treated as stock under the funding rule, they are tested under the per se rule based on the order they are issued, with the earliest tested first. Treas. Reg. §1.385-3(b)(3)(iii)(B).

- When a Covered Debt Instrument may be treating as funding more than one Prohibited Transaction, the Covered Debt Instrument is treated as funding Prohibited Transactions in the order in which they occur, with the earliest tested first. Treas. Reg. §1.385-3(b)(3)(iii)(C).

- When a Covered Debt Instrument is treated as stock pursuant to the funding rule, the Prohibited Transaction that is funded by such Covered Debt Instrument is not recharacterized as a result of the treatment of the Covered Debt Instrument as stock. Treas. Reg. §1.385-3(b)(3)(vi).

- Except for retesting that occurs when a Covered Debt Instrument leaves the EG (discussed below), a Prohibited Transaction that is treated as funded by a Covered Debt Instrument cannot be treated as funded by a different Covered Debt Instrument, and to the extent a Covered Debt Instrument is treated as funding one Prohibited Transaction, it cannot be treated as funding another Prohibited Transaction. Treas. Reg. §1.385-3(b)(6).
Other cascading and non-duplication rules:

- An acquisition of a Covered Debt Instrument that is treated as stock under the funding rule is not treated as an acquisition of EG Stock. Treas. Reg. §1.385-3(c)(2)(v)(A).

- A transaction described under the general rule is not also a Prohibited Transaction subject to the funding rule. Treas. Reg. §1.385-3(b)(5).

- If a transaction would constitute more than one type of Prohibited Transaction, the funded member is treated as making only a single Prohibited Transaction. Treas. Reg. §1.385-3(b)(3)(ii).
EG Stock Acquisition and Cascading Example

**Facts**

1) In Year 1, FP loans $100 to US1 for a US1 note ("US1 Note").

2) In Year 2, US1 loans $100 to US2 for a US2 note ("US2 Note").

3) In Year 3, US2 distributes $100 cash to FP.

**Analysis**

- US2’s Year 3 distribution is a Prohibited Transaction that recharacterizes US2 Note into stock.
- Because US2 Note is stock, US1 would generally be treated as acquiring EG Stock for cash in Year 2, which would be a Prohibited Transaction that recharacterizes US1 Note into stock.
- Treas. Reg. section 1.385-3(c)(v)(A) prevents this iterative result by providing that “an acquisition of a Covered Debt Instrument that is treated as stock” under the funding rule is not treated as an acquisition of EG Stock.
Cascading Taint Continues Under Final Regulations, Example 1

Facts
1) In Year 1, FP lends $100 to US1 for a US1 note ("US1 Note A").
2) In Year 1, US1 distributes $100 to FP.
3) In Year 2, US1 repays US1 Note A.
4) In Year 3, FP lends $100 to US1 for another US1 note ("US1 Note B").

Analysis
• Because the distribution of cash in step 2 is a Prohibited Transaction, US1 Note A is recharacterized as stock.
• As a result, the repayment of US1 Note A in Year 2 is a section 302(d) redemption of US1 stock treated as a distribution with respect such stock, resulting in US1 Note B being recharacterized as US1 stock.
• This iterative consequence is not prevented by any provision of the Final Regulations, and is affirmed in the Preamble: “the funding rule could be circumvented if the repayment of a note that is treated as stock were not treated as a distribution.” See Preamble at 119.
Cascading Taint Continues Under Final Regulations, Example 2

Facts
1) In Year 1, USS2 distributes $100 to FP.
2) In Year 2, USS1 lends $100 to USS2 in exchange for a note (“Note 1”).
3) Later in Year 2, USS3 lends $100 to USS2 in exchange for a note (“Note 2”).
4) In Year 3, USS2 repays Note 1.
5) In Year 4, USS2 repays Note 2.

Conclusion
• The result appears to be the same as in the prior example—the repayment of Note 1 is a Prohibited Transaction that causes Note 2 to be recharacterized.
In general, a predecessor or successor of a funded member is also subject to the funding rule as though it were the funded member.

**A predecessor is:**
- A distributor or transferor in a §381(a) transaction
- The distributing corporation in a tax-free divisive transaction described in §355

**A successor is:**
- An acquirer in a §381(a) transaction
- The controlled corporation in a tax-free divisive transaction described in §355
- The seller in an acquisition that would qualify for the subsidiary stock exception subject to certain limitations

**A corporation may have multiple predecessors or successors**
- Proposed Regulations appeared to apply the funding rule regardless of when the transaction occurred that created the predecessor / successor relationship.

- The Final Regulations limit application to events occurring in the 72 month period beginning 36 months before the relationship arose.
Partnerships

- **Documentation rule**
  - Debts issued by partnerships are generally out of scope although debt issued by a CP may be subject to the anti-abuse rule
  - Debts issued by an EG member and held by a CP of that EG are in scope

- **Transaction rule**
  - A CP is treated as an aggregate of its partners
    - Debt instruments issued by a CP are treated as issuances of debt by the CP partners
    - If members of a US consolidated tax group own 100% of a CP, debt issued by the CP to a member of the US consolidated tax group is treated as out of scope consolidated group debt as the US consolidated tax group members are treated as the issuers of the debt instrument
    - Debts held by CPs should have the same result