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ALERT MEMORANDUM

IMPLICATIONS OF FINAL SECTION 385 REGULATIONS FOR FINANCIAL INSTITUTIONS

November 10, 2016

On October 13, 2016, the Department of Treasury issued final regulations under section 385.[1] The final regulations have two key sections: the documentation rules of Treasury regulation section 1.385-2, which require the preparation and maintenance of certain documentation for related party loans, and the general and funding rules of Treasury regulation section 1.385-3, which apply mechanical rules to recharacterize certain intercompany borrowings as equity.

This memorandum discusses the impact of the final regulations on multinational financial institutions headquartered either inside or outside the United States.[2]

The final regulations substantially improve upon the proposed regulations in many respects. Several significant changes are applicable to all types of taxpayers:

- The rules now apply only to domestic corporations borrowing from (foreign or domestic) related parties that are not members of the same U.S. consolidated tax group; thus, except under anti-abuse rules, foreign debt issuers are not covered.[3]
- The final documentation rules allow taxpayers substantial time to prepare appropriate documentation, and do not apply at all to instruments issued before 2018 (unless they are materially modified thereafter).
- The final regulations do not contain the "bifurcation" rule (permitting an instrument to be treated as in part stock and in part debt) that was part of the proposed regulations.

If you have any questions, please feel free to contact any of your regular contacts at the firm. You may also contact our U.S. partners and counsel listed under "Tax" located in the "Practices" section of our website.

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1 Unless otherwise indicated, all section references herein are to the Internal Revenue Code of 1986, or to the Treasury regulations thereunder.

2 Special rules applicable to insurance companies are not addressed here.

3 Although the final regulation leave a placeholder for foreign issuers, Treasury officials have indicated informally that any changes expanding the reach of the rules to foreign issuers would be prospective only (and that step likely will not be seriously considered for some time, if ever).

Two special rules apply to regulated financial companies:

- With limited exceptions, regulated financial companies are exempted from the general and funding rules under Treasury regulation section 1.385-3.
- Regulatory capital securities are generally exempt from the documentation rule.

The final regulations are not perfect, however. Numerous issues remain, most significantly:

- The regulated financial entity exception to the general and funding rules applies only to U.S. corporations that are subject to specific non-tax regulatory regimes. Due to the technical implementation of this exception, unregulated U.S. subsidiaries of non-U.S. financial institutions – such as leasing or other finance companies – that are not held under a regulated U.S. intermediate holding company ("IHC") treated as a corporation for U.S. tax purposes, or under a U.S. chartered bank, bank holding company or similar financial institution subject to consolidated supervision, will generally be subject to the general and funding rules.
- Aside from special rules for regulatory capital securities, there are no general exemptions to the documentation rule for debt of regulated entities. Thus, the Treasury Department did not accept the argument that regulated entities should not be required to demonstrate an ability to pay related party debt.
- The documentation rules apply broadly to short-term debt and trade receivables. There are no exceptions for short-term debt, deposits or other debt incurred in the ordinary course of business (although exceptions exist under the general and funding rules).
- The precise contours of the documentation rule safe harbor for regulatory capital securities are unclear, and need to be clarified.

I. Background: The Stakes for Financial Institutions

Due to the nature of their business and the extensive non-tax regulation to which they are subject, financial institutions are disproportionately harmed by tax rules that increase the cost of intercompany funding arrangements or create uncertainty as to the tax characterization of intercompany debt. Financial institutions function as intermediaries between those in need of funds and those with excess funds, and thus for these institutions, money is their inventory, and interest is akin to cost of goods sold. Due to commercial and legal imperatives, large financial institutions fund themselves with significant amounts of intercompany debt. Treating even a portion of such intercompany debt as equity would overstate a financial group's taxable income by denying interest deductions to borrowers engaged in integral business activities and treating as taxable dividend income a lender's receipt of principal repayments which do not give rise to economic gain.

Thus, financial institutions were understandably alarmed by the issuance of the proposed regulations under section 385. If finalized in their proposed form, those regulations would have adversely affected the tax treatment of financial institutions' day-to-day operations in servicing customers, subjected them to significant new tax costs, and imposed unadministrable and burdensome compliance obligations. The final regulations fix many of the most serious problems posed by the proposed regulations, but nevertheless are likely to impose significant compliance costs on financial institutions. Further, as noted above, the final regulations generally provide no relief from the general and funding rule for unregulated U.S. subsidiaries of foreign banking organizations ("FBOs") that are not held under a U.S. corporate IHC, U.S. bank, U.S. bank holding company or similar financial institution subject to consolidated supervision.

II. The Documentation Rules (Treasury Regulation Section 1.385-2)

The documentation rules require members of an "expanded group" ("EG")[4] to prepare and maintain certain documentation for "expanded group interests" ("EGIs"), meaning debt between members of the group with some exceptions. In principle, these rules apply in the same manner to financial institutions regardless of whether they are headquartered inside or outside the United States. However, as discussed in more detail below, in practice the rules likely create more compliance obstacles for non-U.S. headquartered financial institutions. For a more detailed discussion of the documentation rules, please refer to our alert memo dated October 21, 2016 entitled "Documentation Rules Round 2—A Taxpayer Project for 2016 Not 2018".[5]

A. Description of the Final Rule.

The documentation rules impose two broad sets of requirements on intercompany borrowings. The first set relate to the manner in which an EGI is documented: the legal documents establishing the EGI must (i) include an unconditional promise to pay by the borrower and (ii) provide creditor rights to the lender ("contractual requirements").[6] The second set of requirements impose obligations on related lenders: they must (i) carry out a credit analysis of the borrower and (ii) demonstrate that they have reasonably exercised creditor rights if there is a nonpayment or event of default on the EGI ("lender requirements").[7] Failure to comply with these rules will cause an EGI to be treated as equity for U.S. federal income tax purposes, subject to the exception described below. These rules apply only to borrowings documented in the legal form of debt, including deposits and service payables, but not to other types of agreements such as repos or loans embedded in swaps or forward contracts.[8]

The documentation rules do not provide a general exception for debt incurred by a regulated financial institution and its affiliates, or for ordinary course transactions. However, the final rules have been substantially narrowed relative to the proposed regulations:

U.S. issuers only

- The rules do not apply to foreign-to-foreign loans (loans between two foreign entities), or to any other borrowing by a foreign issuer.[9]
- The rules also do not apply to borrowings by a U.S. branch of a foreign bank or other corporation.
- Debt instruments between members of a U.S. consolidated tax group remain outside the scope of the rules.[10] For many taxpayers, this means that loans between U.S. affiliates will not be subject to documentation requirements.

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4 "Expanded group" is defined in general as one or more chains of corporations with a common parent that are connected by 80% direct or indirect ownership, including through a partnership, measured by vote or value. Related foreign corporations are included in this definition. Treasury regulations section 1.385-1(c)(4).

5 Our earlier alert memo is available at https://www.clearygottlieb.com/~/media/cgsh/files/alert-memos/alert-memo-201698.pdf.

6 Treasury regulations sections 1.385-2(c)(2)(i) and (ii).

7 Treasury regulations sections 1.385-2(c)(2)(iii) and (iv).

8 Treasury regulations section 1.385-2(d)(2).

9 Treasury regulations section 1.385-1(c)(2).

10 Treasury regulations section 1.385-2(d)(2)(ii)(A).

- The rules *do* apply to loans from a U.S. branch of a foreign financial institution to a domestic affiliate.
- Loans from partnerships that are 80% or more owned by EG members are covered even if the partners and borrower belong to the same consolidated group; however, debt issued by such a partnership (or any other partnership) is not subject to the documentation rules unless issued with a principal purpose of avoiding the rules.[11]

Extended compliance period

- The deadline for preparing documentation for the contractual and lender requirements applicable to a particular tax year has been extended to the date on which the borrower's tax return for that year is due (including extensions).[12] This generally means September 15 for a calendar year taxpayer.
- The documentation rules will apply to interests issued on or after January 1, 2018 (rather than 2017).[13] In practice, this effective date, taken together with the extended preparation deadline, means that the first compliance date under the regulations for many taxpayers will be September 2019.[14]

Ability to rebut or cure

- If the EG (the entire group, not borrower by borrower) has a high percentage of EGIs that are compliant with the documentation rules (as shown by meeting mechanical 90% (or 95%) tests), the characterization of a noncompliant EGI as equity is a presumption, not a *per se* rule, and may be rebutted on common law grounds.[15] Demonstrating compliance with this test may require information that most corporate groups do not now maintain.[16]
- Ministerial noncompliance may be cured without penalty prior to discovery by the IRS.[17]

Other helpful rules

- A single credit analysis may be prepared on an annual basis for a borrower that has multiple EGIs.[18] However, this analysis must be refreshed as of the date of a "material event."[19]

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11 Treasury regulations sections 1.385-2(d)(3) and 1.385-2(f) and the Preamble.

12 Treasury regulations section 1.385-2(c)(4)(i).

13 Treasury regulations section 1.385-2(d)(2)(iii).

14 As discussed in our alert memo dated October 20, 2016, the documentation rules do not replace common law debt-equity principles, which would often require a taxpayer to show that it wished to establish a debtor-creditor relationship effective as of the date when money is advanced.

15 Treasury regulations section 1.385-2(b)(2)(i).

16 For a discussion, see our alert memo dated October 20, 2016.

17 Treasury regulations section 1.385-2(b)(2)(iii).

18 Treasury regulations section 1.385-2(c)(2)(iii)(B)(1).

19 Treasury regulations section 1.385-2(c)(2)(iii)(B)(2). A "material event" includes, among other things, (1) the issuer entering into bankruptcy proceedings or becoming insolvent, (2) a disposition of 50 percent or more of the total fair market value of the issuer's "included assets," (3) the issuer changing its line of business or (4) a merger involving the issuer where the surviving entity does not assume liability for any of the issuer's outstanding EGIs. Treasury regulation section 1.385-2(d)(5).

- Market standard documentation that is customarily used in comparable third-party transactions is sufficient to satisfy the contractual requirements.[20] This may, for example, eliminate the need to prepare special documentation for deposits from foreign affiliates with a U.S. bank affiliate.

- Payments of principal and interest may be documented with records of netted payments between issuer and holder, or payments of interest, evidenced by journal entries in a centralized accounting system.[21]

Hybrid instruments

- The regulations have a curious rule that appears to require U.S. taxpayers to treat as debt for U.S. federal income tax purposes (subject to challenge by the IRS) any EGI that is either in the legal form of debt or that is treated as debt for financial accounting purposes.[22] Groups that have EGIs that are in the form of or accounted for as debt but are expected to be stock for tax purposes should consider the effect of this rule.[23]

B. Practical Implications.

- *Largest impact on inbound group funding arrangements.* The exception for loans between members of a U.S. consolidated tax group, together with the exclusion of foreign borrowers, means that domestic group funding arrangements (*i.e.*, U.S. lender, U.S. borrower) and outbound group funding arrangements (*i.e.*, U.S. lender, non-U.S. borrower) are generally not subject to the documentation rule. However, inbound group funding arrangements (*i.e.*, non-U.S. lender, U.S. borrower) must comply with the documentation rules (as must loans between U.S. affiliates that are not members of the same U.S. consolidated tax group).

- *FBOs will be impacted disproportionately.* Banking organizations headquartered outside the United States are more likely to raise external funds in non-U.S. jurisdictions, which must then be on-lent to U.S. affiliates by means of inbound loans that are subject to the documentation rule. U.S. headquartered banks, by contrast, are likely to raise external funds in the U.S. and on-lend through domestic or outbound loans.[24]

- *Service payables*. Financial groups headquartered outside the United States often centralize back office functions in their home jurisdiction. If an internal service provider located outside the United States renders services to a U.S. affiliate, the resulting payable is subject to documentation. The same fact pattern may apply to U.S. groups with inbound service arrangements. In each case, groups should consider documenting related party service payables in the same manner as third party service payables so as to qualify for the safe harbor for third party documentation.

- *Intercompany bank deposits and repos are subject to a lower compliance burden than intercompany loans.* The safe harbor for third party documentation lowers the compliance burden for intragroup bank deposits relative to intragroup loans. Because standard bank deposit agreements generally do not contain substantial events of default or financial covenant provisions, it will be easier for related parties to use substantially similar documentation for intercompany deposits. Third party loan documentation, by contrast, includes numerous

20 Treasury regulations section 1.385-2(c)(1)(ii).

21 Treasury regulations section 1.385-2(c)(2)(iv)(A).

22 Treasury regulations section 1.385-2(a)(5)(i).

23 This rule is discussed in our alert memo dated October 20, 2016.

24 Potential deemed dividends under section 956 also reduce the likelihood that a U.S. financial institution will fund domestic operations with inbound loans from non-U.S. affiliates.

terms that are irrelevant or impractical for related party borrowers. Intragroup repo agreements and derivative contracts are entirely exempted from the documentation rules.

- *Ordinary course business activities may trigger additional documentation requirements.* As discussed above, an issuer's ability to pay multiple EGIs may be documented with an annual credit analysis. However, the annual report must be updated as of the date of a "material event", which is defined to include (among other things) a disposition of 50 percent or more of the total fair market value of the issuer's "included assets".[25] Helpfully, "inventory sold in the ordinary course of business" and "investment assets such as portfolio stock investments to the extent that other investment assets or cash of equivalent value is substituted" are not "included assets".[26] Nevertheless, the term is still defined broadly enough that ordinary course business activities may cause material events for certain financial issuers. For instance, a finance company that makes loans may undergo a material event if more than 50 percent of the loans are repaid in a year. The loans would not be inventory and likely also would not be investment assets. Similarly, a derivatives dealer that terminates more than 50 percent of its derivatives contracts annually in the ordinary course of business may undergo a material event, as those contracts would not be inventory or investment assets.
- *Hybrid instruments apparently will be treated as debt.* As noted above, an ECI must be treated as debt for all federal tax purposes if it is in the legal form of debt.[27] This rule would appear to deny hybrid treatment for instruments issued by U.S. companies that are held by foreign or deconsolidated affiliates (including, *e.g.*, equity-linked notes treated as forward contracts for U.S. tax purposes).

III. The General and Funding Rules (Treasury Regulation Section 1.385-3)

The fundamental mechanics of the general and funding rules in the final regulations are substantially similar to those in the proposed regulations. The "general" rule treats a "covered debt instrument"[28] as equity if it is issued by a "covered member" (a U.S. corporation) in a distribution to an EG member, or in exchange for EG stock or for property in an asset reorganization, subject to various exceptions (each such exchange, an "acquisition transaction").[29] The "funding" rule expands the scope of the general rule, notably by treating a covered debt instrument as equity if it is issued by a "funded member" (that is, a borrower) within 36 months before or after such a distribution from or acquisition by the funded member, including distributions to or acquisition transactions with affiliates that were not the lender under the debt instrument.[30] As discussed below, the final regulations have a number of exceptions to the general and funding rules that ease day-to-day operations for financial institutions. However, they do not relax the automatic nature of this *per se* funding rule.

25 Treasury regulations section 1.385-2(d)(5).

26 Treasury regulations section 1.385-2(d)(6).

27 Treasury regulations section 1.385-2(a)(5)(i).

28 A "covered debt instrument" is defined as a debt instrument issued by a covered member after April 4, 2016, subject to various exceptions (such as the regulated financial company exception and the securities dealer exception discussed below). Treasury regulations section 1.385-3(g)(3).

29 Treasury regulations section 1.385-3(b)(2). Members of a U.S. consolidated tax group generally are treated as one corporation for purposes of the funding and documentation rules. Treasury regulations section 1.385-4T(b)(1).

30 Treasury regulations section 1.385-3(b)(3).

A. Key Exceptions.

1. Regulated financial company exception.

The most significant change for financial institutions is a broad exception to the general and funding rules for debt issued by an "excepted regulated financial company," meaning a U.S. corporation that is a "regulated financial company" or a member of a "regulated financial group."[31] The overwhelming majority of domestic entities owned by a U.S. headquartered financial institution will likely qualify for this exception, and thus not be subject to the general or funding rules. However, the rule is much less favorable to financial institutions headquartered outside the United States that do not have a U.S. corporate IHC, as these institutions may find that the general and funding rules apply to a significant number of their U.S. subsidiaries.

The definition of "regulated financial company" means any of a list of U.S. regulated financial institutions set forth in the regulations.[32] The listed institutions fall into two groups: (i) financial institutions generally subject to consolidated supervision, including U.S. thrift or bank holding companies ("BHCs"); most U.S. banks and thrifts; corporate IHCs; non-bank companies designated as systemically important by the Financial Stability Oversight Council; Edge Act and agreement corporations; and Federal Reserve Board-supervised securities holding companies (each, a "regulated group company"); and (ii) certain other financial entities generally regulated on a standalone basis, such as a registered broker-dealer, FCM, swap dealer or securities-based swap dealer, among others (each, a "regulated standalone company").

U.S. corporations that are not regulated financial companies may still be excluded from the general and funding rule if they are a member of a "regulated financial group." Here, the distinction between regulated group companies and regulated standalone companies is crucial. "Regulated financial group" is defined to mean an expanded group that has a U.S. corporation that is a *regulated group company* as its parent, determined by assuming that it is not owned by any other entity.[33] As a result, subsidiaries of regulated group companies generally will not be subject to the general and funding rules. By contrast, a regulated standalone company, such as a U.S. company that is a registered broker dealer or swap dealer, cannot qualify as the parent of a regulated financial group, and subsidiaries of regulated standalone companies therefore will be subject to the general and funding rules.

In addition, for BHCs that are treated as financial holding companies ("FHCs") under the Bank Holding Company Act of 1956 (the "BHC Act"), subsidiaries held pursuant to certain non-financial activity authorities under the BHC Act ("non-financial entities") cannot be members of regulated financial groups, and thus will be subject to the general and funding rules.[34] Non-financial entities primarily consist of companies engaged in certain physical commodities activities[35] and merchant banking portfolio companies.[36]

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31 Treasury regulations section 1.385-3(g)(3)(iv). Foreign entities are already excluded as they are not covered members.

32 Treasury regulations section 1.385-3(g)(3)(iv)(A).

33 Treasury regulations section 1.385-3(g)(3)(iv)(B)(1).

34 Treasury regulations section 1.385-3(g)(3)(iv)(B)(2). This section cites three provisions of the BHC Act: (1) the "complementary activities" authority under 12 U.S.C. 1843(k)(1)(B); (2) the "merchant banking" authority under 12 U.S.C. 1843(k)(4)(H); and (3) the grandfathering authority under 12 U.S.C. 1843(o) (authorizing FHCs that first became BHCs post-1999 to continue to engage in certain existing physical commodities activities).

35 Under the "complementary activities" authority described in 12 U.S.C. 1843(k)(1)(B), an FHC may seek an order from the Federal Reserve Board permitting the FHC to engage in an activity, or invest in a company engaged in an

2. Other exceptions.

For entities subject to the general and funding rules, several other exceptions provide increased flexibility for ordinary course distributions and short-term loans, including:

- *Earnings and profits basket*. The funding and general rules generally do not apply to the extent that a distribution or acquisition does not exceed a covered member's earnings and profits accumulated in taxable years ending after April 4, 2016[37] and while the covered member belonged to an expanded group with the same parent.[38] This significantly expands the proposed regulation's exception for earnings and profits. On the other hand, distributions of historic (pre-2016) earnings would not qualify for this exception.
- *Netting contributions*. After applying the earnings and profit exception discussed above, distributions or acquisitions potentially subject to the general and funding rules are reduced by the amount of any capital contribution (other than contributions of intracompany debt, expanded group stock and other excluded property) made within 36 months before or after the distribution or acquisition, while the covered member belonged to the same expanded group, but not after the year in which the debt instrument would otherwise be recharacterized under these rules.[39]
- *Short-term loans*. Certain short-term funding arrangements, ordinary course trade payables and cash pooling arrangements are excluded from the rules, subject to detailed technical requirements.[40]
- *Securities dealers*. The acquisition of expanded group stock by a dealer in securities and held for sale to (unrelated) customers in the ordinary course of business generally will not be subject to the general and funding rules.[41]

B. Practical Implications.

- *FBOs without a U.S. corporate IHC or BHC will generally be subject to the general and funding rules.* For FBOs that do not have a U.S. IHC or BHC – for example, an FBO with a U.S. branch, no U.S. bank subsidiary and less than $50 billion of non-branch U.S. assets – or that have a U.S. IHC that is not a corporation (for example, a Delaware LLC that has not "checked the box" to be treated as a corporation) for U.S. federal income tax purposes, the exception will apply to members of the U.S. group that are themselves regulated financial companies, but not to certain other affiliates. Because only certain regulated entities, such as IHCs,

activity, that the Federal Reserve Board determines to be "complementary to a financial activity." The Federal Reserve Board has granted complementary authority to a limited number of FHCs with respect to certain physical commodities activities, such as trading physical commodities in the spot market or making physical delivery of such commodities in connection with settlement of commodity derivatives; certain energy management and tolling activities; and certain disease management and mail-order pharmacy services.

36 Under the "merchant banking" authority described in 12 U.S.C. 1843(k)(4)(H), FHCs may invest in companies engaged in non-financial or mixed financial/non-financial activities. However, among other restrictions, the FHC generally may not engage in day-to-day management of such companies, and must dispose of its investment in the company within a limited period of time (generally, 10 years).

37 Thus for a calendar year taxpayer, January to April earnings for 2016 are within the exception.

38 Treasury regulations section 1.385-3(c)(3)(i).

39 Treasury regulations section 1.385-3(c)(3)(ii).

40 Treasury regulations section 1.385-3T(b)(3)(vii).

41 Treasury regulations section 1.385-3(c)(2)(iv).

BHCs or chartered banks (referred to as "regulated group companies" above), qualify as the parent of a regulated financial group, U.S. affiliates not held underneath such entities will be subject to the general and funding rules unless they are themselves regulated financial companies. For example, debt issued by a U.S. holding company that is not an IHC to a foreign affiliate is not covered by the regulated financial group exception, because the holding company is not owned directly or indirectly by a regulated financial company *that is a covered member* (*i.e.*, a U.S. corporation). Debt issued by such a U.S. holding company or an unregulated subsidiary of such a holding company (including, *e.g.*, an unregulated subsidiary of a securities dealer) therefore is subject to the general and funding rules, unless another exception applies. The impact of this rule may be particularly harsh for leasing and other finance companies that are not owned by a U.S. regulated group company, and may necessitate a restructuring of their funding arrangements.

- *U.S. headquartered financial institutions and FBOs with U.S. IHCs are largely exempt from the rules.* For U.S. groups whose parent is a regulated group company, such as a BHC or corporate IHC, the entire group will qualify as a regulated financial group, and therefore will generally be excluded from the general and funding rules. However, consideration should be given to whether the group contains non-financial entities that do not qualify for the regulated financial group exception and rely on funding from affiliates that are foreign or are not within the same U.S. consolidated tax group.

IV. The Treatment of Regulatory Capital Securities

Certain banking organizations are required by their regulators to issue debt ("regulatory securities") with equity-like features. In particular, the foreign operations of a global systematically important bank ("GSIB") must issue total loss absorbing capital ("TLAC") equity and debt securities to its parent entity to ensure they can be recapitalized outside of resolution proceedings. Under standards proposed by the Financial Stability Board ("FSB"), such internal TLAC debt securities ("internal TLAC") must include contractual provisions allowing for write-down or conversion to equity when the issuer is in severe financial distress. In implementing the FSB's standard, the Federal Reserve Board's proposed TLAC rules would require certain IHCs (*i.e.*, those controlled by an FBO that has been designated as a GSIB by the FSB) to issue internal TLAC securities to its foreign parent, a certain amount of which must take the form of deeply subordinated long-term debt ("LTD") subject to write-down or conversion as described above.

Internal TLAC LTD securities raise issues under both common law debt-equity principles and the regulations under section 385. As discussed below, the final regulations contain broad carve-outs for regulatory securities, which are generally consistent with the treatment of TLAC LTD as debt for U.S. tax purposes, although certain aspects of the rules are unclear. Questions remain as to the tax treatment of TLAC LTD under common law principles, but we expect that additional guidance will be issued on this subject in conjunction with the issuance of final internal TLAC LTD rules by the Federal Reserve Board.

A. The Documentation Rules.

The final documentation rules generally provide that an EGI that is issued by an excepted regulated financial company, as defined above, is treated as meeting the contractual and lender requirements if it contains terms required by a regulator of that company to satisfy regulatory capital or similar rules that govern resolution or orderly liquidation of that company.[42] The EGI must be expected at issuance to be paid in accordance with its terms, and the issuer must prepare documentation establishing that the EGI qualifies for the exception.

This exception is broad insofar as it applies without regard to what the terms required by regulators may be. Its scope, however, is somewhat unclear. On the one hand, the exception applies to EGIs issued by any "excepted regulated financial company," which is defined to include members of regulated financial groups that are not themselves subject to directly regulatory supervision. On the other hand, the exception applies only to EGIs containing terms "required by a regulator of *that* company," which could be read to limit its application to directly regulated companies. The precise scope of the exception will require further consideration, for example in a case where there is a chain of identical or similar debt instruments with terms required by a regulator running from a U.S. regulated subsidiary to a foreign regulated affiliate but where intermediate companies in the chain are not directly subject to regulation.

B. The General and Funding Rules.

The general and funding rules do not include special rules for regulatory securities. As a general matter, special rules of that kind are not needed, in light of the broad exception described earlier for debt issued by excepted regulated financial companies.

As described earlier, that exception does not cover some U.S. subsidiaries of some FBOs. This is generally not a concern under the Federal Reserve's current internal TLAC LTD proposal. Those rules would apply only to FBOs that both (i) are classified as GSIBs by the FSB and (ii) have a U.S. IHC. If the U.S. IHC is treated as a corporation for tax purposes, it is necessarily a regulated financial entity exempted from the general and funding rules. If the U.S. IHC were disregarded for U.S. tax purposes, EGIs between the IHC and its foreign owner would also be disregarded, and EGIs between the IHC and other foreign affiliates would be treated as issued by the IHC's foreign owner, and therefore not within the scope of the rules.

The Federal Reserve Board has indicated that it is considering requiring the entities subject to its TLAC rules to issue "domestic internal TLAC" – that is, TLAC debt and equity securities issued by U.S. subsidiaries to the U.S. parent. In the case of U.S. GSIBs, this would mean issuing such internal TLAC securities to the top-most bank holding company parent; in the case of FBOs, this would mean issuing such internal TLAC securities to the IHC. Non-U.S. financial groups with a non-corporate U.S. IHC could be subject to both the documentation and the general and funding rule in respect of such securities if issued by a U.S. subsidiary that is not itself a regulated financial entity. It is not clear that Treasury fully appreciated this point in drafting the final regulations, and we hope that additional guidance would be forthcoming if domestic internal TLAC rules are proposed.

C. Common Law Debt-Equity Analysis.

The final regulations do not include a rule mandating debt characterization for regulatory securities. It will be necessary, therefore, to continue to apply common law principles to determine the debt / equity status of regulatory securities. The Preamble to the final regulations acknowledges that regulatory securities may contain terms that could impair their characterization as debt, specifically mentioning internal TLAC LTD required under

[42] Treasury regulations section 1.385-2(c)(1)(iii).

regulations proposed by the Federal Reserve Board as an example of such a security. The Preamble also states that the IRS and Treasury are considering additional guidance to address such instruments. We anticipate that additional guidance of this kind will be issued with respect to internal TLAC LTD issued by U.S. IHCs to a foreign parent, once the Federal Reserve Board issues final internal TLAC LTD rules.[43]

In the event that bank regulators develop new forms of regulatory securities required to be issued by U.S. subsidiaries of FBOs, a separate common law analysis would be required.

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If you have any questions, please feel free to contact any of your regular contacts at the firm. You may also contact our U.S. partners and counsel listed under "Tax" located in the "Practices" section of our website.

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[43] A borrowing by a foreign subsidiary from a U.S. affiliate under an instrument with similar terms required by non-U.S. bank regulators is outside the scope of the final section 385 regulations because the borrower is foreign. However, that instrument will still need to be evaluated under common law principles.