ALERT MEMORANDUM

Documentation Rules Round 2—A Taxpayer Project for 2016 Not 2018

October 21, 2016

The final and temporary section 385 regulations released on October 13 are immeasurably better than the version floated in April, at least from the perspective of U.S. based multinationals and regulated financial groups. Foreign parented groups outside of the financial sector, which have now been singled out as the main target, may not share with their domestic counterparts the sense of relief.

Despite the substantial improvements for many taxpayers, there are still respects in which the regulations would benefit from fine-tuning, at the least in clarifying what was meant or in making the rules more workable. This memorandum addresses changes that have been made, and the need for further refinements, in one part of the regulations, which is the documentation rules in section 1.385-2 (sometime "-2").

The revised -2 rules are narrower in scope, and better in other ways, than the April version. Some of the main improvements are that (1) the debt instruments and other interests subject to the rules (which can be called "covered interests") are now limited to those issued by domestic corporations—so debt of foreign and partnership issuers is generally out;[1] (2) the over-the-cliff rule automatically treating as stock any interest that

1 Under sections 1.385-2(a)(3) and -2(b)(1), the documentation rules apply to an "expanded group interest" (EGI) issued by a "covered member" (which is domestic corporation) or a disregarded entity owned by a covered member. The word "interest" has replaced the April term "instrument" presumably to reflect the inclusion in the definition of EGI of trade payables and receivables not evidenced by an instrument. There is also a requirement (carried over from April) that the expanded group include a public company or meet minimum asset or revenue thresholds. An EGI, as defined in section 1.385-2(d)(3), is an applicable interest issued by an expanded group member to another member (in either case, directly or through a disregarded entity). An expanded group, as defined in section 1.385-1(c)(4), is a group of corporations connected through direct or indirect 80 percent or greater ownership links by vote or value, and excluding S corporations and in some cases REITs and RICs. The definition of EGI also includes loans to an expanded group member from a controlled partnership (one 80 percent or more owned by profits or capital by expanded group members). Controlled partnerships as borrowers are not covered except under an anti-abuse rule. The definition of "applicable interest" in section 1.385-2(d)(2) covers both debt evidenced by a debt instrument and a broad range of trade payables and receivables.

is not fully compliant (or stated differently, is "undocumented")[2] has been replaced with a rebuttable presumption in the case of taxpayers that are "highly compliant" (meaning generally fully compliant with respect to 90 percent of the expanded group's covered interests), [3] and (3) compliance deadlines have been relaxed. There is also greater clarity about what documentation is required for debt issued under master agreements. Another little plus is the acknowledgment that a borrower may meet the requirement that it reasonably expects to repay its debt by showing it could refinance,[4] and that payments on a covered interest supporting debt treatment may be reflected only in journal entries or made through netting.[5]

The definition is quoted in paragraph 8 of the comments below. There are some exceptions from the definition of applicable interest, including most significantly for interests issued by one member of a consolidated group and held by another member (directly or through a disregarded entity).

2 Section 1.385-2(b)(3) treats an EGI as undocumented if documentation has not been timely prepared and maintained in any of the four areas covered by -2, which are unconditional obligation to pay, creditor's rights, reasonable expectation to pay, and ongoing actions evidencing a debtor-creditor relationship.

3 See section 1.385-2(b)(2)(i)(B). A taxpayer meets the highly compliant test if its expanded group has a high percentage of EGIs compliant with paragraph (c). The regulations state that a group will meet this test for a calendar year if, as of the end of each calendar quarter during the year (so on four dates), less than 10 percent by outstanding balance of covered interests are undocumented, or alternatively, if each covered interest that is undocumented has an issue price no greater than $100 million (or under a second test $25 million), the average number of undocumented covered interests as of the end of each such calendar quarter is less than 5 percent (10 percent) of the average total number of outstanding covered interests as of the end of each such calendar quarter (presumably the average is taken for all four quarters). It is not entirely clear from the text of the regulations whether the 90 percent test is a safe harbor or the only way of showing that a high percentage of EGIs are compliant, although the preamble at page 57 supports the second reading (and thus reads "if" to mean "if and only if"). Section 1.385-2(b)(2)(i)(B)(5) makes it clear that only covered interests are taken into account in the 90 percent calculation (not all intercompany obligations).

4 Section 1.385-2(c)(2)(iii)(E): "[Documentation of the ability to pay] may assume that the principal amount of an EGI may be satisfied with the proceeds of another borrowing by the issuer, provided that such assumption is reasonable." The regulation does not rule out refinancing from a related lender.

5 Section 1.385-2(c)(2)(iv): "Such evidence [of payment] could include, for example, a wire transfer record or a bank statement. Such evidence could also include a netting of payables or receivables between the issuer and holder, or payments of interest, evidenced by journal entries in a centralized cash management system or in the accounting system of the expanded group (or a subset of the members of the expanded group) reflecting the payment." The reference to "payments of interest" is a little unclear. Does the sentence refer to the netting of receivable or interest payments, which netting is evidenced by journal entries, or is it referring to interest payments that are evidenced by journal entries? Hopefully, the intent was to allow netting, and the use of journal entries to record payments, regardless of the type of obligations or payments involved.

Regarding compliance deadlines, documents for events occurring during a taxable year are required only by the date of filing of the tax return for that year (with extensions), and not within 30 or 120 days after the event as before. Further, the rules will be effective only for covered interests issued on or after January 1, 2018, rather than after the date of issuance of final regulations.[6] Thus, for calendar year taxpayers, the first deadline for preparing documentation will be September 15, 2019.

In one important respect, the rules have become worse. The definition of covered interest now includes explicitly a wide range of trade payables and accounts without *de minimis* exceptions.[7] There is no exception for short-term debt as there is in section 1.385-3. This is an odd policy choice, particularly given the small amounts of interest expense likely to be involved. Also, the drafters did not relax the quite onerous requirements to document responses to defaults or to retest the issuer's creditworthiness when debt is modified, which are clear departures from prior law.

One other significant concern with the regulations is that the types of required documentation are the same for all types and sizes of covered interests (now including trade payable and receivables), and this requirement will have some teeth in light of the new -2 cascading rule discussed below. Applying common law standards, taxpayers (and the IRS) quite sensibly now pay more attention to the documentation for loans that are significant and tax sensitive than for those that are not. There are no comparable rules drawing lines among different categories of covered interests in applying -2.[8]

Perhaps the most important observations to be made at this early stage are that (1) the documentation rules, while better, need work, and (2) with a view to surfacing issues in time for them to be brought to the attention of the IRS and Treasury and potentially be fixed by the end of 2017, taxpayers would be well advised in the coming months to look at the regulations carefully (the text, not summaries) having their particular circumstances in mind.

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6 The January 1, 2018 date is part of the definition of applicable interest in section 1.385-2(d)(2)(iii).

7 See the comment in paragraph 8 below, which addresses some ambiguities in the definition of applicable interest. The preamble at page 58 expressly rejects requests for a *de minimis* rule on the grounds that it is not needed in light of the rebuttable presumption and would open the door to abuse.

8 The various rules of leniency that forgive failures of a taxpayer to prepare documentation still require that it be prepared once the failing is identified even if the amounts involved are minor.

To get the ball rolling, this article lists in the last section below ten uncertain or quirky features of the -2 regulations that are noteworthy and in some cases call out for clarification or change.

Before turning to the list, the next two sections discuss who should care about -2 (it may not always be obvious) and the risk that the -2 rules could lead to undesirable delays in documenting transactions compared with current practice.

Who Should Care?

Given the definition of covered interest,[9] the documentation rules obviously will be of greatest interest to an expanded group in which domestic corporations issue debt to (or otherwise transact with in ways that generate payables to) group members not in the same consolidated group. The lenders/receivable holders could be domestic separate filers, or foreign affiliates, either parents or subsidiaries. Affected taxpayers *do* include regulated financial entities and groups, which got a pass from the general and funding rules in section 1.385-3.[10]

For U.S. headed nonfinancial groups with low-tax foreign earnings, upstream loans from foreign subsidiaries may be relatively rare. Such a loan can give rise to deemed dividends under the rules in section 956 for investments in United States property. There are exceptions for bank deposits and some ordinary course transactions. While levels of optimism about the prospects for legislation vary, it is worth keeping in mind that most recent international tax reform proposals would eliminate the tax restrictions on upstream loans from CFCs, which could make them a more significant category of covered interests.

In coming to terms with -2, an important threshold question for each corporate group will be whether to apply the rules only to covered interests or instead to all related-party debt (and now payables and receivables). Arguments for applying them more broadly than required by -2 are that (1) it is easier to implement compliance systems across the board, (2) generally applicable policies may reduce the risk of inadvertent

9 See footnote 1, above.

10 The preamble at pages 67-68 rejects requests to limit the documentation required of regulated entities. There is a special rule in section 1.385-2(c)(1)(iii) that treats the documentation requirements of -2 as met with respect to EGIs issued by regulated entities and having certain terms required by regulators, provided it is expected at the time of issuance that the instrument will be paid according to its terms (presumably disregarding any terms imposed by regulators limiting or forgiving payments as a result of financial distress).

compliance failures where it matters, (3) IRS exam teams may view the rules as setting the standard taxpayers should meet going forward under tax common law, and (4) states may apply similar rules to loans between consolidated group members that are separate state and local taxpayers.

Avoid New Bad Habits

In broad terms, the documentation rules codify practices that well-advised taxpayers would have observed in any event in structuring and documenting intragroup funding arrangements, at least for conventional debt. Taxpayers have always been required to show that they intended to create a debtor-creditor relationship when funds first were advanced; and that the terms of the arrangements are consistent with arm's-length standards.

The -2 regulations now mandate specific documents by a specific date (when returns are filed). This new *additional* requirement should not be viewed as an invitation to relax existing documentation practices, particularly those needed to show that a loan was intended (and on what terms) when money first flowed.[11]

In practice, the regulations will make it more likely that tax departments will eventually unearth any covered interests that have not already been documented. They will then need to figure out, based on available records and recollections, what terms were originally intended. That task will be easier to accomplish if there are contemporaneous records.

Initial Comments

A few initial comments on the -2 rules:

1. **New cascading rule.** Under section 1.385-2(c)(2)(ii), documentation for each covered interest must establish that the holder has creditor's rights. Those rights "must include rights that are superior to the rights of shareholders (other than holders of interests treated as stock solely by reason of §1.385-3) to

[11] Section 1.385-2(a)(2) makes it clear that the regulations impose additional requirements: "Thus, compliance with this section does not establish that an interest is indebtedness; it serves only to satisfy the minimum documentation for the determination to be made under general federal tax principles." The importance of showing that a debtor-creditor relationship was intended from the beginning is indicated by section 1.385-2(b)(2)(i)(A). It states that a highly compliant taxpayer may rebut a presumption that an undocumented interest is stock "if the taxpayer clearly establishes that there are sufficient common law factors present to treat the EGI as indebtedness including that the issuer intended to create indebtedness when the EGI was issued."

receive assets of the issuer in case of dissolution." The fact that the parenthetical carve out makes no mention of -2 indicates that creditor's rights must be superior to the rights of any holder of a covered interest that is treated as stock because of a failure to comply with -2. According to the preamble (page 81), the drafters intended this result, on the ground that such a failure "speaks to the substance of the interest itself". Thus, if an issuer has outstanding 100 covered interests that are general unsecured creditor claims, and one of them (in any amount) is treated as stock because of an unexcused document failure, all of them will be treated as undocumented and will be converted to stock absent a rescue measure.

If all of the covered interests issued by one corporation are considered to be undocumented under the new cascading rule because of a bad apple in the barrel, that could cause an expanded group no longer to be highly compliant (since that is a group test), resulting in the group's inability to rebut the presumption of stock treatment and the automatic conversion of the undocumented interests to stock. In this way, the highly compliant test can become circular—the test could be failed because one undocumented interest is treated as stock, and whether any one interest is treated as stock may turn on whether the highly compliant test is met.

The new cascading rule would seem to place a premium on perfection, ensuring that each issuer of covered interests is compliant enough so that no debt is recast as stock, no matter how small.[12]

The policy behind the cascading rule is questionable as the failure of one debt claim to be documented may say nothing at all about the parties rights or intent with respect to a different parity interest, and also may say very little about the undocumented interest. A failure of documentation is not necessarily a failure of facts. For example, an interest of a creditworthy borrower would be considered undocumented (and could therefore be treated as stock under -2) if the proper documentation to show the borrower's financial capacity is not prepared before the return filing date even if the interest was paid in full

[12] While this may fall into the realm of lawyer tricks, it might be possible to address this concern by including in the terms of every covered interest a statement that the issuer's obligations under the interest will be subordinated to all other covered interests of the same issuer if the interest is determined to be stock under -2.

according to its terms and the issuer is in fact highly creditworthy. The highly compliant presumption could be lost for corporation A (so that any failure to document an ECI of corporation A would result in its automatic classification as stock) as a result of failures affecting only corporation B even though those failures say nothing about the substance of the interests issued by corporation A.

2. **New highly compliant presumption.** A taxpayer can benefit from the new presumption in section 1.385-2(b)(2) if it can show it is highly compliant because less than 10 percent of covered interests (by amount or in some cases number) of the expanded group are undocumented.[13] This rule will require a taxpayer to determine the amount or number of covered interests outstanding at the end of each quarter for its expanded group. That is not something taxpayers otherwise would have a reason to do, so systems to monitor the amounts likely would need to be developed. And the monitoring may be harder than it first appears. Covered interests is a narrower category than related-party debt; it would not be possible simply to look to the group's financial statements.

   More broadly, how does a taxpayer practically show that it has only a small amount or number of undocumented interests? For example, how does it show that there were no undocumented responses to defaults unless it has an accurate way to monitor defaults? Would it be enough to point to policies in place to achieve compliance? Or could there be some kind of sampling?

   Determining the amount and number of outstanding covered interests also will make it necessary to determine whether (and, if so, when) offsetting rights and obligations should be netted, and otherwise to properly characterize transactions (see the comment below about notional cash pools).

   Counting the number of covered interests rather than the outstanding amount would seem to be highly impractical given that the definition of EGI includes trade payables and receivables with no *de minimis* rule. Who counts the number of trade payables or the number of draws under a revolver rather than amounts?

   Because the 10 percent test is applied at the expanded group level, a significant failure of one corporation within an expanded group to comply (a localized

[13] The rule is described in footnote 3, above.

screw-up discovered too late back at headquarters) could taint the whole group, not just the corporation.

As a related point, the highly compliant test could create an important due diligence issue in acquisitions. The failure of a target company to document its covered interests would affect the 90 percent calculation for the acquiring expanded group starting with the first quarter end after the target joins the group.

3. **Cascading relief measures.** There are now three relief provisions in the -2 regulations, the rebuttable presumption for highly compliant taxpayers mentioned above, a reasonable cause exception, and a third exception for "a ministerial or non-material failure" to document that is remedied before it is discovered by the IRS.[14]

   Taxpayers certainly will want as much flexibility as they can get, but it might make sense to try to integrate these rules, make them less rigid (e.g., not have a specific percentage to show high compliance), and better tailor them to the requirements of the regulations. Concern about the practicality of the highly compliant presumption could be eased by supplementing or replacing it with an "arrangements reasonably designed" standard like the one that applied for purposes of the TEFRA anti-bearer bond rules.[15] In addition, as discussed in the next paragraph, there should be a rule that allows a taxpayer not to document immaterial defaults.

4. **Defaults that must be papered.** Section 1.385-2(c)(2)(iv)(B)(1) says that written documentation evidencing the holder's reasonable response must be prepared if "the issuer did not make a payment of interest or principal that was due and payable under the terms of the EGI, or if any other event of default or similar event has occurred".

   Suppose a note requires an interest payment on the 15th of the month and the payment is actually made on the 17th. Is reporting required or not? The answer should be "no" on some theory. Perhaps it is because the issuer did in fact make the payment even though it was late and the regulation asks if the

[14] For the last two, see sections 1.385-2(b)(2)(ii) and (iii).

[15] Section 1.163-5(c).

payment that was due was made, not whether it was made on time. More importantly in terms of the policy of the rules, a short delay would not be similar to an event of default if, as is highly likely to be the case for most types of interests, no enforcement actions would have been taken by an unrelated creditor under the circumstances.

There clearly would be no need to report if the note had an explicit grace period for interest payments and the 2 day delay is within the period.[16] It would be odd to require more reporting if the note was simpler and lacked an express grace period (and any mention of events of default). The lack of a documented grace period does not mean it would not exist in practice in an arm's length relationship. Sending out a bill on stationary that says at the bottom "due in 30 days" doesn't mean it is understood by anyone to be a rigid date. Payment is expected at some point in the near term, yes, but not necessarily within 30 days.

It would be helpful if there were a blanket rule not requiring reporting for minor or routine delays of a type that would not lead to enforcement actions being taken by unrelated creditors.[17] Unfortunately, the new rule in section 1.385-2(b)(2)(iii) that allows a taxpayer to disregard minor failures to comply with -2 if they are corrected before the IRS discovers them would not do the trick as it relates to minor failures to document that are cured by documenting. It does not help in limiting the need to document in the first place.

Perhaps as a self-help measure, an issuer could adopt an umbrella agreement among expanded group members creating a grace period for all payments made on certain categories of covered interests that do not already provide for explicit grace periods and events of default.

5. **Revising common law principles**. Section 1.385-2(b)(3) says that "in applying federal tax principles to the determination of whether an EGI is

[16] Section 1.385-2(c)(4)(ii)(C)(1) treats as the relevant date triggering reporting of payments "each date on which a payment of interest or principal is due, taking into account all additional time permitted under the terms of the EGI before there is (or holder can declare) an event of default for nonpayment".

[17] A group that has a large number of intragroup payables and receivables may have a routine of netting offsetting amounts, and making appropriate book entries, on a weekly (or even monthly) basis instead of a daily basis. Lags in when netting is done that are attributable to the routine processing of a large number of intragroup payables should not give rise to a reportable event.

indebtedness or stock, the indebtedness factors in paragraph (c)(2) of this section are significant factors to be taken into account. Other relevant factors are taken into account as lesser factors, with the relative weighting of each lesser factor based on facts and circumstances." This does not seem to be a documentation rule but a statement of substantive law, at least for covered interests.[18] The factors that are given most weight are indeed important, but they do not include, for example, the term (e.g., whether it is 5 years or 60) or the ranking of debt compared with other debt (except indirectly through the ability to pay factor).

6. **Consistency and anti-hybrid instrument rule.** The consistency rule in section 1.385-2(a)(5)(i) says that if an issuer characterizes an interest as debt, then the issuer and holder must treat it that way for all federal tax purposes. But (says section 1.385-2(a)(5)(ii)) this rule does not apply "if it has been determined" that the instrument is stock under applicable federal tax principles. There is a reason English teachers don't like the passive voice. The regulations do not say whose determination counts, or on what it must be based. So a taxpayer determination from the beginning that an instrument is stock would seem to be enough, although likely not what was meant.[19]

   In applying the consistency rule, section 1.385-2(a)(5) treats an issuer as characterizing an interest as debt, so that the issuer must then treat the interest as debt for federal tax purposes (subject to the discussion above), if either (1) the interest is in the legal form of debt, regardless of how it is treated by the parties for tax purposes or its economic terms, or (2) the issuer reports the interest as debt, or amounts paid as interest, in an applicable financial statement.

[18] The new weighting system applies where there is a document failure and a taxpayer is seeking to rebut the presumption of stock treatment (see section 1.385-2(b)(2)(i)(C)). In that case, a taxpayer is required to apply "general tax principles" using the factors in section 1.385-2(b)(3). It is not clear if the same factors are to be weighed the same way in applying general tax principles in other settings.

[19] The preamble (page 95) says that the proposed regulations provided that if an issuer treated an EGI as debt, the issuer and all other persons other than the IRS were required to treat the EGI as debt for all federal income tax purposes. It then says that comments requested clarification of this rule if a taxpayer subsequently discovered that an interest it treated as debt would be treated as stock under the documentation rules. The preamble states that this comment was adopted, presumably through the statement that an instrument determined to be stock may be treated as stock. However, under the regulations, it makes no difference what the grounds are for that determination. Also, the preamble makes no mention of applying the consistency rule to require taxpayers to treat an instrument as debt for tax purposes based on its treatment as debt for non-tax purposes.

At least for covered interests, the rule in clause (1) above appears to outlaw hybrid instruments. Thus, it seems, a covered interest in the legal form of debt that entitles a holder to all residual cash flows of an entity apparently would have to be reported by the parties as debt.[20] This rule could result in different treatment of the same class of instruments held by an expanded group member and someone unrelated, and paradoxically would mean equity treatment for the instrument held by the third party and debt treatment for the related party instrument (at least until it is determined otherwise). The anti-hybrid rule may not have practical significance for many taxpayers, but it would represent a significant change in law where it applies.

The rule in clause (2) is very strange as the accounting and tax standards for classifying instruments are simply not the same.[21] For example, since 2003, conventional term preferred stock has been classified as a liability and not equity under U.S. GAAP even though it would clearly be stock for tax purposes.[22] How close this is to calling the stock "debt" is something for accountants to opine on, but in any event, throwing accounting tests into the mix is misguided.

The purpose of these two rules treating an issuer as characterizing an instrument as debt when it has not done so for tax purposes is hard to grasp. The government would not be whipsawed if all parties treat the instrument consistently as equity for U.S. tax purposes (which is all that section 385(c) requires). And why should the government ever push taxpayers to treat an instrument with equity features as debt when they wish to treat it consistently (and properly) as equity?

20 Other examples of legal form debt that are not debt for tax purposes are perpetual notes issued for bank capital reasons and DECS and "access notes", which are properly analyzed as forward contracts, derivatives or custody receipts. Many of these instruments are issued to unrelated investors (and often by non-U.S. companies in non-U.S. markets), but there nevertheless may be cases in which an inflexible consistency rule would produce the wrong results.

21 *Thor Power Tool Co. v. Comm'r*, 439 U.S. 522 (1979), is the usual cite for the proposition that tax advisors and accountants bow down before different gods.

22 See FASB Statement 150, *Accounting for Certain Financial Instruments with Characteristics of Both Liabilities and Equity* (issued May 2003), codified as ASC 480.

One would hope that taxpayers forced to mischaracterize interests would not be expose to the risk of penalties.

7. **Relevant body of law.** Section 1.385-2(c)(2)(ii) says that for each covered interest there must be written documentation establishing that the holder has the rights of a creditor to enforce the obligation. The section goes on to state: "creditor's rights may be provided either in the legal agreements that contain the terms of the EGI or under local law. If local law provides for creditor's rights under an EGI even if such rights are not specified in the legal agreements that contain the terms of the EGI, such creditor's rights do not need to be included in the EGI provided that written documentation for purposes of this paragraph (c)(2)(ii) contains a reference to the provisions of local law providing such rights." The preamble at page 80 seems to suggest that this requires nothing more than a choice of law clause (saying, e.g., that the laws of New York govern),[23] but that is not strictly speaking what the regulation says. The provisions of New York law governing creditor's rights might consist of some combination of the UCC for secured claims, the Debtor and Creditor Law, common law and probably something else a real (non-tax) lawyer would know about. This all seems quite unnecessary for instruments that are unambiguously in the form of debt but hopefully will prove to be only an annoyance for most.[24]

8. **Covered trade payables and receivables.** The -2 rules now embrace not just instruments but more broadly interests, which are defined to include trade payables or receivables. However, the language is a little confusing.

   A covered interest must be an EGI which must be an applicable interest. The definition of "applicable interest" in section 1.385-2(d)(2) is (A) any "interest that is issued or deemed issued in the legal form of a debt instrument" (not including for example a repo), and (B) an "intercompany payable and

23 The preamble at page 80 states: "If creditor's rights are created under local law without being reflected in writing in a loan agreement and no creditor's rights are written as part of the documentation of an interest, the documentation must refer to the law that governs interpretation and enforcement (for example, Delaware law or bankruptcy law)."

24 Some groups are developing model documentation for intragroup loans that is intended to be used, with minor modifications, around the world. In such a case, and particularly in light of the preamble, it hopefully will be sufficient to provide that "this agreement is governed by the law of [the specified jurisdiction], and the lender shall be entitled to all creditor's rights accorded under the law of that jurisdiction."

receivable documented as debt in a ledger, accounting system, open account intercompany debt ledger, trade payable, journal entry or similar arrangement if no written legal instrument or written legal arrangement governs the legal treatment of such payable and receivable."

Clause (B) is hard to parse. The term "trade payable" stands by itself and does not seem to be modified by any of the requirements that it be documented in any particular way. The first part of clause (B) requires a payable or receivable to be "documented as debt" but the last part refers to arrangements "if no written legal instrument or written legal arrangement governs the legal treatment of such payable and receivable". These requirements seem contradictory. Also, it seems odd that there would be no legal agreement of any kind governing the arrangements mentioned. Maybe the idea was to cover in clause (A) anything that was documented as a legal instrument and in clause (B) any trade payable or receivable regardless of how or whether documented, but if so, the phrasing is off.[25]

Since extending the -2 rules to trade payables and receivables could be a big deal practically for many taxpayers, it would be helpful to know exactly what the drafters meant.

One challenge that may be posed by trade payables and receivables is determining the maximum amounts that may be outstanding for any issuer in any period, which would be a factor in establishing that the issuer has a reasonable expectation of being able to pay.

9. **Material event.** Section 1.385-2(c)(2)(iii)(B) allows documentation showing the issuer's ability to pay to be prepared for multiple EGIs using an annual report. However, the report must be updated as of the date of a "material event", which is defined in section 1.385-2(d)(5) to include a disposition of 50 percent or more of the total fair market value of the issuer's "included assets".

25 Section 1.385(c)(3)(i)(A) has special documentation rules for agreements covering multiple EGIs, including "an omnibus or umbrella agreement that governs open account obligations or any other identified set of payables or receivables", which assumes that payables and receivables so documented could be covered interests.

This test is unclear as it does not say over what period the 50 percent change must occur, or require that the disposition be pursuant to a plan.[26] Also, included assets are so broadly defined that ordinary course business activities may cause material events for some issuers. Section 1.385-2(d)(6) carves out "inventory sold in the ordinary course of business" and "investment assets such as portfolio stock investments to the extent that other investment asset or cash of equivalent value is substituted". There should be broader exceptions for dispositions occurring in the normal course of business. For example, suppose a finance company makes loans and more than 50 percent are repaid in a year with the money being reloaned. The loans would not be inventory and likely also would not be investment assets. Or suppose a derivatives dealer terminates derivatives contracts in the ordinary course of business. Those contracts would not be inventory or investment assets.

10. **Notional cash pools.** The regulations treat debt under these arrangements as covered interests if they are covered interests, or stated otherwise are treated for tax purposes as direct loans between expanded group members despite the presence of a third party intermediary.[27] So taxpayers will have to figure it out based on their facts, and it may matter more now than it did. Among the more subtle consequences of getting it right are that a -2 compliant cash pool arrangement that involves covered interests would count favorably in showing that a taxpayer in highly compliant. One without covered interests would not.

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26 Section 1.385(c)(2)(iii)(B)(2) requires new documentation if there is a material event with respect to the issuer within the year beginning on a certain analysis date. However, that rule appears to describe what happens when a material event occurs, not what it is. The language could be clearer.

27 Section 1.385-2(c)(3)(i) states that "A notional cash pool is subject to the rules of this paragraph (c)(3)(i) to the extent that the notional cash pool would be treated as an EGI issued directly between expanded group members."