

New Section 385 Regulations for S Corps: Protecting S Elections and Avoiding Debt Reclassification

Analyzing Related-Party Debt Instruments to Withstand IRS Challenge to S Corp Status

WEDNESDAY, AUGUST 3, 2016, 1:00-2:50 pm Eastern

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New Section 385 Regulations for S Corps

Aug. 3, 2016

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Proposed § 385 Regulations

Considerations for S Corporations

August 3, 2016

Miller & Chevalier



S Corporation Rules

Background

- ▶ Certain domestic corporations may elect to be subchapter S corporations (“S Corps”). In order to elect, the corporation must have
 - ▶ 100 shareholders or less.
 - ▶ No shareholders that are partnerships, corporations or nonresident alien individuals.
 - ▶ Only one class of stock.
 - ▶ Not be an “ineligible corporation” (e.g., an insurance company or certain types of financial institutions)
- ▶ S Corps do not pay corporate level income tax. Shareholders take into account their distributive share of S Corp income or loss on their individual returns.
- ▶ Distribution of cash is generally tax-free to the extent of basis.
- ▶ Basis adjusted for income and loss, distributions.
- ▶ S Corps cannot be members of the consolidated group.
- ▶ Only eligible for direct (section 901) foreign tax credit, not indirect (section 902) foreign tax credit.
- ▶ “Q Sub” also gets pass-thru treatment, but only if parent S corporation owns 100% of Q Sub stock.

Section 385 Proposed Regulations

Background

- ▶ Historically, Courts have analyzed whether an interest in a corporation should be treated as stock or indebtedness for federal tax purposes by applying various sets of factors to the facts of a particular case.
- ▶ Congress enacted Section 385 to authorize the Secretary of the Treasury to issue regulations to determine whether an interest in a corporation is to be treated as stock or indebtedness for U.S. federal income tax purposes. In the absence of such regulations, case law has developed to control the debt/equity analysis.
- ▶ On April 4, 2016, the Department of the Treasury issued a notice of proposed rulemaking concerning Proposed Regulations under Section 385.
 - ▶ “While these Proposed Regulations are motivated in part by the enhanced incentives for related parties to engage in transactions that result in excessive indebtedness in the cross-border context, federal income tax liability can also be reduced or eliminated with excessive indebtedness between domestic related parties. Thus, the proposed rules apply to purported indebtedness issued to certain related parties, without regard to whether the parties are domestic or foreign.”

Section 385 Proposed Regulations

Summary of Proposed Regulations

The Bifurcation Rule (Prop. Reg. §1.385-1(d))

- ▶ Permits the Commissioner, but not a taxpayer, to treat certain debt instruments as part debt and part stock, consistent with the instrument's substance.

The Documentation Rule (Prop. Reg. §1.385-2)

- ▶ Identifies certain threshold documentation and information that must be prepared and maintained, within specified periods, for a purported instrument issued by an expanded group member, including a disregarded entity owned by an expanded group member to a related party, to be treated as indebtedness.

The Transaction Rule (Prop. Reg. §1.385-3)

- ▶ Subject to certain exceptions, treats a debt instrument issued by a corporation or a controlled partnership with an expanded group partner to a member of its "expanded group" in certain transactions as stock.

Consolidated Groups (Prop. Reg. §1.385-1(e), -4(a))

- ▶ All members of a consolidated group are treated as a single corporation. Accordingly, the proposed regulations do not apply to debt instrument issued by one member of a consolidated group to another member of a consolidated group.

Consequences and character of recharacterized equity

- ▶ A debt instrument treated as stock under all three Rules is treated as such for all federal tax purposes.
- ▶ The type of stock that results from the recharacterization (e.g., common or preferred) will be determined by the terms of the instrument.

Section 385 Proposed Regulations

Effective Dates

- ▶ The Documentation Rule and the Bifurcation Rule apply to debt instruments issued (or deemed issued) on or after **the date the regulations are finalized** or as a result of an entity classification election filed after that date.
- ▶ The Transaction Rule applies to all debt instruments issued **on or after April 4, 2016** (the date the Proposed Regulations were published), and to any debt instruments deemed issued prior to such date as a result of an entity classification filed on or after such date when and if the regulations are finalized.
 - ▶ Any debt instrument recharacterized as stock under the Proposed Regulations that is issued on or after April 4th will be respected and treated as debt until the 90th day after the date on which final regulations are published.
 - ▶ Any debt instrument recharacterized as stock under the Proposed Regulations that is held by a member of the issuer's expanded group on the 90th day after the date on which final regulations are published shall be deemed exchanged for stock of the issuer of the debt instrument on such 90th day.

Section 385 Proposed Regulations

Tax Consequences of Treating Purported Debt as Equity

- ▶ For S corporations, violation of single class of stock rules, leading to disqualification of S corporation status.
- ▶ Payment on the intercompany loan may become subject to US withholding tax.
- ▶ Characterizing debt as stock may result in unintended tax consequences for the original transaction in which the debt is issued.
 - ▶ A transaction that is intended to be tax-free may end up being taxable or vice versa.
 - ▶ Unintended consequences under the disguised sale and 752 rules, as well as under the capital account maintenance and allocation provisions.
- ▶ Ownership profiles may change through the recharacterization of debt to non-voting or voting stock (determined by the terms of the instrument) which can impact the utilization of foreign tax credits.

Section 385 Proposed Regulations

Relevant Definitions

In order for an interest potentially to be subject to the Documentation Rule and the Transaction Rule, it must be an expanded group instrument, where the issuer and the holder are members of an expanded group.

Applicable Instrument (“AI”)

- ▶ Any interest issued or deemed issued that is in form a debt instrument.

Controlled Partnership (“CP”)

- ▶ Any partnership in which 80% or more of the capital or profits interests are owned, directly or indirectly, by one or more members of the EG.

Expanded Group (“EG”)

- ▶ References to the term “affiliated group” in Section 1504(a), without regard to Section 1504(b).
- ▶ Requires a common parent corporation (either foreign or domestic corporation), includes corporations held indirectly through partnerships.
- ▶ Changes the requisite ownership threshold *from* “at least 80% vote **and** value” *to* “at least 80% vote **or** value.”
- ▶ Allows the common parent to own directly or *indirectly* (determined by applying the attribution rules of Section 304(c)(3)) at least 80% of the vote or value of at least in one includible corporation.

Expanded Group Instrument (“EGI”)

- ▶ An applicable instrument where the issuer and holder are members of the same EG.

Section 385 Proposed Regulations

Relevant Definitions (Cont'd)

In order for an interest potentially to be subject to the Bifurcation Rule, it must be an expanded group instrument, where the issuer and the holder are members of a modified expanded group.

Modified Expanded Group (“MEG”)

- ▶ An Expanded Group, determined by substituting the 50% for the 80% and including the partnerships in which 50% or more of the capital or profits interests are owned, directly or indirectly, by one or more member of the MEG.
- ▶ A person who owns greater than or equal to 50% of a MEG member is treated as a MEG member.

Modified Controlled Partnership (“MCP”)

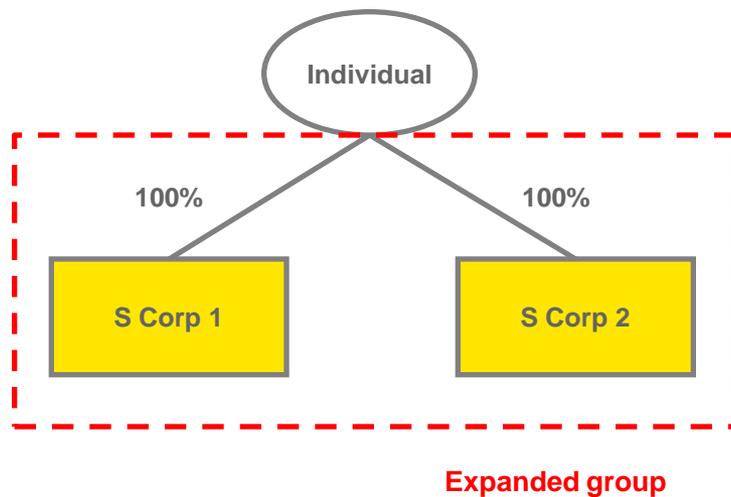
- ▶ Any partnership in which 50% or more of the capital or profits interests are owned, directly or indirectly, by one or more members of a MEG.

Section 385 Proposed Regulations

Indirect Ownership under Section 304(c)(3)

- ▶ The principles of attribution under Section 304(c)(3) are applied for purposes of making the EG determination.
- ▶ Section 304(c)(3) applies the *constructive ownership* rules of Section 318(a), with the following modifications:
 - ▶ Lowers the threshold of ownership for the rule of attribution to and from corporations to 5% or more in the value of the stock
 - ▶ Where stock owned by a shareholder is less than 50% in value of the corporation's stock, attribution of ownership for the shareholder to the corporation is limited to the proportion of the value of the corporation's outstanding stock owned by the shareholder
- ▶ Treas. Reg. §1.318-1(b)(1) provides that, to determine stock ownership, a corporation will not be considered to own its own stock by reason of Section 318(a)(3)(C), i.e., attributing stock ownership from a shareholder.
- ▶ The principles of attribution under Section 304(c)(3) are applied to determine indirect ownership of a partnership interest.
 - ▶ Therefore, treat the partnership interest as if it were stock.

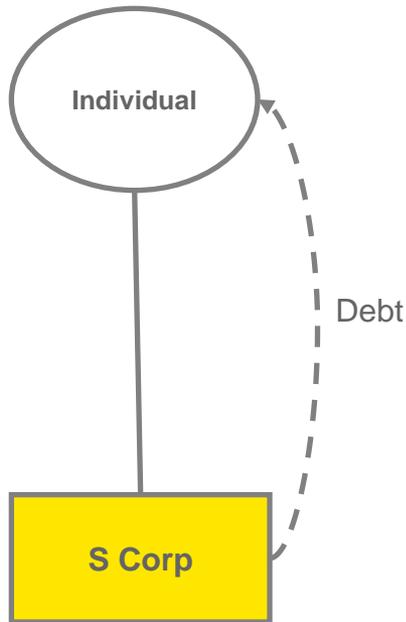
Expanded Group (“EG”) Definition



- ▶ Under section 304(c)(3), S Corp 1 is deemed to own all of the stock of S Corp 2, and the two corporations are therefore members of the same EG.
- ▶ The result is the same if two unrelated individuals each owned 50% of S Corp 1 and 50% of S Corp 2. (Section 318(a)(3)(C) - “50% or more”).

Section 385 Proposed Regulations

The Bifurcation Rule



- ▶ The Bifurcation Rule allows the Commissioner, but not a taxpayer, to treat certain debt instrument as part debt and part stock, consistent with the instrument's substance.
 - ▶ A borrower and lender are required to treat a debt instrument as debt, consistent with the borrower's initial characterization (i.e., a lender may not disclose on its return under Section 385(c) that it treats the debt instrument as part debt or a stock, if the borrower treats it as debt).
- ▶ In order for a debt instrument to be subject to the Bifurcation Rule, it must be an applicable debt instrument, an issuer of which is one member of a MEG and the holder of which is another member of the same MEG.
 - ▶ MEG is an EG with a reduced ownership threshold of 50% by vote or value (instead of 80%) and includes partnerships in which 50% or more of the capital or profits interest are owned directly or indirectly, by one or more members of the MEG.
 - ▶ A person who owns greater than or equal to 50% of a MEG member is treated as a MEG member (see Prop. Reg. §1.385-1(d)(5)).
- ▶ The Bifurcation Rule applies in addition to the Documentation Rule.
- ▶ There is no dollar threshold for the Bifurcation Rule.

Section 385 Proposed Regulations

The Documentation Rule

- ▶ Intercompany debt instruments must meet stringent documentation requirements to be characterized as debt (otherwise, they are treated as stock).
- ▶ Contemporaneous documentation must establish the following four items:
 1. An unconditional and legally binding obligation to repay a sum certain.
 2. Creditor's rights to enforce the obligation to repay (i.e., the right to sue or accelerate principal payments if payments are missed).
 3. A reasonable expectation that the advanced funds can be repaid (cash flow analysis, financial ratio analysis, asset appraisals, etc.).
 4. Actions evidencing a genuine debtor-creditor relationship (including evidence of payment of interest and principal, i.e., wire transfers and bank statements, and evidence of asserting creditors rights in the event of default).

Section 385 Proposed Regulations

The Documentation Rule

- ▶ Documentation that establishes the first three items must be prepared no later than **30 calendar days** after the date that the debt instrument is issued or other relevant events. Documentation for evidencing the fourth item must be prepared no later than **120 calendar days** after the payment or other relevant events.
- ▶ The Documentation Rule applies to an EGI if: (1) *any* EG member is traded on an “established financial market”, (2) the EG’s total assets exceed \$100M ,or (3) the EG’s total revenues exceed \$50M.
- ▶ Documentation alone is not sufficient; the instrument must also be treated as debt under ordinary principles and avoid application of the Bifurcation Rule or the Transaction Rule.

Section 385 Proposed Regulations

The Transaction Rule

- ▶ The Transaction Rule treats a debt instrument issued by a corporation *to a member of its EG* in the following transactions as stock:
 - ▶ In a distribution;
 - ▶ In exchange for stock of a member of the expanded group;
 - ▶ In exchange for property in an asset reorganization to the extent the instrument is received as “boot” by a shareholder of the target in the asset reorganization;
 - ▶ In exchange for property if issued with a principal purpose of funding a proscribed distribution or acquisition described above (the “Funding Rule”); **or**
 - ▶ With a principal purpose of avoiding the application of the Transaction Rule.

Section 385 Proposed Regulations

The Transaction Rule

- ▶ The funding rule as a per se element: a debt instrument will fall under the rule if it issued by the funded member during the period beginning 36 months before the date of the distribution or acquisition, and ending 36 months after the date of the distribution or acquisition (subject to an “ordinary course exception”)
- ▶ Both the general rule and the funding rule are subject to a *threshold exception* and a *current E&P exception*. The funding rule is also subject to a *subsidiary stock issuance exception*.
- ▶ Taxpayers may not use the transaction rule affirmatively to treat an instrument that is otherwise debt as stock.

Section 385 Proposed Regulations

Special Rules for Partnerships

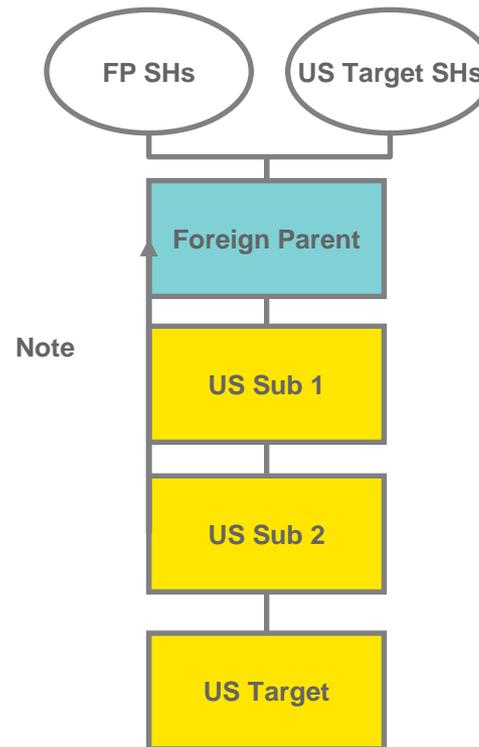
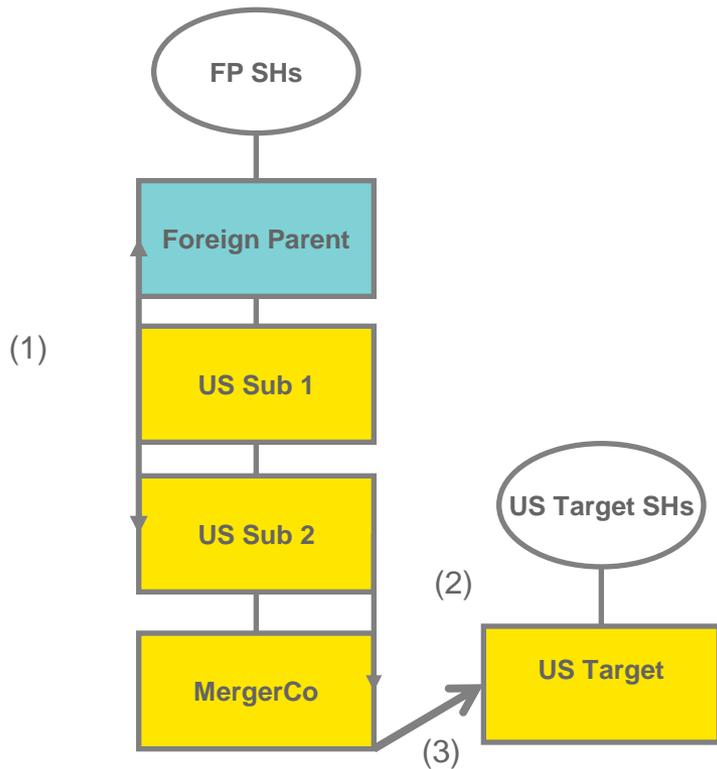
For purposes of the Bifurcation Rule and the Documentation Rule, entity theory applies

- ▶ The Bifurcation Rule and the Documentation Rule apply to the partnership or disregarded entity that issues an EGI.
- ▶ If debt characterized as equity, it is equity in the partnership or disregarded entity. Compare to the Transaction Rule.

For purposes of the Transaction Rule, aggregate theory applies

- ▶ EG partners are treated as owning their proportionate shares of the controlled partnership's assets and liabilities.
- ▶ After applying aggregate principles, if debt is an EGI, debt may be characterized as equity under principles of the Transaction Rule.
- ▶ If debt issued by a partnership or disregarded entity is recharacterized as equity under the Transaction Rule, it is treated as equity in the owners of the partnership or disregarded entity.
 - ▶ If recharacterized, "appropriate conforming adjustments" must be made to reflect this treatment.
 - ▶ Adjustments must be consistent with purposes of the Proposed Regulations and must be made in a manner that avoids the creation of, or increase in, a disparity between inside/outside basis.

Example: Note distribution following inversion



Facts:

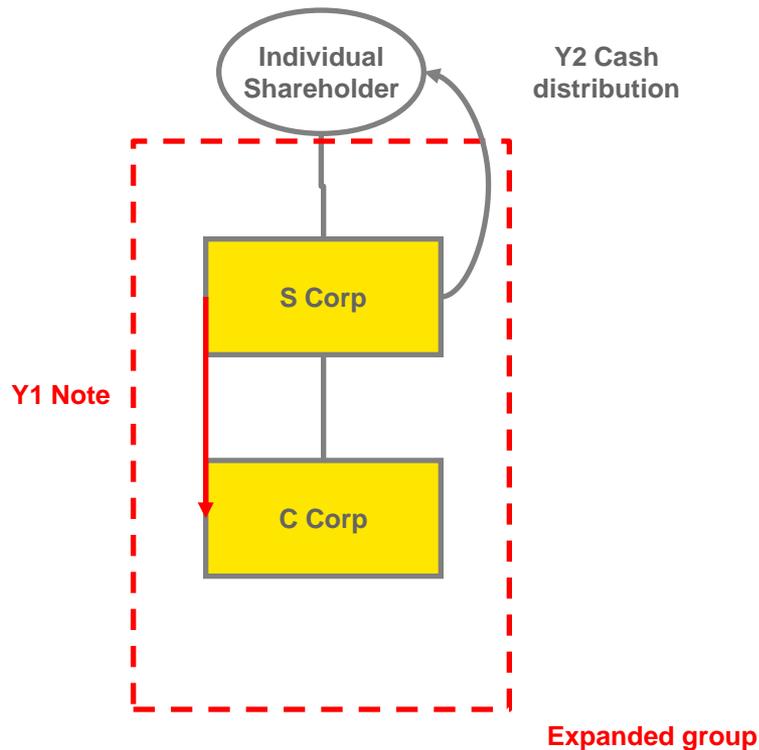
- (1) US Sub 2 acquires Foreign Parent shares in exchange for US Sub 2 Note.
- (2) US Sub 2 contributes Foreign Parent shares to MergerCo
- (3) MergerCo merges with and into US Target, with US Target shareholders receiving FP shares

Intended consequences:

US Sub 2 is able to use interest deductions on its note to offset the income of US Target (in the same consolidated group).

Foreign Parent will include interest payments in income (but likely a lower rate), but can recover principal tax-free. May be eligible for treaty relief on US withholding tax.

Example: Leveraged Distribution under the Funding Rule



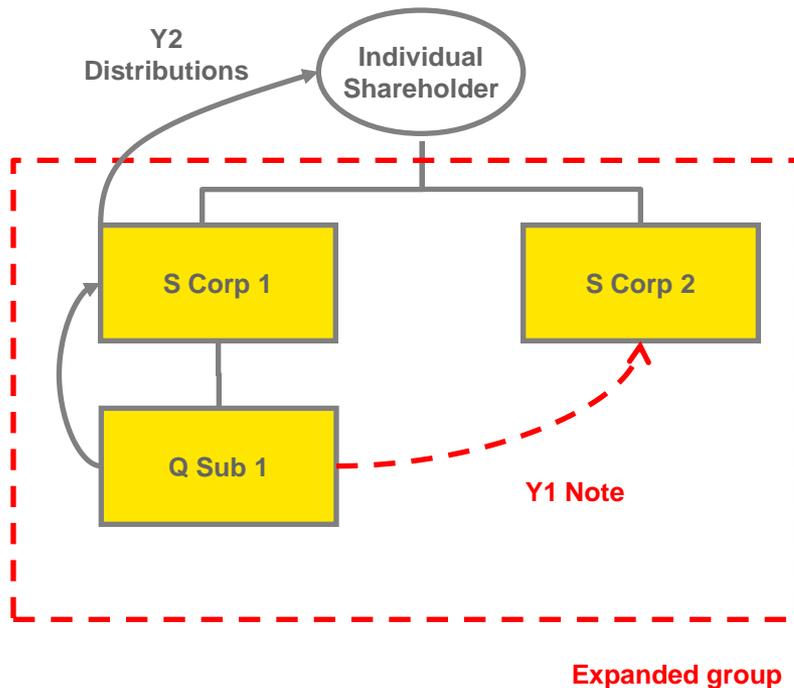
Facts

1. In Year 1, S Corp issues a note to C Corp for cash after April 4th, 2016.
2. In Year 2, S Corp makes a distribution the cash to the individual shareholder.

Considerations

- ▶ S Corp and C Corp are considered members of an EG.
- ▶ Y1 Note would be subject to bifurcation and documentation requirements from its inception.
- ▶ In Year 2, Y2 Distribution would recharacterize the Y1 note as stock as of the date of the distribution under the funding rule.
 - ▶ Example assumes \$50 million threshold has been surpassed.
 - ▶ Consider whether the current E&P exception would apply.

Example: Q Sub



Facts

1. In Year 1, Q Sub 1 issues a note for cash to S Corp 2 after April 4th, 2016.
2. In Year 2, Q Sub 1 distributes the cash received to S Corp 2, which in turn distributes it to the individual shareholder.

Considerations

- ▶ S Corp 1 and S Corp 2 are considered members of an EG. If Q Sub 1 is respected as a Q Sub, it will not be a separate corporation from S Corp 1 under § 1361(b)(3)(A).
- ▶ The individual shareholder is considered a MEG member per Prop. Reg. §1.385-1(d)(5), but not an EG member.
- ▶ Y1 Note would be subject to bifurcation and documentation requirements from its inception.
- ▶ If any portion of the Y1 Note is treated as equity, Q Sub 1 would lose its Q Sub status because S Corp 1 no longer owns 100% of its stock.
- ▶ If Qsub 1 is respected as a Qsub, Transaction Rule should not apply with respect to Y2 Distribution, because Qsub 1 and S Corp 1 are treated as the same entity and Individual Shareholder is not in the EG.

Comments on S Corps

- ▶ “Application in the S corporation context, however, is inappropriate as the rules relating to S corporations likewise eliminate the possibility of tax arbitrage, making the income reported on Form 1120S analogous to the income reported by a consolidated group on Form 1120 for federal income tax purposes. Therefore, S corporations should be exempted, the same as consolidated group members.” – S Corporation Association (July 7, 2016)
- ▶ “The NAM strongly recommends that subchapter S corporations be exempted from the final regulations.” – National Association of Manufacturers (July 7, 2016)
- ▶ “Exclude S corporations from the expanded group.” – American Bar Association (July 13, 2016)

Treasury Response

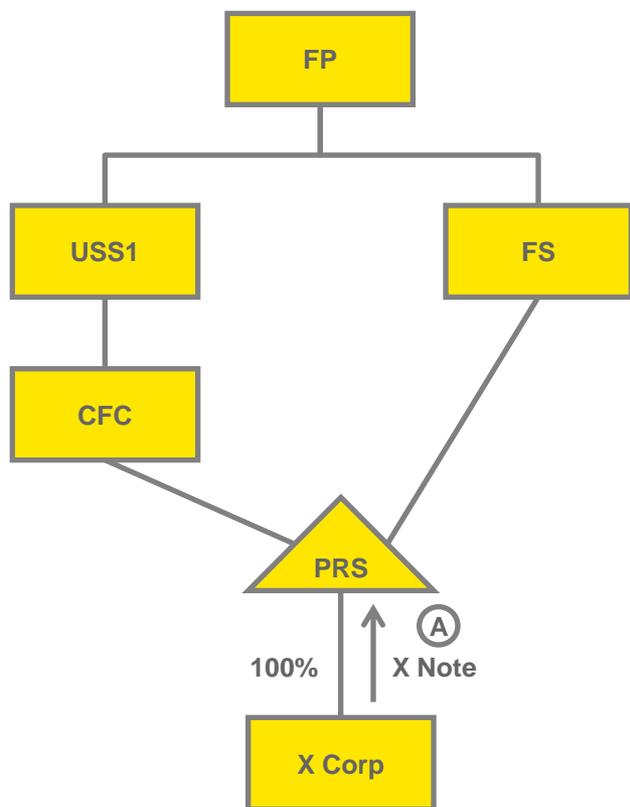
- ▶ On July 16, Bob Stack, the Treasury Deputy Assistant Secretary for International Tax Affairs stated that the proposed 385 regulations were a “blunt instrument” and Treasury intends to modify the application of the regulations in certain areas creating “unintended effects”. S corporations was one of the areas identified.
- ▶ Treasury has indicated that it wants to finalize the regulations this year, ideally before Labor Day.
- ▶ The recent Tax Court case of *Altera v. Commissioner* (currently on appeal to the 9th Cir.) suggests that Treasury will have to carefully consider all taxpayer comments to satisfy the “reasoned decisionmaking” standard of the APA.

Appendix A – Examples 13-15 from Prop. Reg. §1.385-3(g)(3)



Distribution of a Debt Instrument to Partnership

Prop. Reg. §1.385-3(g)(3): Example 13



(i) Facts

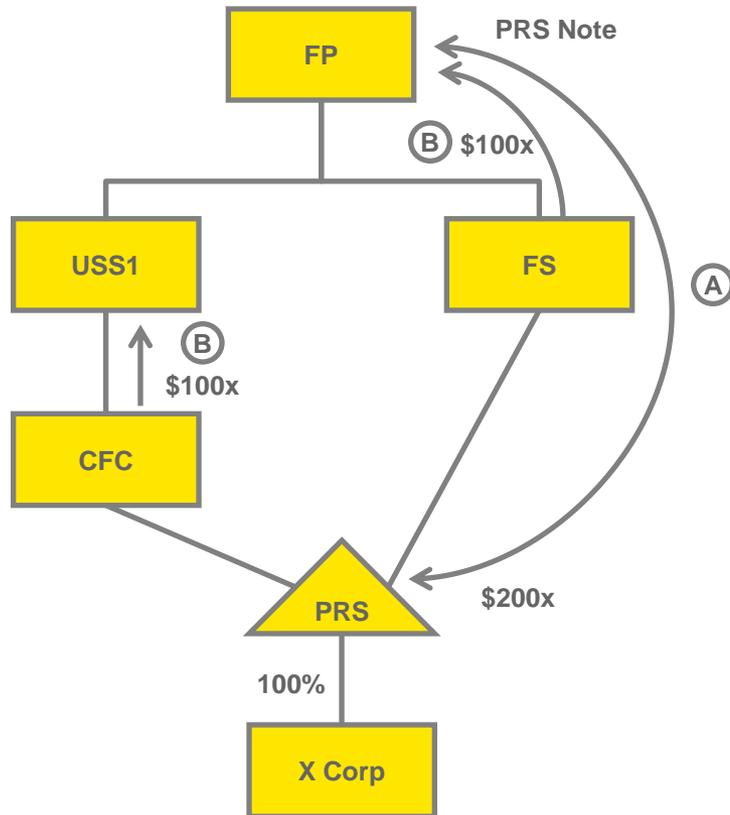
- ▶ CFC and FS are equal partners in PRS. PRS owns 100 percent of the stock of X Corp, a domestic corporation. On Date A in Year 1, X Corp issues X Note to PRS in a distribution.

(ii) Analysis

- ▶ (A) Under prop. Reg. §1.385-1(b)(3), in determining whether X Corp is a member of the expanded group that includes CFC and FS, CFC and FS are each treated as holding 50 percent of the X Corp stock held by PRS. Accordingly, 100 percent of X Corp's stock is treated as owned by CFC and FS under §1.385-1(b)(3)(i)(B), and X Corp is a member of the FP expanded group.
- ▶ (B) Together, CFC and FS own 100 percent of the interests in PRS capital and profits, such that PRS is a controlled partnership described in Prop. Reg. §1.385-1(b)(1). Under paragraph (d)(5)(i) of this section, solely for purposes of this section, when X Corp issues X Note to PRS, proportionate shares of X Note are treated as issued to CFC and FS. Accordingly, for purposes of applying paragraph (b) of this section, in Year 1, 50 percent of X Note is treated as issued to CFC in a distribution and the other 50 percent of X Note is treated as issued to FS in a distribution. Therefore, under paragraphs (b)(2)(i) and (d)(1)(i) of this section, X Note is treated as stock beginning on Date A in Year 1. Under paragraph (d)(5)(i) of this section, CFC and FS are treated as holding X Note solely for purposes of this section. For all other federal tax purposes, X Note is treated as stock in X Corp that is held by PRS, and X Corp is treated as distributing its stock to its shareholder in a distribution that is subject to Section 305.

Loan to Partnership: Same-Year Distribution

Prop. Reg. §1.385-3(g)(3): Example 14



(i) Facts

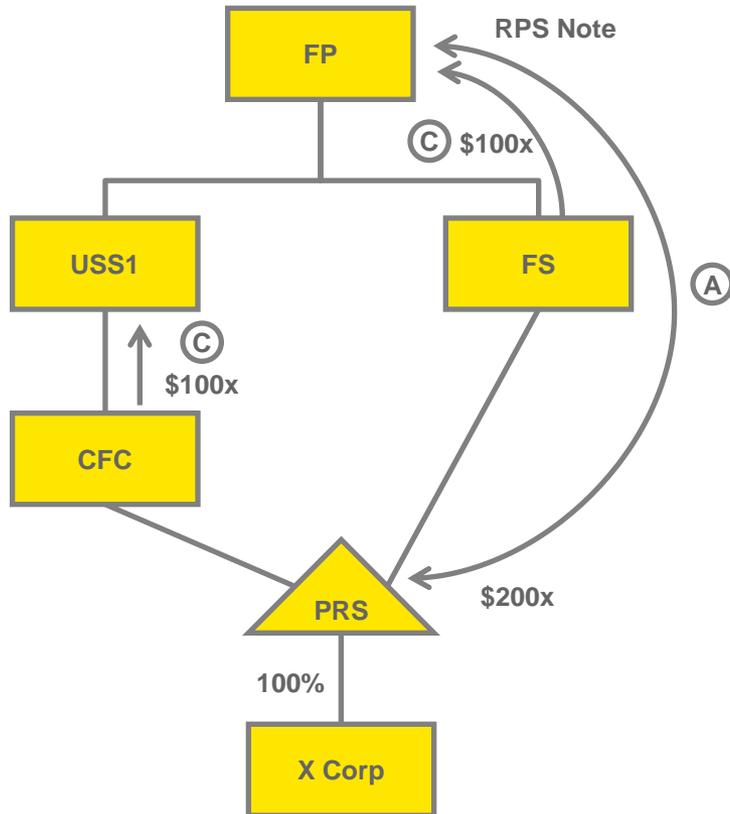
- ▶ The facts are the same as in Example 13, except that X Corp does not distribute X Note to PRS; instead, on Date A in Year 1 FP lends \$200x to PRS in exchange for PRS Note. On Date B in Year 1, CFC distributes \$100x to USS1 and FS distributes \$100x to FP. CFC is not an expatriated foreign subsidiary as defined in §1.7874-12T(a)(9).

(ii) Analysis

- ▶ (A) Under paragraph (d)(5)(i) of this section, solely for purposes of this section, CFC and FS are each treated as issuing \$100x of PRS Note on Date A in Year 1, which represents their proportionate shares of PRS Note. CFC's and FS's shares of PRS Note are each issued to FP, a member of the same expanded group, during the 72-month periods determined with respect to the distributions by CFC and FS. Under paragraph (b)(3)(iv)(B)(1) of this section, PRS Note is treated as issued with a principal purpose of funding the distributions by CFC and FS. Accordingly, under paragraphs (b)(3)(ii)(A) and (d)(1)(i) of this section, PRS Note is a principal purpose debt instrument that is treated as stock when it is issued on Date A in Year 1.
- ▶ (B) Under paragraph (d)(5)(ii) of this section, CFC and FS are each treated as issuing \$100x of stock to FP. Appropriate conforming adjustments must be made to CFC's and FS's interests in PRS to reflect the deemed treatment of PRS Note as stock issued by CFC and FS, which must be done in a manner that avoids the creation of, or increase in, a disparity between PRS's aggregate basis in its assets and the aggregate bases of CFC's and FS's respective interests in PRS. For example, reasonable and appropriate adjustments may occur when the following steps are deemed to occur on Date A in Year 1:
 - 1) CFC issues stock to FP in exchange for \$100x;
 - 2) FS issues stock to FP in exchange for \$100x;
 - 3) CFC contributes \$100x to PRS in exchange for a partnership interest in PRS; and
 - 4) FS contributes \$100x to PRS in exchange for a partnership interest in PRS.

Loan to Partnership: Distribution in Later Year

Prop. Reg. §1.385-3(g)(3): Example 15



(i) Facts

- ▶ The facts are the same as in Example 14, except that CFC and FS do not make distributions on Date B of Year 1; instead, CFC distributes \$100x to USS1 and FS distributes \$100x to FP on Date C of Year 2.

(ii) Analysis

- ▶ (A) As in Example 14, CFC's and FS's shares of PRS Note are each issued to FP, a member of the same expanded group, during the 72-month periods determined with respect to the distributions by CFC and FS. Under paragraph (b)(3)(iv)(B)(1) of this section, PRS Note is treated as issued with a principal purpose of funding the distributions by CFC and FS. Accordingly, PRS Note is a principal purpose debt instrument that is treated as stock under paragraph (b)(3)(i)(A) of this section. Under paragraph (d)(1)(ii) of this section, PRS Note is treated as stock on Date C in Year 2.
- ▶ (B) Under paragraph (d)(5)(ii) of this section, CFC and FS are each treated as issuing \$100x of stock to FP. Appropriate conforming adjustments must be made to CFC's and FS's interests in PRS to reflect the deemed treatment of PRS Note as stock issued by CFC and FS, which must be done in a manner that avoids the creation of, or increase in, a disparity between PRS's aggregate basis in its assets and the aggregate bases of CFC's and FS's respective interests in PRS. For example, reasonable and appropriate adjustments may occur when the following steps are deemed to occur on Date C in Year 2:
 - 1) CFC assumes liability with respect to \$100x of PRS Note;
 - 2) FS assumes liability with respect to \$100x of PRS Note;
 - 3) CFC issues stock to FP in satisfaction of the \$100x of PRS Note assumed by CFC; and
 - 4) FS issues stock to FP in satisfaction of the \$100x of PRS Note assumed by FS.

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