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Federal Tax ADVISORY ■

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Stock Acquisitions Checklist

On October 22, 2016, the Treasury finalized the debt/equity regulations under Section 385 it had proposed in April. The 517-page package can daunt even the most motivated readers. "Expanded groups" (EG) that know they will be subject to the regulations should be deep into the process of preparing to put documentation procedures in place and planning to avoid the "funding rule" on account of intercompany borrowings.

But without getting into that level of detail, M&A analysis of targets in the short term will need to be carried out at a fairly high level because of these regulations. Due diligence on stock acquisitions since the proposal of the regulations should have included consideration of their impact, principally because post-April 4, 2016, debt and transactions might be caught in the regulations when finalized; now we know that is mostly true. In the current period of transition to full application of the regulations, the following checklists should be helpful for stock acquisitions.

Effective Date Applicability

- If an acquisition will close during the target year ending before January 19, 2017, stop here unless the target is a common parent of the EG (for which see below).
- If an acquisition will close during the target year ending on or after January 19, 2017, but before January 1, 2018, the documentation rule cannot apply. If it will close after 2017, come back next year for a documentation checklist for a covered debt instrument issued after 2017.
- For transactions regulations issues for closing during years ending on or after January 19, 2017, is the target an EG member?
- If so, do any exceptions to the application of the transactions regulations apply based on size and amounts?
- If not exempt, go to the following questions that address only the transactions regulation.

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Buying Target with No Subs

- After acquisition, will the target hold stock or debt of a member of the former EG or vice versa (usually not, as deal matter)?
- If so, debt in form may have been recharacterized from stock immediately before leaving the EG. However, that should have no continuing consequences to the target.
- A Section 338 election should have no effect on this analysis.

Buying Target with Its Subs

Target is the EG common parent

Transaction general rule issues:

- For target years closing on or after January 19, 2017, did any EG member issue after April 4, 2016, to another EG member any covered debt instrument in a transaction described in Section 1.385-3(b)(2) ("general rule") (generally: distributions, or for EG stock, or boot in reorganizations)?
- If so, was the covered debt exempt from the rule by virtue of the earnings and profits (E&P) or other exceptions?
- If not, analyze.

Transaction funding rule issues:

- For target years closing after January 19, 2017, did any EG member (funded member) issue after April 4, 2016, to another EG member any covered debt instrument to which Section 1.385-3(b)(3) ("funding rule") might apply? This can be any sort of borrowing or debt financed intra-EG acquisition of property of any kind.
- If so, after April 4, 2016, did the funded member make any distribution of property or acquisition using property (i.e., cash) in the type of transactions described above for the general rule?
- If so, and the two events occurred within 36 months, was the covered debt exempt from the rule by virtue of the E&P or other exceptions?
- If not, analyze.
- The "principal purpose" rule for funding can be ignored due to the inevitability of 36-month linkage for the next few years.

Target is not common parent (subgroup):

- Unlike the acquisition of a single corporation, this raises the additional issues of interests issued and held within the target subgroup.
- There is no general "subgroup exception" to recharacterization of debt on exiting the expanded group, so the same considerations for a single target apply to all covered debt, owned within the subgroup or to former affiliates.
- Were all of the corporations acquired members of a consolidated group, and will they join the acquirer's consolidated group? If so, there should be no covered debt within that group to be concerned with.

For additional information, call Jack Cummings at 919.862.2302.

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