State Implementation Issues for Internal Revenue Code Section 385

Issue

The U.S. Department of the Treasury and the IRS recently issued regulations under Internal Revenue Code section 385 that may result in unintended state tax consequences for taxpayers who file in multiple states and engage in related party transactions.

Because states employ a variety of methodologies to impose tax on income and capital, the new regulations will result in added compliance complexities and potential tax impacts.

Background

The new regulations are intended to prevent U.S. corporations from engaging in tax planning strategies to divert income outside the country through the use of related-party interest deductions. However, the regulations are also applicable to domestic related-party transactions.

The regulations place documentation requirements on U.S. corporations as a precondition to treat financial instruments as debt when issued to a related party. While the regulations will generally apply to taxable years ending on or after January 19, 2017, the rules include a retroactive effective date that will apply to many transactions that occurred on or after April 4, 2016.

Importance to CPAs

Businesses across the U.S. use these related-party transactions with domestic affiliates as a way to fund operations in the ordinary course of business. The regulations will have broad federal and state tax consequences. CPAs assist corporations with tax compliance and planning, including on transactions affected by the regulations.

AICPA Position

The AICPA encourages state CPA societies to work with policymakers for fair, reasonable, and administrable rules that minimize the complexities and burdens to taxpayers and state tax authorities alike.

The AICPA supports state CPA society efforts to work with policymakers to provide published guidance on the state treatment of the regulations to provide certainty to taxpayers and practitioners as to whether the state will conform to the new regulations. This guidance will be important for taxpayers reviewing and developing intercompany arrangements and for practitioners to provide appropriate guidance on these issues.

State Activity

To date, no state has provided guidance on the regulations. However, states have considered and litigated this issue and are likely to issue guidance in the future.

February 28, 2017