SECTION 385 REGULATIONS STATE IMPLEMENTATION ISSUES

ISSUE

The U.S. Department of the Treasury (Treasury) and the Internal Revenue Service (IRS) recently issued final and temporary regulations (Regulations) under Internal Revenue Code (IRC) section[1] 385 that may result in unintended state tax consequences for multistate filers engaging in related party transactions.

The multitude of methodologies that states employ to impose tax on income and capital, the potential lack of guidance from state authorities, and the variety of taxpayer-specific fact patterns and transactions will likely result in added compliance complexities and potential tax impacts.

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.

State CPA societies may want to consider suggesting that each state 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, or decouple from, the Regulations. This guidance is important for taxpayers reviewing and developing intercompany arrangements to understand what will happen for state corporate income and franchise tax purposes, and for practitioners to provide appropriate guidance on these issues.

Specifically, CPA state societies may want to consider the following potential issues in working with their state legislatures and tax authorities.

Conformity

- Are states that generally conform to the IRC bound to adopt the Regulations?
- To the extent that states that do not conform to federal consolidated filing rules apply the Regulations, how will the state provide for the computation of taxable income?
    - For combined or separate states that require the computation of taxable income "as if" the entity filed in a manner other than it did for federal consolidated purposes, will states apply

[1] All references herein to "section" or "§" are to the Internal Revenue Code of 1986, as amended, or the Treasury Regulations promulgated thereunder.

the Regulations for state income/franchise tax purposes to transactions between domestic members of a consolidated group that were exempt for federal income tax purposes.

- Similarly, how will states implement the documentation rules where a taxpayer meets an exception for federal tax purposes? States likely may need to consider conformity issues for each federal exception.

  - For example, states may consider the federal exception for S corporations.

  - Another example is how will states consider the situation where a taxpayer meets the federal exception because the taxpayer is a member of a consolidated group? Will the state require documentation solely to achieve an exception from re-characterization in that state?

- How will states, such as Massachusetts, that already have case law providing guidance on defining debt incorporate the Regulations?

Cash Management Arrangements

- Have the states contemplated how the Regulations may affect centralized cash management and cash pooling practices, and have the states considered annual requirements that may apply?

- Given all the exceptions in the final regulations, will the states provide the ability for taxpayers to make use of similar exceptions at the state level?

Interest and Dividends Received Deductions and Related-Member Addback Exceptions

- How will states that already have rules providing exceptions to the addback of interest deductions, particularly the conduit exception applicable to "back-to-back" debt, incorporate the Regulations?

- If debt is re-characterized as equity and the payee can no longer deduct the interest expense, is a dividends received deduction available to the payor? Depending upon when the re-characterization is made, would the state hold the statute of limitations open for the payor? *See also below under increased audit activity.*

Increased Audit Activity

- Will states look to the Regulations for guidance or as an audit tool on how to analyze debt versus equity issues regardless of the level of conformity, and are taxpayers and practitioners prepared to address this?

- To the extent the taxpayer has adjustments as a result of a federal audit, are taxpayers and practitioners prepared to address the state impact within the state's time frame for filing amended returns as the result of a Revenue Agent Report? Will the state consider ancillary state issues relating to re-characterization of debt to equity open under the statute of limitations

for taxpayers to make adjustments, or will the state only allow the taxpayer to "flow through" the federal change?

Apportionment

- Have states that source interest income differently from dividend income considered the impact that re-characterization may have on the apportionment factor?

Net Worth Tax

- Have states that impose a tax based on net worth considered the impact on the taxpayer's liability if debt is re-characterized as equity?

Ownership Changes Impacting Combined Groups

- Have states that mandate or allow combined or consolidated filing considered the potential impact to the composition of the filing group if the debt that is re-characterized as equity results in a significant change to the ownership percentage between a parent and its affiliate?

Earnings & Profits/Basis

- If states adopt the exception to the recast rule relating to distributions for covered members with cumulative positive earnings and profits, how will the corporation calculate earnings and profits and stock basis attributes for state corporate income tax purposes?

BACKGROUND

On October 13, 2016, the IRS and Treasury issued the Regulations, which address the treatment of related-party debt. The Regulations became effective as of October 21, 2016, the date of publication in the Federal Register.[2]

The Regulations were a result of the Treasury's concerns relating to international inversions and were intended to prevent U.S. corporations from engaging in tax planning strategies to divert income outside the U.S. through use of related-party interest deductions. However, the manner in which the Regulations were crafted also makes them applicable to domestic related-party transactions.

The Regulations provide rules for corporations to determine if a financial instrument issued to a related party is treated as debt or re-characterized as equity. The Regulations now levy documentation requirements as a precondition to treat financial instruments as debt (documentation rules) and target certain transactions involving financial instruments that insert leverage without introducing new capital to the group of related entities (recast rules).

[2] T.D. 9790 (10/21/16) and REG-130314-16 (10/21/16).

The Regulations generally apply to taxable years ending on or after January 19, 2017 (90 days after October 21, 2016). As it relates to the recast rules, a retroactive effective date may apply to many transactions where "debt" was issued occurring on or after April 4, 2016 (the date of the proposed regulations). If the corporations must re-characterize the debt as equity under the Regulations, the recast will coincide with the January 19, 2017 date. The documentation rules will apply to instruments issued on or after January 1, 2018.

IMPORTANCE TO CPAs

Given the number of businesses in modern America that employ related-party transactions with domestic affiliates as a way to fund operations in the ordinary course of business, it is anticipated that 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, and interact with the state tax authorities on behalf of their corporate clients.

CPAs are interested in working with the state tax authorities and legislatures as conformity to, or decoupling from, the Regulations is considered and potentially implemented in each state.

RECENT STATE ACTIVITY

On July 22, 2016, the Multistate Tax Commission (MTC) Counsel issued a memo to the MTC Uniformity Committee Chair regarding the state income tax implications of the proposed section 385 regulations pertaining to intercompany debt and equity classifications.

To date, we are unaware of any states that have provided guidance on the Regulations. However, states have considered and litigated this issue and are likely to issue guidance in the future.

For example, Massachusetts is a leader in case law related to debt versus equity treatment. In fact, several recent Massachusetts decisions held that the state taxing authority can make its own determinations in the debt-equity reclassification.[3] In *National Grid Holdings*, the Massachusetts Appellate Tax Board held that the IRS determination that a portion of the debt was treated as debt was not dispositive, and the Board engaged in its own analysis of whether the underlying instrument was correctly classified as debt under its common law debt-equity principles.

In the cases referred to above in the footnote, the Massachusetts Department of Revenue disallowed intangible and interest expense deductions in which the underlying obligations do not qualify as bona fide debt. Some of the factors the Massachusetts Department of Revenue has traditionally used in its determinations include: (1) arm's-length, unqualified, legal obligations to repay; (2) fixed payment dates; (3) actual payments; and (4) clear terms.

Given the Massachusetts Department of Revenue's history in litigating debt-equity reclassifications and recent discussions with officials at the Department, we anticipate that Massachusetts will provide guidance on this issue.

[3] See *Staples, Inc. v. Commissioner of Revenue* (2015); *National Grid Holdings Inc. v. Commissioner of Revenue* (2014); *Kimberly-Clark Corp. v. Commissioner of Revenue* (2013).

Similarly, New Jersey Division of Taxation officials indicated in public presentations that they are having internal meetings in order to determine how best to provide guidance to taxpayers.

The AICPA's State and Local Tax Technical Resource Panel and AICPA State Legislative and Regulatory Affairs team continue to monitor state guidance on this topic.

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