

State income tax effect of proposed federal intercompany debt regulations

Overview

On April 4, 2016, the Internal Revenue Service (IRS) issued proposed Treasury regulations under Section 385 of the Internal Revenue Code¹ (Proposed Regulations) that would, if adopted in their current form, have a wide-ranging impact on intercompany debt, including requiring certain debt instruments issued between related parties to be recharacterized as equity, and establishing minimum documentation requirements that must be satisfied for intercompany debt instruments to be respected. While the Proposed Regulations are not intended to affect debt between members of a consolidated federal return for federal tax purposes, they may have implications for state income tax purposes, especially in states that do not fully conform to the federal consolidated return regulations.

In this Tax Alert, we summarize and highlight the relevant provisions of the Proposed Regulations and provide some taxpayer considerations in light of the potential state income tax implications. For a more comprehensive discussion, please see the Deloitte United States Tax Alert, [Proposed Regulations Addressing Treatment of Certain Interests in Corporations as Stock or Indebtedness](#), issued April 6, 2016.

Debt instruments could be recharacterized as equity

The Proposed Regulations generally apply to “expanded group instruments” (EGIs) between members of an “Expanded Group,” which is an affiliated group as defined in Section 1504 of the Internal Revenue Code (Code), plus many other entities affiliated through direct or indirect ownership, including foreign corporations, tax exempt corporations, insurance companies, RICs, REITs, and S corporations otherwise excludable from a federal consolidated group.²

There are two provisions which would generally operate to recharacterize certain EGIs as equity in all instances: (1) the “General Rule” and (2) the “Funding Rule.” Under the General Rule, an EGI will be treated as stock to the extent that it is issued in the following contexts (General Rule EGIs):

- As a distribution (e.g., a dividend note);
- In exchange for expanded group stock; or
- In exchange for property in an asset reorganization where an expanded group member receives the debt instrument with respect to its stock in the transferor corporation.³

In addition to the General Rule EGIs, the Funding Rule provides that an EGI that is issued to a member of the Expanded Group in exchange for property (including cash) will be re-characterized as equity, where the “principal purpose” of the loan is to allow the issuing entity to fund a distribution of property or certain acquisitions of expanded group stock or assets (Principal Purpose EGIs).⁴ While the determination of whether an EGI has the principal purpose of funding such a distribution or acquisition depends upon the facts and circumstances, there is a presumption that an EGI will be treated as stock if it is issued during the period lasting from 36 months before or after the date of the distribution or acquisition.⁵

There are two general exceptions to the required re-characterization rules. First, an EGI will not be treated as stock if, immediately following its issuance, the total amount of EGIs held by members of the expanded group that would otherwise be subject to the recharacterization rules is less than \$50 million.⁶ Second, distributions or acquisitions that do not exceed the current year’s earnings and profits of the member making the distribution or acquisition are

¹ Prop. Treas. Reg. §§ 1.385-1, *et seq.*, REG-108060-15 (Apr. 4, 2016).

² Prop. Treas. Reg. § 1.385-1(b)(3); IRC § 1504. Other provisions apply to instruments between members a “modified expanded group,” as explained further below.

³ Prop. Treas. Reg. § 1.385-3(b)(2).

⁴ Prop. Treas. Reg. § 1.385-3(b)(3).

⁵ Prop. Treas. Reg. § 1.385-3(b)(3)(iv)(B). The only exception being where the debt arises in the ordinary course of business in connection with the purchase of property or receipt of services between affiliates. *Id.* The Funding Rule could also potentially cause intercompany debts unrelated to the purchase or acquisition to be recharacterized if issued within the 72-month window.

⁶ Prop. Treas. Reg. § 1.385-3(c)(2).

not treated as distributions or acquisitions for purposes of determining whether an EGI is a General Rule EGI or a Principal Purpose EGI.⁷

Proposed Regulations impose new documentation requirements

Under the Proposed Regulations, an EGI will be recharacterized as stock unless a taxpayer satisfies certain minimum documentation and information requirements contemporaneously with the issuance of the debt, unless the taxpayer can establish that the failure is due to reasonable cause.⁸ The documentation requirements apply to expanded groups (1) which are publicly traded; (2) whose total assets exceed \$100 million; or (3) whose total annual revenue per financial statements exceeds \$50 million, as of the date the instrument first becomes an EGI.⁹ Meeting the new documentation criteria does not definitively establish that an EGI is properly treated as debt for tax purposes, but only serves as a minimum threshold that the EGI may qualify as debt. The analysis of whether an EGI is properly treated as debt or equity (apart from those discussed above which are classified as equity by default) will continue to be done by weighing the relevant factors outlined in federal common law.¹⁰

The written documentation related to an EGI must generally include the following evidence:

- The issuer has an unconditional and legally binding obligation to pay a sum certain on demand at one or more fixed dates;
- The holder has the rights of a creditor to enforce the obligation;
- The issuer's financial position supports a reasonable expectation of repayment; and
- Timely payments of interest and principal and/or reasonable exercise of diligence in the event of a default.¹¹

The documentation must be prepared no later than 30 days after the date on which a member of the expanded group becomes an issuer of a new or existing EGI.¹²

Discretionary recharacterization by the IRS under the Proposed Regulations

The Proposed Regulations would allow the IRS to recharacterize EGIs as part indebtedness and part equity where both the issuer and the holder of the EGI are members of the same modified expanded group.¹³ Taxpayers may not affirmatively bifurcate debt; the issuer and any person relying on the characterization of the EGI as debt for federal tax purposes must treat the EGI consistently with the initial characterization.¹⁴ Instead, the determination is solely within the discretionary authority of the IRS.¹⁵ The IRS may also recast indebtedness as stock if it finds that the principal purpose for the issuance of the debt was to avoid the application of the Proposed Regulations.¹⁶

Proposed Regulations could apply domestically in separate filing states and combined filing states that do not follow the federal consolidated return rules

Because most states that impose a corporate income tax generally use federal taxable income as the starting point for calculating state taxable income, the recharacterization of debt as equity for federal income tax purposes would typically result in the disallowance of the deduction of interest for state income tax purposes as well. Although likely not intended by the IRS, as explained below, the Proposed Regulations also could have an effect for state income tax purposes even where they are not applicable for federal income tax purposes.

The Proposed Regulations treat all members of a federal consolidated group as one corporation, and thus their provisions do not apply to transactions between members of a group filing a consolidated federal income tax return.¹⁷ However, many states have specific provisions requiring taxable income to be calculated for state income tax purposes as if a separate federal return had been filed, without regard for the federal consolidated return rules. In such states, the Proposed Regulations may likely apply for state-only purposes to affiliated indebtedness between members of a group filing a federal consolidated return. In addition to separate company filing states, the Proposed Regulations could also potentially apply in combined filing states where there are differences between

⁷ Prop. Treas. Reg. § 1.385-3(c)(1).

⁸ Prop. Treas. Reg. § 1.385-2(b), (c).

⁹ Prop. Treas. Reg. § 1.385-2(a)(2).

¹⁰ Prop. Treas. Reg. § 1.385-2(a).

¹¹ Prop. Treas. Reg. § 1.385-2(b)(2).

¹² Prop. Treas. Reg. § 1.385-2(b)(3). Evidence of timely payments made should be recorded within 120 days of the due date. *Id.*

¹³ Prop. Treas. Reg. § 1.385-1(d). A modified expanded group means an Expanded Group as determined by, *inter alia*, substituting a 50% ownership threshold for the 80% threshold that applies to the Expanded Group determination. Prop. Treas. Reg. § 1.385-1(b)(5).

¹⁴ *Id.*

¹⁵ *Id.*

¹⁶ Prop. Treas. Reg. §§ 1.385-2(d) and 1.385-3(b)(4).

¹⁷ Prop. Treas. Reg. § 1.385-1(e).

the federal consolidated group and the combined filing group, such as where state rules exclude certain types of entities (e.g., non-unitary entities, 80/20 companies, captive insurance companies, etc.).

The provisions in the Proposed Regulations which involve the discretionary authority of the Commissioner (such as the partial recharacterization of an EGI as equity) would arguably be considered the authority of only the IRS and not as an express authority to be asserted by a state taxing authority; however, many state taxing authorities already have wide discretion to redetermine income.

Proposed Regulations could override certain existing state intercompany interest provisions

States currently have a number of methods available under state law to adjust or disallow the payment of interest between related parties. Since the early 2000s, many separate company filing states have enacted statutes that require taxpayers to add back the deduction for interest paid to an affiliated entity (addback statutes). However, most addback statutes contain various safe harbors. Many states also provide other exceptions, such as a conduit exception when the interest is ultimately paid to a third party. The Proposed Regulations have no such safe harbors or exceptions and could potentially disallow the state-level deduction when applied to recharacterize an EGI as stock.

The Proposed Regulations, if enacted in their present form, would likely require taxpayers to make affirmative adjustments to their separate company pro-forma federal returns due to mandatory recharacterization under the General Rule, Funding Rule, or minimum documentation standards in certain states. Accordingly, what previously may have been an exposure analysis consideration may now become a required state adjustment on an originally-filed state return under the Proposed Regulations, absent state authority to the contrary.

Effective dates

Please see the Deloitte United States Tax Alert referenced above for a full discussion of the effective dates for all provisions of the Proposed Regulations.

Proposed Regulation provision	Application
Mandatory Recharacterization rules	Debt instruments issued on or after April 4, 2016. Any instrument that would be recharacterized as equity that is issued after April 4, 2016, but before the issuance of final regulations, would be treated as debt until 90 days after final regulations are issued. ¹⁸
Minimum documentation requirements	Debt instruments issued on or after the issuance of final regulations.

While debt issued prior to these effective dates generally would not fall under the Proposed Regulations, a number of transactions (e.g., a material modification by refinancing or other changes; a transfer of the debt; or change in entity classification) could trigger the deemed issuance of a new note that would be subject to these rules.

Because many states adopt the Code and Treasury Regulations as of a particular date, the Proposed Regulations would only potentially be applicable in states which adopt the Code and its interpretation under the Treasury Regulations contemporaneously or in a manner that includes the effective dates of the Proposed Regulations upon final adoption.

Considerations

Companies should undertake a careful consideration of the potential impact of the Proposed Regulations on any existing or planned intercompany debt, including:

- Applicability of the Proposed Regulations to existing and anticipated intercompany debt for state purposes;
- Intercompany debt documentation practices, including cash management systems and recordkeeping of payments made on intercompany receivables;
- Federal/state basis differences where transactions are recast for state tax purposes but not federal tax purposes; and
- Deductibility of interest expense on originally-filed returns and the associated financial statement implications.

¹⁸ In addition, indebtedness issued before April 4, 2016, would be subject to the mandatory recharacterization rules of debt under the General Rule and the Funding Rule as a result of an entity classification election made under Treas. Reg. § 301.7701-3 that is filed on or after April 4, 2016. Prop. Treas. Reg. § 1.385-3(h)(1).

Contacts

If you have questions regarding the state tax impacts of the Proposed Regulations, please contact any of the following Deloitte Tax professionals:

[Valerie Dickerson](#)

Partner

Deloitte Tax LLP, Washington, DC
+1 202 220 2693

[Mike Porter](#)

Principal

Deloitte Tax LLP, Boston
+1 617 437 2607

[David Vistica](#)

Director

Deloitte Tax LLP, Washington, DC
+1 202 370 2268

[Michael Bryan](#)

Director

Deloitte Tax LLP, Philadelphia
+1 215 977 7564

[Alexis Morrison-Howe](#)

Senior Manager

Deloitte Tax LLP, Boston
+1 617 437 2345

[Scott Schiefelbein](#)

Senior Manager

Deloitte Tax LLP, Portland
+1 503 727 5382

For further information, visit our website at www.deloitte.com

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