External Multistate Tax Alert
December 20, 2016

Practical state tax considerations arising from final/temporary intercompany debt regulations

Overview

On October 21, 2016, the U.S. Treasury and the IRS published final and temporary regulations under section 385 of the Internal Revenue Code (the 385 Regulations) that generally would allow for certain debt instruments to be recast as equity.[1] Extensive comments were submitted to these Proposed Regulations that had been issued in April, 2016,[2] and the 385 Regulations addressed several of the issues raised by those comments. In many respects these changes are expected to facilitate taxpayer compliance with the 385 Regulations.[3] However, as explained in the Deloitte MTS Alert at the time, the Proposed Regulations raised several issues for state corporate income and franchise taxes,[4] and the updated provisions of the 385 Regulations continue to raise several of these same issues.

This Alert discusses several of the practical state tax considerations for taxpayers that arise from the 385 Regulations.

General Purpose of 385 Regulations

Although a thorough review of the 385 Regulations is beyond the scope of this Alert, the general purpose of these Regulations is twofold:

- To establish threshold documentation requirements that must be met by taxpayers in order for certain related-party debt instruments in a corporation to be treated as debt for tax purposes;[5] and
- To recast certain related-party debt instruments as stock when issued in connection with distributions and certain transactions.[6]

385 Regulations & unintended state income tax consequences

Unintended state income tax consequences may arise from the 385 Regulations because certain states may not conform to the 385 Regulations' exceptions for intercompany debt instruments between corporations filing a federal consolidated return (the One Corporation exception).[7] A number of combined and separate filing states statutorily require taxable income to be computed 'as if' the corporation had filed separately for federal income tax purposes, thereby possibly rendering the One Corporation exception inapplicable.

Further, certain states may attempt to conform or partially conform but apply their own standards upon audit.

For example, the following states have adopted varying provisions defining their filing methodologies, ownership thresholds for unitary returns, respective conformity to the IRC and Treasury Regulations, and conformity to the federal consolidated return regulations.

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[1] Treas. Reg. §§ 1.385-1, *et. seq.*, 81 FR 72858 (Oct. 21, 2016). All subsequent references to the "IRC" are to the Internal Revenue Code of 1986, as amended.
[2] Prop. Treas. Reg. §§ 1.385-1, *et. seq.*, REG-108060-15 (Apr. 4, 2016).
[3] See Deloitte US Tax Alert (October 14, 2016) available here.
[4] See Deloitte MTS Alert (April 29, 2016) available here.
[5] The documentation rules are generally found in Treas. Reg. § 1.385-2.
[6] These recast rules are generally found in Treas. Reg. §§ 1.385-3 and -3T.
[7] Such intercompany debt instruments are not subject to recast for federal tax purposes. Treas. Reg. §§ 1.385-2(d)(2)(ii); 1.385-4T(a).

	California	**Illinois**	**New Jersey**	**New York**	**Virginia**
Filing Methodology	Unitary Combined	Unitary Combined	Separate	Unitary Combined	Separate
Ownership Threshold	>50%	>50%	N/A	>50%	N/A
IRC Conformity, Generally	Selective conformity to IRC including to Subchapter C as in effect on 01/01/2015	Rolling Conformity	FTI Starting Point	Rolling Conformity	IRC as in effect On 12/31/2015
Specific § 385 Guidance	No specific guidance	No specific guidance	No specific Guidance	No specific guidance	No specific guidance
Does the state respect Treas, Reg, guidance (excl. consol. return regs.)?	Generally follows	Generally follows	Generally follows	Generally follows	Generally follows
How is taxable income computed? (excluding special state-specific elections)	Unitary group taxable income aggregates all combined filers' business income & most interco transactions are eliminated; CA conforms to -13 CRRs	FTI computed as if unitary business group members filed cons. fed. return	FTI is computed as if separate federal returns had been filed	FTI computed using fed. cons. return regs. except for elimination of intercompany dividends	FTI is computed as if separate federal returns had been filed

While it is generally expected that many states will conform to the 385 Regulations, the differing provisions for the five states summarized above indicate that a careful state-by-state technical analysis will be required to determine how a particular state will apply the 385 Regulations.

Practical Considerations

The likelihood of state application of the 385 Regulations to debt instruments that are exempt from federal review under the One Corporation exception raises a number of practical considerations for state taxpayers, including:

- Documentation of Domestic Debt Instruments: Taxpayers should bear in mind that if the taxpayer files in at least one state that does not conform to the One Corporation exception (either in whole or in part), the taxpayer should implement policies and procedures to comply with the 385 Regulations for all domestic debt instruments. These policies and procedures, if applied to all debt instruments, will facilitate compliance with each state's particular application of the 385 Regulations.

- Effective Dates for 385 Regulations: The 385 Regulations are generally effective for tax years ending on or after January 19, 2017,[8] although certain exceptions apply (e.g., the documentation rules applicable under Treas. Reg. § 1.385-2 do not apply to interests issued or deemed issued before January 1, 2018).[9] Accordingly, the debt recast rules generally apply to tax years ending on or after January 19, 2017. However, for debt instruments issued after April 4, 2016, but before January 19, 2017, and where the 385 Regulations would have applied to recast them as stock during this period, the debt instruments will be recast as stock immediately after January 19, 2017.[10]
- Financial Statement Impact: Based on the foregoing, January 19, 2017, is generally the first date that any tax effect of the 385 Regulations may apply to taxpayers. Accordingly, for calendar year taxpayers, the 385 Regulations should be considered as having a financial statement impact in the first quarter of 2017. As soon as possible, taxpayers should assess the sufficiency of its internal controls and whether it has a sufficient workplan and timeline to address the 385 Regulations for state income tax purposes.
- Other Short-Term Tasks Include: In addition to assessing the financial statement impact as described above, state taxpayers should immediately:
  - Inventory all intercompany debt obligations, including both domestic-to-foreign and domestic-to-domestic lending as well as the existence of any cash management or cash pooling arrangements;
  - Consider if any prohibited leveraging transactions under the -3 or -3T Regulations exist that were entered into after April 4, 2016 and, if so, consider eliminating the tainted debt instruments;
  - Consider alternative debt structures for any planned new issuances of internal or external debt, including refinancing, and execute on desired alternatives prior to entering into new debt issuance; and
  - Review any planned merger and acquisition activity and update due diligence procedures for both acquisitions (i.e., analyze target compliance with 385 Regulations) and disposition (i.e., prepare for acquirer to review taxpayer's compliance with 385 Regulations).
- Tasks to be Completed Prior to January 1, 2018, include (all tasks to be applied to domestic debt instruments exempt from federal review):
  - Implement steps for compliance with the minimum annual documentation requirements of the -2 Regulations (e.g., creditworthiness analysis needs to document each borrower's ability to repay);
  - Implement changes for cash management and cash pooling that qualify for short term debt exceptions;
  - Implement cash management master documentation;
  - Address intercompany receivables/payables; and
  - Review transfer pricing policies and support.
- Tasks to be Completed Prior to filing 2018 (and subsequent) tax returns include (all tasks to be applied to domestic debt instruments exempt from federal review):
  - Confirm that all documentation and credit analysis required is in place;
  - Determine whether interest deductions are available for state tax purposes, including whether state tax returns can be signed claiming such deductions.
- Consequences of Non-Compliance with 385 Regulations for State Purposes: A taxpayer that does not implement procedures for complying with the 385 Regulations for state tax purposes (e.g., fails to maintain documentation requirements for domestic debt not subject to federal review) could lead tax authorities to recast debt instruments as stock for state but not federal purposes. The state tax consequences might include:
  - Payments of interest and principal being recast as equity distributions or contributions for state tax purposes only, which could lead to 'hook stock' where subsidiaries own stock of parent corporations;

[8] See, e.g., Treas. Reg. §§ 1.385-1(f), 1.385-2(i), 1.385-3(j), 1.385-3T(k), and 1.385-4T(g).
[9] Treas. Reg. § 1.385-2(d)(2)(iii).
[10] Treas. Reg. § 1.385-3(j)(2).

  - Need for separate entity E&P and basis calculations for state tax purposes to determine the state tax treatment of any deemed distribution of interest on a recast instrument; and
  - States may provide a full or partial dividends-received deduction (DRD) for deemed distributions.
- Limited exception for interest-free debt instruments: The 385 Regulations generally apply to interest-free loans except for a narrow exception to the funding rule;[11] taxpayers should confirm and document that any particular debt instrument is exempt from 385 Regulations.
- Broad Application of Documentation Rules: The -2 documentation rules apply both to formal intercompany loans as well as informal balances that are treated as debt on the balance sheet, including:
  - Cash management arrangement balances;
  - Intercompany expenses; and
  - Other intercompany accounts.
- Cash Management Arrangements: Many taxpayers employ cash management/cash pooling arrangements that will be exempt from federal review under the One Corporation exception. These arrangements may raise unusual state tax issues, including:
  - Domestic parent may not be eligible to serve as a "qualified cash pool header" (QCPH) as required by the 385 Regulations. Cash sweeps from domestic subsidiaries to domestic parents within the federal consolidated group will be exempt from federal review under the One Corporation exception but may be subject to state application of the 385 Regulations. A QCPH must have as its principal purpose managing a cash pool arrangement, but a domestic parent may have many obligations/purposes. Accordingly, taxpayers may need to consider restructuring cash management arrangements to insert a QCPH.
  - Cash management master documentation can be used for cash management arrangements, but such master documentation may need to be put in place for debt instruments exempt from federal review.
- State Tax Guidance Regarding 385 Regulations: States have taken a 'wait and see' approach to addressing the 385 Regulations. Taxpayers should carefully consider the consequences and risks of waiting for a particular state to issue guidance regarding the 385 Regulations before implementing a compliance plan. States that have historically recast intercompany debt potentially have new support to do so, while other states may increase activity in this area pursuant to the 385 Regulations.
- Net Worth Tax Issues: States may contend that recast debt instruments must be similarly recast for state net worth tax purposes. However, many state net worth taxes are imposed based on GAAP valuations rather than tax valuations, so this contention may not apply in a number of states.

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[11] Treas. Reg. §§ 1.385-3(b)(3)(i) (qualified short-term debt instrument exception to funding rule); 1.385-3T(b)(3)(vii)(C) (definition of qualified short-term debt instrument includes certain interest-free loans). This exception is not comprehensive (e.g., there is no interest-free loan exception to the documentation rules under Treas. Reg. § 1.385-2).

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