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Proposed Debt-Equity Regulations — Unintended State Tax Headache?

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In this article, the authors discuss several state tax issues raised by the proposed Treasury regulations under IRC section 385, including state conformity, the potential state tax issues that may arise for states with filing groups that differ from the federal affiliated group, and the potential issues for documentation of intercompany debt transactions for state tax purposes.

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On April 8, the IRS issued proposed Treasury regulations under Internal Revenue Code section 385[1] that, if adopted in their current form,[2] would have a wide-ranging impact on treasury operations, intercompany debt, federal income tax recharacterization of some debt as equity,[3] and that would establish minimum documentation requirements that must be satisfied for intercompany debt instruments to be respected. For federal income tax purposes, the proposed regulations do not apply to debt between members of a group filing a consolidated federal return; however, the potential effect of the proposed regulations at the state income tax level is less clear. As this article shows, there may be potential unintended state tax impacts associated with domestic debt that exists between affiliates relative to some states' partial conformity to the taxable income starting point, and a lack of conformity to the federal consolidated return rules (CRRs) and other state requirements to determine federal taxable income as if a separate return has been filed.

I. State Tax Issues in a Nutshell

As a general rule, the state tax effects resulting from new federal income tax legislation or IRS promulgations are not given significant consideration by Treasury. Accordingly, significant analysis is necessary to adequately gauge the scope of a state's conformity to federal income tax law and the associated interpretations of those issues by a state revenue agency. The proposed regulations contain many provisions that could give rise to a wide-ranging application at the state level. This article considers several of the more significant potential implications.

The proposed regulations address whether a given debt instrument between related parties will be treated as debt, equity, or part-debt, part-equity.[4] Debt issued in some transactions between related parties would be automatically recharacterized as equity, and intercompany debt instruments would generally be subject to strict documentation requirements that, if not satisfied, would also lead to automatic recharacterization as equity. The proposed regulations contain several exceptions, including but not limited to an exception for all debt instruments issued between members of an affiliated group of corporations filing a federal consolidated return. Even with those exceptions, the universe of affected debt instruments is expected to be vast.

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[1]Prop. reg. section 1.385-1, *et seq.*, 81 *Fed. Reg.* 20911 (Apr. 8, 2016).

[2]References to the proposed regulations, as the context dictates (for example, to the date of conformity), are to the proposed regulations once adopted or published in final form.

[3]The proposed regulations generally refer to the stock of a corporation and the equity of other entities such as partnerships. Notwithstanding the subtle differences that may exist between the terms, for this article we generally use the term "equity."

[4]The article does not attempt to address or concede the validity of the proposed regulations, if adopted.

While the IRS and Treasury drafted the proposed regulations to address federal income tax issues, the proposed regulations raise several key issues for state tax practitioners to consider, including:

- Does a particular state conform to IRC section 385, directly or indirectly, through a federal taxable income starting point? If indirectly, how is that starting point defined?
- Does a particular state conform to the Treasury regulations in general (including the CRRs) and the proposed regulations promulgated under IRC section 385 in particular?
- What are the effective conformity dates for the specific state and how would that conformity date affect the inventory of taxpayer debt instruments subject to the proposed regulations?
- If applicable, how would a particular state apply the federal consolidated group exception?
- Would separate return states conform to the exception for transactions between members of a federal consolidated group?
- Would unitary filing states apply that exception more widely to intercompany transactions between members of the state unitary filing group that are not filing as part of the same federal consolidated return?
- Similarly, how would separate return states and unitary states with filing groups that differ from the federal affiliated group apply the loan documentation requirements?
- Would affected states follow federal determinations? Would state tax administrators have the ability to assert their own bifurcations?
- How would a federal recharacterization of debt as equity affect existing state tax attributes and tax computations relative to the following:
  — interest expense addback provisions?
  — dividends received deduction calculations?
  — federal versus state differences on basis and earnings and profits calculations?
  — net worth-franchise tax calculations?

In this article, we will briefly summarize the operative provisions of the proposed regulations and then turn to the state tax implications, including the potential for federal and state differences in classification, the impact of the documentation requirements on domestic intercompany debt, the state tax effect of treating interest payments as distributions, the interplay of the proposed regulations with existing addback statutes, and the potential consequences on net worth or franchise tax calculations.

II. Overview of Proposed Regulations

Congress enacted IRC section 385 in 1969 and amended it most recently in 1992.[5] IRC section 385 essentially authorizes the Treasury secretary to promulgate regulations to determine whether a given debt instrument is equity or debt.[6] Treasury and the IRS published regulations in 1980 under IRC section 385 but withdrew those regulations in 1983.[7] The following analysis provides an overview of the significant provisions of the new proposed regulations, although a comprehensive analysis is beyond the scope of this article.[8]

A. Some Debt Instruments Would Be Automatically Recharacterized as Equity

The proposed regulations generally apply to expanded group instruments (EGIs) between members of an expanded group (EG), which is an affiliated group, as defined in IRC section 1504 expanded to include any affiliated foreign corporations, tax-exempt corporations, insurance companies, regulated investment companies, real estate investment trusts, and S corporations otherwise excludable from a federal consolidated group.[9] While direct ownership is normally required for determination of an affiliated group under IRC section 1504, an EG includes any of the above entities in which at least 80 percent of the vote or value of its ownership interests are directly or indirectly commonly owned.[10]

The proposed regulations contain two provisions that generally operate to automatically recharacterize some EGIs as equity in all instances: the general rule and the funding rule. Subject to exceptions, under the general rule, an EGI will be treated as stock when issued in the following contexts (general rule EGIs):

- as a distribution (for example, a dividend note);
- in exchange for EG stock; or
- in exchange for property in an asset reorganization in which an EG member receives the debt instrument regarding its stock in the transferor corporation (for example, a cash "D" reorganization).[11]

For example, if a foreign corporation owned the stock of two U.S. subsidiaries, S1 and S2, and transferred its stock in S1 to S2 in exchange for a note, whereupon S1 converted to a single-member limited liability company that is disregarded for federal income tax purposes, the note issued by S2 would be considered stock under the general rule.

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[5]P.L. 102-486, section 1936(a) (Oct. 24, 1992).

[6]IRC section 385(a).

[7]Treatment of Certain Interests as Stock or Indebtedness, 81 *Fed. Reg.* 20911, 20913 (Apr. 8, 2016).

[8]*See, e.g.*, "Practitioners, Officials Hash Out Earnings Stripping Regs," *Tax Notes*, May 2, 2016, p. 561 (citing, among other things, Craig Gibian of Deloitte Tax LLP regarding federal effective date provisions and impact on when instruments are deemed issued).

[9]Prop. reg. section 1.385-1(b)(3); and IRC section 1504. Other provisions apply to debt instruments between members of a modified EG, as explained below.

[10]*Id.* As drafted, there is some uncertainty as to the scope of the definition of an EG. Also, the use of the word "or" is another deviation to the federal attribution rule.

[11]Prop. reg. section 1.385-3(b)(2).

In addition to the general rule, the funding rule provides that an EGI issued to a member of the EG in exchange for property (including cash) will be recharacterized as equity when the principal purpose of the loan is to allow the issuing entity to fund a distribution of property or some acquisitions of EG stock or assets (principal purpose EGIs).[12] For example, if a parent lent cash to a subsidiary, which the subsidiary then distributed as a dividend within 36 months, the original loan to the subsidiary would be treated as a principal purpose EGI and automatically recast as stock.[13] While the determination of whether an EGI has the principal purpose of funding such a distribution or acquisition depends on the facts and circumstances, there is a nonrebuttable presumption that an EGI will be treated as stock if it is issued during the period extending 36 months before to 36 months after the date of the distribution or acquisition (72-month rule).[14] However, an acquisition of EG stock will not be recharacterized if the acquisition results from a transfer if the acquiring entity holds, directly or indirectly, more than 50 percent of the total vote and value of stock of the member of the EG whose stock is acquired for the 36-month period immediately following the issuance.[15]

There are two general exceptions to the required recharacterization rules: the threshold exception and the current-year E&P exception. First, the threshold exception provides that an EGI will not be treated as stock if, immediately following its issuance, the aggregate issue price of EGIs held by EG members that would otherwise be subject to the recharacterization rules is less than $50 million.[16] Once the $50 million threshold is exceeded, any EGIs that formerly avoided recharacterization because of that safe harbor provision would all be treated as equity.[17] Second, under the current-year E&P exception, the aggregate distributions or acquisitions are reduced by the current year's E&P of the distributing or acquiring corporation for purposes of determining whether an EGI is a general rule EGI or a principal purpose EGI.[18]

B. Documentation and Financial Analysis Requirements for Intercompany Debts

The proposed regulations would also recharacterize an EGI as stock if a taxpayer does not satisfy some minimum documentation and information requirements contemporaneously with the issuance of the debt, unless the taxpayer can establish that its failure to do so was because of reasonable cause.[19] If adopted in their present form, the documentation requirements may trigger significant changes to the taxpayer's treasury functions regarding cash management documentation and tracking procedures. The documentation requirements apply to EGs that are (1) 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.[20] Failure to satisfy those documentation requirements dictates that the IRS will recharacterize the debt as equity, though meeting the new documentation criteria in and of itself does not definitively establish that an EGI is properly treated as debt for tax purposes.[21] 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.[22]

The written documentation regarding an EGI must include the following:

- evidence that the issuer has an unconditional and legally binding obligation to repay the debt;
- evidence that the holder has the rights of a creditor to enforce the obligation;
- evidence that the issuer's financial position supports a reasonable expectation of repayment;[23] and
- evidence of timely payments of interest and principal and evidence of reasonable exercise of diligence in the event of a default.[24]

The documentation generally must be prepared no later than 30 days after the date on which a member of the EG becomes an issuer of a new or existing EGI.[25] The documentation supporting the reasonable expectation of repayment may include cash flow projections, financial statements, business forecasts, asset appraisals, determination of debt-to-equity and other relevant financial ratios of the issuer in

[12]Prop. reg. section 1.385-3(b)(3).

[13]Prop. reg. section 1.385-3(g)(3) (Example 4).

[14]Prop. reg. section 1.385-3(b)(3)(iv)(B). The only exception to the 72-month rule applies to transactions when the debt arises in the ordinary course of business in connection with the purchase of property or receipt of services between affiliates for which the amount paid would be deductible under IRC section 162 or in the costs of goods sold. *See id.*

[15]Prop. reg. section 1.385-3(c)(1).

[16]Prop. reg. section 1.385-3(c)(2).

[17]*Id.*

[18]Prop. reg. section 1.385-3(c)(1).

[19]Prop. reg. section 1.385-2(b). The proposed regulations do not offer any further discussion about what constitutes reasonable cause apart from reference to the general principles of Treas. reg. section 301.6724-1. *See* Prop. reg. section 1.385-2(c).

[20]Prop. reg. section 1.385-2(a)(2).

[21]The proposed regulations provide that a taxpayer cannot intentionally fail to satisfy the documentation requirements with a principal purpose of reducing its federal tax liability. *See* Prop. reg. section 1.385-2(d).

[22]Prop. reg. section 1.385-2(a)(1).

[23]If a disregarded entity is the issuer of an EGI and the owner has limited liability, only the assets and financial position of the disregarded entity would be taken into account in determining whether it would reasonably be expected to pay. *See* Prop. reg. section 1.385-2(b)(2)(iii).

[24]Prop. reg. section 1.385-2(b)(2).

[25]Prop. reg. section 1.385-2(b)(3).

relation to industry averages, and other information regarding the sources of funds enabling the issuer to meet its obligations under the terms of the applicable instrument.[26]

Those documentation requirements could have a more significant impact on taxpayers who have historically relied on journal entries as evidence of payment of intercompany debts. In particular, taxpayers who have implemented daily cash sweeps and treated such sweeps as debt without documenting actual interest payments, ability to repay, and so forth, may be particularly vulnerable to recharacterization.

C. Recharacterization of Some Intercompany Debt as Part-Debt, Part-Equity

The proposed regulations allow the IRS to treat any EGI between members of a modified expanded group (MEG) as part indebtedness and part equity.[27] A MEG is generally the same as an EG, except that the applicable ownership threshold drops from 80 percent to 50 percent.[28] A MEG may also include modified controlled partnerships and other persons who own actually or by attribution the requisite threshold.[29] 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.[30] Instead, the determination of part-debt, part-stock is solely within the discretionary authority of the IRS.[31] 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.[32]

D. The Consolidated Group Exception

In general, the proposed regulations treat all members of a consolidated group as one corporation.[33] Accordingly, during any period when an issuer and a holder of a debt instrument are members of the same consolidated group, the debt instrument is treated as not outstanding under the proposed regulations, and the potential recharacterization tests noted above would not apply.[34] Although not explicitly defined, such a debt instrument is referred to as a consolidated group debt instrument.[35] A debt instrument issued to or by one consolidated group member to another EG member that is not also a consolidated group member is treated as issued to or by all members of the same consolidated group. The proposed regulations provide coordination rules when (1) a consolidated group debt instrument, or the holder or obligor under such instrument, is transferred outside the consolidated group but remains an EGI, and (2) an EGI treated as stock under proposed reg. section 1.385-3 becomes a consolidated group debt instrument.[36]

E. Effective Dates of the Proposed Regulations

The mandatory recharacterization rules of debt under the general rule and the funding rule, as proposed, would apply to any debt instruments issued on or after April 4, 2016.[37] Any instrument that would be recharacterized as equity that is issued after April 4, but before the issuance of final regulations, would be treated as debt until 90 days after the proposed regulations are published as final.[38] Also, indebtedness issued before April 4, is 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. section 301.7701-3 that is filed on or after April 4.[39]

The minimum documentation requirements and the commissioner's discretionary authority to recharacterize part of a debt instrument as stock apply to instruments issued on or after the date of the issuance of final regulations.[40] Also, indebtedness issued before the date those regulations are issued as final is subject to the minimum documentation requirements and the commissioner's discretionary authority to recharacterize part of a debt instrument if and to the extent it was deemed issued as a result of an entity classification election made under Treas. reg. section 301.7701-3 that is filed on or after the date those regulations become final.[41]

While debt instruments issued before those effective dates would generally not fall under the proposed regulations, to the extent that they are materially modified by refinancing or other changes, it could trigger the deemed issuance of a new note that would be subject to those rules.[42]

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[26] *Id.*

[27] Prop. reg. section 1.385-1(d).

[28] Prop. reg. section 1.385-1(b)(5). This definition incorporates the attribution rules under IRC section 318, substituting a 50 percent threshold instead of an 80 percent threshold. *See id.*

[29] Prop. reg. section 1.385-1(b)(5). The term "modified controlled partnership" means a partnership with respect to which at least 50 percent of the interests in partnership capital or profits are owned, directly or indirectly, by members of a MEG. *See* Prop. reg. section 1.385-1(b)(4).

[30] Prop. reg. section 1.385-1(d)(1).

[31] *Id.*

[32] Prop. reg. section 1.385-3(b)(4).

[33] Prop. reg. sections 1.385-1(e) and 1.385-4. The proposed regulations adopt the definition of consolidated group from the CRRs: "The term 'consolidated group' means a group filing (or required to file) consolidated returns for the tax year." *See* Treas. reg. section 1.1502-1(h).

[34] *See, e.g.*, prop. reg. section 1.385- 2(c)(4).

[35] *See, e.g.*, prop. reg. section 1.385-4(a).

[36] Prop. reg. section 1.385-4(b)-(c).

[37] Prop. reg. section 1.385-3(h)(1).

[38] Prop. reg. section 1.385-3(h)(3). Assuming the debt instrument is held by a member of the issuer's EG on that date the debt instrument is deemed exchanged for stock at that time.

[39] Prop. reg. section 1.385-3(h)(1). Debt instruments issued before April 4, 2016, would generally not be subject to recharacterization as an EGI solely based on activities occurring in the 36 months following their issuance, unless the activities resulted in a material alteration of terms or the deemed issuance of a new note.

[40] Prop. reg. sections 1.385-1(f) and 1.385-2(f).

[41] *Id.*

[42] *See, e.g.,* prop. reg. section 1.385-2(f).

III. Potential State Income Tax Effects of Proposed Regulations

A. Overview

The recharacterization of debt as equity is not an entirely new issue for state tax practitioners and state taxing authorities. Some states, such as Massachusetts, have used common law principles to recharacterize debt instruments as equity, while others have enacted statutes requiring the addback of intercompany interest payments.[43] The proposed regulations, however, if finalized in their current form, could dramatically change the landscape in that area by potentially recasting broad swaths of intercompany transactions as equity for both federal and state tax purposes. The remainder of this article provides a framework for addressing some of the potential state income tax questions raised in the introduction.

B. Conformity to IRC Section 385 and the Proposed Regulations

A threshold question for the analysis of the state impact of the proposed regulations is whether the individual states will conform to their provisions. States generally conform to the IRC as of a specific date or have rolling conformity, which automatically updates to the version of the IRC in effect for the current tax year. In a few states, the IRC conformity date is not recent. For example, New Hampshire has what may be the oldest conformity date, conforming to the IRC in effect as of December 31, 2000,[44] while Texas conforms to the IRC and regulations in effect for the tax year beginning on January 1, 2007.[45] Even when that limited number of dated conformity states are considered, however, states generally conform to the IRC as of a date after the most recent amendment to IRC section 385, which occurred in 1992. Thus, it is reasonable to assume that most, if not all, of the states that impose a net income tax will conform to the statutory provisions of IRC section 385 itself.

However, IRC section 385 only directs Treasury to prescribe regulations regarding the characterization of a debt instrument as debt or equity according to some general factors; it contains no operative provisions of its own except to say that a taxpayer is bound by its own characterization of an instrument as debt or equity.[46] Accordingly, absent regulations issued under IRC section 385, the section has no effect on taxpayers.

Whether a particular state will conform to the proposed regulations, if they are made final, differs from the threshold question of IRC conformity because many states do not conform to the Treasury regulations in the same explicit fashion as they do the IRC.[47] States may determine that, given their conformity to IRC section 385 and that its sole purpose is to authorize the publication of regulations regarding intercompany debt, conformity to IRC section 385 dictates conformity to any regulations promulgated thereunder. Even in that scenario, however, further complications may arise as to the exact adoption date of the finalized regulations in a particular state. (Is it April 4, 2016? The specific date of finalization by the IRS? An undetermined later date when the state's conformity to the IRC is amended and incorporates the date of finalization by the IRS?) When states do not conform to the Treasury regulations, even for a single year, significant federal-state tax differences could result. Accordingly, a careful analysis of potential conformity must be undertaken state by state.

C. The Consolidated Return Exception

Perhaps the most significant domestic exception to the proposed regulations at the federal level is the federal consolidated return exception: The proposed regulations treat all members of an affiliated group filing a federal consolidated return as a single entity, and transactions between those affiliates are disregarded.[48] However, given that many states do not allow consolidated returns or follow the federal CRRs,[49] the proposed regulations raise numerous potential complex state tax issues that may extend beyond the computation of taxable income to the application of minimum documentation requirements to the federal versus state tax differences in basis and E&P calculations, and the application of state dividends received deductions.

The states in which the federal consolidated return exception is least likely to apply are the states that require taxpayers to file corporate income tax returns on a separate basis. Such states generally do not adopt the federal consolidated return regime at all, and in some of those states, each entity is generally required to compute its income as if it had filed a separate federal income return.[50]

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[43]*See, e.g., Overnite Transp. Co. v. Commissioner of Revenue*, 54 Mass. App. Ct. 180 (2002); *N.Y. Times Sales Inc. v. Commissioner of Revenue*, 40 Mass. App. Ct. 749, 753 (1996); *Staples Inc. v. Commissioner of Revenue*, No. C310640 (Mass. App. Tax Bd. Sept. 4, 2015); *Nat'l Grid USA v. Commissioner of Revenue*, No. C314926 (Mass. App. Tax Bd. Sept. 19, 2014); and *The TJX Cos. Inc. v. Commissioner of Revenue*, No. C26229-31 (Mass. App. Tax Bd. Aug. 15, 2007).

[44]N.H. Rev. Stat. Ann. section 77-A:1.XX.(1).

[45]Tex. Tax Code Ann. section 171.0001(9).

[46]*See* IRC section 385(c).

[47]*See, e.g.*, Ariz. Rev. Stat. section 43-102.A.2; and Or. Rev. Stat. sections 317.010(7) and 317.018(1).

[48]Prop. reg. section 1.385-4.

[49]*See, e.g.*, Conn. Gen. Stat. section 12-223a(c)(1)(A); and N.J. Admin. Code section 18:7-5.1(c).

[50]*See, e.g.*, Fla. Stat. section 220.03(1)(n); and Ga. Code Ann. section 48-1-2(14). It is possible a state revenue agency may assert that if the state conforms to IRC section 385 and the Treasury regulations promulgated thereunder, the state may be required to conform to the exceptions contained therein. However, given that most separate company states specifically require calculation of federal taxable income without regard to federal consolidated adjustments, it is reasonable to conclude that the federal consolidated return exception would generally not apply.

A similar issue arises in states that require combined or consolidated return filings, which may conform to IRC section 385 but do not fully conform to the federal CRRs.[51] Generally, those states require each member of a combined group to calculate its income as if it were a separate company for federal tax purposes and then either eliminate intercompany transactions or defer them in a manner similar to Treasury reg. section 1.1502-13.[52]

At first pass, one might think that regardless of whether a payment is treated as a dividend or interest, it would be eliminated if the transaction occurs between group members, and thus conclude that the proposed regulations would not have a meaningful impact on debt between members of a combined filing group. However, that ignores the potential effect on dividends received deductions, basis, and E&P of the combined group members. Consider the typical hypothetical involving a Parent and Subsidiary that file as part of a state combined group and a federal consolidated group. Subsidiary issues a dividend note to Parent that is subject to recharacterization for state purposes in a combined state that does not fully conform to the CRRs but is treated as debt for federal purposes. Payments on the instrument are treated as distributions for state purposes, which, to the extent they are treated as dividends, are generally subject to elimination, as would have the interest. However, Parent later sells its interest in Subsidiary to a third party. While for federal tax purposes Parent's basis in Subsidiary would not have changed, if the amount of Subsidiary's distributions was greater than its current-year E&P, the Parent's basis in Subsidiary for state tax purposes may be less.

Similar issues may also arise in jurisdictions that otherwise conform to the CRRs but which define the filing groups differently than the federal affiliated group under IRC section 1502. For example, many mandatory combined reporting states follow the CRRs but exclude domestic captive insurance companies from the state's combined group, even though the captive may be includable in a federal consolidated return.[53] A debt transaction between an insurance company and a non-insurance company affiliate raises the question whether an intercompany transaction eliminated from federal consideration would also be eliminated for state purposes when the insurance company could not file as part of the state unitary return. Given the range of state-specific exclusions from state unitary returns, that analysis would need to be applied state by state.

[51]*See, e.g.*, 17 N.C. Admin. Code 05F.0501(1) (applicable to taxpayers with special permission to file N.C. combined returns); N.D. Admin. Code section 81-03-05.3-3(2)(a) and (3); and S.C. Code Ann. section 12-6-5020(D).

[52]*See, e.g.*, Cal. Code Regs., tit. 18, section 25106.5-1; and 830 Code Mass. Regs. 63.32B.2(6).

[53]*See, e.g.*, Or. Rev. Stat sections 317.013(3) and 317.710(5)(b); and Or. Admin. R. 150-317.710(5)(a)-(B)(2)(c) and 150-317.710(5)(b)(1)(a).

Still other issues may arise in states where the state filing group is larger than or otherwise differs from the federal filing group. While states generally require that affiliated corporate taxpayers must be engaged in a single unitary business to be in a state combined return, many of those states also apply a 50 percent ownership threshold for inclusion in the filing group. For many taxpayers, lowering the threshold to 50 percent from the 80 percent federal threshold expands the state filing group, even with the unitary business limitation that does not exist at the federal level.

Some combined filing states also expand the state filing group beyond the federal affiliated group to include foreign affiliates. For example, California allows taxpayers the option of filing on a worldwide basis. While California specifically conforms to IRC subchapter C[54] and to limited provisions of the CRRs,[55] the state generally eliminates intercompany transactions between affiliates in the California worldwide combined return.[56] The question would then arise whether a state would expand the federal consolidated group exception of proposed reg. section 1.385-4 to all members of a worldwide group or whether it would apply it more literally to only those members of the worldwide filing that are part of the same federal consolidated group. That will need to be considered case by case, looking generally to how each state treats members of the group that do not file as part of the same federal consolidated return.

D. Impact of State Conformity on Documentation Requirements

Perhaps the most cumbersome aspect of the proposed regulations may arise regarding states' respective application of the documentation requirements of proposed reg. section 1.385-2. As described earlier, the proposed regulations require extensive documentation of intercompany debt in an attempt to require those transactions to mirror transactions between independent third parties. The proposed regulations' consolidated return exception would provide for easier administration of that requirement between members of the consolidated group by exempting those transactions from federal review.

However, as discussed above, it is possible that states may assert documentation requirements for purely domestic intercompany loans when no federal documentation is required, thereby extending an already extensive documentation exercise beyond the scope of the federal rules. Accordingly, taxpayers would need to consider the minimum documentation requirements of the proposed regulations in light of all intercompany debts, domestic as well as foreign, in order to avoid automatic state recharacterization of debt as equity. A

[54]Cal. Rev. & Tax. Code section 24451.

[55]Cal. Code Regs., tit. 18, section 25106.5-1(a)(2) (conforms to Treas. reg. section 1.1502-13 as amended through Apr. 1, 2012).

[56]Cal. Code Regs., tit. 18, section 25106.5-1(b)(2).

necessary first step for any taxpayer seeking to comply with the proposed regulations, both for federal and state tax purposes, will be making an inventory of potentially affected intercompany debts. Domestic debt should be included as part of that inventory.

In that context, taxpayers should also examine the impact of the potential inapplicability of the federal consolidated return exception on their intercompany loan documentation requirements. That may impose substantial burdens on taxpayers who have adopted daily cash sweep procedures for transactions between members of the federal affiliated group relative to those states that do not follow the federal consolidated return exception to the proposed regulations.

E. State Conformity to the Bifurcation Rules

Prop. reg. section 1.385-1 allows the IRS to bifurcate debt, treating it partially as debt and partially as equity. That power has potentially existed for decades in IRC section 385(a), allowing the IRS to make adjustments to deductible interest on audit. However, the proposed regulations spell out that authority in significantly greater detail. It remains to be seen whether a state revenue agency would attempt to assert that it has bifurcation authority similar to what the proposed regulations grant to the IRS. That would include potentially acting when the IRS has not done so as well as reaching a different conclusion than the IRS regarding what portion of debt should be reclassified as equity. While the proposed regulations expressly limit the authority to bifurcate to the IRS, some states may already have case law supporting the proposition that the state has the ability to make adjustments to taxable income regarding determinations made under the IRC.

For example, Massachusetts case law supports the proposition that the state taxing authority can make its own determinations on some federal tax issues involving questions of facts and circumstances, such as a determination of whether a taxpayer is in a trade or business under IRC section 183 and thus allowed to claim some business deductions.[57] The state has specifically applied that power in the area of debt-equity reclassification in *National Grid Holdings Inc. v. Commissioner* and its companion case *National Grid USA Service Inc. v. Commissioner.*[58] The taxpayer in that case had entered into an intercompany hybrid instrument that purported to be debt for U.S. tax purposes and equity for U.K. tax purposes. The IRS audited and ultimately allowed a partial deduction of interest as part of the closing agreement with the taxpayer. The Massachusetts Department of Revenue recharacterized the instrument as equity for Massachusetts tax purposes and accordingly disallowed all of the interest deducted. The appellate tax board held that the IRS's determination that the debt was partially treated as debt was not dispositive, and it engaged in its own analysis of whether the underlying instrument was properly treated as debt under common law debt-equity principles. In the board's view, "the amount of interest deduction provided for in the Closing Agreement did not constitute a binding determination of the interest deduction allowable for Massachusetts corporate excise purposes."[59]

While Massachusetts has historically been one of the most aggressive states when it comes to recharacterizing debt as equity, it is important to remember that although the IRS has made a determination that a portion of the interest on a debt is deductible for purposes of section 385, it may not preclude states from acting independently of the IRS treatment and reaching a different conclusion relative to a debt instrument.

F. Impact on Common Intercompany Transactions

The potential application of the proposed regulations for state tax purposes to transactions between domestic affiliates would have a material effect on many types of debt transactions. Historically, many companies have pushed down outside debt owed by a parent or holding company in order to take the interest deductions at the operating company level in separate company filing jurisdictions. Often those debt push-downs have involved the distribution of a note from the operating company to the parent or other transactions in which the operating company does not directly receive cash. The result of that distribution generally is a "back-to-back" loan in which the operating company has a debt to the parent that mirrors the debt the parent holds with the outside lender. Under the proposed regulations, future allocations of debt to subsidiaries may need to comply with the documentation requirements and be structured so that the subsidiaries receive value (for example, if a taxpayer can show that the operating company directly received the proceeds from the outside borrowing) to avoid recharacterization. However, if the payment of what would have been treated as interest is recharacterized as a dividend and therefore not deductible by the payer, the receipt of the recharacterized distribution may in many cases be eligible for a dividends received deduction for state tax purposes, depending on each state's dividends received deduction rules.

Another significant implication of transactions that may be recast as equity for federal purposes but not state (or vice versa) will be the potential deviation of federal and state basis and E&P calculations. For example, if a domestic EGI is recast for state tax purposes, and interest payments are

[57]*See, e.g., Thayer v. Commissioner of Revenue*, Mass. ATB Findings of Fact and Reports 2014-1184, 1204 (holding that "the determination of the IRS's auditor [that the taxpayer was conducting a trade or business] was not binding on the amount of expenses which could be deducted for Massachusetts income tax purposes and thus the [Massachusetts Appellate Tax] Board conducted its own analysis," which came to the opposite conclusion of the IRS).

[58]*Nat'l Grid Holdings Inc. v. Commissioner of Revenue*, No. 292287 (Mass. App. Tax Bd. June 4, 2014) and *Nat'l Grid USA*, *supra* note 43.

[59]*Nat'l Grid USA*, *supra* note 43, at 643.

thus treated as distributions under IRC section 301, the distributions would result in a significantly different state tax basis. As described earlier, there are exceptions to the funding rule that rely on distributions being made from current-year E&P. Without knowing the separate company E&P of the distributing entity, it would be exceedingly difficult to know how much of the distribution might qualify for the exception. While many taxpayers already track those differences for federal-versus-state conformity issues such as bonus depreciation, opening up the debt-versus-equity determination to differing federal and state treatment provides a potentially vast area for differences to arise.

Further, 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 safe harbors or exceptions when the primary purpose of the underlying debt instrument was not tax avoidance, the terms of the debt instrument reflect those of an arm's-length agreement, and the relationship between the parties has the hallmarks of a debtor-creditor relationship. 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 exceptions and, accordingly, may disallow those deductions. Also, many states provide an exception to their addback statutes for interest paid to an affiliate that is resident in a country that has a bilateral tax treaty with the United States. If a cross-border EGI is recharacterized under the proposed regulations, however, the related interest deductions could conceivably no longer be available for some state income tax purposes, notwithstanding the treaty exception. In essence, while a state's addback rules and safe harbors would continue to have effect, they would only be implicated to the extent that the intercompany debt (and the associated interest expense) passes muster under the proposed regulations.

G. Potential Application of the Proposed Regulations To Net Worth Taxes

States impose a variety of non-income-based taxes, many of which are imposed on a tax base measured by an entity's net assets or net worth. Many states look to a taxpayer's balance sheet determined under generally accepted accounting principles to calculate net worth. While the proposed regulations are unlikely to affect the GAAP characterization of a debt instrument, to the extent that debt is recharacterized as stock for income tax purposes, a state may seek to make a similar recharacterization for net worth tax purposes as well. For example, Massachusetts, which calculates net worth according to the GAAP balance sheet, has held in two separate cases that if debt is recharacterized for income tax purposes, it should likewise be treated as equity for net worth tax purposes.[60]

H. Potential for State Action to Address Proposed Regulations

Given the wide-ranging application of the proposed regulations and the likelihood of disparate treatment of EGIs at the federal and state level, it is expected that states may enact legislation, adopt rules, or publish other administrative guidance clarifying ambiguities in that area. As stated above, the proposed regulations are intended by the IRS to combat the perceived abuse of intercompany interest transactions at the federal level. While it may be reasonable to expect the states to seek to use the proposed regulations as a tool to combat perceived abuses, states will almost certainly receive substantial feedback from affected taxpayers, particularly when the potential for a lack of state conformity to the federal provisions would result in a considerable administrative burden. Accordingly, states may be under some pressure to enact statutes or adopt administrative guidance to clarify ambiguities and provide taxpayers with a measure of relief.

IV. Conclusion

While the proposed regulations may be primarily targeted at cross-border transactions, they may have significant unintended consequences for state tax purposes. Although the majority of separate company filing states have already instituted measures that have served to limit the benefit of intercompany interest, the proposed regulations may go beyond those measures and trigger material state-only tax impacts for many taxpayers in addition to the intended federal tax impact. Understanding the state tax effects of the proposed regulations and planning for their implementation are prudent steps recommended for all affected taxpayers. ■

[60] *Staples Inc.*, *supra* note 43; *Nat'l Grid USA*, *supra* note 43. While those cases recharacterized debt as equity under federal common law, the potential exists for the state to assert the principles outlined in those cases to instruments recharacterized under section 385 as well.