In this issue:

Impact of the Proposed 385 Regulations on Cash-Pooling Arrangements

Introduction

On April 4, 2016, the US Department of Treasury ("Treasury") and the Internal Revenue Service (the "IRS") issued proposed regulations (the "Proposed 385 Regulations") under section 385.[1] In general, the Proposed 385 Regulations: (1) authorize the IRS to treat certain related-party interests in part as indebtedness and in part as equity (the "Bifurcation Rule");[2] (2) impose documentation requirements to establish certain related-party interests as debt (the "Documentation Rules");[3] and (3) treat as equity certain related-party interests issued as part of, or in connection with, certain distribution and acquisition transactions (the "Debt Recast Rules").[4]

[1] All references to "section" or "§" are to the Internal Revenue Code of 1986, as amended, and all references to "Treas. Reg. §" and "Prop. Treas. Reg. §" are to the Treasury Regulations issued and proposed thereunder.
[2] Prop. Treas. Reg. § 1.385-1.
[3] Prop. Treas. Reg. § 1.385-2.
[4] Prop. Treas. Reg. § 1.385-3.

Since the publication of the regulations, a substantial number of technical comments regarding the Proposed 385 Regulations have been submitted to Treasury and the IRS, including a comment letter submitted by Deloitte Tax LLP (the "Deloitte Comment Letter") on July 7, 2016.[5] Many of the comment letters that were submitted to Treasury highlight the negative impact that finalization of the Proposed 385 Regulations could have on cash-pooling arrangements. This article highlights certain provisions contained in the Proposed 385 Regulations related to cash-pooling arrangements, certain negative impacts, recommendations for mitigation made by commenters, and the current legislative outlook as it relates to cash-pooling arrangements. For a more complete discussion of the Proposed 385 Regulations, please see the April edition of the U.S. Inbound Corner.[6]

Cash-Pooling Arrangements in General

The Documentation Rules contain certain requirements that relate to cash-pooling arrangements; however, the rules do not specifically define the term.[7] Given the lack of specificity in the regulations, we provide some general background regarding cash-pooling arrangements.

The two primary forms of cash-pooling arrangements are physical cash-pooling arrangements and notional cash-pooling arrangements. Under physical cash-pooling arrangements, generally, a multinational enterprise will use a "treasury center," *i.e.*, an in-house bank, for global cash management and intercompany lending purposes. In general, under a zero balancing structure, "cash-rich" participants of the cash pool transfer cash into accounts of the cash pool leader (or the treasury center) and in turn, the cash pool leader transfers cash to accounts of cash-poor participants. Typically, cash balances of all pool participants are automatically transferred on a daily basis to or from the cash pool leader.

Under notional cash-pooling arrangements, a third-party bank is used in place of a treasury center as the cash pool leader. Under such arrangements there is no physical transfer of cash between participating members, rather all transfers between participating members are recorded by the third-party bank as "notional" credits and debits on the accounts of the participating members.

Many comment letters asserted that taxpayers enter into cash-pooling arrangements for non-tax reasons. For example, one letter stated:

> Multinational groups do not set up cash pooling operations for tax reasons. Cash pooling creates complexities from a tax perspective that have to be navigated such as withholding tax issues, currency exchange issues, etc.... If anything, tax planning would often be easier if each entity held its cash in its own decentralized account.[8]

Cash-pooling arrangements can provide a variety of non-tax advantages, such as the ability for a multinational enterprise to efficiently manage liquidity and currency risk on a worldwide basis, reduce borrowing costs (e.g., due to economies of scale or reduction in third-party credit risk), and increase return on excess cash by aggregating cash and

---

[5] *See* Letter from Deloitte Tax LLP to IRS, *Comments on Proposed Regulations Issued Under Section 385 of the Internal Revenue Code, as Amended*, (July 7, 2016) [hereinafter Deloitte Comment Letter]
URL: http://www2.deloitte.com/content/dam/Deloitte/us/Documents/Tax/us-tax-deloitte-tax-comments.pdf
[6] *See* "Navigating Complexity," *U.S. Inbound Corner*, April 2016
URL: http://www2.deloitte.com/content/dam/Deloitte/us/Documents/Tax/us-tax-usinboundcorner-160418.pdf
[7] An official from the Treasury has stated that Treasury is still developing their own understanding of what "cash pooling" encompasses: "[w]e would like to understand what people mean when they say 'cash pooling.' I view that term as label. We need to understand what's behind it." Alison Bennett, *Controversy Ahead: Treasury Rules Threaten Cash Pooling*, BNA DAILY TAX REPORT (Apr. 26, 2016)
URL: http://taxandaccounting.bna.com/btac/T11100/split_display.adp?fedfid=89053649&vname=dtrnotirc&fcn=4&wsn=553986000&fn=89053649&split=0
[8] *See* Letter from Org. for Intern'l Inv. to Jacob Lew, *REG-108060-15 Proposed Section 385 Regulations*, (July 7, 2016) [hereinafter OFFI Comment Letter]
URL: http://www.taxnotes.com/tax-notes-today/cross-border-mergers-and-acquisitions/international-investors-group-asks-irs-rethink-debt-equity-regs/2016/07/12/18540516

investing in a single currency.[9] Cash-pooling arrangements are implemented to accomplish the foregoing non-tax business objectives.

Specific Cash-Pooling Rules in the Proposed 385 Regulations

In general, the Documentation Rules require the preparation of certain documentation within 30 days of the "relevant date," i.e., the date of issuance of an expanded group instrument, or "EGI."[10] Further, certain additional documentation must be prepared within 120 days of another "relevant date,"[11] i.e., each date on which a payment of interest or principal is due, or each date on which an event of default, acceleration event, or similar event occurs. In place of the foregoing "relevant dates" and accompanying documentation requirements, the Proposed 385 Regulations provide specific "relevant dates" and accompanying documentation requirements for cash-pooling arrangements or internal banking services that involve account sweeps, revolving cash advance facilities, overdraft set-off facilities, operational facilities, or similar features. First, in this context, the regulations define the relevant dates[12] to include the date of the execution of the legal documents governing the EGI and the date of any amendment to those documents that provides for an increase in the permitted maximum amount of principal.[13]

Second, in these instances, documentation establishing that the issuer has an unconditional and legally binding obligation to pay a sum certain on demand or at one or more fixed dates will be satisfied only if the material documentation governing the ongoing operations of the cash-pooling arrangement or internal banking service, including any agreements with entities that are not members of the expanded group, is prepared, maintained, and provided in accordance with the Documentation Rules. Such documentation must contain the relevant legal rights and responsibilities of any members of the expanded group and any entities that are not members of the expanded group in conducting the operation of the cash-pooling arrangement or internal banking service.[14]

Negative Impact of the Proposed Regulations on Cash-Pooling Arrangements

This section will highlight certain negative implications that the Proposed 385 Regulations have with respect to cash-pooling arrangements.

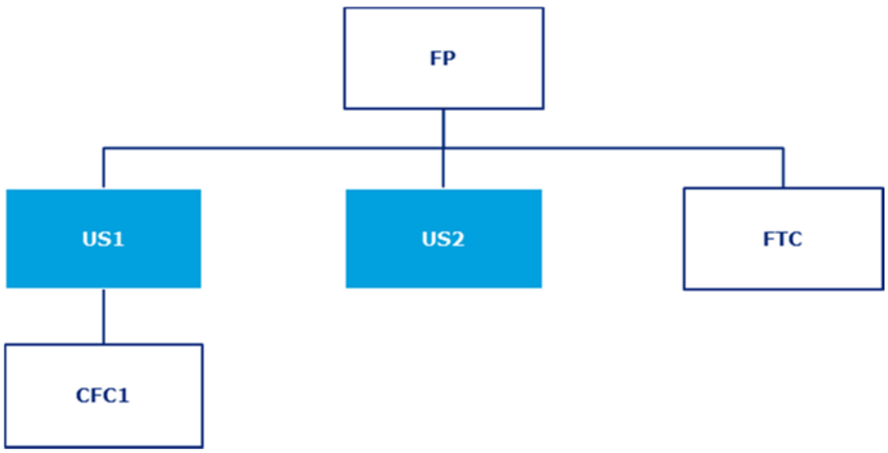
Debt Recast Rules: Application of the Debt Recast Rules[15] to cash-pooling arrangements could result in cascading consequences.

---

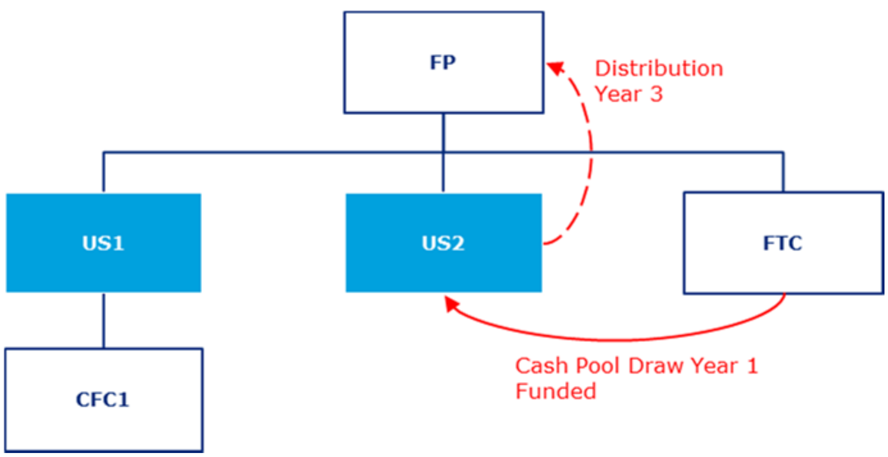
[9] *See generally*, Deloitte Comment Letter, supra note **Error! Bookmark not defined.**; Prillaman, Mou & Yuldasheva, *Treasury Centers Presumed Guilty Under Proposed Debt-Equity Regs*, 151 Tax Notes 1537 (June 13, 2016)
URL: http://www.taxnotes.com/tax-notes/entity-characterization/treasury-centers-presumed-guilty-under-proposed-debt-equity-regs/2016/06/13/18512391?highlight=Prillaman
[10] The Documentation Rules require the following initial documentation: (1) documentation establishing that the issuer has an unconditional and legally binding obligation to pay a sum certain on demand or at one or more fixed dates. Prop. Treas. Reg. § 1.385-2(b)(2)(i); (2) documentation establishing that the holder has rights of a creditor to enforce the obligation. Prop. Treas. Reg. § 1.385-2(b)(2)(ii); and (3) documentation containing information establishing that, as of the date of issuance of the applicable instrument and taking into account all relevant circumstances, the issuer's financial position supported a reasonable expectation that the issuer intended to, and would be able to, meet its obligations under the expanded group instrument. Prop. Treas. Reg. § 1.385-2(b)(2)(iii).
[11] The Documentation Rules require the following additional documentation: (1) documentation recording each payment of principal or interest due under an expanded group instrument, if such payment is claimed to support the treatment of an expanded group instrument as indebtedness under general federal tax principles. Prop. Treas. Reg. § 1.385-2(b)(2)(iv)(A); and (2) If the issuer does not make a payment of interest or principal that is due and payable under the terms of an expanded group instrument, or any other event of default or similar event has occurred, there must be written documentation evidencing the holder's reasonable exercise of the diligence and judgment of a creditor. Prop. Treas. Reg. § 1.385-2(b)(2)(iv)(B).
[12] These modified "relevant dates" also apply for revolving credit facilities. Prop. Treas. Reg. § 1.385-2(b)(2)(iii)(A).
[13] Prop. Treas. Reg. § 1.385-2(b)(3)(iii).
[14] Prop. Treas. Reg. § 1.385-2(b)(3)(iii)(B).
[15] In particular, the "Funding Rule," Prop. Treas. Reg. § 1.385-3(b)(3). For a more complete discussion of the Funding Rule, see *U.S. Inbound Corner*, *supra* note 6, and the Deloitte Comment Letter, *supra* note **Error! Bookmark not defined.**.

The following represents an example of the potential cascading consequences of the Debt Recast Rules in the context of cash-pooling arrangement for a non-US multinational.

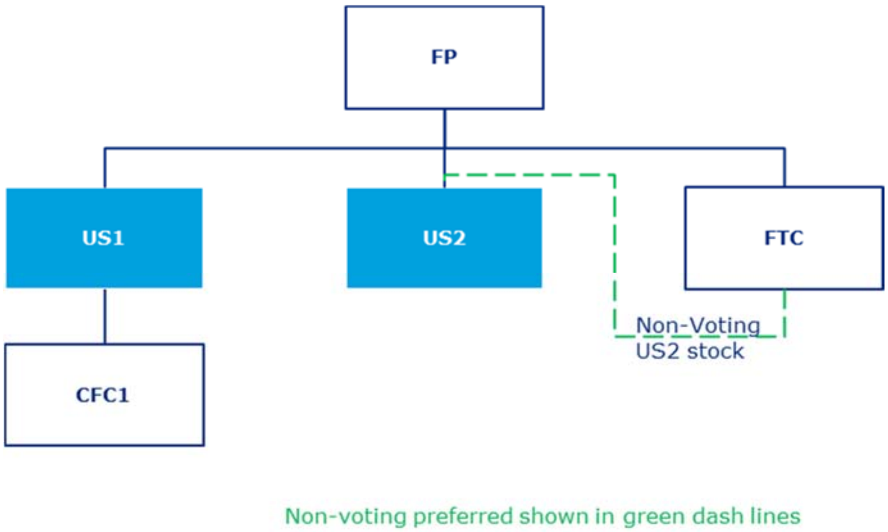
Cash-pooling example 1: Foreign Parent ("FP") is a publicly traded corporation, which owns all of the outstanding shares of US1 and US2. Each of US1 and US2 is a corporation organized under state law in United States. FP also owns all of the outstanding shares of Foreign Treasury Company ("FTC"), a company organized outside of the United States. US1 owns all of the outstanding shares of CFC1, a "controlled foreign corporation" as defined in section 957(a). Each of FP, US1, US2, and FTC are members of an expanded group within the meaning of Prop. Treas. Reg. § 1.385-1(b)(3). Each of US1, US2, FTC and CFC participate in a cash-pooling arrangement in which FTC serves as the cash-pooling leader. Further, each of FP, FTC and CFC1 is a resident of a jurisdiction that has a double tax treaty with the United States that provides for a 0 rate of withholding tax on interest payments made between two treaty residents, and if applicable, each is eligible to claim such exemption.



Assume that on day 1, Year 1, US2 makes a distribution of $100 in excess of its current E&P to FP. In year 3, in the ordinary course of business, US2 borrows $100 from FTC.

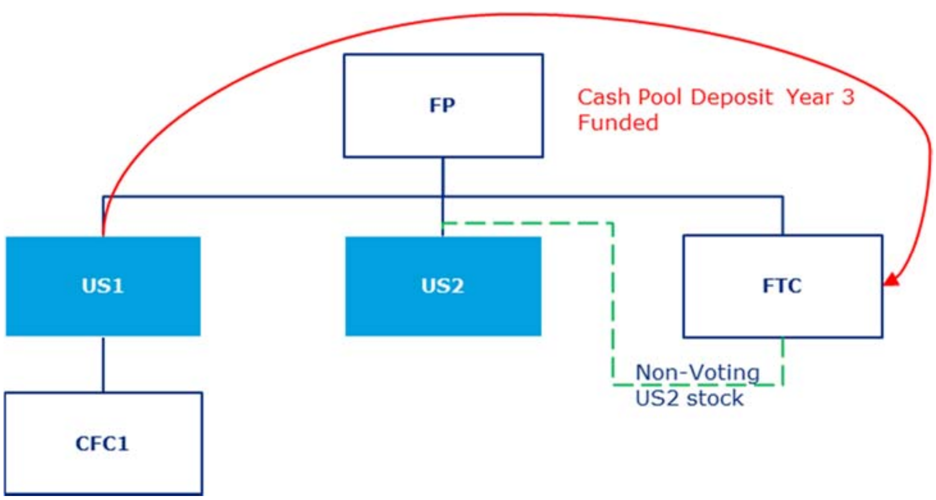


Under Prop. Treas. Reg. 1.385-3(b)(iv)(B), US2's cash-pool borrowing from FTC is treated as issued with a principal purpose of funding the distribution by US2 to FP because the cash-pool borrowing is issued to a member of the FP expanded group during the 72-month period with respect to US2's distribution to FP. As such, under Prop. Treas. Reg. § 1.385-3(b)(ii)(A) and (d)(1)(ii), the US2 borrowing from the cash pool is recast as stock (likely, non-voting preferred stock)[16] in US2 in Year 3, upon the distribution by US2. This result applies for all purposes of the Code, regardless of whether US2 otherwise had the capacity to make the distribution in Year 1 from its historic earning power.



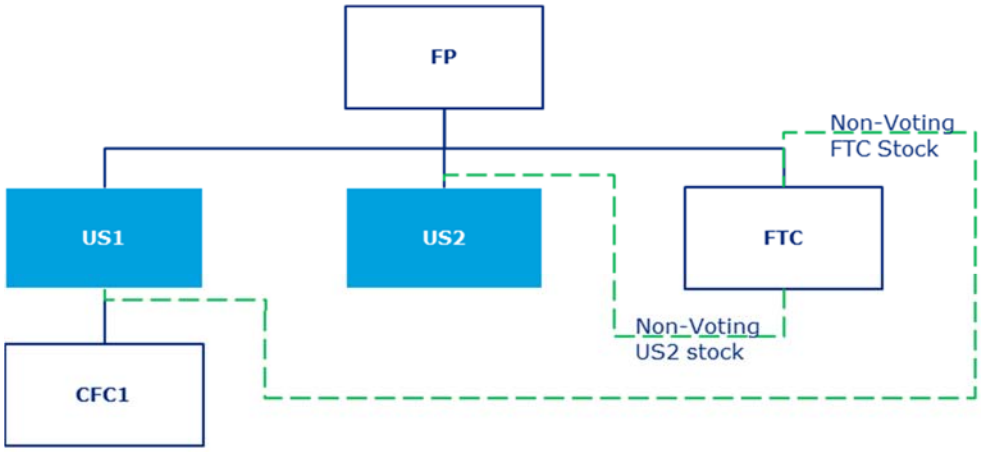
The foregoing recast could have several negative consequences for FP and its subsidiaries. For example, instead of making interest payments to FTC that are subject to 0 rate of withholding, US2's interest payments with respect to its borrowings from FTC would be treated as dividends with respect to preferred stock, and its repayments on the borrowing would be treated as a distribution under section 302(d). Thus, both the interest payments and the redemptions will be treated as prohibited leveraging transactions under Prop. Treas. Reg. § 1.385-3(b)(3). Further, if FTC does not own at least 10 percent of the voting shares of US2, under most US treaties, US2's dividend payment to FTC would be subject to a 15% rate of withholding tax.

Moreover, as noted above, the Debt Recast Rules could result in far reaching "cascading effects." It could impact other cash-rich entities which are making deposits with the cash-pool leader, FTC. Assume that US1 makes regular deposits with FTC.

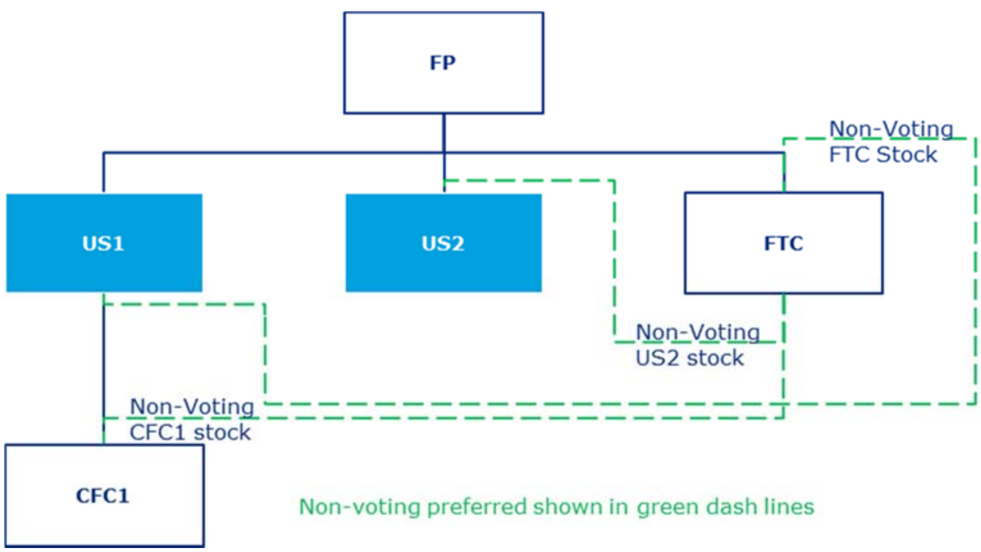


[16] Whether the recast results in non-voting or preferred stock is not clearly defined in Prop. Treas. Reg. § 1.385-(b)(3). However, we are not aware of any authority that would treat this transaction, which is still legally a borrowing that does not grant voting rights, as voting stock.

The impact of the deposit would follow the logic that is noted above. Under Prop. Treas. Reg. § 1.385-3(b)(iv)(B), FTC's borrowing from US1 is treated as issued with a principal purpose of funding the acquisition of expanded group member stock by FTC because the cash-pool borrowing is issued to a member of the FP expanded group during the 72-month period with respect to FTC's acquisition of US2 stock. This acquisition of US2 stock should be treated as a prohibited leveraging transaction under Prop. Treas. Reg. § 1.385-3(b)(3)(ii)(B) because FTC does not own greater than 50 percent of the total combined voting power of all classes of stock of US2 entitled to vote and more than 50 percent of the total value of the stock of US2.[17] As such, the FTC borrowing (USI deposit) from the cash pool is recast as stock (likely, non-voting preferred stock)[18] in FTC in Year 3. This result applies for all purposes of the Code, regardless of whether FTC otherwise had the capacity to make the distribution in Year 1 from its historic earning power.



Cash-pooling example 2: Same facts as Example 1, except CFC1 also has a borrowing with FTC which has been recast as stock under the Debt Recast Rules.

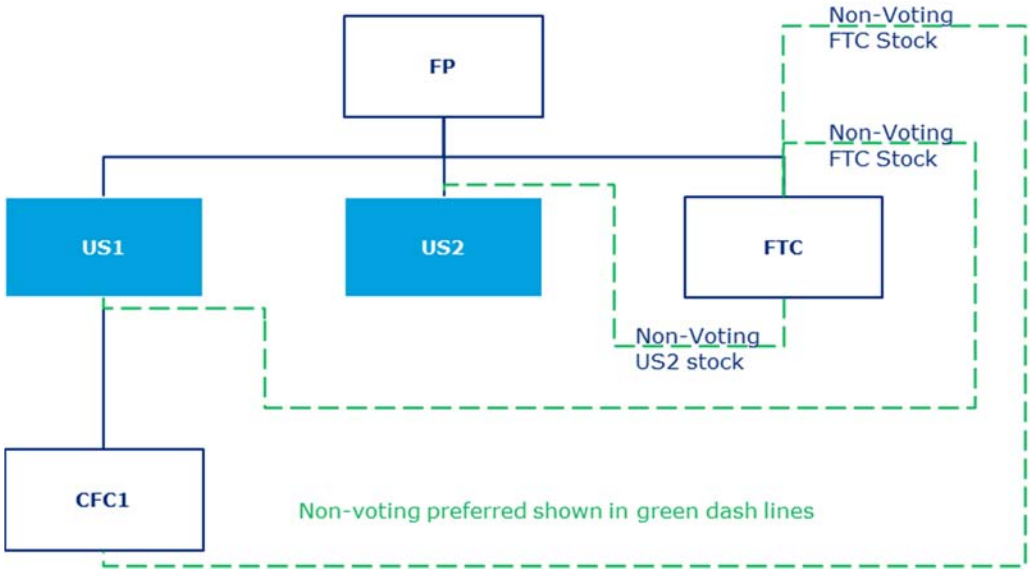


---

[17] Prop. Treas. Reg. § 1.385-3(c)(3).
[18] Prop. Treas. Reg. § 1.385-3(b)(ii)(B) and (d)(1)(ii); *See also* supra note **Error! Bookmark not defined.**.

A repayment of the borrowing by CFC1 to FTC would be recharacterized as a dividend with respect to the CFC1 Non-Voting Stock. The dividend would result in the reduction of the tax pools of CFC and the loss of potential section 902 foreign tax credits for US1, which would be a significant cost if CFC1 operates in a high tax jurisdiction.[19] In contrast, if CFC1 operates in a low tax jurisdiction, the repayment would be treated as a dividend of low tax earnings to FTC, potentially up and over US1. If this is the correct result, the recast of CFC1's borrowing from FTC would provide a positive tax benefit to US1. It is unclear whether the Service would apply the no-affirmative-use rule in the Proposed 385 Regulations[20] or another set of rules to provide an alternative (and more negative) answer for US1 in this scenario.[21]

Cash-pooling example 3: Same facts as Example 1, except CFC1 also has a deposit to FTC which has been recast as stock under the Debt Recast Rules.



If a loan from FTC to CFC1 is recast as stock in FTC, any hedging transactions with respect to CFC1 borrowing would not satisfy the requirements of hedging transactions for US federal income tax purposes such that any foreign currency gains of CFC1 on that hedging transaction would constitute subpart F income for US federal income tax purposes.[22] Treas. Reg. § 1.954-2(g)(4) provides that:

> …a controlled foreign corporation shall include in its computation of foreign personal holding company income the excess of foreign currency gains over losses or the excess of foreign currency losses over gains attributable to any section 988 transaction. …and any section 1256 contract that would be a section 988 transaction but for section 988(c)(1)(D).

If CFC1 has made that election, a recast of CFC1 loan (or borrowing) as stock could cause CFC1 to be in an unbalanced currency position and increase its risk of a subpart F inclusion.

The above is a sample of the potential consequences of the Proposed 385 Regulations. There are potentially many other potential consequences to account for, such as the impact on consolidation under section 1504, accounting methods, and other subpart F consequences.

---

[19] Note, if FTC were a CFC for US federal income tax purposes, it would be receiving a dividend without the associated foreign tax credits. This could result in a significant tax cost for FTC and its US shareholder.
[20] Prop. Treas. Reg. § 1.385-3(e).
[21] See Treas. Reg. § 1.7701-(l)-3.
[22] See section 954(c)(1)(D).

The OFII Comment Letter[23] highlighted the negative impact of the Proposed 385 Regulations have in the context of a notional cash-pooling arrangement.

> **EXAMPLE 2:** FP is a publicly traded corporation that owns all of the outstanding shares of F1, F2, and F3, all of which are foreign corporations. F1 and F2 have the Euro as their functional currency. F3 has the GBP as its functional currency. FP also owns all of the outstanding shares of USCO, a US corporation. FP uses a notional pooling arrangement with a bank, BANK XYZ, pursuant to which each of USCO, F1, F2, and F3 can deposit monies with BANK XYZ or withdraw monies from BANK XYZ. No participating member is entitled to withdraw more than the positive cash pool balance. F1 serves as the cash pool leader. On June 1, 2017, USCO makes a deposit with BANK XYZ of $100 million.[24]

If Bank XYZ is respected as an unrelated party, arguably, the Debt Recast Rules should not apply to borrowings or deposits made by USCO, F1, F2 and F3 with Bank XYZ. The OFFI Comment Letter, however, highlights that there may be authority for the Service to look through Bank XYZ (i.e., treat it as a conduit) such that borrowings and deposits made by USCO, F1, F2 and F3 in this notional cash-pooling arrangement are treated as transactions entered into by related members of the same expanded group; if the Service could apply such a rule, notional cash-pooling arrangement would be subject to the same potential "spider web" of equity highlighted by the example in the Deloitte Comment Letter.[25]

Recommendations Made by Commenters

The following section provides a summary of common recommendations made by commenters to the Proposed 385 Regulations.

1. The final regulations should provide specific definitions of "cash-pooling arrangements", treasury centers, or other similar arrangements (for the purpose of this section, "Cash Concentration Centers") and other related cash management operations.[26]
2. The Documentation Rules[27] and the Debt Recast Rules[28] should not apply to Cash Concentration Centers. If they are applicable, the rules should at least provide an exception or short term debt borrowings for working

---

[23] OFII Comment Letter, supra note **Error! Bookmark not defined.**.
[24] *Id.*
[25] *Id.*
[26] *See e.g.*, Deloitte Comment Letter, supra note **Error! Bookmark not defined.**, at 28; Letter from Am. Bar Assoc. to John Koskinen, *Comments on Proposed Regulations under Section 385*, at 85 [hereinafter ABA Comment Letter]; OFII Comment Letter, supra note **Error! Bookmark not defined.**, at 53; Letter from Tate & Lyle PLC, *Proposed Regulations under Section 385 (Reg. 108060-15)-108060-15 Section 385*, at 6 (July 6, 2016)[hereinafter Tate & Lyle Comment Letter](providing that cash pooling arrangements should be defined as "any mechanism used among members of an affiliated group of companies to pool cash balances in order to meet members' short-term cash needs and access short-term cash surpluses in a cost-efficient manner"); Letter from Repsol S.A. to Jacob Lew, *Proposed Regulations under Section 385 [REG 108060-15]*, at 5 (July 7, 2016)[hereinafter Repsol Comment Letter](defining the term "Qualified Pooling Arrangement" to mean "[a]ny mechanism used by members of an affiliated group of companies to pool cash balances so as to access members' cash surpluses to meet other members' short-term liquidity needs in a cost-efficient manner.").
URL: http://pdfs.taxnotes.com/2016/2016-14423-1.pdf
URL: http://www.taxnotes.com/tax-notes-today/cross-border-mergers-and-acquisitions/corporation-describes-impact-debt-equity-regs-its-business/2016/07/11/18538491
URL: http://www.taxnotes.com/tax-notes-today/cross-border-mergers-and-acquisitions/oil-gas-corporation-recommends-exceptions-debt-equity-regs/2016/07/12/18540371
[27] *See* Letter from Baker & Mckenzie LLP to Jacob Lew, *REG-108060-15 Proposed Section 385* Regulations, at 7, 80 (July 6, 2016) [hereinafter Baker Comment Letter];Tate & Lyle Comment Letter, supra note 26, at 6; Repsol Comment Letter, supra note **Error! Bookmark not defined.**, at 5.
[28] *See* Deloitte Comment Letter, supra note 5, at 31; OFII Comment Letter, supra note 9, at 45, 52; ABA Comment Letter, supra note **Error! Bookmark not defined.**, at 86; Baker Comment Letter, supra note **Error! Bookmark not defined.**, at 80; Letter from New York State Bar Association to Mark J. Mazur, *Report No. 1351 on Proposed Regulations under Section 385*, at 68-69 [hereinafter NYSBA Comment Letter]; Tate & Lyle Comment Letter, supra note **Error! Bookmark not defined.**, at 6; See Repsol Comment Letter, supra note **Error! Bookmark not defined.**,

capital needs or transactions in the ordinary course of business, and for borrowings or deposits that have a low interest rate. The specific interest rates suggested by comments varied, but in general, commenters suggested that arrangements which do not result in significant interest deductions to a US borrower should be excluded from the scope of the rules because such arrangements do not factually implicate the policy concerns that underscore the Proposed 385 Regulations. Further, it has been suggested by many commenters that foreign-to-foreign loans should be completely exempt from the rules of the Proposed Regulations.[29]

3. If the final regulations do not exclude Cash Centers from the application of the Documentation Rules and the Debt Recast Rules, commenters commonly suggested some version of the following:
    a. For the purpose of the Documentation Rules, "reasonable expectation" of repayment should be tested at the time the Cash Concentration Center is initiated[30] and separate and subsequent documentation should not be required for each transaction in the cash pool.[31]
    b. The Documentation Rules should not apply to notional cash-pooling arrangements.[32]
    c. In the context of Cash Concentration Centers, the Debt Recast Rule should be limited to a single recast.[33]

There were many other specific comments included by commenters. The above list represents just a representative sample of common themes that were observed.[34]

Legislative Outlook

Treasury officials have acknowledged the multitude of comments on cash pooling and have indicated that their desire is not to eliminate the use of cash-pooling arrangements in the ordinary course of business. They have indicated that their objective is to distinguish in final regulations between routine short-term cash management, which does not concern them, from longer term financing, which should be subject to the same rules as other intercompany loans. For now, the Administration continues to insist that the regulations will be finalized in the fall of 2016.

---

at 5.
URL: http://www.taxnotes.com/tax-notes-today/cross-border-mergers-and-acquisitions/nysba-tax-section-report-takes-aim-proposed-debt-equity-regs/2016/06/30/18527326

[29] *See* Deloitte Comment Letter, supra note **Error! Bookmark not defined.**, at 12; ABA Comment Letter, supra note **Error! Bookmark not defined.**, at 73; NYSBA Comment Letter, supra note **Error! Bookmark not defined.**, at 88-91; Baker Comment Letter, supra note **Error! Bookmark not defined.**, at 80; OFII Comment Letter, supra note **Error! Bookmark not defined.**, at 10, 52; Letter from SAP America, Inc. to Raymond Stahl, *Re: REG-108060-15 (Proposed Section 385 Regulations)*, at 3 (July 7, 2016) [hereinafter SAP Comment Letter].
URL: http://www.taxnotes.com/tax-notes-today/cross-border-mergers-and-acquisitions/software-company-finds-fault-proposed-debt-equity-regs/2016/07/14/18542876?highlight=SAP 385

[30] *See* Deloitte Comment Letter, supra note **Error! Bookmark not defined.**, at 28; NYSBA Comment Letter, supra note **Error! Bookmark not defined.**, at 68; See generally ABA Comment Letter, supra note **Error! Bookmark not defined.**, at 21-22. Baker Comment Letter, supra note **Error! Bookmark not defined.**, at 82; OFII Comment Letter, supra note **Error! Bookmark not defined.**, at 4; Letter from Retail Leaders Indus. Assoc. to Jacob Lew, *Re: REG-108060-15 Proposed Section 385 Regulations*, at 25 (July 7, 2016) [hereinafter RILA Comment Letter]
URL: http://www.taxnotes.com/tax-notes-today/cross-border-mergers-and-acquisitions/retailers-make-technical-recommendations-debt-equity-regs/2016/07/12/18540466

[31] ABA Comment Letter, supra note **Error! Bookmark not defined.**, at 68.

[32] OFFI Comment Letter, supra note **Error! Bookmark not defined.**, at 52-53; *see* ABA Comment Letter, supra note **Error! Bookmark not defined.**, at 49-50 (ABA recommends that the final regulations "turn off the iterative consequences by providing that a repayment of a recharacterized debt instrument cannot itself trigger the application of the Funding Rule; NYSBA Comment Letter, supra note **Error! Bookmark not defined.**, at 161 ("[i]t should be possible to eliminate the issues described above if the Per Se Stock Rules are revised to state that when an intragroup debt instrument is recast as equity, the deemed issuance of that equity, and any transfer or (actual or deemed) redemption of that equity, will not be treated as a distribution or acquisition for purposes of the Per Se Stock Rules"); Baker Comment Letter, supra note **Error! Bookmark not defined.**, at 81.

[33] *See* ABA Comment Letter, supra note **Error! Bookmark not defined.**, at 49-50; NYSBA Comment Letter, supra note **Error! Bookmark not defined.**, at 162; Baker Comment Letter, supra note **Error! Bookmark not defined.**, at 81.

[34] The citations noted in notes **Error! Bookmark not defined.**-**Error! Bookmark not defined.** above are also meant to be representative, and not inclusive of all comments which highlight these themes.

— Michael Steinsaltz (Philadelphia)
Partner
Deloitte Tax LLP
msteinsaltz@deloitte.com

Anu Thomas Alex (New York)
Senior Manager
Deloitte Tax LLP
aalex@deloitte.com

Proposed debt-equity regulations: Unintended state tax headache?

The article discusses 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.

On April 8, the IRS issued proposed Treasury regulations under Internal Revenue Code section 385[35] that, if adopted in their current form,[36] would have a wide-ranging impact on treasury operations, intercompany debt, federal income tax recharacterization of some debt as equity,[37] 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.

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.[38] Debt issued in some transactions between related parties would be automatically re-characterized 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.

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?

---

[35] Prop. reg. section 1.385-1, *et seq.*, 81 *Fed. Reg.* 20911 (Apr. 8, 2016).
[36] 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.
[37] 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."
[38] The article does not attempt to address or concede the validity of the proposed regulations, if adopted.

- 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.

Overview of Proposed Regulations

Congress enacted IRC section 385 in 1969 and amended it most recently in 1992[39]. IRC section 385 essentially authorizes the Treasury secretary to promulgate regulations to determine whether a given debt instrument is equity or debt.[40] Treasury and the IRS published regulations in 1980 under IRC section 385 but withdrew those regulations in 1983.[41] 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.[42]

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.[43] 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.[44]

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

---

[39] P.L.102-486, section 1936(a) (Oct. 24, 1992).
[40] IRC section 385(a).
[41] Treatment of Certain Interests as Stock or Indebtedness, 81 *Fed. Reg.* 20911, 20913 (Apr. 8, 2016).
[42] *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).
[43] 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.
[44] *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.

- 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).[45]

For example, if a foreign corporation owned the stock of two US 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. 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).[46] 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.[47] 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 non-rebuttable 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).[48] 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.[49]

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.[50] 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.[51] 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.[52]

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.[53] 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.[54] 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.[55] The analysis of whether an EGI is properly treated

---

[45] Prop. reg. section 1.385-3 (b)(2).
[46] Prop. reg. section 1.385-3(b)(3).
[47] Prop. reg. section 1.385-3(g)(3) (Example 4).
[48] 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.
[49] Prop. reg. section 1.385-3(c)(1).
[50] Prop. reg. section 1.385-3(c)(2).
[51] *Id.*
[52] Prop. reg. section 1.385-3(c)(1).
[53] 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).
[54] Prop. reg. section 1.385-2(a)(2).
[55] 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).

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.[56]

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;[57] and
- Evidence of timely payments of interest and principal and evidence of reasonable exercise of diligence in the event of a default.[58]

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.[59] 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 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.[60]

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.

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.[61] A MEG is generally the same as an EG, except that the applicable ownership threshold drops from 80 percent to 50 percent.[62] A MEG may also include modified controlled partnerships and other persons who own actually or by attribution the requisite threshold.[63] 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.[64] Instead, the determination of part-debt, part-stock is solely within the discretionary authority of the IRS.[65] 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.[66]

The Consolidated Group Exception: In general, the proposed regulations treat all members of a consolidated group as one corporation.[67] 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.[68] Although not explicitly defined, such a debt

---

[56] Prop. reg. section 1.385-2(a)(1).
[57] 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).
[58] Prop. reg. section 1.385-2(b)(2).
[59] Prop. reg. section 1.385-2(b)(3).
[60] *Id.*
[61] Prop. reg. section 1.385-1(d).
[62] 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.*
[63] 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).
[64] Prop. reg. section 1.385-1(d)(1).
[65] *Id.*
[66] Prop. reg. section 1.385-3(b)(4).
[67] 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).
[68] *See, e.g.*, prop. reg. section 1.385- 2(c)(4).

instrument is referred to as a consolidated group debt instrument.[69] 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.[70]

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.[71] 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.[72] 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.[73]

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.[74] 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.[75]

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.[76]

Potential State Income Tax Effects of Proposed Regulations

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.[77] 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.

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

---

[69] *See, e.g.*, prop. reg. section 1.385-4(a).
[70] Prop. reg. section 1.385-4(b)-(c).
[71] Prop. reg. section 1.385-3 (h)(1).
[72] 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.
[73] 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.
[74] Prop. reg. sections 1.385-1(f) and 1.385-2(f).
[75] *Id.*
[76] *See, e.g.*, prop. reg. section 1.385-2(f).
[77] *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).

Hampshire has what may be the oldest conformity date, conforming to the IRC in effect as of December 31, 2000,[78] while Texas conforms to the IRC and regulations in effect for the tax year beginning on January 1, 2007.[79] 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.[80] 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.[81] 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.

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.[82] However, given that many states do not allow consolidated returns or follow the federal CRRs,[83] 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.[84]

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.[85] 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.[86]

---

[78] N.H. Rev. Stat. Ann. section 77-A:1.XX.(1).
[79] Tex. Tax Code Ann. section 171.0001(9).
[80] *See* IRC section 385(c).
[81] *See, e.g.*, Ariz. Rev. Stat. section 43-102.A.2; and Or. Rev. Stat. sections 317.010(7) and 317.018(1).
[82] Prop. reg. section 1.385-4.
[83] *See, e.g.*, Conn. Gen. Stat. section 12-223a(c)(1)(A); and N.J. Admin. Code section 18:7-5.1(c).
[84] *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.
[85] *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).
[86] *See, e.g.*, Cal. Code Regs., tit. 18, section 25106.5-1; and 830 Code Mass. Regs. 63.32B.2(6).

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.[87] 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.

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[88] and to limited provisions of the CRRs,[89] the state generally eliminates intercompany transactions between affiliates in the California worldwide combined return.[90] 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.

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 necessary first step for any

---

[87] *See, e.g.*, Or. Rev. Stat sections 317.013(3) and 317.710(5)(6); and Or. Admin. R. 150-317.710(5) (a)-(B) (2) (c) and 150-317.710 (5) (b) (1) (a).
[88] Ca1. Rev. & Tax. Code section 24451.
[89] Ca1. Code Regs., tit. 18, section 25106.5-1 (a) (2) (conforms to Treas. reg. section 1.1502-13 as amended through Apr. 1, 2012).
[90] Cal. Code Regs., tit. 18, section 25106.5-1(6)(2).

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.

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.[91] 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*.[92] The taxpayer in that case had entered into an intercompany hybrid instrument that purported to be debt for US tax purposes and equity for UK 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."[93]

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.

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

---

[91] *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).
[92] *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.
[93] *Nat'l Grid USA*, *supra* note 43, at 643.

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 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.

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.[94]

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.

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.

---

[94] *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.

— Valerie Dickerson (Washington, DC)
Partner
Deloitte Tax LLP
vdickerson@deloitte.com

Scott Schiefelbein (Portland)
Senior Manager
Deloitte Tax LLP
sschiefelbein@deloitte.com

Alexis Morrison-Howe (Boston)
Senior Manager
Deloitte Tax LLP
alhowe@deloitte.com

Tax Data Analytics and Country-by-Country Reporting: Insight to Action

Sweeping changes to tax laws worldwide are creating a new paradigm that affects nearly every aspect of global business

Over the last two years, the Organization for Economic Co-operation and Development (OECD) has been working on its Base Erosion and Profit Shifting (BEPS) project, “the first substantial renovation of the international tax rules in almost a century.”[95]

Final reports on the project’s focus areas were issued in October 2015 and the leaders of the G20 committed to the implementation of BEPS at their summit the following month. The OECD will subsequently finalize guidance that fundamentally changes the global tax landscape.

Further new legislation and reporting requirements aim to create a degree of public transparency and global tax fairness that has never before existed. On the same theme, additional reporting obligations are also being implemented in the banking and extractive industries.

The confluence of the BEPS project, high levels of sovereign debt, increased media attention, and information sharing between tax authorities is culminating in sweeping changes to tax laws and treaties and triggering a complete Global Tax Reset.

Country-By-Country Reporting

CbCR will give tax authorities access to detailed financial information about group operations worldwide: One of the key BEPS changes is the introduction of Country-by-Country Reporting (CbCR) requirements for multinational corporations (MNCs) with turnover in excess of €750 million. CbCR will give tax authorities access to detailed financial information about group operations worldwide.

CbCR provides tax authorities with information to help them assess Transfer Pricing risks and allocate their tax audit resources. A draft template has been issued by the OECD which requires MNCs to report on revenues, pre-tax profits, corporate income taxes paid and accrued, headcount, assets, capital, business activity codes for each operating entity, and several other items of information. Countries are expected to implement local legislation to give effect to the BEPS outputs so that MNCs file their first CbC report 12 months after the end of the fiscal year beginning on or after 1 January 2016.

CbCR reports will be filed with the tax authorities in the country where the MNC is headquartered. Where that country is delayed in implementing the legislation, the MNC can select one of its subsidiaries operating in a country where CbCR is already required and where their most significant activities occur to act as a surrogate filer.

In other words, as long as an MNC operates in at least one country where CbCR is required, it will have to comply and the countdown has already started

How are affected companies responding to CbCR?

---

[95] http://www.oecd.org/ctp/beps-frequentlyaskedquestions.htm

How do I get it, how do I check it, and how do I analyze it?: Currently, MNCs tend to fall into one of two groups. The first group has recognized the size and complexity of the requirement and started to develop their overall CbCR approach strategy and data discovery, or have at least put in place the new annual processes required to gather the data. They have appreciated that compliance with CbCR is more than a data gathering exercise and must involve a strategic first step to determine impacts of their organization and tax structure. This involves assessing how items such as permanent establishments, branches, minority investments, joint ventures, and subpart F income would be treated and adjusted for on their CbC report. These companies have also realized that the data to be collected is of commercial value while being a powerful tool in the hands of the tax authorities. Finally, they are taking a holistic approach to proactively performing a dry run with 2015 data during 2016 in order to analyze how their CbCR data could look, how it could be interpreted by the tax authorities, and what data anomalies might create or highlight potential risks and exposures.

The second group are adopting a "wait and see" approach, holding off taking action until they see the proposed legislation in their headquarter country. This group is on the decline as the first filing deadline looms closer and the scale of the compliance effort comes into focus.

Why is complying with CbCR an issue?

The existing global tax environment is already challenging for MNCs. Most countries' tax laws were written last century; in many cases they are outdated and unsuited for addressing today's digital, globalized economy. In response to these developments, tax authorities have introduced: 1. e-filing; 2. data requirements in a more structured form, such as XBRL or iXBRL supported with standard tax charts of accounts (taxonomies); and 3. mandated access to ledgers or individual transactions for compliance purposes and to calculate liabilities. In response to this evolving environment, MNCs have started to transform their tax functions and the BEPS project is accelerating the need for change.

In an ideal world, the data required to comply with CbCR would reside in a tax-sensitized, group-wide ERP or consolidation system. In reality, such a system is still likely to be an aspiration for most MNCs. The situation is further complicated as group tax departments have previously had no requirement to gather this data (and thus lack the mechanisms for doing so) and tax compliance at the local level has often been a largely standalone process with little or no involvement of the head office tax function. Equally the process of gathering group-wide information for financial reporting purposes has generally resided in the finance function; that data has been collected for a different purpose with different requirements as to the materiality, definitions, and granularity. For CbCR, it is necessary to go beyond locally consolidated data to entity level information, as current OECD guidance indicates that the data should be reported on an aggregated (rather than consolidated) country basis. Unsurprisingly, in some MNCs, discussions are taking place about who is responsible and accountable for these new data needs.

On top of this challenge – which can be summarized as "how do I get it, how do I check it, and how do I analyze it?" – are complications which may arise if a legal entity map denoting permanent establishments and branches and partnerships is incomplete or does not exist. In addition, a decentralized corporate culture in which new processes and information requests of the sort necessary to comply with CbCR, could likely be seen as unwelcome head office "interference." Taken together, the tax function would not have a complete picture of the data it needs to collect and help in building that picture may be reluctantly given.

A typical tax function is staffed by tax technical and compliance specialists. These resources may lack the experience necessary to develop and manage an automated process for gathering information from disparate sources and assessing it from a risk perspective. In addition, they may not possess the workflow to aggregate the data for compliance given that information may have been prepared and presented under differing local rules. Data harmonization is a key step in the CbCR process.

The transparency and consistency agenda; a board room issue

In parallel and interlinked with the BEPS project is the increased expectation of transparency leading to heightened focus on consistency in the tax affairs of MNCs. A wide variety of stakeholders including the investment community, the media, and tax justice activists are scrutinizing the tax conduct of large MNCs, creating increased reputational risk associated with both aggressive and what may be perceived as artificial structures at one end if the scale or straightforward reporting errors at the other. Inevitably CbCR increases this risk, providing tax authorities and whistleblowers with additional data which can be used to highlight tax behavior. Although it is intended for CbCR to be confidential, heads of tax need to be aware of the risk that they could enter the public domain and put an appropriate public relations strategy in place.

Research undertaken since the BEPS project's launch estimates annual losses for tax authorities at four to ten percent of global corporate income tax revenues or USD 100 – 240 billion per annum.96 This is the context in which tax authorities will be examining MNCs' CbCR, using analytical techniques to identify where their efforts should be focused to increase the opportunity to recoup income. This will not just happen in developed countries; many non-OECD and non-G20 countries have been actively involved in the BEPS project and there is a common commitment to building capability in developing countries so they too benefit from the project's tax fairness objectives.

Tax risk management and data analytics

As tax authorities and MNCs have responded to the challenges and opportunities presented by digitalization, technology and automation are playing an increasingly important role in the tax compliance process. Revenue authorities are building up their own tax data warehouses with tax risk management systems and using analytical techniques to validate and benchmark data so that they can direct audit and enquiry activities towards higher risk taxpayers. In some jurisdictions, tax authorities are adding statistical and quantitative expertise to refine and reinforce their scope for more sophisticated analytics. Data reported under CbCR can expect to receive similar treatment.

MNCs and other taxpayers are using analytics for their own tax risk management both for hindsight – to gain a better understanding of the risk associated with what has already happened – and to gain foresight through scenario planning of alternative future strategies or the impact of variables on tax outcomes. Such exercises can be incredibly powerful given the scope for working with live data and taking into account a group's own tax risk appetite.

Tax data analytics is currently helping forward-thinking MNCs to risk assess their CbCR using inputs from earlier years. This allows them to replicate the insights which tax authorities might generate, identifying anomalies for further examination and explanation. It is certainly beneficial to be able to correct data errors, fill gaps, and take strategic actions prior to the first period on which they have to report.

In the area of transfer pricing, tax data analytics goes beyond identifying inconsistencies in policies, errors, and anomalies; it is now possible to identify their root causes. In many cases these can be attributed to:

- The incorrect or partial application of a transfer pricing policy, because the tax department that designed it is not responsible for its day-to-day implementation; or
- Transfer pricing policies which work at a group reporting GAAP level, produce divergent results under local GAAP; or
- Actual results differ markedly from forecasts based on standard costs implementation.

These and other insights from analytical tools and processes help MNCs to take corrective action where necessary, explain deviations and inconsistencies, and decide the requisite level of detail to provide an explanation from both a quantitative and qualitative perspective.

While analytics will still be relevant once CbCR is a fact of life, using analytics on reportable historic data provides a "heads up" on likely areas of tax authority interest and also an opportunity to proactively analyze and impact what needs to be reported. For MNCs that have not already started to collect and examine the data which will be used for their CbCR, there is no time like the present. If post-filing errors are uncovered by tax authority enquiries or unexplainable anomalies are identified, potential monetary impact could result (e.g., due to audit adjustments) and the reputation of the tax function could suffer. And as tax authorities will automatically be sharing BEPS data with the authorities in all relevant jurisdictions, a MNC's tax function will need consistent policies and approaches across all countries of operation so that the reporting makes sense when the group is benchmarked against itself. To achieve this, the tax function must evolve from its traditional role as a passive consumer of historic data, to a proactive business partner able to use the data it gathers, validates, harmonizes, collates, and reports to provide input into strategic decision-making.

---

[96] http://www.oecd.org/ctp/beps-about.htm

Over time, MNCs will integrate these analytics into their ERP, consolidation, and tax compliance systems, but for now most will need to run analytics on extracted data. Starting to use analytics early in the BEPS journey is one way to gauge the readiness of the organization, as a whole, to collect and aggregate the data required for CbCR and identify any challenges in data collection which will need to be overcome in order to meet the 2017 reporting deadline.

In the near future, the vision is that end-to-end tax data analytics techniques will enable MNCs to assess the impact of decisions made for one tax purpose on all relevant taxes. For example, if a business makes an adjustment to intra-group arrangements based on a desired transfer pricing and corporate income tax outcome, what will be the customs duty and other indirect tax implications? A holistic tax overview of this type will help enhance decision making and avoid unintended consequences.

Crunchy questions for CbCR

Hindsight and foresight to manage risks and facilitate tax-sensitized scenario planning: Tax data analytics can help MNCs manage the risks associated with CbCR. Key questions MNCs need to start asking themselves include:

- Who is responsible for data gathering and who is accountable for its accuracy?
- Do taxes paid and accrued and profits before tax tell a consistent story?
- Do the outputs make sense when benchmarked against past performance?
- Are consistent results achieved across similar entities in the group?
- Is the CbCR headcount consistent with other reportable information and taxable status per jurisdiction?
- Can the CbCR data be reconciled to other local reporting?
- Are the outputs of the CbCR in line with transfer pricing policies (and is the policy consistent)?
- What impact could proactive monitoring of transfer pricing policies against targets have on future CbCR?
- Are there anomalies in the CbCR data or policies which may need correction or explanation?
- Could the outputs of the CbCR lead to tax audit or reputational risk?
- Who provides the budget to implement and maintain the CbCR compliance process?
- To support more efficient CbCR in the future, is a change to technology strategy and infrastructure needed?
- What new skills are needed in the tax function for a robust, end-to-end, analytics-enabled CbCR process?

— Beth Mueller (Chicago)
Partner
Deloitte Tax LLP
bethmueller@deloitte.com

Calendars to watch

Each edition, be sure to mark your calendars for some of the more important events (recent and upcoming) as well as tax developments making in impact on businesses investing into the United States.

Recent and Upcoming Activities

August 9 — **Dbriefs webcast archive:** Tax refund claims: An overview and discussion of recent changes
Watch
URL: http://www2.deloitte.com/us/en/pages/dbriefs-webcasts/events/august/2016/dbriefs-tax-refund-claims-an-overview-and-discussion-recent-changes.html?id=us:2em:3na:usic:awa:tax:081516

August 16 — **Dbriefs webcast:** New GAAP and IFRS revenue recognition standards: Tax compliance and planning implications
Register
URL: http://www2.deloitte.com/us/en/pages/dbriefs-webcasts/events/august/2016/dbriefs-new-gaap-and-ifrs-revenue-recognition-standards-tax-compliance-and-planning-implications.html?id=us:2em:3na:usic:awa:tax:081516

September 22 — **Dbriefs webcast:** Customs and global trade: What every tax executive should know
Register

URL: http://www2.deloitte.com/us/en/pages/dbriefs-webcasts/events/september/2016/dbriefs-customs-and-global-trade-what-every-tax-executive-should-know.html?id=us:2em:3na:usic:awa:tax:081516

September 26 — **Dbriefs webcast:** Year-end updates, annual disclosures, and 2016 hot topics
Register
URL: http://www2.deloitte.com/us/en/pages/dbriefs-webcasts/events/september/2016/dbriefs-year-end-updates-annual-disclosures-and-2016-hot-topics.html?id=us:2em:3na:usic:awa:tax:081516

Recent Tax Developments

June 24 — **United States Tax Alert:** US and Luxembourg Announce Agreement to Adopt Exempt Branch Provision from 2016 US Model Treaty
URL: http://www2.deloitte.com/content/dam/Deloitte/global/Documents/Tax/dttl-tax-alert-united-states-24-june-2016.pdf

July 8 — **OECD Tax Alert:** Discussion draft issued on revised guidance on profit splits
URL: http://www2.deloitte.com/content/dam/Deloitte/global/Documents/Tax/dttl-tax-alert-oecd-8-july-2016-profit-splits.pdf

July 8 — **OECD Tax Alert:** Discussion draft issued on attribution of profits to PEs
URL: http://www2.deloitte.com/content/dam/Deloitte/global/Documents/Tax/dttl-tax-alert-oecd-8-july-2016-permanent-establishments.pdf

About Deloitte