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Brady doubles down on border-adjustment tax; White House promises tax reform 'outline'

House Ways and Means Committee Chairman Kevin Brady, R-Texas, recently reiterated his position that a destination-based cash flow tax (DBCFT) is a "critical component" of the House Republican tax reform blueprint and that "it is staying" in the tax reform legislation that GOP leaders expect to move through the chamber this year.

Meanwhile, the Trump administration announced plans to release a comprehensive tax reform "outline" in the near future but offered few details on what it would include.

Border-adjustment tax

The DBCFT provides for “border adjustments” through an as-yet unspecified mechanism that would serve to eliminate US tax on products, services, and intangibles exported abroad (regardless of their production location) and impose US tax on products, services, and intangibles imported into the US (also regardless of production location). The proposal has been unofficially estimated to raise $1.2 trillion in revenue over 10 years to help offset the cost of lower tax rates on business income.

Brady contended in an interview on Bloomberg Television February 6 that the DBCFT would make American businesses more competitive globally by “eliminating” tax advantages of foreign products in the US; moreover, he said, the border-adjustment tax would largely put a stop to corporate inversion transactions by “eliminating” any tax incentives to move US jobs, research, or headquarters overseas.”

Transition relief, yes; Carve-outs, no: The proposal has won support from export-heavy sectors as well as from businesses who think the change is a reasonable price to pay to facilitate rate-reducing tax reform; but it has come under increasing scrutiny from retailers, oil refiners, and other industry sectors that are import-dependent.

Brady said that as House tax writers fine-tune the proposal, they have been listening to concerns from stakeholders in the business community and would attempt to ease the transition from the current set of rules to a new one.

“We don’t expect businesses to change their business model overnight, which is why we’ve invited them to engage in the design of this provision, its mechanics …and the transition [rules] because we know doing that will allay a number of those concerns,” he said.

But Brady cautioned that while some design changes are possible, the fundamental contours of the proposal would remain unaltered.

“If any industry is asking Congress to keep in place the tax advantage of foreign products over made-in-America products, that is not going to work. And if they’re going to ask to keep in place incentives to move jobs overseas, that won’t succeed, either,” he said.

Brady stated that he is “not anticipating any exceptions or carve-outs” for specific industries, but added that “the more I listen to the valid concerns [of business stakeholders]…the more positive I am that we can design this in a positive, pro-growth way.”

Pushback from lawmakers: Brady acknowledged that some lawmakers – particularly in the Senate – have not yet embraced the notion of a border-adjustment tax. Senate Finance Committee Chairman Orrin Hatch, R-Utah, for example, recently stated that “at least a handful of senators” have expressed reservations about the proposal and that he has questions of his own regarding who would ultimately bear the tax, whether it would be consistent with US trade obligations, and whether adjustments would be necessary to avoid undue burden on particular industries. Senate taxwriter – and Majority Whip – John Cornyn, R-Texas, recently told reporters that he has asked Hatch to convene a Finance Committee hearing on the proposal. (For prior coverage, see *Tax News & Views*, Vol. 18, No. 5, Feb. 3, 2017.)
URL: http://newsletters.usdbriefs.com/2017/Tax/TNV/170203_1.html

But Brady noted that the DBCFT is a relatively new concept for lawmakers and suggested that many of their concerns can be addressed as they become more familiar with the proposal.

“As we go through discussions and they learn our competitors are already doing this that America is an outlier and, frankly, getting beaten because of it, we see support for this growing.”

WTO compliance: Since the release of the GOP’s tax reform blueprint, a question that has arisen among some commentators is whether the DBCFT would be considered an impermissible export subsidy under World Trade Organization rules.

Brady, who has likened that DBCFT to the value-added taxes imposed by most major US trading partners, has sought to tamp down those concerns in recent weeks. In remarks at an international tax forum at Georgetown University February 3, Brady dismissed talk of a possible trade war over a border-adjustable tax as “silly.”

“What are they going to say? ‘Stop copying us’?” he asked.

Ways and Means Tax Policy Subcommittee Chairman Peter Roskam, R-Ill., echoed that sentiment in response to a question he received following a speech at the Heritage Foundation on February 6.

Framing the question as “a threshold fairness issue,” Roskam stated that “[w]e are moving toward the consumption tax; we are mirroring essentially what the rest of the world is doing; and we are essentially saying we are asserting a right to be treated in the same fashion as the rest of the world is. And we think that we have that right and we think when it all comes down to it, we will be exonerated on that.”

Buchanan stresses rate parity for passthroughs, C-corps: Turning to other elements of the GOP blueprint, Ways and Means Committee member Vern Buchanan, R-Fla., this week stressed the need for tax reform to help small businesses organized as passthroughs in addition to traditional C corporations.

The blueprint calls for a tax rate of 20 percent for corporations and 25 percent for passthroughs. (The differential is likely intended to address the fact that passthrough income is taxed only once while corporate income is taxed twice – once at the entity level and then again when it is distributed to shareholders.) But in a speech at the Bipartisan Policy Center on February 8, Buchanan argued that the 20 percent rate should apply to all businesses regardless of their form.

Buchanan noted that many small business owners are taxed on income earned even if they reinvest that money in the business, leading to distortions between corporations and passthroughs.

“We shouldn’t have Exxon paying less in taxes than a small business person,” he said.

When asked if the reduced rates for passthroughs would or should extend to larger businesses like private equity funds or real estate investment trusts, Buchanan said the Ways and Means Committee has not yet reached consensus on that issue.

Buchanan also expressed reservations about a proposal in the blueprint to repeal the deduction for net interest expenses. While acknowledging that the provision was likely needed to pay for a proposal to allow full expensing of business purchases, he argued that many small businesses need to borrow money to grow and suggested that he would be open to making the interest and expensing provisions more flexible.

Buchanan reiterated he is confident that tax reform would pass “in one form or another.” He also expressed his preference for a bipartisan bill – an approach that he contended would lead to lasting reform while legislation moved under budget reconciliation protection, which can be passed in the Senate with only 51 votes rather than the 60-vote majority normally required under regular order, might more closely resemble the Bush tax cuts by being temporary. (That is a possible, but not certain, outcome of a tax reform plan considered under the rules of budget reconciliation.)

Timeline unclear: Exactly when a completed tax reform bill will be unveiled, moved through the Ways and Means Committee, and brought to the House floor remains unclear. During the congressional Republican planning retreat in Philadelphia last month, House Speaker Paul Ryan, R-Wis., laid out a 200-day plan for top-priority initiatives, culminating with passage of tax reform legislation before Congress breaks for its annual August recess. (For prior coverage, see *Tax News & Views*, Vol. 18, No. 4, Jan. 27, 2017.)
URL: http://newsletters.usdbriefs.com/2017/Tax/TNV/170127_1.html

Ways and Means Chairman Brady stated in his Bloomberg Television interview this week that the House is “pointed toward tax reform in 2017” and that draft legislation could be released “in the first half of this year.”

During a question-and-answer session following his remarks at the Heritage Foundation, Tax Policy Subcommittee Chairman Roskam did not address the timing issue directly, stating only that taxwriters are still in the process of thinking through specific issues as they work to turn the blueprint into legislative language.

For his part, Rep. Buchanan called an August delivery “optimistic” based on where things currently stand and said that moving tax reform legislation becomes more difficult the longer it sits waiting.

White House tax reform 'outline'

Also this week, White House Press Secretary Sean Spicer told reporters at a February 9 press briefing that the Trump administration plans within "the next few weeks" to release "the outline of a comprehensive tax plan" that would be fleshed out in conjunction with Congress.

Spicer's announcement follows published reports from earlier in the day stating that President Trump told a group of airline executives during a White House meeting that the administration would be unveiling "something over the next two or three weeks that will be phenomenal in terms of tax."

Spicer would not comment on the whether the outline would hew more closely to the House GOP tax reform blueprint or to the tax proposals that then-candidate Donald Trump laid out while on the campaign trail, nor did he comment on the level of detail expected to be included in the document. He did, however, emphasize that the outline would be aimed at providing tax relief for the middle class as well as creating "a tax climate that not only keeps jobs here but [also] incentivizes companies to want to come here, to grow here, to create jobs here, [and] to bring their profits back here." (For details on Trump's campaign platform and how it compares to the House GOP blueprint, see *Tax policy decisions ahead: Impact of the 2016 elections* from Deloitte Tax LLP.)
URL: https://www2.deloitte.com/us/en/pages/tax/articles/tax-policy-impact-of-the-2016-elections.html?id=us:2em:3na:usic:awa:tax:021717

Spicer also suggested that tax reform could move through Congress under fast-track reconciliation protections that are expected to be included in a budget resolution for fiscal year 2018.

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Anti-inversion guidance: Treasury finalizes expiring regulations and modifies *de minimis* exceptions

On January 13, 2017, the US Department of the Treasury ("Treasury") and the Internal Revenue Service (IRS) issued final regulations and revised temporary regulations under Internal Revenue Code section 7874. These regulations finalize expiring Temp. Reg. §§1.7874-4T and 1.7874-5T with modifications (the "Final Regulations"), including a modification to the *de minimis* exception to application of the disqualified stock rule of Treas. Reg. §1.7874-4 ("disqualified stock rule"). These regulations also revise existing temporary regulations to make conforming changes to the *de minimis* exceptions to application of the passive assets rule of Temp. Reg. §1.7874-7T ("passive assets rule") and the non-ordinary distribution rule of Temp. Reg. §1.7874-10T ("non-ordinary course distribution rule").

The Final Regulations and the revised temporary regulations generally adopt or modify, as appropriate, rules described in temporary regulations issued on January 16, 2014, or April 4, 2016 (the "Temporary Regulations"). For prior discussion of the Temporary Regulations, see United States tax alert, January 18, 2014 and United States tax alert, April 6, 2016.[1]
URL: https://www2.deloitte.com/content/dam/Deloitte/global/Documents/Tax/dttl-tax-alert-united-states-180114.pdf
URL: https://www2.deloitte.com/content/dam/Deloitte/global/Documents/Tax/dttl-tax-alert-united-states-6-april-2016.pdf

Summary of noteworthy changes

As compared to the Temporary Regulations, the Final Regulations and revised temporary regulations:

[1] T.D. 9654, 79 F.R. 3100 (Jan. 17, 2014); T.D. 9761, 81 F.R. 20897 (Apr. 8, 2016). The rules were first announced in part on September 17, 2009 in Notice 2009-78 (2009-40 I.R.B. 452).

- Exclude from the definition of nonqualified property an obligation of a member of the Foreign Acquirer's expanded affiliated group (EAG, defined below) if the holder (or a successor) of the obligation immediately before the domestic entity acquisition (and all related transactions) is a member of the EAG immediately after the Acquisition (defined below) and all related transactions;[2]
- Exclude from the definition of nonqualified property obligations of former *de minimis* owners of the US Target (defined below);[3]
- Exclude from the definition of nonqualified property obligations of persons that have a *de minimis* ownership in a member of the Foreign Acquirer's EAG or a Significant Shareholder (defined below);[4]
- Expand the application of the "associated obligation rule";[5]
- Clarify (or modify) the definition of "obligation" to include a contractual obligation to provide goods and services;[6]
- Clarify that stock included in the numerator of the ownership continuity fraction is also included in the denominator (even if such stock would otherwise be disqualified stock);[7]
- Clarify that an interest in a partnership is only nonqualified property if it is a marketable security or is transferred with a principal purpose of avoiding the purposes of section 7874;
- Finalize Temp. Reg. §1.7874-5 without substantive modification; and
- Modify the *de minimis* exceptions included in Treas. Reg. §1.7874-4T(d)(1), Temp. Reg. §1.7874-7T(c), and Temp. Reg. §1.7874-10T(d).

Inversion transactions – basic rules

A foreign corporation (or a foreign publicly-traded partnership, in either case a "Foreign Acquirer") generally will be treated as a US corporation[8] under section 7874 if, pursuant to a plan or series of related transactions:

- The Foreign Acquirer acquires "substantially all" of the properties held directly or indirectly by a US corporation or held in a domestic partnership's trade or business (such domestic entity, the "US Target," and such acquisition, an "Acquisition");
- Former owners of the US Target acquire 80% or more (by vote or value) of stock of the Foreign Acquirer in exchange for their interests in the US Target; and
- The Foreign Acquirer's EAG does not have substantial business activities in its home country relative to the group's worldwide activities.[9] For purposes of section 7874, an EAG is an affiliated group under §1504(a), with a 50% threshold, attribution through partnerships and inclusion of foreign corporations.[10]

If former shareholders or partners hold less than 80%, but at least 60% (by vote or value) of the stock of the Foreign Acquirer by reason of holding an equity interest in the US Target, the Foreign Acquirer continues to be treated as a foreign corporation (or foreign publicly-traded partnership, as applicable) for US federal income tax purposes. However, certain rules can apply that prevent certain business integration transactions and that apply to deny the use of certain attributes to offset US tax of the US Target. This ownership continuity percentage, expressed as a fraction, is referred to as the "ownership fraction."

General disqualified stock rules

Subject to a *de minimis* exception, certain "disqualified stock" of a Foreign Acquirer is excluded from the denominator of the ownership fraction.[11] Disqualified stock generally includes stock of the foreign acquiring corporation that is (i) transferred to a person (other than the US Target) in exchange for "nonqualified property" (the "nonqualified property

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[2] Treas. Reg. §1.7874-4(i)(2)(iii)(A).
[3] Treas. Reg. §1.7874-4(i)(2)(iii)(B).
[4] Treas. Reg. §1.7874-4(i)(2)(iii)(C).
[5] Treas. Reg. §1.7874-4(c)(1).
[6] Treas. Reg. §1.7874-4(i)(3).
[7] Treas. Reg. §1.7874-4(c)(1).
[8] Section 7874(b). Section 7874 overrides any conflicting provisions contained in current or future treaties. Section 7874(f).
[9] Section 7874(a)(2)(B).
[10] Section 7874(c)(1).
[11] Treas. Reg. §1.7874-4(b).

rule"), or (ii) transferred by a person (transferor) to another person (transferee) in exchange for property (exchanged property) if, as part of the same plan, the transferee subsequently transfers such stock in satisfaction of, or in exchange for the assumption of, one or more obligations of the transferee or a person related (within the meaning of section 267 or 707(b)) to the transferee (the "associated obligation rule").[12] The term "nonqualified property" generally means (i) cash or cash equivalents, (ii) marketable securities, (iii) certain obligations described below, or (iv) any other property acquired in a transaction (or series of transactions) related to the Acquisition with a principal purpose of avoiding the purposes of section 7874.[13]

De minimis **exception**

Prior to modification, the *de minimis* exception as contained in the Temporary Regulations applied if both:

1. The ownership of the Foreign Acquirer by the former owners of the US Target determined without regard to the disqualified stock rule, the passive assets rule, and the non-ordinary course distribution rule is less than 5% (by vote and value); and
2. After the Acquisition and all related transactions, former owners of the US Target, in the aggregate, own (applying the attribution rules of section 318(a) with the modifications described in section 304(c)(3)(B)) less than 5% (by vote and value) of the stock of (or a partnership interest in) each member of the Foreign Acquirer's EAG.

With respect to the second requirement of the *de minimis* exception, the Temporary Regulations required that the former shareholders or partners *collectively* own less than 5% (through attribution) of each member of the Foreign Acquirer's EAG after the Acquisition and all related transactions. The Final Regulations modify the second requirement to provide that the *de minimis* rule is met only if after the Acquisition and all related transactions, *each former owner* of the US Target individually owns (through applying the section 318 attribution rules, as modified by section 304(a)(3)(B)) less than 5% (by vote and value) of the stock or partnership interest in each member of the Foreign Acquirer's EAG.[14] While this modification makes it somewhat easier for taxpayers to apply the exception in certain circumstances (*e.g.*, certain public deals), it continues to be difficult to apply in many other situations where investments in either a privately-held US Target or privately-held Foreign Acquirer are either (i) made through complex investment structures where ultimate ownership is unknown or (ii) held by investment funds.

As indicated above, the temporary regulations issued on January 13, 2017 similarly revise the *de minimis* exceptions to the passive asset rule and the non-ordinary course distribution rule of Temp. Reg. §§1.7874-7T and 1.7874-10T, respectively.

Special rules with respect to obligations; Treatment of certain obligations under the nonqualified property rule

Obligations owed by certain persons constitute nonqualified property under both the Final and Temporary Regulations. Generally, nonqualified property includes obligations of: (i) the Foreign Acquiring's EAG ("EAG Obligations"), (ii) former shareholders or partners of US Targets ("Shareholder Obligations"), and (iii) persons that own stock of or are related (under section 267 or 707(b)) to members of the Foreign Acquiring's EAG or former shareholders or partners of US targets ("Related Party Obligations"). The Final Regulations modify the definitions so as to exclude certain obligations from the definition of nonqualified property. First, the Final Regulations modify part (i) of the definition to exclude from the definition of nonqualified property EAG Obligations where the holder of the obligation before the Acquisition is a member of the Foreign Acquirer's EAG immediately after the Acquisition and related transactions ("Excluded Intercompany Obligations").[15]

Second, the Final Regulations modify part (ii) of the definition to insert a *de minimis* rule with respect to Shareholder Obligations, and limit their scope to obligations where the former shareholder or partner actually or constructively

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[12] Treas. Reg. §1.7874-4(c).
[13] Treas. Reg. §1.7874-4(i)(2).
[14] Treas. Reg. §1.7874-4(d)(1).
[15] Treas. Reg. §1.7874-4(i)(2)(iii)(A).

(through section 318 attribution, as modified by section 304(c)(3)(B)) owns at least 5% (by vote or value) of the US Target before the Acquisition (a “Significant Shareholder”).[16]

Third, the Final Regulations similarly modify part (iii) of the definition to insert a *de minimis* rule with respect to Related Party Obligations, and limit their scope to obligations where persons actually or constructively (through section 318 attribution, as modified by section 304(c)(3)(B)) own, before or after the Acquisition, at least 5% (by vote or value) either a member of the Foreign Acquirer’s EAG or a Significant Shareholder.[17] However, the Final Regulations retain the rule that obligations of persons that are related (under sections 267 or 707(b)) to a member of the Foreign Acquiring’s EAG or former shareholders or partners of the US Target before or after the Acquisition constitute nonqualified property.[18]

It is important to note that the exception to Related Party Obligations does not carve out Excluded Intercompany Obligations, which could cause such obligations to fall within the definition of a Related Party Obligation even though such obligations clearly are intended to fall outside the scope of nonqualified property based on their exclusion from the definition of EAG Obligations. To give effect to the carve-out of Excluded Intercompany Obligations from EAG Obligations, taxpayers might construe the term “person” as used in the definition of Related Party Obligation as “person (other than an EAG member)”. Nevertheless, Treasury and the IRS should issue further guidance to clarify the scope of Related Party Obligations.

Treatment of certain obligations under the associated obligation rule

As noted above, under the associated obligation rule, disqualified stock generally includes stock of the foreign acquiring corporation transferred by a person (transferor) to another person (transferee) in exchange for property (exchanged property) if, as part of the same plan, the transferee subsequently transfers such stock in satisfaction of, or in exchange for the assumption of, *one or more obligations* of the transferee or a person related (within the meaning of section 267 or 707(b)) to the transferee (the “associated obligation rule”). In contrast to the Temporary Regulations, the Final Regulations apply to transfers of stock of the Foreign Acquirer to satisfy, or in exchange for the assumption of, any obligation of the transferee, rather than only those obligations associated with the exchanged property (*e.g.*, those obligations that arose from the conduct of a trade or business in which the exchanged property was used).[19] However, the amount of disqualified stock cannot exceed the proportionate share of obligations *associated with* the exchanged property that are not assumed by the Foreign Acquirer (the “Proportionate Share Limitation”). Additionally, the rule in the Final Regulations now covers situations in which the transferee indirectly uses Foreign Acquirer stock to satisfy an obligation or have it assumed (subject to the Proportionate Share Limitation), such as where the transferee sells its stock of the Foreign Acquirer and uses the proceeds to repay an obligation.

Definition of obligations

The Final Regulations remove the reference to Treas. Reg. §1.752-1(a)(4)(ii) that was provided in the Temporary Regulations for the definition of an “obligation”. Instead, the Final Regulations define an obligation as:

> [A]ny fixed or contingent obligation to make a payment or provide value without regard to whether the obligation is otherwise taken into account for purposes of the Internal Revenue Code. An obligation includes, but is not limited to, a debt obligation, an environmental obligation, a tort obligation, a contract obligation (including an obligation to provide goods or services), a pension obligation, an obligation under a short sale, and an obligation under derivative financial instruments such as options, forward contracts, and swaps. An obligation does not include any obligation treated as stock for purposes of section 7874 (see, for example, §1.7874-2(i), which treats certain interest, including certain creditor claims, as stock).[20]

The preamble to the Final Regulations states the reason for this change was to avoid confusion when applying Treas. Reg. §1.752-1(a)(4)(ii) outside of the partnership context. However, some taxpayers may view the new definition as

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[16] Treas. Reg. §1.7874-4(i)(2)(iii)(B).
[17] Treas. Reg. §1.7874-4(i)(2)(iii)(C).
[18] Id.
[19] Treas. Reg. §1.7874-4(c)(1)(ii).
[20] Treas. Reg. §1.7874-4(i)(3).

expanding the definition of an obligation to cover obligations to make payment or provide value, including contractual obligations to provide goods and services.

Certain clarifications

In response to comments, the Final Regulations clarify that a partnership interest is treated as nonqualified property only to the extent that it is a marketable security or is transferred with a principal purpose of avoiding section 7874.

Additionally, the Final Regulations clarify that stock included in the numerator of the ownership fraction (*i.e.*, stock of the Foreign Acquirer that former equity owners of the US Target receive by reason of owning equity of the US Target) is also included in the denominator of this fraction.[21] This clarifies that stock included in the numerator is also included in the denominator even if the stock in the numerator would otherwise be disqualified stock.

Finalization of Temp. Reg. §1.7874-5T

The Final Regulations also finalize Temp. Reg. §1.7874-5T without substantive modification.[22]

Effective dates

The rules described in the Final Regulations and the revised temporary regulations have a variety of effective dates, which reflect the dates on which they were first introduced in published guidance. Taxpayers may elect to apply a provision in the Final Regulations or the revised temporary regulations to Acquisitions occurring before such provision is published (but after the provision was first introduced in published guidance), provided that the taxpayer applies it consistently to all Acquisitions completed during such period.

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Putting Transfer Pricing in Context

Introduction

Transfer pricing is one of the most complex issues inbound tax professionals face. While the US and global transfer pricing rules are based on a relatively straightforward concept – that commonly controlled taxpayers should transact with one another on an arm's length basis – the complexity arises because transfer pricing impacts many other foreign and domestic tax matters, as well as the day-to-day operations of the company. In addition, companies that do not comply with transfer pricing rules may put their global public reputation at risk. This article provides an overview of transfer pricing and describes how it can affect other tax and operational matters.

What is Transfer Pricing?

Transfer pricing refers to the policies under which a multinational company prices intercompany transactions among its affiliates. For inbound companies, intercompany transactions can include the following:

- Sales and/or purchases of tangible property such as inventory to or from a non-US affiliate;
- Royalties paid for the use of intangible property owned by an affiliate;
- Provision of and/or receipt of services from affiliates;
- Joint development of intangibles with a related party; or
- Loans and guarantees.

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[21] Treas. Reg. §1.7874-4(c)(1).
[22] The changes are primarily to use and cross-reference the definitions introduced by Temp. Reg. §1.7874-12T as part of T.D. 9761, 81 F.R. 20897 (Apr. 8, 2016).

The US transfer pricing rules are described in Section 482 of the Internal Revenue Code and the associated regulations. The IRS regulations are based on the arm's length standard, which requires that the results of an intercompany transaction between affiliates should be consistent with the results that would have been realized if uncontrolled taxpayers had engaged in the same transaction under the same circumstances.[23] The IRS regulations also provide detailed guidance on how to apply the arm's length standard based on the type of intercompany transaction being analyzed.

Most countries have similar, but not identical, transfer pricing rules in their tax laws. The OECD has also published *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, which serves as a common reference for most tax jurisdictions.

In the United States and other countries, if the tax authority determines that a taxpayer's intercompany transactions are not consistent with the arm's length standard, then it will propose adjustments to the company's taxable income and may also propose tax penalties. In the example below, ForCo manufactures widgets and sells the widgets to a US Distributor for USD 70. US Distributor then sells to a customer for USD 85. The separate and consolidated income statements are below:

	ForCo	**US Distributor**	**Consolidated**
Revenues	70	85	85
COGS	40	70	40
SGA	10	10	20
Profit	20	5	25

As you can see, the total consolidated profit is USD 25, USD 20 of which is earned by ForCo and USD 5 by US Distributor. By decreasing the sales price from ForCo to US Distributor by USD 5, the income of ForCo is increased, even though the consolidated results remain the same.

To assist in complying with global transfer pricing requirements, taxpayers may adopt an internal transfer pricing policy to guide employees in setting arm's length intercompany prices. In addition, multinational companies often seek the assistance of transfer pricing and other tax advisors to prepare transfer pricing documentation to demonstrate to the global tax authorities that their transfer pricing is consistent with the arm's length standard, in order to defend against proposed adjustments and penalties.

Why is Transfer Pricing in the News?

Transfer pricing has received significant attention from global tax authorities around the world because if transfer prices are not arm's length, profits (taxable income) may be shifted from one tax jurisdiction to another. The OECD has found that the integration of global economies and markets has put a strain on the international tax framework and created opportunities for base erosion and profit shifting (BEPS). The OECD estimates that global corporate income tax (CIT) revenue losses could be between 4 percent and 10 percent of global CIT revenues, that is, USD 100 billion to USD 240 billion annually.[24] The OECD explained that BEPS can be caused by several factors, including incorrect transfer pricing.

Consequently, global tax authorities, including the IRS, have significantly increased their transfer pricing enforcement efforts. According to a recent report by the US Treasury Inspector General for Tax Administration, transfer pricing issues account for approximately 46 percent of the IRS Large Business and International Division's international issues inventory and 71 percent of the potential total dollar adjustment amounts of all international issues.[25] The IRS has also published information about their transfer pricing audit roadmap,[26] instructions to IRS auditors for examining

[23] Treas. Reg. §1.482-1(b)(1).
[24] http://www.oecd.org/ctp/beps-explanatory-statement-2015.pdf
[25] https://www.treasury.gov/tigta/auditreports/2016reports/201630090fr.pdf
[26] https://www.irs.gov/pub/irs-utl/FinalTrfPrcRoadMap.pdf

inbound transfer pricing matters,[27] and announced that it will begin auditing the transfers pricing practices of middle market inbound distributors.[28]

This increased scrutiny by the IRS and other global tax authorities has attracted much attention in the media, and an internet news search for "transfer pricing audit" will bring up numerous reports of multinational companies receiving tax assessments. Such unwanted media attention may negatively affect a multinational company's global reputation in the eyes of its customers, shareholders, and other stakeholders.

Why is Transfer Pricing so Complex?

Transfer Pricing Adjustments Affect Taxable Income in More than One Country: As shown in the example in the prior section, transfer prices affect the amount of taxable income for each affiliate engaged in the intercompany transaction. If the IRS proposes a transfer pricing adjustment to increase the income of a US inbound distributor, the income of the foreign seller to the US distributor must be decreased; otherwise, the amount of income subject to tax will exceed the amount of consolidated income (commonly referred to "double taxation"). Conversely, if a foreign tax authority proposes a transfer pricing adjustment to increase the income of the foreign seller, then the income of the US distributor must be decreased to prevent double taxation. The tax teams of both the seller and US distributor must take steps to protect their ability to obtain double tax relief. Double tax relief can be obtained by requesting competent authority assistance pursuant to the Mutual Agreement Procedure article of the applicable tax treaty. Consequently, the tax department of an inbound company should be informed of tax examinations in the countries of affiliates with which it transacts.

Post-transaction Pricing Adjustments: The IRS transfer pricing regulations provide that in certain circumstances taxpayers may be required to retroactively adjust their transfer prices to comply with the arm's length standard.[29] Such post-transaction adjustments can be recorded on the company's financial statements at a later time during the tax year or as a book/tax difference on Schedule M of the taxpayer's US federal income tax return. However, the transfer pricing rules in other countries may not allow such post-transaction pricing adjustments. Inbound companies should consult with their transfer pricing advisors to understand the US and foreign tax rules with respect to post transaction adjustments so that they are compliant in the countries in which they operate. If the company does not comply with these rules, it may be subject to double taxation, meaning that two tax authorities tax the same amount of income of the multinational group, which may have an adverse impact on the group's effective tax rate.

TP adjustments affect both income statement and balance sheet positions: If the IRS determines that an inbound company's transfer pricing is incorrect, it will propose an adjustment to increase the company's taxable income. In addition to this adjustment to the company's tax return income statement, the IRS may make conforming adjustments to the company's balance sheet accounts to reflect the transfer pricing adjustments. Such adjustments may include the treatment of the adjusted amount as a deemed distribution/dividend or a capital contribution.[30] Depending on the country of residence of the foreign affiliate, a deemed dividend may be subject to withholding taxes. The IRS may also allow repayment of the adjusted amount to eliminate the need for a deemed distribution/dividend or capital contribution treatment.[31]

Customs duties: Transfer pricing for inventory has a direct impact on Customs duties. For inbound distributors, IRC Section 1059A generally limits the amount of a COGS deduction for imported goods to the declared value for Customs purposes. Any post-importation adjustments to the transfer price may require amended filings with the Customs authorities. The rules for making such amended filings are very detailed, and inbound distributors should consult with Customs advisors.

State taxes: States may have transfer pricing regulations that differ from the IRS Section 482 regulations. In Addition, when a taxpayer receives a notice of final determination from the IRS (commonly referred to as a Revenue Agent's Report or RAR), states require that the taxpayer (i) redetermine its state tax liabilities, taking into account the

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[27] https://www.irs.gov/businesses/corporations/international-practice-units
[28] IRS Announcement, "Large Business and International Launches Compliance Campaign," Feb 1, 2017, found at https://www.irs.gov/businesses/large-business-and-international-launches-compliance-campaigns.
[29] Treas. Reg. 1.482-1(a)(3).
[30] Treas. Reg. §1.482-1(g)(3).
[31] Rev. Proc. 99-32.

adjustments reflected in the RAR, and (ii) notify the applicable state tax authorities regarding any related impact. In addition, states may have similar requirements if a foreign tax authority proposes a transfer pricing adjustment to which the IRS has agreed pursuant to the Competent Authority process. There tends to be no statutory *de minimis* threshold for notification requirements, and taxpayers often are required to notify applicable states within a very short time frame (typically 30 to 90 days following final determination of the IRS audit) by filing an amended return along with other required documentation. These state tax rules can be very complex, and inbound distributors should consult with state a local tax advisors.

Impact on the company's operations: As stated above, the arm's length standard requires that the results of an intercompany transaction between affiliates should be consistent with the results that would have been realized if uncontrolled taxpayers had engaged in the same transaction under the same circumstances. Consequently, any change to the company's operations, whether it is a change in functions performed, risks assumed, or transaction terms, may affect the necessary transfer pricing analysis, which is based on what uncontrolled taxpayers would have charged under the same circumstances. The tax department of an inbound company should be aware of business changes in all relevant affiliates, so that the transfer pricing analysis can be revised if necessary.

Conclusion

These are just a few examples of why transfer pricing is one of the most complex issues faced by inbound tax professionals. Addressing related issues requires input from many different tax specialties. Deloitte Tax has transfer pricing and other tax professionals who can assist you to put your transfer pricing issues in context.

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Temporary regulations under section 721(c); Limitations on tax-free contributions of appreciated property to a partnership

Affects

The rules described below apply to (i) contributions (actual and deemed) by US persons that were previously subject to Notice 2015-54 (the "Notice"), (ii) transactions involving partnerships that were previously subject to the Notice, and (iii) future contributions by US persons of built-in gain property to a partnership with related foreign partners.

The Temporary Regulations generally apply to all contributions occurring on or after August 6, 2015. However, new rules, including any substantive changes to the rules described in the Notice, apply to contributions occurring on or after January 18, 2017.

Situation presented

On January 19, 2017, the US Department of the Treasury and the Internal Revenue Service published temporary regulations under section 721(c) (T.D. 9814, the "Temporary Regulations") with respect to the contribution of built-in gain property by a US person (a "US Transferor") to certain partnerships having one or more direct or indirect related foreign partners (a "Related Foreign Person").

The Temporary Regulations include rules previously announced in the Notice on August 6, 2015, which addressed (i) the contribution of built-in gain property to a partnership with one or more related foreign partners under section 721(c), and (ii) the appropriate valuation of controlled transactions involving partnerships under sections 482 and 6662.

The Temporary Regulations adopt the rules announced in the Notice with respect to section 721(c) with certain substantive modifications and additions. Specifically, if (i) a US Transferor contributes certain property with a built-in gain of greater than $1 million to a partnership during its taxable year, (ii) a Related Foreign Person with respect to the US Transferor is a direct or indirect partner in the partnership, and (iii) the US Transferor and Related Foreign

Persons own 80 percent or more of the interests in partnership capital, profit, deductions, or losses, then the US Transferor must recognize any built-in gain with respect to the contributed property unless the requirements of the "Gain Deferral Method" are satisfied.

Regulations under sections 482 and 6662 ensuring the appropriate valuation of controlled transactions involving partnerships are not contained in the Temporary Regulations but are anticipated in future regulations.

Issue

General Rule of Gain Recognition: The Temporary Regulations apply on a property-by-property basis and provide a general rule that nonrecognition under section 721(a) will not apply to gain realized upon a contribution of "Section 721(c) Property" to a "Section 721(c) Partnership" (defined below). Certain exceptions and an anti-abuse rule apply. The Temporary Regulations also contain complex rules for tiered partnerships ("Partnership Look-Through Rule"), which, in certain circumstances, would deem non-Section 721(c) Property to be treated as Section 721(c) Property and non-Section 721(c) Partnership to be treated as Section 721(c) Partnership.

- **Section 721(c) Property:** Section 721(c) Property is property, other than "Excluded Property," with built-in gain that is contributed directly or indirectly to a partnership by a US Transferor. Excluded Property includes (i) a cash equivalent, (ii) a security within the meaning of section 475(c)(2), without regard to section 475(c)(4), (iii) tangible property with a built-in gain of no more than $20,000 or a built-in loss, and (iv) an interest in a partnership in which 90 percent or more of the property (measured by value) held by the partnership (directly or indirectly through interests in one or more partnerships that are not Excluded Property) consists of Excluded Property described in (i) through (iii) above.

  Property that gives rise to income effectively connected with a US trade or business ("ECI Property") continues to be subject to section 721(c) but with limited application of the Gain Deferral Method. The Temporary Regulations do not adopt a similar rule for property the gain on which would be subject to US tax under subpart F of the Code.

- **Section 721(c) Partnership:** A partnership (domestic or foreign) is a Section 721(c) Partnership if there is a contribution of Section 721(c) Property to the partnership and, after the contribution and all transactions related to the contribution (i) a Related Foreign Person with respect to the US Transferor is a "Direct or Indirect Partner" in the partnership and (ii) the US Transferor and Related Foreign Persons own 80 percent (a modification from the 50 percent threshold in the Notice) or more of the interests in partnership capital, profits, deductions, or losses. A Direct or Indirect Partner is defined as a person (other than a partnership) that owns an interest in a partnership directly or indirectly through one or more partnerships.

- **Exceptions:** Contributions of Section 721(c) Property will not be subject to immediate gain recognition if the sum of all built-in gain for all Section 721(c) Property contributed to a Section 721(c) Partnership during the partnership's taxable year does not exceed $1 million. In addition, the following events will not cause a partnership to become a Section 721(c) Partnership: (i) a deemed contribution in a technical termination of a partnership described in section 708(b)(1)(B), and (ii) a mere change in identity, form, or place of organization of a partnership or a recapitalization of a partnership.

- **Anti-Abuse Rule:** The Temporary Regulations include an anti-abuse rule providing that if a US Transferor engages in a transaction (or series of transactions) or arrangement with a principal purpose of avoiding the application of the Temporary Regulations, the transaction or the arrangement may be recharacterized in accordance with its substance.

Gain Deferral Method

The Gain Deferral Method must be applied on a property-by-property basis in order to avoid gain recognition. There are five general requirements for applying the Gain Deferral Method to an item of Section 721(c) Property: (i) the Section 721(c) Partnership adopts the remedial allocation method and allocates section 704(b) items of income, gain, loss, and deduction with respect to the Section 721(c) Property in a manner that satisfies the "Consistent Allocation Method;" (ii) the US Transferor either recognizes gain equal to the remaining built-in gain with respect to the Section 721(c) Property upon an "Acceleration Event," or recognizes an amount of gain equal to a portion of the remaining built-in gain upon a "Partial Acceleration Event" or a transfer to a foreign corporation described in section 367; (iii) procedural and reporting requirements are satisfied; (iv) the US Transferor extends the period of limitations on assessment of tax; and (v) the rules for tiered partnerships are satisfied if either the Section 721(c) Property is an interest in a partnership or the Section 721(c) Property is described in the Partnership Look-Through Rule.

Consistent Allocation Method: The Consistent Allocation Method must be applied on a property-by-property basis and requires a Section 721(c) Partnership to allocate the same percentage of each book item of income, gain, deduction, and loss with respect to Section 721(c) Property to the US Transferor. The Consistent Allocation Method does not apply to allocation of creditable foreign tax expenditures. The Temporary Regulations also provide an exception to the Consistent Allocation Method for "Regulatory Allocations" as long as the allocation is (i) an allocation of income or gain to the US Transferor (or a member of its consolidated group); or (ii) an allocation of deduction or loss to a partner other than the US Transferor (or a member of its consolidated group). However, if the US Transferor receives less income or gain or more deductions or loss with respect to the Section 721(c) Property because of the Regulatory Allocation, the Section 721(c) Regulations require a portion of the remaining built-in gain to be recognized.

ECI Property: The Temporary Regulations modify the Gain Deferral Method with respect to Section 721(c) Property that is ECI Property by providing that ECI Property is not subject to the remedial allocation method or the Consistent Allocation Method as long as (i) beginning on the date of the contribution and ending when there is no remaining built-in gain with respect to the property, all distributive shares of income and gain with respect to the ECI Property for all Direct and Indirect Partners that are Related Foreign Persons will be subject to taxation as ECI (under section 871 or 882), and (ii) neither the Section 721(c) Partnership nor a Direct or Indirect Partner that is a Related Foreign Person claims benefits under an income tax treaty that would exempt the income or gain from tax or reduce the rate of taxation to which the income or gain is subject.

Anti-Churning Property: The Temporary Regulations provide detailed rules revising the remedial allocation method as to related partners when a Section 721(c) Partnership applies the Gain Deferral Method with respect to Section 721(c) Property that is a section 197(f)(9) intangible that was not amortizable in the hands of the contributor ("Section 197(f)(9) Intangible Property").

Tiered Partnership Rules

Indirect Contribution of Section 721(c) Property: If an upper-tier partnership ("UTP") (regardless of whether it is a Section 721(c) Partnership) in which a US Transferor is a Direct or Indirect Partner contributes Section 721(c) Property to a lower-tier partnership ("LTP") (that is a Section 721(c) Partnership), the LTP must apply the Gain Deferral Method to the contributed property in order for the UTP to avoid gain recognition. This application of the Gain Deferral method has several additional requirements as described in the Preamble and the Temporary Regulations.

Contribution of an Interest in a Partnership: Similarly, the Temporary Regulations provide additional requirements (as described in the Preamble) for applying the Gain Deferral Method if the Section 721(c) Property that is contributed to a Section 721(c) Partnership is an interest in a LTP (which need not be a Section 721(c) Partnership).

Acceleration Events

Under the Temporary Regulations, when an "Acceleration Event" occurs with respect to Section 721(c) Property, the "Remaining Built-in Gain" in the property (as opposed to all Section 721(c) Property as required by the Notice) must be recognized and the Gain Deferral Method no longer applies. The Temporary Regulations define an Acceleration Event as any event that either would reduce the amount of Remaining Built-In Gain that a US Transferor would recognize under the Gain Deferral Method if the event had not occurred or could defer recognition of the Remaining Built-In Gain. With respect to Section 721(c) Property, Remaining Built-In Gain is defined as the property's built-in gain, reduced by decreases in the difference between the property's book value and adjusted tax basis (and without taking into account adjustments to book values upon a partnership revaluation).

An Acceleration Event with respect to Section 721(c) Property occurs when any party fails to comply with a requirement of the Gain Deferral Method with respect to that property. An acceleration event will not occur solely as a result of a failure to comply with a procedural or reporting requirement of the Gain Deferral Method if that failure is not willful and relief is sought under the prescribed procedures.

When an Acceleration Event occurs, the US Transferor must recognize gain in an amount equal to the Remaining Built-in Gain that would have been allocated to the US Transferor if the Section 721(c) Partnership had sold the Section

721(c) Property immediately before the Acceleration Event for fair market value. The US Transferor and Section 721(c) Partnership are each required to make correlative adjustments to its Section 721(c) Partnership interest and Section 721(c) Property, respectively.

Acceleration Event Exceptions

The Temporary Regulations provide categories of Acceleration Event exceptions that are applied on a property-by property basis.

Termination Events: Specified Termination Events, as described more fully below, do not constitute Acceleration Events. In addition, upon the occurrence of a Termination Event, Section 721(c) Property will no longer be subject to the Gain Deferral Method.

Transfers of Section 721(c) Property (other than a partnership interest) to a domestic corporation in a section 351 transaction.

- Incorporations of a Section 721(c) Partnership into a domestic corporation by any method of incorporation other than a method involving an actual distribution of partnership property to the partners, followed by a contribution of that property to a corporation, provided that the Section 721(c) Partnership is liquidated as part of the incorporation transaction.
- Distributions of Section 721(c) Property from a Section 721(c) Partnership to (i) the US Transferor or (ii) a member of the US Transferor's consolidated group and where the distribution occurs more than seven years after the contribution.
- A Section 721(c) Partnership ceases to have a related Foreign Person Partner, provided there is no plan for a Related Foreign Person to subsequently become a Direct or Indirect Partner in the partnership (or a successor). An Acceleration Event, however, will occur upon a distribution of Section 721(c) Property in redemption of a Related Foreign Person's interest in a Section 721(c) Partnership.
- A Section 721(c) Partnership disposes of Section 721(c) Property in a transaction in which all gain or loss, if any, is recognized ("Fully Taxable Disposition"). In addition, a Termination Event occurs if either a US Transferor or a partnership in which a US Transferor is a Direct or Indirect Partner disposes of an interest in a Section 721(c) Partnership that owns Section 721(c) Property in a transaction in which all gain or loss, if any, is recognized. This rule, however, does not apply if a US Transferor is a member of a US consolidated group and it transfers its interest in the Section 721(c) Partnership in an intercompany transaction.

Successor Events: A Successor Event described below will not constitute an Acceleration Event if a "Successor US Transferor" or a "Successor Section 721(c) Partnership" continues applying the Gain Deferral Method.

- **Domestic Corporation Becomes a Successor US Transferor:** A Successor Event occurs if either a US Transferor or a partnership in which a US Transferor is a Direct or Indirect Partner transfers (directly or indirectly through one or more partnerships) an interest in a Section 721(c) Partnership to a domestic corporation in a transaction to which sections 351 or 381 applies. In addition, a Successor Event occurs if a US Transferor is a member of a US consolidated group and it transfers its interest in a Section 721(c) Partnership (directly or indirectly through one or more partnerships) in an intercompany transaction.
- **Technical Termination of a Section 721(c) Partnership:** A Successor Event occurs if there is a technical termination under section 708(b)(1)(B) of a Section 721(c) Partnership, and the Gain Deferral Method is continued by treating the new partnership as the Section 721(c) Partnership.

Tiered Partnership Transactions:

- **Indirect Contribution of Section 721(c) Property:** As described in the Preamble, a Successor Event will occur if (i) a Section 721(c) Partnership contributes Section 721(c) Property to an LTP that is a Controlled Partnership; (ii) the Gain Deferral Method is applied both with respect to the Section 721(c) Partnership's interest in the LTP and with respect to the Section 721(c) Property in the hands of the LTP; and (iii) the LTP either is a Section 721(c) Partnership, or is a Controlled Partnership that fails the ownership requirement but is treated as a Section 721(c) Partnership.
- **Contribution of an Interest in a Partnership:** As described in the Preamble, a Successor Event will also occur if (i) either a US Transferor or a partnership in which a US Transferor is a Direct or Indirect Partner contributes an interest in a Section 721(c) Partnership to a UTP that is a Controlled Partnership; (ii) the Gain

Deferral Method is continued with respect to the Section 721(c) Property in the hands of the Section 721(c) Partnership; (iii) if the UTP directly owns its interest in the Section 721(c) Partnership, the Gain Deferral Method is applied with respect to the UTP's interest in the Section 721(c) Partnership and the UTP is, or is treated as, a Section 721(c) Partnership; and (iv) if the UTP indirectly owns its interest in the Section 721(c) Partnership through one or more partnerships, the principles described in clause (iii) are applied with respect to the UTP and each partnership through which the UTP indirectly owns an interest in the Section 721(c) Partnership.

Partial Acceleration Events: Upon a Partial Acceleration Event, the US Transferor recognizes an amount of gain that is less than the full amount of Remaining Built-In Gain in the Section 721(c) Property, and the Gain Deferral Method continues to apply. The Temporary Regulations define Partial Acceleration Events as Regulatory Allocations and positive section 734(b) adjustments.

- **Regulatory Allocations:** As discussed above, a Regulatory Allocation that results in an over-allocation of book deduction or loss to a US Transferor or an under-allocation of book income or gain to a US Transferor will be treated as satisfying the Consistent Allocation Method provided that gain is recognized. This gain is recognized through a Partial Acceleration Event. Specifically, the US Transferor must recognize an amount of gain equal to the amount of the allocation that, under the Consistent Allocation Method, had the Regulatory Allocation not occurred, would have been allocated to the US Transferor in the case of income or gain, or would not have been allocated to the US Transferor in the case of deduction of loss.
- **Positive Section 734(b) Adjustments:** A Partial Acceleration Event will occur if a Section 721(c) Partnership makes a distribution of other property resulting in a positive adjustment to the basis of the Section 721(c) Property under section 734(b). In these cases, the US Transferor must recognize an amount of gain equal to the positive basis adjustment reduced by the amount of gain recognized by the US Transferor (or a member of its consolidated group) under section 731(a). The Section 721(c) Partnership will not increase its basis in the Section 721(c) Property by the amount of gain recognized by the US Transferor under this provision.

Transfers of Section 721(c) Property in a Section 367 Transaction: If a Section 721(c) Partnership transfers Section 721(c) Property, or a US Transferor or a partnership in which a US Transferor is a Direct or Indirect Partner transfers an interest in a Section 721(c) Partnership to a foreign corporation in a transaction described in section 367, the underlying Section 721(c) Property will no longer be subject to the Gain Deferral Method. Instead, the tax consequences will be determined under section 367. However, the US Transferor must recognize any Remaining Built-In Gain with respect to the portion of the Section 721(c) Property that is attributable to non-US partners.

Fully Taxable Dispositions of a Portion of an Interest in a Section 721(c) Partnership: If a US Transferor, or a partnership in which a US Transferor is a Direct or Indirect Partner, disposes of a portion of an interest in a Section 721(c) Partnership in a fully taxable transaction, an Acceleration Event will not occur with respect to the portion of the interest transferred. The Gain Deferral Method, however, will continue to apply with respect to the Section 721(c) Property of the Section 721(c) Partnership. The principles of Treas. Reg. § 1.704-3(a)(7) will apply to determine the Remaining Built-In Gain in the Section 721(c) Property that is attributable to the portion of the interest in the Section 721(c) Partnership that is retained. This rule does not apply to an intercompany transaction between members of a US consolidated group.

Reporting and Procedural Requirements

The Temporary Regulations require that taxpayers satisfy certain reporting and procedural requirements for the year of a contribution of Section 721(c) Property for which gain is deferred under the Gain Deferral Method (a "Gain Deferral Contribution"). The Temporary Regulations also require taxpayers to satisfy annual reporting requirements.

Effective Date

In general, the effective date of the Temporary Regulations relates back to the issuance of the Notice. Accordingly, unless specified otherwise, the Temporary Regulations apply (i) to all contributions occurring on or after August 6, 2015 and (ii) to all contributions occurring before August 6, 2015 that resulted from an entity classification election that was filed on or after August 6, 2015. However, any new rules described in the Temporary Regulations, including any substantive changes to the rules first described in the Notice, will only apply to (i) contributions occurring on or after January 18, 2017, or (ii) contributions that occurred before January 18, 2017 that resulted from an entity classification election that was filed on or after January 18, 2017. Importantly, taxpayers may elect to apply the new rules described in the Temporary Regulations, including any substantive changes from the Notice, to any contribution occurring on or after August 6, 2015. Taxpayers can make this election by reflecting the application of the relevant rule on a timely filed or amended return.

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

On October 21, 2016, the US Treasury and the IRS published final and temporary regulations under section 385 of the Internal Revenue Code (the 385 Regulations) that generally would allow for certain debt instruments to be recast as equity.[32] Extensive comments were submitted to these Proposed Regulations that had been issued in April, 2016,[33] and the Section 385 Regulations addressed several of the issues raised by those comments. In many respects these changes are expected to facilitate taxpayer compliance with the 385 Regulations. See Multistate tax alert, October 14, 2016. However, as explained in Multistate tax alert, April 29, 2016, the Proposed Regulations raised several issues for state corporate income and franchise taxes, and the updated provisions of the 385 Regulations continue to raise several of these same issues.
URL: https://www2.deloitte.com/us/en/pages/tax/articles/us-supreme-court-denies-petition-for-review-of-gillette-california-compact-appeal.html?id=us:2em:3na:usic:awa:tax:022017
URL: https://www2.deloitte.com/us/en/pages/tax/articles/state-income-tax-effect-of-proposed-federal-intercompany-debt-regulations.html?id=us:2em:3na:usic:awa:tax:022017

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

General Purpose of 385 Regulations

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

- To establish threshold documentation requirements that must be met by taxpayers in order for certain related-party debt instruments in a corporation to be treated as debt for tax purposes;[34] and
- To recast certain related-party debt instruments as stock when issued in connection with distributions and certain transactions.[35]

385 Regulations & unintended state income tax consequences

Unintended state income tax consequences may arise from the 385 Regulations because certain states may not conform to the 385 Regulations' exceptions for intercompany debt instruments between corporations filing a federal consolidated return (the One Corporation exception).[36] A number of combined and separate filing states statutorily require taxable income to be computed 'as if' the corporation had filed separately for federal income tax purposes, thereby possibly rendering the One Corporation exception inapplicable.

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

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[32] Treas. Reg. §§ 1.385-1, et. seq., 81 FR 72858 (Oct. 21, 2016). All subsequent references to the "IRC" are to the Internal Revenue Code of 1986, as amended.
[33] Prop. Treas. Reg. §§ 1.385-1, et. seq., REG-108060-15 (Apr. 4, 2016).
[34] The documentation rules are generally found in Treas. Reg. § 1.385-2.
[35] These recast rules are generally found in Treas. Reg. §§ 1.385-3 and -3T.
[36] Such intercompany debt instruments are not subject to recast for federal tax purposes. Treas. Reg. §§ 1.385-2(d)(2)(ii); 1.385-4T(a).

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

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

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

Practical Considerations

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

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

Effective Dates for 385 Regulations: The 385 Regulations are generally effective for tax years ending on or after January 19, 2017,[37] although certain exceptions apply (e.g., the documentation rules applicable under Treas. Reg. § 1.385-2 do not apply to interests issued or deemed issued before January 1, 2018).[38] Accordingly, the debt recast rules generally apply to tax years ending on or after January 19, 2017. However, for debt instruments issued after

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

April 4, 2016, but before January 19, 2017, and where the 385 Regulations would have applied to recast them as stock during this period, the debt instruments will be recast as stock immediately after January 19, 2017.[39]

Financial Statement Impact: Based on the foregoing, January 19, 2017, is generally the first date that any tax effect of the 385 Regulations may apply to taxpayers. Accordingly, for calendar year taxpayers, the 385 Regulations should be considered as having a financial statement impact in the first quarter of 2017. As soon as possible, taxpayers should assess the sufficiency of its internal controls and whether it has a sufficient workplan and timeline to address the 385 Regulations for state income tax purposes.

Other Short-Term Tasks Include: In addition to assessing the financial statement impact as described above, state taxpayers should immediately:

- Inventory all intercompany debt obligations, including both domestic-to-foreign and domestic-to- domestic lending as well as the existence of any cash management or cash pooling arrangements;
- Consider if any prohibited leveraging transactions under the -3 or -3T Regulations exist that were entered into after April 4, 2016 and, if so, consider eliminating the tainted debt instruments;
- Consider alternative debt structures for any planned new issuances of internal or external debt, including refinancing, and execute on desired alternatives prior to entering into new debt issuance; and
- Review any planned merger and acquisition activity and update due diligence procedures for both acquisitions (i.e., analyze target compliance with 385 Regulations) and disposition (i.e., prepare for acquirer to review taxpayer's compliance with 385 Regulations).

Tasks to be Completed Prior to January 1, 2018, include (all tasks to be applied to domestic debt instruments exempt from federal review):

- Implement steps for compliance with the minimum annual documentation requirements of the -2 Regulations (e.g., creditworthiness analysis needs to document each borrower's ability to repay);
- Implement changes for cash management and cash pooling that qualify for short term debt exceptions;
- Implement cash management master documentation;
- Address intercompany receivables/payables; and
- Review transfer pricing policies and support.

Tasks to be Completed Prior to filing 2018 (and subsequent) tax returns include (all tasks to be applied to domestic debt instruments exempt from federal review):

- Confirm that all documentation and credit analysis required is in place;
- Determine whether interest deductions are available for state tax purposes, including whether state tax returns can be signed claiming such deductions.

Consequences of Non-Compliance with 385 Regulations for State Purposes: A taxpayer that does not implement procedures for complying with the 385 Regulations for state tax purposes (e.g., fails to maintain documentation requirements for domestic debt not subject to federal review) could lead tax authorities to recast debt instruments as stock for state but not federal purposes. The state tax consequences might include:

- Payments of interest and principal being recast as equity distributions or contributions for state tax purposes only, which could lead to 'hook stock' where subsidiaries own stock of parent corporations;
- Need for separate entity E&P and basis calculations for state tax purposes to determine the state tax treatment of any deemed distribution of interest on a recast instrument; and
- States may provide a full or partial dividends-received deduction (DRD) for deemed distributions.

Limited exception for interest-free debt instruments: The 385 Regulations generally apply to interest-free loans except for a narrow exception to the funding rule;[40] taxpayers should confirm and document that any particular debt instrument is exempt from 385 Regulations.

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[39] Treas. Reg. § 1.385-3(j)(2).
[40] Treas. Reg. §§ 1.385-3(b)(3)(i) (qualified short-term debt instrument exception to funding rule); 1.385-3T(b)(3)(vii)(C) (definition of qualified short-term debt instrument includes certain interest-free loans). This exception

Broad Application of Documentation Rules: The -2 documentation rules apply both to formal intercompany loans as well as informal balances that are treated as debt on the balance sheet, including:

- Cash management arrangement balances;
- Intercompany expenses; and
- Other intercompany accounts.

Cash Management Arrangements: Many taxpayers employ cash management/cash pooling arrangements that will be exempt from federal review under the One Corporation exception. These arrangements may raise unusual state tax issues, including:

- Domestic parent may not be eligible to serve as a "qualified cash pool header" (QCPH) as required by the 385 Regulations. Cash sweeps from domestic subsidiaries to domestic parents within the federal consolidated group will be exempt from federal review under the One Corporation exception but may be subject to state application of the 385 Regulations. A QCPH must have as its principal purpose managing a cash pool arrangement, but a domestic parent may have many obligations/purposes. Accordingly, taxpayers may need to consider restructuring cash management arrangements to insert a QCPH.
- Cash management master documentation can be used for cash management arrangements, but such master documentation may need to be put in place for debt instruments exempt from federal review.

State Tax Guidance Regarding 385 Regulations: States have taken a 'wait and see' approach to addressing the 385 Regulations. Taxpayers should carefully consider the consequences and risks of waiting for a particular state to issue guidance regarding the 385 Regulations before implementing a compliance plan. States that have historically recast intercompany debt potentially have new support to do so, while other states may increase activity in this area pursuant to the 385 Regulations.

Net Worth Tax Issues: States may contend that recast debt instruments must be similarly recast for state net worth tax purposes. However, many state net worth taxes are imposed based on GAAP valuations rather than tax valuations, so this contention may not apply in a number of states.

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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

January 11 **Dbriefs webcast archive:** Navigating the presidential transition: Lessons from commercial M&A Watch
URL: https://www2.deloitte.com/content/www/us/en/pages/dbriefs-webcasts/events/january/2017/dbriefs-navigating-a-presidential-transition-lessons-from-commercial-m-and-a.html?id=us:2em:3na:usic:awa:tax:022017

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is not comprehensive (*e.g.*, there is no interest- free loan exception to the documentation rules under Treas. Reg. § 1.385-2).

January 18 **Dbriefs webcast archive:** Global treasury and cash management: New approaches for the global tax reset
Watch
URL: https://www2.deloitte.com/content/www/us/en/pages/dbriefs-webcasts/events/january/2017/dbriefs-global-treasury-and-cash-management-new-approaches-for-the-global-tax-reset.html?id=us:2em:3na:usic:awa:tax:022017

January 19 **Dbriefs webcast archive:** Advanced data management: Building the digital tax department
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URL: https://www2.deloitte.com/content/www/us/en/pages/dbriefs-webcasts/events/january/2017/dbriefs-advanced-data-management-building-the-digital-tax-department.html?id=us:2em:3na:usic:awa:tax:022017

February 28 **Dbriefs webcast:** IRS practice and procedure: Recent developments and emerging issues
Register
URL: https://www2.deloitte.com/content/www/us/en/pages/dbriefs-webcasts/events/february/2017/dbriefs-irs-practice-and-procedure-recent-developments-and-emerging-issues.html?id=us:2em:3na:usic:awa:tax:022017

March 7 **Dbriefs webcast:** Preparing for the changing landscape: The new section 385 regulations
Register
URL: https://www2.deloitte.com/content/www/us/en/pages/dbriefs-webcasts/events/march/2017/dbriefs-preparing-for-the-changing-landscape-the-new-section-385-regulations.html?id=us:2em:3na:usic:awa:tax:022017