State tax implications of I.R.C. § 385 regulation

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MTC meetings, 12/14/2016

*This presentation reflects my views and not necessarily those of the MA Department of Revenue
Background

• 10/13/16: IRS promulgates temporary and final regulation under I.R.C. s. 385 to address related party debt (modifying and finalizing proposed regulation issued 4/4/16)

• Although generally issued to address international “inversions,” the IRS regulation would apply to purported debt transactions between related corporations even where there is no attempted inversion and where the debt is between two domestic corporations
Statutory authority

• I.R.C. s. 163(a): “There shall be allowed as a deduction all interest paid or accrued within the taxable year on indebtedness.”

• I.R.C. s. 385(a): “The Secretary is authorized to prescribe such regulations as may be necessary or appropriate to determine whether an interest in a corporation is to be treated for purposes of this title as stock or indebtedness (or as part stock and in part indebtedness).”
Statutory authority (continued)

• Code s. 385(b): “The regulations prescribed under this section shall set forth factors which are to be taken into account in determining with respect to a particular factual situation whether a debtor-creditor relationship exists or a corporation-shareholder relationship exists.”

• These factors “may include ... (1) whether there is a written unconditional promise to pay on demand or on a specified date a sum certain in money in return for an adequate consideration in money...”
Substance of proposed rules

• What regulation does (2 components):
  1. Re-characterize certain purported related party debt as equity ("per se rule")
  2. Require contemporaneous and ongoing documentation of related party debt (failure to meet this test may cause the purported debt to be re-characterized as equity) ("documentation rule")

• Proposed regulation’s “bifurcation rule” has been withdrawn
Effective dates

- Per se rule applies to debt issued on or after 1/19/17 and to debt that was issued after 4/4/16 (i.e., regulation proposal date) that is still outstanding as of 1/19/17
- Documentation rule applies to debt issued after 1/1/18; compliance is required by due date of tax return as extended for tax year in question
- Certain transactions could trigger the rules as to debt issued prior to the effective dates (e.g., a material modification by refinancing; a transfer of the debt; or a change in entity classification)
Relationship to pre-existing law

• Validity of debt under Code s. 163 has generally been policed by multi-factor judicial tests – e.g., as stated in *Alterman Foods, Inc.*, 611 F.2d 866 (Ct. Cl. 1979)

• One key judicial test: whether there is a written unconditional promise to pay on demand or on a specific date a sum certain of money in return for an adequate consideration in money

• Regulation makes clear that these judicial factors remain relevant, serve as a “back stop” even after application of the regulation
1. Per se rule

• Focus of per se rule is so-called “dividend notes;” *see Kraft Foods Co. v. Comm'r*, 232 F.2d 118 (2d. Cir. 1956). *See also Overnite Transportation*, 54 Mass. App. Ct. 180 (2002).

• Proposed regulation preamble: These are transactions: (1) “in which no new capital is introduced;” and where (2) there is a “typical lack of a substantial non-tax business purpose” and where (3) “the non-tax effects are often minimal or eliminated.”

• …therefore, in the case of “a distribution of a debt instrument to an affiliate” and “in fact patterns similar to *Kraft* it is appropriate to treat a debt instrument as stock.”
1. Per se rule (continued)

• Per se rule: treats related party debt as equity if it is issued (1) in a distribution; (2) in certain exchanges for related party stock; and (3) in exchange for property in certain asset reorganizations

• Funding rule: related party debt issued to fund such transactions is also treated as equity; such funding is presumed if it occurs 36 months before or after the prohibited transaction
1. Per se rule (continued)

• Several exceptions, including: (1) where distribution is made out of e&p accumulated in tax years ending after 4/4/16; and (2) *to extent that* the aggregate adjusted price of such instruments group-wide does not exceed $50 million (i.e., no cliff effect as in the proposed rules)

• There is an exception from the per se rule’s *funding rule* for “qualified short term debt instruments” (the result of numerous comments noting the potential for the funding rule to frequently apply in the context of *cash pooling agreements* and other common short-term funding arrangements)
2. Documentation rule

- Documentation must demonstrate:
  1. Unconditional & legally binding debtor/issuer obligation to repay a sum certain on demand or at one or more fixed dates;
  2. Creditor/holder rights to enforce the obligation;
  3. Issuer’s position supports reasonable expectation of repayment at time of creation;
  4. An ongoing relationship during the life of the instrument consistent with an arm’s length relationship (such as timely payments of interest and principal, and actions taken upon default)
2. Documentation rule (continued)

• Documentation must be in place by the due date of the issuer’s tax return for the tax year at issue, as extended

• Rule applies to related party “expanded groups” that are:

  1. publicly traded;
  2. have total assets in excess of $100 million; or
  3. have total annual revenue in excess of $50 million (per financial statements) as of date of instrument
2. Documentation rule (continued)

• Exceptions apply for: (i) certain “highly compliant” expanded groups, for which there is a rebuttable presumption that an undocumented debt interest constitutes equity; (ii) ministerial and non-material failures that have been timely cured; and (iii) taxpayers that establish reasonable cause for failing to comply

• Streamlined documentation rules apply for debt issued by certain regulated entities & for intragroup revolving credit and cash pooling arrangements
Application to related parties

• Regulation applies to purported debt between members of an “expanded group”

• Generally includes all corporations connected to a common parent that owns directly or indirectly 80% of the vote or value of each such corporation

• Broader notion than a U.S. consolidated group (though a narrower definition than originally proposed)

• Modified attribution rules under I.R.C. s. 318 apply
Exempt entities

• Entities exempt from the regulatory rules in all instances:
  – Foreign *issuers*
  – S corporations
  – Non-controlled REITs and RICs
  – Non-controlled partnerships

• *Issuers* that are regulated financial companies & regulated insurance companies (but not captives) are not subject to the per se rule and are subject to relaxed documentation requirements
Federal consolidated returns

• Corporations filing a federal consolidated return are treated as “one corporation” for purposes of the per se rule
• Debt instruments entered into between corporations that file a federal consolidated return are not instruments that are subject to the documentation rule
• Stated IRS rationale: that the intercompany elimination rules that generally apply in the context of a federal consolidated return render the application of the s. 385 rules unnecessary/superfluous as to such federal filers
Federal consolidated returns

• For federal tax purposes, the regulation applies to transactions between a federal consolidated group member and a related corporation that is outside the federal consolidated group but within the “expanded group”

• So, for example, the regulation applies to debt issued by a domestic corporation to an 80% controlled: (1) foreign corporation; (2) REIT; or (3) captive insurance company
Threshold state conformity issue

• If states determine income based on federal taxable income, assuming date conformity, could be “trickle down” state tax benefit where there are federal tax “adjustments”

• Note that where purported debt is treated as equity, state interest expense add back laws – and therefore a state tax add back “exception,” permitting an interest expense deduction – would not logically apply
State conformity where no federal adjustment?

- High-profile question: to what extent do the rules apply at the state tax level as to transactions between related domestic corporations that file a federal consolidated return but do not file on a consolidated/combined basis for state tax purposes (i.e., where there will be no federal adjustment)?
- States generally apply the I.R.C. and the relevant regulations as if each corporation is to file a stand-alone federal tax return (i.e., each entity prepares a separate pro forma return based on the I.R.C.)
Per se rule & consolidated returns

• § 1.385-3(b): provides a “per se rule” for recast of related party debt issued in a distribution and related transactions.

• § 1.385-4T(b) pertaining to “Treatment of consolidated groups” provides that for purposes of §§ 1.385–3 “all members of a consolidated group (as defined in § 1.1502–1(h)) that file (or that are required to file) a consolidated U.S. federal income tax return are treated as one corporation.”

• The regulation also includes an “order of operations” that says you “[f]irst, determine the characterization of the transaction under federal tax law without regard to the one-corporation rule,” then apply the -4 rules to the “transaction as characterized” to determine whether to treat the debt instrument as stock,” given the one corporation principle
“State and Local Tax Comments”

• PREAMBLE: “Comments noted that the regulations add complexity to state and local tax systems and may result in additional state tax costs and compliance burdens for taxpayers. In particular, a comment noted that, if a state applies the one corporation rule based on the composition of the state filing group rather than the federal consolidated group, transactions could be subject to the regulations for state income tax purposes even when the transactions are not subject to the regulations for federal income tax purposes. ...
“State and Local Tax Comments”

• ...The comment suggested that this concern could be mitigated in states that adhere to the literal language of the section 385 regulations by modifying proposed § 1.385–1(e) to provide that “all members of a consolidated group (as defined in § 1.1502–1(h)) that file (or that are required to file) consolidated U.S. federal income tax returns are treated as one corporation.’ The temporary regulations adopt this recommendation.”
Documentation rule & consolidated returns

• Documentation rules apply to an “applicable interest”

• Pursuant to § 1.385–2(d)(2)(ii) the term “applicable interest does not include— (A) An intercompany obligation as defined in § 1.1502–13(g)(2)(ii) or an interest issued by a member of a consolidated group and held by another member of the same consolidated group.”
Relevance of state add back laws?

• State tax interest expense add back statutes (which “add back” related party interest expense deductions in some cases) do not logically apply if the transaction is denied debt treatment in the first instance (i.e., because the transaction would not generate an interest expense)

• Therefore, in such cases, state tax add back “exceptions” that allow a taxpayer’s interest expense to avoid add back treatment and be deducted would not logically apply
Other implications?

• Debt recast as equity may result in dividends to the extent of e&p; may implicate the state’s dividend’s received deduction and/or result in dividend income, etc.

• Debt recast could impact the percentage ownership of an entity and therefore could affect inclusion within a combined/consolidated group

• Debt determination may be relevant for other state tax purposes (e.g., the determination of a state net worth or franchise tax, or a state’s corporate income tax sales factor computation where interest is included in the relevant gross receipts)