MULTISTATE TAX COMMISSION

To: Wood Miller, Chair, Uniformity Committee

From: Bruce Fort, Counsel, Multistate Tax Commission

Date: 7/22/16

Re: **State Income Tax Implications of Proposed Section 385 Regulations Pertaining to Intercompany Debt and Equity Classifications**

On April 4, 2016, the U.S. Treasury Department issued a notice of proposed rulemaking for proposed regulations on re-classifying debt and equity under Section 385 of the Internal Revenue Code.[1] The regulations are primarily addressed to making inversions less favorable for U.S. companies, but the regulations also apply to other international and domestic transactions which occur with between members of a federal consolidated group and related but unconsolidated entities. The Treasury's proposed regulations and the April 25, 2016 summary of their contents are found here: https://www.irs.gov/irb/2016-17_IRB/ar07.html.

The proposed regulations have unleashed a firestorm of commentary and objection, suggesting the issue has significant tax implications for many multinational corporations.[2] The regulations should have a direct revenue effect for the states as federal adjustments flow through on state returns. The more

[1] IRC Section 385 provides in part:

(a) Authority to prescribe regulations

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 in part stock and in part indebtedness).

(b) Factors: 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. The factors so set forth in the regulations may include among other factors:
(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 or money's worth, and to pay a fixed rate of interest,
(2) whether there is subordination to or preference over any indebtedness of the corporation,
(3) the ratio of debt to equity of the corporation,
(4) whether there is convertibility into the stock of the corporation, and
(5) the relationship between holdings of stock in the corporation and holdings of the interest in question.

[2] See, e.g., https://www.pwc.com/us/en/tax-services/publications/insights/assets/pwc-proposed-section-385-regs-would-impact-related-party-financings.pdf; http://www.mofo.com/~/media/Files/ClientAlert/2016/04/160412IRSDebtEquityRegulations.pdf.

difficult question is the extent to which the states may be able to use those federal guidelines in making adjustments for transactions among members of the federal consolidated group on state "pro-forma" returns, both for separate-entity states and for combined filing states, where transactions which would otherwise be eliminated on federal consolidated returns occur with non-combined members.

In most states, I believe it should be possible to apply the substantive provisions of the federal regulations without adopting state-level regulations. Although all of the provisions should be effective for the states without additional state-level regulation, one could expect arguments that one or more of the provisions relating to record-keeping (see #2 below) and percentage adjustments (see #3 below) would not be binding on taxpayers at the state level without a separate state regulation.

The proposed regulations are voluminous and complex, but to summarize their contents, it is fair to say that the proposed regulations have three main components:

1. a per se rule that debt arising from certain transactions should be treated as equity;

2. the requirement for contemporaneous documentation of the debt at the time of issuance and during the course of the loan, based on an arms-length standard of how unrelated parties would document such loans; significantly, the penalty for failure to maintain such records is disallowance of the interest deduction or similar tax benefits;

3. Clarification that the IRS has authority to adjust the *amount* of a transaction treated as debt versus equity, and not simply allowing or disallowing the taxpayer's treatment.

Effective Dates: Debt issued after 4/4/16, but may apply to prior debt instruments which are substantially reorganized after the effective date.

I hope this broad outline is sufficient for purposes of introducing the subject matter to our member states. If you have questions, I will attempt to answer them as best as possible.