AN ALERT FROM THE BDO STATE AND LOCAL TAX PRACTICE

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SUBJECT

PROPOSED FEDERAL "EARNINGS STRIPPING" REGULATIONS COULD HAVE UNSUSPECTED STATE CORPORATE INCOME AND FRANCHISE TAX CONSEQUENCES

SUMMARY

On April 8, 2016, the U.S. Department of the Treasury and Internal Revenue Service published proposed regulations under Section 385 of the Internal Revenue Code of 1986, as amended ("IRC § 385"). The proposed IRC § 385 or "earnings stripping" regulations would treat a broad group of intercompany financing, and some cash management arrangements, as stock, not debt, for federal income tax purposes. Read the regulations here. Although the proposed IRC § 385 regulations were issued in conjunction with proposed regulations addressing corporate inversion transactions, the proposed IRC § 385 regulations are not limited to inversion transactions and apply to wholly U.S., and not just to U.S./foreign, intercompany financing arrangements. Based on the various ways in which states conform to the Internal Revenue Code and Treasury Regulations for purposes of a state income tax, the proposed IRC § 385 regulations could have unsuspected consequences for state corporate income and franchise tax purposes as well.

DETAILS

Background

IRC § 385 was enacted in 1969 and amended in 1989 and 1992. IRC § 385(a) authorizes the Secretary to prescribe regulations to determine whether an interest in a corporation is to be treated as stock or indebtedness, as is necessary or appropriate. Although proposed and final IRC § 385 regulations existed between 1980 and 1984, those were withdrawn and the section has been essentially inoperative since.

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If the proposed IRC § 385 regulations are finalized, they will reclassify certain intercompany financing arrangements as stock, not debt, and thereby disallow any interest expense deduction for federal income tax purposes. The proposed regulations provide in part the following:

- The proposed IRC § 385 regulations apply to an "Expanded Group," which generally means a group of related U.S. and non-U.S. corporations that satisfy an 80% vote or value test. To treat certain debt as part stock and part debt, however, the relatedness test is 50% vote or value.
- Intercompany financing will be required to meet specific documentation preparation and maintenance requirements in order to be treated as debt. The documentation requirements are onerous and apply not just at the time a debt instrument is issued, but throughout the term.
- Although the proposed regulations do not follow some federal judicial decisions, they reiterate that federal case law applying the debt or equity doctrine continues to apply in general.
- However, if an intercompany financing arrangement is (1) a note distributed by one related party to another, (2) a note issued by one related party in exchange for another's stock, or (3) a note issued by one related party to another in an internal asset reorganization ("Targeted Transactions"), it will be treated as stock, regardless of whether the documentation requirements and federal case law are satisfied.
- In addition, a note issued by one related party to another to fund an intercompany distribution, acquisition of stock, or acquisition of property in an internal asset reorganization will also be treated as stock.

The proposed IRC § 385 regulations are expressly inapplicable to intercompany financing arrangements by and among affiliates filing a federal consolidated return.

The proposed regulations become effective only when published in the Federal Register as final regulations. Nonetheless, the regulations would apply to any debt instrument that is a Targeted Transaction issued on or after April 4, 2016 that is still outstanding 90 days after the proposed regulations are finalized.

Potential State Income Tax Considerations – a Host of Questions

Whether, and to what degree, any final IRC § 385 regulations could apply at the state level raises a number of questions.

1. No affiliate member of a federal consolidated group will be subject to the proposed IRC § 385 regulations if they become final, but could a separate return state independently apply the regulations to determine state taxable income?

   While most states start with federal taxable income and then apply their addition and subtraction adjustments to arrive at state taxable income, separate return states require a pro forma federal return for the affiliate(s) taxable in the state. Some separate return states specifically provide that an affiliate of a federal consolidated group must determine its federal taxable income starting point "as if" the affiliate filed a separate federal return. Following this line of reasoning, a separate return state might try to justify an independent application of the regulations. Although such a result could be considered by some as unsupportable, especially when the federal regulations expressly do not apply to a federal consolidated return, certain states could contemplate independent application of the IRC § 385 regulations. At a minimum, states should be expected to use the documentation requirements and other aspects of the proposed IRC § 385 regulations when challenging the debt or equity character of intercompany financing.

2. Should a state be required to specifically adopt IRC § 385 (or like California, adopt subchapter C as a whole with exceptions) before IRC § 385 regulations could apply?

   Other factors to consider in determining whether a state could apply the IRC § 385 regulations include how a state conforms to federal tax provisions, including fixed date conformity, moving date conformity, specific IRC section enactment, or does not conform to federal tax provisions, as well as whether the state's federal tax conformity includes federal tax regulations.

3. For Targeted Transactions that are treated as stock and not debt by the proposed IRC § 385 regulations, the regulations could apply to a broader range of intercompany financing than the various state-related party interest expense add-back statutes. If applicable in a state, could the IRC § 385 regulations disallow an interest expense deduction that is either not subject to or is excluded from the state's related party interest expense add-back statute?

   For example, some states limit the interest expense add-back provisions to "intangible-related interest expense," but other forms of intercompany interest are deductible, subject to traditional debt or equity case law (e.g., Kentucky). The proposed IRC § 385 regulations are not so limited. If such a state attempts to independently apply the regulations in this context, another question could be raised as to whether the state's interest expense add-back statute is the sole basis to deny an intercompany interest expense deduction for state income tax purposes.

There are concerns that common affiliated group business structures for cash management ("sweeps") and cash pooling could be impacted by the proposed IRC § 385 regulations. While these cash management arrangements serve a business purpose of managing cash and liquidity, they may be structured as an intercompany financing arrangement and thus may come under the purview of the IRC § 385 regulations.

BDO INSIGHTS

- There are serious questions as to whether any IRC § 385 regulations could apply independently at the state level. However, states continue to aggressively challenge intercompany financing arrangements, and the proposed IRC § 385 regulations would likely be contemplated for use by a number of state taxing authorities.
- Any corporate taxpayer that engages in an intercompany financing arrangement using a Targeted Transaction on or after April 4, 2016, should not only address the potential federal income tax consequences of the proposed IRC § 385 regulations to the intercompany financing arrangement, but also the potential reach and effect for state corporate income tax purposes.
- Other anticipated intercompany financings should take the proposed IRC § 385 regulations into consideration for federal and state corporate income tax purposes.