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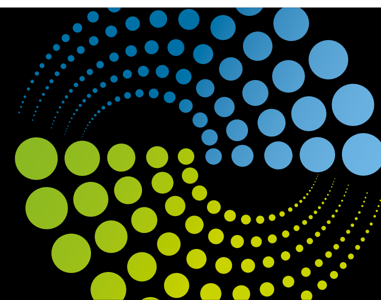
M&A Tax Talk
State tax insights on debt



Key takeaway

Companies and practitioners who do not give thought to the structure of debt within the US group and the state tax profile when it comes to debt can face significant adverse tax consequences that could have been avoided by being aware of these issues.

Debtor identity is crucial outside of a consolidated return

State filing requirements can differ greatly from a federal consolidated return. For example, an operating company may be subject to tax on a separate company basis, meaning that unless it had interest expense of its own, it generally does not get the benefit of deducting interest owed by other members of the US group. When states apply section 163(j), they may do so based on separate company adjusted taxable income (ATI) or the ATI of the members of a combined group return, which may differ significantly from the section 1504 consolidated group. Accordingly, if the interest expense is not incurred by entities with significant ATI, it can result in a more severe limitation.

"Pushing down" debt may not be easy

Where debt is owed by a parent company, a common strategy has been to "push down" debt via the use of dividend notes issued by the subsidiary to the parent. However, there are three primary challenges to such a strategy: (1) Treas. Reg. § 1.385-3, which, when applied outside of a consolidated return, would recast any distributed debt instrument unless it came out of post-April 2016 E&P; (2) intercompany addback rules applied by many states, which require that deductions of interest paid to related parties be added back to income; and (3) transfer pricing adjustments. While some states have so-called "conduit exceptions" to the addback rules, where the interest is ultimately paid to a third-party lender, this is not true in all states, and it may be difficult to claim an exception if the parent does not have nexus in any separate company jurisdictions. With respect to transfer pricing, states have greatly increased their enforcement in this area recently, and many states routinely adjust intercompany interest deductions.

Co-obligor on third-party debt versus intercompany notes

Instead of the use of a dividend note, to the extent an affiliate may be a primary obligor on a debt instrument, it may be possible for that entity to treat interest expense as a third-party deduction instead of an intercompany one, especially where it directly books or assumes a portion of the debt. This may avoid some section 385 issues and intercompany addback rules present with distributed intercompany debt. Crucial to the analysis from a state perspective is whether the interest expense can be substantiated as a deduction against apportionable business income, instead of an allocable nonbusiness deduction, which could generally only be claimed in the state of commercial domicile. This analysis would look to how any borrowing is connected to the business activities of the particular entity claiming a deduction.

Conclusion

As a business is evaluating the use of debt and interest within the structure of a US group, state tax implications can vary and may require additional consideration. Taxpayers, with their tax advisers, should carefully evaluate the issues described in an effort to mitigate adverse consequences and benefit from potential tax efficiencies.

Want to learn more?
Reach out to our contacts below –

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