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In this installment of Inside Deloitte, the authors examine various state tax issues in mergers and acquisitions involving third-party and intercompany debt.

Debt is one of the most commonly used financial instruments, yet its impact on a company's capital structure, internal governance, and tax reporting can be profound. Whether used to accelerate growth, facilitate an acquisition, or restructure existing operations, debt influences the way a company behaves and how key decisions are made. Despite its ubiquity, companies often overlook the state tax impact of their debt structure. This challenge becomes particularly relevant in the context of mergers and acquisitions, when the treatment of a potential target's current debt — or debt that may be issued as part of an acquisition — can have meaningful tax implications.

While debt is often issued by a holding company, there are two primary methods for allowing an operating subsidiary to claim interest expense deductions for state tax purposes: the allocation of third-party debt and the establishment of intercompany debt agreements. The allocation of third-party debt involves various entities within a company's structure taking primary responsibility for servicing the debt and generally necessitating the presence of co-obligors to obtain interest deductibility. Alternatively, the various entities within a company's structure may enter into intercompany debt agreements and claim interest expense deductions on the intercompany debt for state tax purposes, as opposed to claiming interest expense deductions on the third-party debt.

From intercompany addbacks to state section 163(j) limitations, state-specific tax rules can quickly complicate diligence associated with a target's historical debt, along with debt structuring that may affect both the short-term economics of a deal and the long-term financial health of an acquired company. This article seeks to assist tax professionals in assessing the potential state tax implications related to a target's existing debt, as well as any debt incurred in connection with a proposed transaction.[1]

Co-obligors: Because Teamwork Makes the Dream Work

A taxpayer is generally allowed to deduct interest paid or accrued on debt to determine taxable income, subject to certain limitations.[2] Nevertheless, as part of due diligence, it is important to verify whether a target's treatment of interest expense on historical state filings is reasonable. In addition to assessing practices surrounding existing debt, understanding a target's tax profile may help identify future tax planning opportunities that can address inefficiencies and increase cash savings for a potential buyer.

To the extent an affiliate is a primary obligor on a third-party debt instrument, it may be possible for the entity to deduct the corresponding interest expense. However, the interest can be deducted only if the taxpayer is considered primarily liable for payment on the debt.[3] Primary liability typically refers to an obligation under which the creditor can directly request payment from the obligor without requiring another obligor to default on the debt first.[4]

Debt agreements commonly have multiple obligors, or co-obligors.[5] In the context of debt with co-obligors, one key question is who should receive the interest deduction. A co-obligor that is primarily liable is typically permitted to take an interest deduction for its portion of the interest it paid if, in addition to being primarily liable under the debt agreement, the co-obligor also formally assumed the debt for book and tax purposes. Even in the context of co-obligors, the implementation of an intercompany agreement is advisable to formalize the terms and conditions of the debt allocation — providing enhanced clarity and enforceability of the debt structure.

Certain debt agreements may designate multiple affiliates as guarantors. Depending on the terms of the guarantee, such as whether the guarantors are liable for payments without the pursuit of collection activity against the main obligor, the guarantors may be treated as co-obligors and be primarily liable under the specific terms of the debt agreement.[6] Other guarantee arrangements may require the creditor to pursue collection activity against the obligor before any liability arises for the

guarantor; in these cases, a guarantor is not a primary obligor on the debt until the obligor is in default. Accordingly, these guarantors are generally unable to claim any tax deduction until they are legally obligated to make payments under the specific terms of the debt agreement.

Debt Push-Down, State Pushback

When a target's parent company has existing or outstanding debt, it is common for the parent to attempt to reallocate a portion of the debt to a target's operating subsidiary (occasionally referred to as the push-down of debt), which can be accomplished using a variety of strategies. Taxpayers — and potential buyers — should confirm that the interest expense associated with any reallocated debt is deductible for state tax purposes and supportable from a transfer pricing perspective in the overall context of the entity's operations for the strategy to be effective.

While the analysis is usually focused on separate company states, several combined filing states also statutorily require taxable income to be computed "as if" the corporation filed separately for federal income tax purposes.[7] When an operating company is subject to state tax on a separate company basis, it generally does not receive the benefit of deducting interest owed by other members of the federal consolidated group.

To the extent an intercompany debt arrangement has been put into place within a target's structure or is intended to be reallocated among affiliates as part of a proposed transaction, the following state concepts should be considered as part of assessing the risk of interest deductibility:

- The federal regulations under IRC section 385 (385 regs) require certain debt instruments distributed as dividends to be recast as equity, although exceptions exist for intercompany debt instruments between corporations filing a federal consolidated return. Because many states require taxable income to be computed outside consolidation, the 385 regs can apply for state purposes, even if they do not apply between members of a federal consolidated return.[8] Consequently, the 385 regs would recast certain related-party debt instruments as stock when issued in connection with a distribution.[9]
- Statutory requirements to add back intercompany interest deductions — which have been adopted by many states — may apply unless an exception exists (intercompany addbacks).[10] While certain states have "conduit exceptions" to intercompany addbacks (that is, when the interest is ultimately paid to a third-party lender), an exception may not exist or be available in all states.[11] Claiming an exception may also present challenges if a parent company lacks nexus in separate filing jurisdictions.
- Transfer pricing adjustments are also frequently applied by states under state statutory or regulatory law that are similar to or expressly adopt the antiabuse provisions under IRC section 482, which allows a tax authority to allocate income or deductions among two or more taxpayers that are commonly controlled to clearly reflect the income of the parties. States may attempt to apply these provisions to certain intercompany expenses, including intercompany interest expenses. The application of section 482 could include scrutiny of the interest rate applied or whether the debt should be treated as equity as discussed above, especially if a debt capacity analysis has not been prepared. Notably, states have increased

enforcement in this area recently, and many "routine" audits will result in an adjustment for intercompany interest deductions.[12]

State and Federal Consequences of Debt Reallocation — One Transaction, Different Outcomes

To the extent a co-obligor is primarily liable under a third-party debt agreement and engages in a transaction to reallocate the debt, IRC section 301(c) generally dictates the tax consequences. Although states typically conform to section 301(c), various nuances can lead to distinct state tax consequences following an assumption of debt or a distribution, including (1) state filing methods, and (2) nonconformity to certain IRC sections that may affect a shareholder's adjusted stock basis and earnings and profits. When conducting due diligence, it is crucial to assess whether a target fully analyzed the state-specific tax consequences and accounted for any state tax differences on its returns as required.

When a company distributes property to its shareholders, tax consequences can arise for both the distributing corporation and the receiving shareholder — regardless of whether a distribution is actually paid or deemed to have been paid under the relevant authority (for example, reallocation of debt).[13] Under section 301(c), the shareholder is treated as receiving either:

- a dividend to the extent of the corporation's E&P;
- a reduction of the shareholder's adjusted basis in the distributing corporation's stock if the amount of the distribution exceeds E&P; or
- a capital gain when the distribution exceeds stock basis.[14]

Further, corporate shareholders are oftentimes permitted to claim a deduction for federal purposes under section 243 to offset all or a portion of the dividend income that they receive.[15]

When the corporation assuming the debt is a member of the same federal consolidated return group as the shareholder corporation, the federal tax consequences noted above are altered according to Treasury regulations under IRC section 1502 (the consolidated return regulations). Under Treas. reg. section 1.1502-13(f), the entire amount of an intercompany distribution is excluded from the shareholder's gross income.[16]

The state tax consequences of a distribution oftentimes will differ from the federal tax consequences, and in many instances, those differences result from states not adopting the consolidated return regulations. In separate filing jurisdictions, as well as several combined filing states that require taxable income to be computed as if the corporation filed separately for federal income tax purposes, the consolidated return regulations are generally inapplicable. As a result, the corresponding impact on E&P and basis within the federal consolidated group under the consolidated return regulations may be similarly inapplicable. Thus, when analyzing a distribution under section 301(c), the potential consequences (for example, the amount of dividend income, return of basis, and capital gain) may differ for state tax purposes. For example, any income realized on the distribution would be recognized currently in separate filing states, and no basis adjustment would be necessary.

In combined filing states that adopt the consolidated return regulations, the federal treatment is generally followed for state income tax purposes. In combined filing states that do not follow the consolidated return regulations, provisions may exist that result in permanently eliminating the distribution with no adjustment to basis so that there is no current state tax impact — similar to the federal result. However, in certain combined filing states, an intercompany elimination applies only when a dividend was paid out of E&P of the unitary business.[17]

In certain combined reporting states, to the extent any portion of a distribution exceeds state-specific E&P and adjusted basis, a deferred intercompany stock account (DISA) is created. For example, California law established DISA rules as an accounting mechanism to report and track nondividend distributions in excess of adjusted basis. The balance of each DISA account must be disclosed annually on a taxpayer's return until the intercompany item is required to be taken into account or is otherwise cured.[18] However, if a taxpayer fails to disclose a DISA balance on its annual corporate income tax return, the California Franchise Tax Board has discretion to require the undisclosed amounts to be taken into account in any year of that failure.[19] Further, events that trigger a DISA under California law are notably different from events that may cause a federal excess loss account.[20]

To the extent a target previously reallocated debt whereby a subsidiary corporation assumed the debt, it's essential to confirm that a comprehensive state tax analysis was performed when evaluating potential exposure that may succeed to the buyer. As discussed, confirming that a target's operating affiliates are co-obligors to a third-party debt arrangement and the debt reallocation is properly documented may mitigate intercompany debt concerns that are identified during due diligence. However, it is important to consider other mechanisms by which state tax authorities have challenged interest deductions related to intercompany debt, including examining whether the funds as advanced qualify as bona fide debt under state law. Jurisprudence across various jurisdictions suggests that state courts are not bound by an IRS determination, including on whether an advance is properly characterized as debt for federal purposes. For example, in *National Grid USA Service Co.* the Massachusetts Appellate Tax Board considered whether the commissioner could recharacterize a balance as equity when the IRS had allowed a portion of the interest to be deducted.[21] In holding that the board was entitled to its own determination, the opinion stated, "The issue of whether the [balance] constituted debt is not one that is controlled by the [Internal Revenue] Code, but is a matter of common law that has been taken up by Massachusetts courts on numerous occasions."[22]

It is also important to consider whether interest expense can be substantiated as a deduction against apportionable business income instead of an allocable nonbusiness deduction, which may generally be claimed as a deduction only in the state of the taxpayer's commercial domicile.[23]

Power Play of Interest Deductibility Known as Section 163(j)

Fully understanding a target's application of IRC section 163(j) for state purposes is crucial as part of due diligence, particularly given that state conformity to the IRC varies. While certain states conform to section 163(j), others specifically decouple from or conform to a version of the IRC that would not

include the changes under the Tax Cuts and Jobs Act related to section 163(j).[24] Even among jurisdictions that conform to section 163(j), state-specific filing requirements are nuanced and regularly differ from a taxpayer's federal consolidated return presentation. For example, corporations that are included within a federal consolidated return group may be subject to state tax on a separate company basis. In many states that default to separate company reporting for corporations, the section 163(j) limitation is applied based on separate company adjusted taxable income.[25] To the extent interest expense is incurred by entities with minimal ATI, the application of section 163(j) can result in a more severe limitation in separate company reporting states.[26]

Notably, the composition of a unitary combined group for state purposes frequently differs from the federal consolidated group under IRC section 1504; in combined reporting states that conform to section 163(j), the limitation is generally applied based on the ATI of the members of each specific state's unitary group. As a result, the section 163(j) limitation may be materially different in certain combined reporting states compared with the federal tax treatment.[27]

During due diligence, buyers should also evaluate whether state limitations associated with related-party interest were applied by a target in each filing state before or after the section 163(j) limitation along with the potential impact on carryover interest for state tax purposes to the extent some portion of the carryover is associated with related-party interest.[28] As demonstrated by the above discussion, the identity of the debtor and state filing profile of a target are critical considerations in evaluating the potential state income tax consequences of indebtedness, as is confirming that any posttransaction structuring does not result in unanticipated state taxes or increased risk.[29]

FOOTNOTES

[1] *See* Jacob Aguero et al., "State Mergers and Acquisitions, Part 1: Successor Liability," *Tax Notes State*, Apr. 8, 2024, p. 139; *see also* Youngbok Ko et al., "State Mergers and Acquisitions, Part 2: Non-Income-Tax Types," *Tax Notes State*, July 15, 2024, p. 137; *see further* Tyler Greaves et al., "State Mergers and Acquisitions, Part 3: Inbound Considerations," *Tax Notes State*, Dec. 2, 2024, p. 573.

[2] Section 163 generally allows "a deduction [for] all interest paid or accrued within the taxable year on indebtedness."

[3] *See id.* In the context of section 163, "indebtedness" generally refers to the obligation of the specific taxpayer, meaning that obligations of *others* do not fulfill the statutory requirement. Consequently, only the taxpayer responsible for the debt obligation is permitted to deduct the interest. *See* Treas. reg. section 1.163-7(a) (providing that regarding original issue discount, "an issuer is permitted a deduction under section 163(e)(1) only to the extent the issuer is primarily liable on the debt instrument"); *see further Guardian Investment Corp. v. Phinney*, 253 F.2d 326 (5th Cir. 1958) (taxpayer unable to deduct interest when associated liability was contingent because note's language did not create a definite, fixed, and existing debt); *see also United States v. Norton*, 250 F.2d 902 (5th Cir. 1958) (explaining that "only the person owning property at the time when a tax lien attaches is subjected to the burden of payment which the law imposes; and only the person who has been thus

subjected to the burden of the tax is entitled to a deduction for paying it" (internal citations omitted)); *see also Stratmore v. Commissioner*, 785 F.2d 419 (3rd Cir. 1986) (holding that taxpayers were entitled to deduct interest expense based on possessing a direct and fixed obligation); *see further Anderson Dairy Inc. v. Commissioner*, 39 T.C. 1027 (1963) (explaining that the party was at no time monetarily obligated to make certain payments, and therefore, a deduction under section 163 was not permitted); *see also Nelson v. Commissioner*, 281 F.2d 1 (5th Cir. 1960).

[4] *See* Restatement (Third) of Suretyship & Guaranty, Interpretation of the Secondary Obligation — Use of Particular Terms, section 15(a) (American Law Institute 1996); *see also* Daniel M. Dunn, "Joint and Several Liability: A Common Arrangement With Uncommon Tax Consequences," *Tax Notes*, Aug. 29, 2005, p. 1021 (discussing the distinction between guarantors and primary obligors and noting that "the authority relevant to making such a distinction is not always consistent"); *see, e.g.*, *Arrigoni v. Commissioner*, 73 T.C. 792, 806 (1980) (holding that when two parties were jointly and severally liable for obligations, both "parties were primarily liable for payment of the [obligations]. The fact that the obligations were imposed jointly does not change what is a primary liability into a derivative one"); *see also Williams v. Commissioner*, 3 T.C. 200 (1944); *see further Neracher v. Commissioner*, 32 B.T.A. 236 (1935) (holding that a taxpayer could deduct interest for a payment on an obligation that listed two borrowers as jointly and separately liable).

[5] *See further* Luís Calderón Gomez, "Whose Debt Is It Anyway?" 76 *Tax L. Rev.* 159, 164A (2022) (explaining "co-obligated debt is a debt with several obligors [and] provides the creditor with the right to proceed directly against any individual obligor for the entire amount owed. Although obligors might agree to apportion the debt among themselves and thus be only ultimately liable vis-à-vis each other for a portion of the debt, they are liable for the entire amount vis-à-vis the creditor" (internal quotations omitted)).

[6] *See Golder v. Commissioner*, T.C. Memo. 1976-150 (1976), *aff'd*, 604 F.2d 34 (9th Cir. 1979) (denying an interest deduction to taxpayer because the taxpayer's liability was contingent upon a default by the primary obligor); *see also Putnam v. Commissioner*, 332 U.S. 82 (1956) (losses sustained by guarantors are deductible under section 166); *see further U.S. Bank N.A. v. Perlmutter (In re S. Side House LLC)*, 470 B.R. 659, 675 (Bankr. E.D.N.Y. 2012) (describing that the "fundamental distinction between a guaranty of payment and one of collection is, that in the first case the guarantor undertakes unconditionally that the debtor will pay, and the creditor may, upon default, proceed directly against the guarantor, without taking any steps to collect of the principal debtor" (internal citations omitted)).

[7] *See, e.g.*, Va. Code Ann. section 58.1-442 (stating a "combined return shall mean a single return for a group of corporations . . . in which income or loss is separately determined in accordance with [the following]: (a) Virginia taxable income or loss is computed separately for each corporation; (b) allocable income is allocated to the state of commercial domicile separately for each corporation; (c) apportionable income or loss is computed, utilizing separate apportionment factors for each corporation; (d) income or loss computed in accordance with subdivisions a, b, and c is combined and reported on a single return for the affiliated group").

[8] *See* Treas. reg. section 1.385-1; *see further* Treas. reg. section 1.385-4 (explaining that intercompany debt instruments between federal consolidated group members are not subject to recast for federal tax purposes).

[9] *See* Treas. reg. section 1.385-3 (explaining overall recast framework).

[10] *See, e.g.*, Ala. Code. section 40-18-35(b)(1) (stating that for "purposes of computing its taxable income, a corporation shall add back otherwise deductible interest expenses and costs and intangible expenses and costs directly or indirectly paid, accrued, or incurred to, or in connection directly or indirectly with one or more direct or indirect transactions, with one or more related members").

[11] *See, e.g.*, N.J. Stat. section 54:10A-4(k)(2)(I) (providing for a conduit exception whereby "a deduction shall also be permitted to the extent that the taxpayer establishes a preponderance of the evidence . . . that the interest is directly or indirectly paid, accrued or incurred to (i) a related member in a foreign nation which has in force a comprehensive income tax treaty with the United States and the related member (aa) was subject to tax in the foreign nation on a tax base that included the payment paid, accrued, or incurred; and (bb) under which the related member's income received from the transaction was taxed at [specified tax rate], provided however that the taxpayer shall disclose on its return for the privilege period the name of the related member, the amount of the interest, the relevant foreign nation . . . or (ii) to an independent lender and the taxpayer guarantees the debt on which the interest is required"). Notwithstanding typical conduit exceptions, uncertainty may exist. *See* Charles Barnwell, "Addback: It's Payback Time," *State Tax Notes*, Nov. 17, 2008, p. 437.

[12] States have also attacked intercompany transactions via forced combination, alternative apportionment, the sham transaction doctrine, and an expanded application of income tax nexus. *See* Ind. Code section 6-3-2-2(p); *see further* Ind. Code section 6-3-2-2(l); *see further Syms Corp. v. Commissioner*, 436 Mass. 505, 510, 765 N.E.2d 758 (2002) (disallowing deduction of intercompany expenses and explaining that the sham transaction "is a doctrine long established in State and Federal jurisprudence. . . . It works to prevent taxpayers from claiming the tax benefits of transactions that, although within the language of the tax code, are not the type of transactions the law intended to favor with the benefit. . . . 'Usually, transactions that are invalidated by the doctrine are those motivated by nothing other than the taxpayer's desire to secure the attached tax benefit,' and are structured to completely avoid economic risk.").

[13] *See, e.g.*, Treas. reg. section 1.1502-13(f)(2)(iv) ("An intercompany distribution is treated as taken into account when the shareholding member becomes entitled to it. . . . For example, if B becomes entitled to a cash distribution before it is made, the distribution is treated as made when B becomes entitled to it.").

[14] *See* section 301(c). Regarding a subsidiary corporation making a deemed distribution, under section 311(b), a gain (but not loss) is recognized on a distribution regarding its stock. In the context of a deemed distribution resulting from the assumption of debt by a subsidiary corporation, gain would ordinarily not be recognized by the subsidiary corporation. *See id.*

[15] For a dividend to be eligible for the deduction provided under section 243(b), it must be received by a corporation that is a member of the same affiliated group as the corporation distributing the dividend at the close of the day on which the dividend was received and the dividend was distributed out of E&P of a tax year of the distributing corporation that ends after December 31, 1963, and on each day of which the distributing corporation and the corporation receiving the dividend were members of the affiliated group. Section 243(b)(1)(A)-(B). To the extent a state relies on section 243 to determine whether a dividend is eligible for a state's dividends received deduction, a dividend may be ineligible for the deduction if it is not paid from E&P generated in a tax year in which both corporations were members of the same affiliated group.

[16] *See* Treas. reg. section 1.1502-32 (explaining that an exclusion from gross income applies only if there is a corresponding negative basis adjustment reflected in a shareholder's basis in the stock of the subsidiary corporation).

[17] *See, e.g.*, 830 Mass. Code Regs. section 63.32B.2(6)(c)4.a (stating that "dividends paid by one combined group member to another combined group member shall, to the extent those dividends are paid out of the E&P of the unitary business included in the combined report, from the current or an earlier year, be eliminated from the income of the recipient"); *see also* Cal. Rev. & Tax. Code section 25106(a) (providing for an elimination of dividends paid by one member of the group to another "to the extent those dividends are paid out of the income previously described of the unitary business").

[18] Cal. Code Regs. tit. 18, section 25106.5-1(j)(7).

[19] *Id.*

[20] *Compare* Treas. reg. section 1.1502-19 *with* Cal. Code Regs. tit. 18, section 25106.5-1(f)(B) (requiring deferred intercompany stock account balance to be taken into account upon liquidation of subsidiary corporation into its shareholder).

[21] Mass. ATB Findings of Fact and Reports 2014-630, Dkt. No. C314926 (Sept. 19, 2014).

[22] *Id.* at 2014-645.

[23] *See In re Appeal of Leslie's Holdings Inc.*, No. 955278 (Cal. State Bd. Equal. Nov. 14, 2017) (nonprecedential); *see also Arkansas Department of Finance and Administration v. [Redacted Taxpayer]*, Dkt. Nos. 19-185 and 19-186 (Ark. Off. Hearings & Appeals Apr. 1, 2019).

[24] *See, e.g.*, Conn. Gen. Stat. section 12-217(a)(6) ("For purposes of determining net income under this section . . . the deduction allowed for business interest paid or accrued shall be determined as provided under the Internal Revenue Code, except that in making such determination, the provisions of Section 163(j) shall not apply.").

[25] *See, e.g.*, Tennessee Department of Revenue, Notice 19-18: Tennessee Franchise and Excise Tax (Aug. 2019) (outlining method for allocating the federal consolidated group's allowed business interest expense deduction on a separate company Tennessee return); *see also* Pennsylvania DOR, "Pennsylvania Corporate Net Income Tax Treatment of IRC s. 163(j)," CTB 2019-03 (updated Oct. 12, 2023) (explaining that section 163(j) limitation is applied only for state purposes when a federal consolidated group is subject to the limitation, although the limitation must be determined for state purposes on a separate company basis).

[26] *See* Pennsylvania DOR, *supra* note 25.

[27] *See* N.J. Stat. section 54:10A-4(k)(2)(K)(ii) (explaining that members of a combined group are treated as one taxpayer for purposes of applying the section 163(j) limitation).

[28] *See* Massachusetts DOR, "Application of IRC s. 163(j) Interest Expense Limitation to Corporate Taxpayers," Technical Information Release 19-17 (Dec. 18, 2019) (explaining that Massachusetts statutory law "require[s] that a taxpayer add back to net income related member interest expenses and costs. The Massachusetts add back adjustments to a member's separately determined Massachusetts [business interest expense (BIE)] must be made at the separate entity level on a pre-apportioned basis. Where an add back is required, the Massachusetts deduction for BIE should be determined by applying the steps set out above, after first reducing current year BIE by the amount of the required add back. Any amount of BIE that is disallowed due to a Massachusetts add back, or any other provision of Massachusetts law, may not be deducted in the current year nor may it be carried forward.").

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END FOOTNOTES