

## ***Massachusetts – Obligations without an unconditional requirement to pay do not qualify as bona fide debt***

June 18, 2014

### ***In brief***

On June 4, 2014, the Massachusetts Appellate Tax Board (Board) ruled that deferred subscription arrangements (DSAs) did not qualify as bona fide debt because the DSAs did not require payments to satisfy the obligations. Accordingly, the entity subscribing for shares could neither deduct the interest expense component of its payments pursuant to the DSAs in determining its taxable net income nor deduct as liabilities the book value of the DSAs in determining its taxable net worth.

Massachusetts taxpayers should be aware that the state is continuing to recharacterize debt as equity, which results in the disallowance of both interest and balance sheet deductions. Taxpayers should take care that their debt instruments satisfy state requirements for bona fide debt. [[\*National Grid Holdings Inc. v. Commissioner of Revenue\*](#), Massachusetts Appellate Tax Board, No. ATB 2014-357 (June 4, 2014)]

### ***In detail***

#### ***Facts***

The DSAs were part of several financing transactions used by National Grid that generally involved National Grid Holdings, Inc. (NGHI) subscribing for shares of an affiliated subsidiary (Subsidiary). Pursuant to a DSA, NGHI made an initial small payment for shares and agreed to make deferred payments equal to the remaining amount due on the shares plus an amount for interest. The deferred payments were made on a call basis, which meant the obligation to make payments

was at the discretion of the Subsidiary.

NGHI treated the DSAs as debt for US income tax purposes, but not for UK income tax purposes. A portion of the deferred payments was treated as interest payments for US income tax purposes. Accordingly, the DSAs were intended to achieve a successful international tax arbitrage by producing US interest deductions but not generating UK taxable interest income. The Board noted that National Grid took 'meticulous care' in ensuring that NGHI did not

issue a 'debenture' (debt) for UK purposes.

The Board viewed the DSAs as 'effectively identical.' One of the DSAs involved the following:

- NGHI subscribes for 10 million shares of Subsidiary on deferred payment terms (the DSA). This essentially capitalized Subsidiary on a deferred subscription basis.
- The DSA requires an initial \$15 million payment and three additional payments (Call Payments) that represent the remaining subscription payments due

plus an interest component. The Call Payments are dependent on the issuance of discretionary Calls by Subsidiary.

- Subsidiary could make Calls to require payment, but the terms of the DSA direct only when the Calls could *not* be made (e.g., “a payment of \$3.50 per share not before March 1, 2002”).
- NGHl assigns to Subsidiary \$15 million of a loan receivable to satisfy the initial subscription payment.
- NGHl sells the shares of Subsidiary to an affiliate for \$2.68 billion in cash.
- All three Call Payments are remitted.

***Determining ‘true indebtedness’ for income and net worth purposes***

The Massachusetts corporate excise tax consists of an income and a non-income measure. In determining net taxable income for purposes of the income measure, taxpayers may deduct amounts allowed under Section 163 of the Internal Revenue Code for “all interest paid or accrued within the taxable year on indebtedness.” Additionally, in determining taxable net worth for purposes of the non-income measure, taxpayers may deduct ‘liabilities,’ which include debt obligations. Accordingly, the determination of whether an item is ‘debt’ is relevant for purposes of calculating deductions for both the income and non-income measures of the Massachusetts corporate excise tax.

The Board recognized that a transaction gives rise to a valid interest deduction when the transaction constitutes ‘true indebtedness,’ which requires: (1) the

payee’s unconditional intent to secure payment and (2) the payor’s unconditional obligation to repay the money.

***Factors favoring debt***

The Board reviewed several authorities that described multifactor tests to determine whether instruments constitute debt. Although the Board did not establish a standard set of determinative factors, the Board noted that no one factor is decisive and that an examination of the particular circumstances of each case is required.

The Board determined that the following factors supported a finding that the DSAs constituted debt:

- service of repurchase notice provisions in the DSAs that gave the right to enforce payment of principal and interest
- incorporation of a fixed rate of interest in the sums due in the Call Payments, though the precise rate was affected by the dates of the payments
- cash flow generated by the U.S. operating companies was concededly a sufficient source of payment of the interest component of the DSAs.

***Factors disfavoring debt***

The Board determined that the following factors undermined the characterization of the DSAs as debt:

- the DSAs had no fixed maturity date
- the lack of evidence presented establishing that NGHl could have obtained financing from outside sources on terms that were the same as or similar to those provided by the DSAs

- the names given to the operative documents made reference only to sale and purchase of shares and subscription for share capital.

The Board appeared to focus on the absence of a fixed maturity date. The Board noted that payment dates and method of payment were indeterminate and that, generally, payments were required only when the payee provided notice to the payor. Simply having the *right* to enforce payment is not equivalent to the *unconditional obligation* to pay. The discretionary nature of repayment “inevitably lead[s] to the conclusion that there was no unconditional obligation . . . to repay. This conclusion precludes a determination that the essential nature of the DSA arrangements was debt.”

***The takeaway***

*National Grid* is the latest among a number of published Massachusetts decisions examining whether an intercompany transaction constitutes debt or equity. For example, in *Kimberly-Clark*, the Massachusetts Court of Appeals disallowed interest expenses that occurred between related entities made through the taxpayer’s cash-management system ([click here](#) for our Insight). The recharacterization of debt as equity is an issue that the Massachusetts Department of Revenue closely examines on audit, and an issue on which the Department may litigate.

Although the Board appeared to review several factors, the critical fact in determining that the DSAs did not constitute debt was the absence of an unconditional obligation for NGHl to repay the debt. *National Grid* is instructive for Massachusetts taxpayers entering into debt transactions with related entities. They should be aware that the state may challenge the treatment of debt.

Additionally, taxpayers should be mindful that debt instruments should be crafted to satisfy debt requirements established by Massachusetts courts.

The Board provided that the taxpayer's 'sole motivation' was to create federal tax interest deductions in the US without a corresponding recognition of income in the UK. Although the taxpayer's intent did not appear to enter into the Board's

decision regarding whether the DSA instruments constituted true indebtedness, it remains unclear the extent to which the taxpayer's tax strategy would have affected the Board's decision-making process if more factors favoring debt had been present.

Finally, *National Grid* highlights an issue that we have observed on audit for a number of taxpayers recently:

the recharacterization of debt as equity for non-income measure purposes, particularly in the context of liabilities arising from the operation of a cash management system. Since this is an area receiving audit scrutiny, taxpayers may wish to examine their intercompany financing to determine any possible tax exposure.

## ***Let's talk***

### ***State and Local Tax Services***

Jon Muroff  
Partner, *Boston*  
+1 (617) 530-4573  
[jon.muroff@us.pwc.com](mailto:jon.muroff@us.pwc.com)

Rob Ozmun  
Partner, *Boston*  
+1 (617) 530-4745  
[robert.c.ozmun@us.pwc.com](mailto:robert.c.ozmun@us.pwc.com)

David Sheehan  
Managing Director, *Boston*  
+1 (617) 530-4872  
[david.sheehan@us.pwc.com](mailto:david.sheehan@us.pwc.com)