

AN ALERT FROM THE BDO STATE AND LOCAL TAX PRACTICE

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SUBJECT

MASSACHUSETTS APPELLATE COURT HOLDS DEFERRED SUBSCRIPTION ARRANGEMENT DID NOT CONSTITUTE TRUE INDEBTEDNESS AND DISALLOWS INTEREST AND LIABILITY DEDUCTIONS

SUMMARY

On June 8, 2016, the Massachusetts Appeals Court issued its decisions in companion cases *National Grid Holdings, Inc. v. Commissioner of Revenue*, No. 14-P-1662 (Jun. 8, 2016) (“*Grid Holdings*”) and *National Grid USA Service Co., Inc. v. Commissioner of Revenue*, No. 14-P-1861 (Jun. 8, 2016) (“*Grid USA*”). In *Grid Holdings*, the court held that deferred subscription arrangements (“DSA”) between a UK parent corporation and various U.S. subsidiaries did not constitute true indebtedness. In *Grid USA*, the court held that a closing agreement entered into between the taxpayer and the I.R.S. pursuant to which a portion of the interest expense on a DSA was allowed as a deduction for federal income tax purposes was not binding on the state.

DETAILS

General Background

The taxpayers in *Grid Holdings* and *Grid USA* implemented a corporate structure that uses DSAs to replace and maintain the income tax benefits of a domestic reverse hybrid structure following the issuance of U.S. Treasury regulations that restricted the use thereof. The DSAs were structured to be debt for U.S. tax purposes and equity for UK tax purposes so as to achieve related income tax benefits in both countries without subjecting certain UK entities to criminal sanctions for running afoul of UK law. UK law prohibits debentures between UK entities and foreign subsidiaries.

On its combined Massachusetts Corporation Excise Tax return for the taxable year ended March 31, 2002, National Grid USA Service Company, Inc. (“NG Service”) deducted debt owed and payments made to related UK entities under the DSAs.

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The Massachusetts Commissioner of Revenue denied the deductions because it had determined that the related debt did not constitute true indebtedness.¹ The taxpayers, National Grid Holdings, Inc. (“NGHI”), National Grid USA (“NGUSA”), and NG Service, who are members of the Massachusetts combined group, filed an application or abatement with the Commissioner who denied it. The taxpayers then appealed the Commissioner’s determination to the Massachusetts Appellate Tax Board where it was upheld. The taxpayers then appealed to the Massachusetts Appeals Court.

Grid Holdings Background

In *Grid Holdings*, the court of appeal analyzed the following representative DSA structure in connection with its holding.

- ▶ A UK parent corporation, National Grid plc (“NGPLC”) organized a UK subsidiary, National Grid Eight Limited (“NG8”), to enter into a DSA with NGHI, a U.S. subsidiary of NGPLC.
- ▶ NGHI subscribed for 10 million shares of stock of NG8 for \$2.695 billion under deferred payment terms.
- ▶ After oral acceptance by NGHI of the subscription offer, NGHI made an initial payment to NG8 in the amount of \$15 million and agreed to four additional deferred payments, referred to as “call payments.” The call payments represented the remaining amounts due for the subscribed NG8 stock, plus interest. The first three call payments represented interest only, and the fourth represented principal and interest.
- ▶ Pursuant to a separate sale and purchase agreement (“S&P agreement”), NGHI then sold the shares to another U.S. affiliate, National Grid (US) Investments 4, Inc. (“NGUSI4”), in the amount of \$2.68 billion and used the proceeds from the sale to repay loans related to the reverse hybrid structure. NGHI remained liable to make the call payments to NG8.
- ▶ NGHI was obligated to make the call payments after specified dates only after NG8 made a call for the payments by issuing a call payment notice. If NG8 failed to issue a call payment notice, NGHI could request, through NGUSI4, that NG8 issue the call.
- ▶ Under a clause in the S&P agreement between NGHI and NGUSI4, if NGHI failed to make a call payment or if NGHI failed to exercise its right to request a call from NG8, then NGUSI4 could exercise a right under the S&P agreement to require NGHI to repurchase the NG8 shares from NGHI. The interpretation of this clause was central to the dispute.
- ▶ All calls and call payments were made, and the clause in the S&P agreement was never implicated.

Grid USA Background

With respect to this separate but related matter, NG Service had filed a second application for abatement to report changes made by the I.R.S. for federal income tax purposes pursuant to a closing agreement, which allowed NG Service to deduct a portion of its DSA payments. The Commissioner did not act on the application for abatement, and NG Service appealed to the Board who ruled that the closing agreement did not entitle NG Service to the deductions for Massachusetts Corporate Excise Tax purposes. NG Service appealed the Board’s decision to the Massachusetts Appeals Court.

True Indebtedness Requires an “Unqualified Obligation to Repay”

The court of appeal in *Grid Holdings* first ruled that the Board applied the correct legal standard - whether NGHI had an “unqualified obligation to pay a sum certain at a reasonably close fixed maturity date.” Although the question related to putative interest expense paid by NGHI to NG8, the court focused on whether or not NGHI’s obligation to repurchase NG8 shares from the NGUSI4 was a mandatory obligation, or discretionary in the absence of the issuance of a call payment notice by NG8 or the failure of NGHI to exercise its right to procure a call payment.

Ambiguous Agreement

Upon review of the S&P agreement, the court of appeal in *Grid Holdings* agreed with the Board’s ruling that the relevant clause was ambiguous due to an inconsistency in language. On the one hand, the S&P agreement provided that NGUSI4 “shall” serve notice on NGHI to repurchase the NG8 shares if a call payment was not made by NG8 or call payment notice

¹ The related party interest and intangible expense add-back statute did not impact any interest deductions in this case because the add-back statute applies to taxable years beginning on or after January 1, 2002, and the taxable year at issue began before that effective date.

not requested by NGHI. However, another sentence in the same clause provided that NGUSI4 could “exercise its rights” and demand repurchase of the NG8 shares.

After siding with the Board regarding the ambiguity, the court looked at extrinsic evidence such as the parties’ circumstances, and their intentions at the time of formation as had the Board. However, the court was willing to give little credence to such factors given the tax motivation behind the DSA structure, the sophistication of the parties, and the fact that when the parties drafted the agreement they could have used more appropriate language. Accordingly, the court ruled that the taxpayer failed to carry its burden of proof that the DSA constituted an unqualified obligation to repay.

DSAs Were Not “Liabilities” for Purposes of Computing Taxable Net Worth

The court of appeal in *Grid Holdings* similarly sided with the Board and held that the DSAs could not properly be treated as debt (or liabilities) for purposes of the net worth tax component of the Corporation Excise Tax. The court refused to adopt the taxpayer’s financial accounting practice of treating the DSAs as debt as the sole evidence of the proper treatment of the DSAs. Instead, the court of appeal allowed the income tax treatment to dictate the result in this case.

IRS Closing Agreement Not Binding on Massachusetts Department of Revenue²

In *Grid USA*, the court of appeal ruled that the I.R.S. closing agreement was not binding on the Commissioner and did not establish that the call payments were deductible interest. The closing agreement provided that only a portion of the expenses were allowed as deductible interest expenses and, as the Board observed and the court of appeal agreed, “either all of the payments are interest or none is.” Further, based on case law precedent, a change in federal taxable income does not automatically result in a change in Massachusetts taxable income, and the Commissioner engages in an independent review when there is a change for federal income tax purposes, which it had done here.

BDO INSIGHTS

- ▶ The *Grid Holdings* decision is the latest in a number of Massachusetts (and other state) court decisions disallowing the deduction of intercompany interest expenses on the basis that the underlying obligations were not debt.
- ▶ *Grid Holdings* highlights the importance of proper drafting of intercompany debt agreements, as well as the importance of considering state and local tax implications when structuring cross border arrangements.
- ▶ The *Grid Holdings* decision also demonstrates the significance of debt or equity characterization for net worth tax purposes.
- ▶ Massachusetts taxpayers should be mindful of the court’s holding in *Grid USA* that a change in federal taxable income does not automatically result in a change in Massachusetts taxable income and be sure to conduct a careful analysis of any such changes before reporting them to Massachusetts.

² In *Grid Holdings*, the taxpayers had tried to introduce the closing agreement as evidence that the DSA’s were debt, but, here too, the court agreed with the board that it was inadmissible on grounds that no evidence of settlement is admissible to prove liability or the amount of a claim.

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