

Strategic approaches to intercompany debt in legal entity rationalization



In the first of a series of webcasts on legal entity rationalization (LER), held on March 17, 2025, KPMG professionals Megan Fitzsimmons, Ashley Marx, Blair Gowasack, Brian Helak, and Andrew Grace began to unravel the complexities of intercompany debt, particularly within US domestic structures. The webcast emphasized the importance of addressing intercompany debt early in the LER process to avoid potential tax issues and ensure compliance with both federal and state tax law. Here's a closer look at the key insights and considerations that can help tax professionals ensure compliance and optimize tax positions.



Early and comprehensive information gathering

A crucial aspect of LER involves early collection of thorough information on intercompany balances. This fundamental stage is imperative for multiple reasons:

- ◆ **Location and amount:** Understanding the geographical distribution and amounts of intercompany debts is vital for state and local tax analysis. This information helps in identifying potential tax implications and opportunities.
- ◆ **Documentation:** Proper documentation of debt, including payment schedules and terms, is vitally important. It helps support the treatment of the instrument as debt and can help prevent recharacterization issues.
- ◆ **Debt versus equity characterization:** Analyzing whether the instrument should be treated as debt or equity is a nuanced process with several relevant factors. It is important to thoroughly evaluate elements such as the parties' intentions when entering into the agreement, the debtor's financial state, and the legal structure of the agreement.
- ◆ **Commercial constraints:** External debts and covenants can impose constraints on rationalizations if a guarantor entity is involved. Being aware of these can help in navigating the restructuring process smoothly.
- ◆ **History of balances:** Understanding the historical context and any deferred items related to the intercompany balances provides a clearer picture for winding up these balances.



Debt recharacterization: A double-edged sword

Intercompany obligations can be recharacterized as debt, equity, or contributions and distributions. Each scenario has its own set of implications:

- ◆ **Debt:** Ensuring the instrument is documented and treated consistently by all parties is paramount. Cleaning up debt can lead to cancellation of debt income or bad debt deductions.
- ◆ **Equity:** If an instrument is recharacterized as equity, then it can lead to complex issues such as split ownership structures or unintended partnership formations, especially with disregarded entities.
- ◆ **Contributions and distributions:** If there is no documentation or state law rights, then intercompany transactions may be treated as contributions and distributions over time. This could have an impact on stock basis and earnings and profits, which are key attributes to consider during an LER.





Liquidation of subsidiaries: Solvent versus insolvent

The tax implications of liquidating subsidiaries can vary significantly depending on their financial status:

- ◆ **Solvent subsidiary:** In a solvent liquidation, the subsidiary is treated first as transferring assets to the parent to satisfy its debt. Any remaining assets are then distributed on the common equity. This generally qualifies for nonrecognition treatment under Section 332, although there could be gain recognition if the parent has a basis less than the note.
- ◆ **Insolvent subsidiary:** In an insolvent liquidation, the subsidiary's assets are insufficient to cover its debt, leading to no recovery on the common stock, producing a taxable liquidation. The parent may recognize a worthless stock deduction or bad debt deduction, though there may be character mismatches between gains and losses.

Conclusion: Proactive and strategic planning

Effective management of intercompany debt is not just a compliance issue; it's a strategic imperative. By being proactive in gathering and analyzing intercompany data, considering both federal and state tax implications, and planning for potential recharacterizations, organizations can navigate the complexities of LER and achieve their business objectives. Tax professionals should take a holistic and strategic approach to intercompany debt management. The benefits, in terms of reduced compliance costs and tax optimization, are well worth the effort.



State and local tax considerations: A critical component

Consideration of the state and local income tax implications is a critical component of LER:

- ◆ **Location of debt:** The location of debt in the organization can impact interest deduction limitations under Section 163(j) and state-specific rules. This can significantly affect the overall tax position.
- ◆ **Interest deduction limitations:** In separate filing states, interest deductions may be limited if the entity with the debt has no income or is not the operating entity. This can unnecessarily increase tax liabilities.
- ◆ **Related-party add-back rules:** Some states have add-back rules for related-party interest expenses, which can further complicate the tax position if debt is pushed down to the operating company.
- ◆ **385 regulations:** Even if the 385 regulations are unlikely to apply for federal income tax purposes, the 385 regulations may apply in the state and local income tax context. Careful consideration of exceptions such as the earnings exception and the threshold exception is essential.
- ◆ **Debt capacity analysis:** Even if 385 regulations are not a concern, common law rules and debt-to-equity concepts should be considered to ensure the arrangement is respected as debt.

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