New York State Department of Taxation and Finance
Taxpayer Services Division
Technical Services Bureau

TSB-A-81 (9) C
Corporation Tax
December 11, 1981

Also see TSB-H-81(34)C

STATE OF NEW YORK
STATE TAX COMMISSION

MODIFIED ADVISORY OPINION PETITION NO. C810119A

On March 27, 1981 a Petition for Advisory Opinion was received from Kowa Realty (America), Ltd., 60 East 42nd Street, New York, New York 10017. An Advisory Opinion was issued in response thereto on May 21, 1981 (Petition No. C810119A). Such Advisory Opinion is hereby modified, as set forth hereinbelow, and, as so modified, is superseded.

At issue is the deductibility of interest paid to a stockholder which owns more than 5% of the taxpayer's issued capital stock, for purposes of the Franchise Tax on Business Corporations imposed under Article 9-A of the Tax Law.

Petitioner is a real estate leasing company. It is a Delaware corporation which conducts business activities in New York and several other states. Petitioner is a 97% owned subsidiary of Kowa Real Estate Investment Co., Ltd., a Japanese corporation which has no operations within New York and which is not a New York taxpayer. Kowa Real Estate Investment Co., Ltd., because of its asset size as well as other factors, has access to funds at a lower cost than is available to Petitioner. Petitioner obtains all of its funds from its parent in the form of equity contributions and debt. Petitioner borrows from its parent rather than directly from third party lenders because it is able to obtain more favorable interest rates from its parent. Even though Petitioner pays interest to its parent at a rate that is slightly higher than the cost to the parent, the rate paid by Petitioner is significantly lower than the rate it would have to pay to unrelated third parties. The parent does not lend its own operating funds to Petitioner. Rather, bank loans are taken specifically to re-lend to Petitioner, when needed by Petitioner.

Section 208.9(b)(5) of the Tax Law provides, in pertinent part, that in arriving at entire net income for franchise tax purposes an addition to federal taxable income must be made in the amount of interest paid on indebtedness directly or indirectly owed to any stockholder or shareholder owning more than five per cent of the taxpayer's issued capital stock, or to a subsidiary of such a stockholder or shareholder. (Such a stockholder or shareholder, or subsidiary thereof, shall hereinafter be referred to as "stockholder.")

Under certain conditions, where a "stockholder" of a corporation borrows money from an unrelated source, and then lends the borrowed funds to such corporation, the interest paid to such "stockholder" by such corporation is deemed to have actually been paid to the "stockholder" merely as a conduit, and the provisions of section 208.9(b)(5) are not applicable to such interest. The conditions under which such a "pass-through" is said to occur are as follows:

1. The deduction for interest expense must be for indebtedness owed by the taxpayer to a "stockholder" (viz., any stockholder or shareholder, including subsidiaries

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of a corporate stockholder or shareholder, owning in the aggregate in excess of five per centum of the issued capital stock of the taxpayer).

The debt instrument issued by the taxpayer must not be convertible into stock or one (such as an income bond or a participating bond) that provides for any contingent payment to the holder (other than a call premium).

There must be no postponement of the maturity date or other substantial modification of the terms of the loan to the taxpayer, and all payments of principal and interest must be made when due.

2. The taxpayer must demonstrate that at the time the indebtedness was incurred the "stockholder's" financial standing permitted it to borrow funds on better terms than those obtainable by the taxpayer.

3. The taxpayer must demonstrate that the funds loaned to it were borrowed by the "stockholder" from an entity unrelated to either the "stockholder" or the taxpayer, solely for the purpose of re-lending the funds to the taxpayer.

4. The loan to the taxpayer must not be a substitute for investment in the taxpayer by the "stockholder". Thus, the taxpayer must demonstrate that at the time the loan was made it was not under-capitalized. The question of under-capitalization may be determined in light of the taxpayer's size, age, industry, geographic location and financial condition. In any event, a corporation will be considered not to be under-capitalized if --

   (1) The corporation's outside ratio is less than or equal to 10:1, and

   (2) The corporation's inside ratio is less than or equal to 3:1.

These ratios are determined both immediately after the issuance of the loan and must be satisfied, at all times, with respect to more than one-half of the remainder of the taxable year during which the loan is issued to the corporation.

In addition, such ratios must be satisfied, at all times, with respect to more than half of each subsequent taxable year of the corporation with respect to which recognition of interest pass-through is sought.

The inside ratio is determined in the same manner as the outside ratio except that there is an exclusion of liabilities to independent creditors (except in computing stockholders' equity). The outside ratio is the ratio that --

(i) The corporation's liabilities (excluding trade accounts payable, accrued operating expenses and taxes, and other similar items) bears to

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(ii) The stockholders' equity.

5. Except where the taxpayer can demonstrate that the nature of the regular course of business of the taxpayer and the "stockholder" mandate otherwise, there must be sustantial congruence between the terms of the loan to the "stockholder" and the loan to the taxpayer. Thus, the interest rate applicable to each must be identical (although an additional amount demonstrated by the taxpayer to represent a recoupment of expenses, and not simply a higher interest rate, may be charged to the taxpayer), and the maturity dates and repayment schedules applicable to the two loans must be similar. In addition, the funds received by the "stockholder" from the unrelated lender must be promptly transferred to the taxpayer. Where the taxpayer has established that the nature of the regular course of business of itself or the stockholder render such congruence impossible, the stockholder may not charge the taxpayer a higher rate of interest than its average rate of interest paid to unrelated lenders, such average determined with respect to the portion of its taxable year ending with the date of the loan to the taxpayer, or with respect to such other period as the taxpayer can demonstrate to be appropriate.

In claiming a deduction for interest paid to a "stockholder," as described herein, the taxpayer must attach to its corporation franchise tax return a rider providing sufficient information to substantiate such deduction. In addition, the rider should contain the following information:

1. Name, address and federal identification number of the "stockholder".

2. The article of the Tax Law, if any, under which the "stockholder" is subject to tax in New York.

3. Other borrowings of the corporation during the period in question, including the rate of interest paid.

DATED: December 9, 1981

s/LOUIS ETLINGER
Deputy Director
Technical Services Bureau