

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

TSB-H-81 (34)C
Corporation Tax
May 21, 1981

STATE OF NEW YORK
STATE TAX COMMISSION

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.

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 less expensive funds than 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 much lower than the rate it would have to pay to unrelated third parties. The parent does not lend its own operating funds to Petitioner; bank loans are taken specifically to relend 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, some or all of 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. These conditions are:

1. The deduction for interest expense must be for indebtedness owed by the corporation to a "stockholder".
2. The corporation must demonstrate that at the time the indebtedness was incurred the "stockholder's" financial standing allowed it to borrow funds at a lower rate of interest than that obtainable by the corporation.
3. The corporation must demonstrate that the funds loaned to it were borrowed by the "stockholder" from an entity unrelated to either the "stockholder" or the corporation, for the purpose of re-lending the funds to the corporation.

4. The corporation must demonstrate that, at about the time the loan was made, it was not under-capitalized and that the funds were needed to meet ordinary business expenses or working capital needs, and were not a substitute for an investment in the stock of the corporation.

If all four conditions are met, the "stockholder" is deemed to have acted as a mere conduit between the unrelated source of funds and the corporation. The corporation is allowed to deduct as interest expense an amount equivalent to the amount of interest paid by the "stockholder" to the unrelated source of funds. Where the "stockholder," for example, borrows funds at 15% and in turn lends these funds to the corporation at 16%, and where the four conditions set forth above are satisfied, the corporation is allowed to deduct its interest expense at 15%, and the remaining 1% is required to be added back to its federal taxable income in determining its entire net income. Such add-back is required because, under the conduit theory enunciated herein, the 1% loses its character as interest expense and the federal deduction therefor is accordingly disallowed for purposes of the franchise tax.

Information contained in the Petition indicates that the first three of the four conditions for permitting a deduction are satisfied. In claiming a deduction for interest paid to its "stockholder," as described herein, Petitioner must attach to its corporation franchise tax return a rider providing sufficient information to substantiate such deduction, including information indicating compliance with the fourth stated condition for permitting a 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: May 21, 1981

s/LOUIS ETLINGER
Deputy Director
Technical Services Bureau