Instructions for 2015 Schedule RT: Wisconsin Related Entity Expenses Disclosure Statement

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Who Must File Schedule RT

A corporation, individual, or pass-through entity must modify federal income for Wisconsin purposes so that certain expenses that were paid, accrued, or incurred to a related entity (or related person) are "added back." Then, if certain conditions apply, the taxpayer may subsequently deduct those expenses.

The related entity expenses that must be added back to federal income for Wisconsin purposes are:

- Interest expenses
- Rent expenses
- Management fees
- Intangible expenses

See the *Definitions* section for definitions of "related entity" and of each of these types of expenses.

Taxpayers that added back these expenses must file Schedule RT **if** the total deduction for all of the "added back" expenses reduces Wisconsin taxable income by more than $100,000. For multistate taxpayers, the $100,000 threshold is determined after applying the Wisconsin apportionment percentage.

TIP: You don't have to file Schedule RT if the total interest, rent, management fees, and intangible expenses that you paid, accrued, or incurred to all related entities reduces your Wisconsin net income by less than $100,000 (or by exactly $100,000).

File Schedule RT as an attachment to your Wisconsin return. If Schedule RT is required, it is important that you file the return on or before the extended due date of the return. This is because the Department is authorized to disallow related entity expenses if they are not timely disclosed on Schedule RT.

When Must Schedule RT be Filed

IMPORTANT: If Schedule RT is required, you must file it with your Wisconsin franchise or income tax return ***no later than*** the extended due date of the return. If you file your return before the extended due date and forget to include the Schedule RT, you may file an amended return until the extended due date to include the Schedule RT.

For example, if a calendar year corporation is required to file Schedule RT for 2015 and filed its return on March 15, 2016 without Schedule RT, the corporation would have until October 17, 2016 to file Schedule RT with an amended return.

Caution: The Department ***will not*** accept Schedule RT if it is filed after the extended due date of the Wisconsin franchise or income tax return.

Special Instructions for Pass-Through Entities

For pass-through entities, such as tax-option (S) corporations, partnerships, limited liability companies treated as partnerships, estates, and trusts, the pass-through entity is responsible for filing Schedule RT where required. The shareholder, partner, member, or beneficiary doesn't have to file Schedule RT for expenses that are passed through.

Special Instructions for Combined Groups

Corporations that file in combined groups aren't required to add back expenses between members of the same combined group if there is no net effect on combined unitary income (in other words, if the payer's expense and the payee's income from the transaction cancel each other out in combined unitary income). These corporations don't have to file Schedule RT if they were not required to add back any expenses.

However, a corporation in a combined group may have to add back interest, rent, management fees, or intangible expenses if they were paid, accrued, or incurred to a related entity that is not a member of the group or to a member of the group that excluded its income from the transaction from combined unitary income.

For corporations that are in combined groups and are required to add back expenses, complete Schedule RT separately for each corporation that paid, accrued, or incurred the "added back" expenses and file the Schedule(s) RT with the combined return. However, you may apply the $100,000 threshold to each corporation separately.

To determine if a combined group member exceeds the $100,000 threshold for filing Schedule RT, multiply that member's "added back" expenses by the combined group's total Wisconsin apportionment percentage from Form 6, page one, line 2.

Definitions

For purposes of determining if an addback (and Schedule RT filing, if applicable) is required, the Wisconsin Statutes provide specific definitions for the terms "related entity" and the types of expenses that must be added back (for example, see sec. 71.22 (3g), (3m), (6d), (9ad) and (9am), Wis. Stats.).

These instructions provide practical definitions of the terms that apply to the addback requirement and Schedule RT.

"Related Entity"

A "related entity" is a related person under one of the following sections of the Internal Revenue Code (IRC):

- Section 267(b), which defines relationships through which taxpayers would be considered "related" for purposes of disallowing deduction or loss on transactions between related taxpayers
- Section 707(b), which provides that for purposes of disallowing deduction or loss on transactions between related taxpayers, related taxpayers include:
  - A. A partnership and a partner owning, directly or indirectly, more than 50% of the capital or profits interest in the partnership, and
  - B. Two partnerships in which the same persons own, directly or indirectly, more than 50% of the capital or profits interests.

TIP: A shareholder, partner, member, or beneficiary of a pass-through entity is related to the pass-through entity if it owns, either directly or indirectly, more than 50% of the pass-through entity's stock, capital interests, or profits interests.

For purposes of determining indirect ownership, the stock attribution rules of section 318(a), IRC apply.

Under Wisconsin Statutes (sec. 71.22(9ad) and (9am), Wis. Stats.) a "related entity" also includes certain real estate investment trusts (REITs) if they are not "qualified REITs." In general, this means that a captive REIT is a related entity. For more on REITs, refer to the statute. Also see *Wisconsin Tax Bulletin #158*, page 17, Questions A2 and A3.

"Interest Expenses"

"Interest expenses" are expenses that would otherwise be deductible in computing Wisconsin net income which are for "interest" as defined in section 163, IRC, after applying any Wisconsin modifications.

"Rent Expenses"

"Rent expenses" are expenses that would otherwise be deductible in computing Wisconsin net income which are attributable to, for the use of, or for the right to use, real property, including:

- Tangible personal property affixed to real property if the owner of the tangible personal property is the same as or related to the owner of the real property

- Services rendered in connection with rented real property if the owner of the property is the same as or related to the entity providing the service

For purposes of the addback and Schedule RT requirement, the method used to compute the expense and the manner in which it is reported for financial accounting purposes do not matter. For example, amounts paid under capital leases might not be called "rent expenses" in the financial accounting records, but they are considered "rent expenses" for purposes of the addback and Schedule RT requirement.

NOTE: Schedule RT and these instructions use the term "rent expenses" in place of "rental expenses" which is the specific term used in the statutes (for example, in sec. 71.22(9an), Wis. Stats.). For purposes of these instructions, the terms "rent expenses" and "rental expenses" have the same meaning.

"Management Fees"

"Management fees" are expenses that would otherwise be deductible in computing Wisconsin net income which are for the purchase of services (other than services provided by taxpayer's own employees) that pertain to any of the following:

- Accounts receivable
- Employee benefit plans
- Insurance, including self-insurance
- Legal matters
- Payroll
- Data processing
- Purchasing
- Taxation
- Financial matters
- Securities
- Accounting
- Reporting on compliance matters
- Similar activities

"Intangible Expenses"

"Intangible expenses" include any of the following expenses to the extent they would otherwise be deductible in the computation of Wisconsin net income:

- Royalty, patent, technical, and copyright fees
- Licensing fees
- Losses related to, or incurred in connection directly or indirectly with, factoring transactions or discounting transactions
- Amortization expenses
- Other expenses, losses, or costs for, related to, or directly or indirectly in connection with acquiring, using, maintaining, managing, owning, selling, exchanging, or disposing of intangible property

NOTE: If you purchased amortizable intangible property from a related entity, the amortization expenses on that property are "intangible expenses" that must be added back and reported on Schedule RT if otherwise required.

Under sec. 71.22(3h), Wis. Stats., "Intangible property" includes, but is not limited to:

- Stocks
- Bonds
- Financial instruments
- Patents
- Patent applications
- Trade names
- Trademarks
- Service marks
- Copyrights
- Mask works
- Trade secrets
- Similar types of intangible assets

Instructions for Parts I and II

Part I: Addition Modification for Related Entity Expenses

On lines 1 through 4, enter the name and identification number of related entities to whom the taxpayer paid, accrued, or incurred the expense described. Fill in the aggregate amount of the expense attributable to each entity. If you are filing under the apportionment method, enter the unapportioned amounts.

If you are reporting expenses incurred to more than two related entities for any of the expense types shown, prepare and attach a schedule listing each additional entity's name and identification number and the total amount of interest expenses, rent expenses, management fees, or intangible expenses, as applicable, for that entity. Enter the totals from that schedule on lines 1c, 2c, 3c, or 4c, as applicable.

You must disclose actual numbers. Entering "available on request" is not adequate. However, disclosure will be considered adequate if the total of each expense type reported is within 10% of the actual amount of the expense.

CAUTION: You must disclose actual numbers on Schedule RT. Stating "available on request" is not adequate disclosure.

The total on Part I, line 5 should tie out to the amount you reported as an addition modification for related entity expenses. For members of combined groups, the amount on Part I, line 5 should match the amount the member included in the combined group's total on Form 6, Part II, line 2c.

Part II: Subtraction Modification for Related Entity Expenses Eligible for Deduction

In order to complete Part II, you'll need to analyze the expenses you reported in Part I and determine the amount eligible for deduction. Interest expenses, rent expenses, management fees, or intangible expenses paid, accrued, or incurred to a related entity may be deducted to the extent they meet Condition A, Condition B, or Condition C, as described on the form.

Conditions A, B, and C correspond to the provisions of sec. 71.80(23)(a), Wis. Stats. Conditions A, B, and C are each described in more detail in the sections that follow. After you've completed your analysis, on lines 6a through 6d, enter the amount of each expense that is eligible for a deduction, and enter the total on line 7.

The total on Part II, line 7 should tie out to the amount you reported as a subtraction modification for related entity expenses. For members of combined groups, the amount on Part II, line 7 should match the amount the member included in the combined group's total on Form 6, Part II, line 4b.

NOTE: If any of your expense is not deductible, see *What if the Expense Isn't Deductible?* on page 6.

Is the Expense Deductible?

In order to deduct interest expenses, rent expenses, management fees, or intangible expenses you paid, accrued, or incurred to a related entity, the expenses must meet either Condition A, Condition B, or Condition C as described in Part II of Schedule RT.

NOTE: The Department of Revenue has specific statutory authority to distribute, apportion, or allocate income, deductions, credits, or allowances between or among related entities in order to prevent evasion of taxes or clearly to reflect the income of the entities. The Department also has express statutory authority to disregard transactions that lack economic substance. This authority remains even if the taxpayer meets one of the conditions in Schedule RT, Part II.

More information about each of the three conditions is presented next:

Condition A: General Indicators

Section 71.80(23)(a)3., Wis. Stats., provides that if a taxpayer added back a related entity expense, it may then deduct the expense if the taxpayer establishes that all of the following are true:

- The primary motivation for the transaction was one or more business purposes other than the avoidance or reduction of state income or franchise taxes;
- The transaction changed the economic position of the taxpayer in a meaningful way apart from tax effects; and
- The expenses were paid, accrued, or incurred using terms that reflect an arm's length relationship.

Specific evidence that these criteria are met will vary based on the facts and circumstances. However, if an expense meets Condition B or Condition C (described in detail later) then it probably also meets the criteria in Condition A.

NOTE: Condition A is the primary test for whether the expenses may be deducted. Conditions B and C are possible indicators that Condition A is satisfied.

Examples of factors that may indicate that the expense does **not** satisfy Condition A are presented below:

- There was no actual transfer of funds from the taxpayer to the related entity, or the funds were substantially returned to the taxpayer, either directly or indirectly
- If the transaction was entered on the advice of a tax advisor, the advisor's fee was determined by reference to the tax savings
- The related entity does not regularly engage in similar transactions with unrelated parties on terms substantially similar to those of the subject transaction

- The transaction was not entered into at terms comparable to arm's length as determined by Treas. Reg. §1.482-1(b)
- There was no realistic expectation of profit from the transaction apart from the tax benefits
- The transaction resulted in improper matching of income and expenses
- An expense for the transaction was accrued under FIN 48
- If a rent expense, the rent was paid, accrued, or incurred to a captive REIT
- Factors specific to interest expenses:
  - The taxpayer is not sufficiently capitalized or has no reasonable expectation to make payment on the debt underlying the interest expense
  - There is no written contract underlying the interest expense that reflects an arm's length interest rate
  - The interest is attributable to any of the following:
    - An unpaid charge that is not an allowable expense
    - A loan from a captive insurance company
    - A dividend note
    - A loan from a related entity with net operating loss carryforwards
    - A loan from a related entity that is an intermediary set up in a jurisdiction that imposes no corporate-level income tax

Condition B: Related Entity Included Income in Tax Base

Section 71.80(23)(a)2., Wis. Stats., provides that for a related entity expense that was "added back," a Wisconsin deduction is generally allowable if both of the following are true:

- The related entity included the income or receipts from the transaction in its tax base for a tax on (or measured by) net income or receipts in Wisconsin or another jurisdiction, **and**
- The related entity's "aggregate effective tax rate" was at least 80% of the taxpayer's "aggregate effective tax rate."

An entity's "aggregate effective tax rate" is the sum of its effective tax rates for each state, U.S. possession, or foreign country where it does business. An entity's "effective tax rate" for a jurisdiction is the maximum tax rate imposed by that jurisdiction multiplied by the entity's apportionment percentage (if any) computed for that jurisdiction.

Worksheet 1 at the end of these instructions demonstrates how to compute the aggregate effective tax rates and apply the 80% test. Special rules and exceptions apply to this computation, which are described in more detail below.

NOTE: If you use Worksheet 1, keep it for your records. You do not have to submit it with your Schedule RT.

Additional information, special rules, and exceptions regarding Condition B are presented next:

Differing Taxable Years. For both the taxpayer and the related entity, compute the aggregate effective tax rate for the taxable year that included the transaction date. If the taxpayer and the related entity are on differing taxable years and the related entity's taxable year has not yet ended, special rules apply. See *Wisconsin Tax Bulletin* #158, page 21, Question C9 for details.

Items Not Includable in "Aggregate Effective Tax Rate." Do not include the following in the computation of the aggregate effective tax rate:

- If the expense was incurred to a pass-through entity, any tax rate that is imposed at the shareholder, partner, member, or beneficiary level rather than at the pass-through entity level
- The tax rate of any jurisdiction where the taxpayer or related entity files a combined or consolidated report or return if the consolidation or combination eliminates the tax effects of the transaction

See *Wisconsin Tax Bulletin* #158, page 21, Questions C5 and C6 for further details of these exceptions.

Dividends Paid Deduction. If the related entity is not taxed on some or all of its income in a jurisdiction because the entity is eligible for a dividends paid deduction under the laws of that jurisdiction, the amount considered to be included in its tax base in that jurisdiction is the amount after applying the dividends paid deduction.

If the dividends paid deduction is less than 100% of the related entity's total income, a pro rata share of its income from the transaction is deemed to be excluded from its tax base in that jurisdiction.

Additionally, sec. 71.80(23)(a)2., Wis. Stats., specifically provides that Condition B does not apply to expenses paid, accrued, or incurred to a REIT that does not meet the definition of "qualified REIT."

CAUTION: Condition B does not apply to expenses paid, accrued, or incurred to a captive REIT.

Related Entity Has Loss or Credit Carryforwards. For purposes of Condition B, the related entity's aggregate effective tax rate is computed without regard to loss carryforwards or credit carryforwards. If the related entity has no tax liability in a particular state because of its loss or credit carryforwards, its effective tax rate in that state is still that state's maximum statutory tax rate multiplied by the entity's apportionment percentage in that state. See *Wisconsin Tax Bulletin* #158, page 21, Question C7 for an example.

Condition C: Related Entity Acts as Conduit

Section 71.80(23)(a)1., Wis. Stats., provides that for a related entity expense that was "added back," a Wisconsin deduction is generally allowable if either of the following are true:

- The related entity paid, accrued, or incurred that same expense to an unrelated third party during the same taxable year (in other words, the related entity acted as a conduit between the taxpayer and the unrelated third party), or
- The related entity is a bank holding company under 12 USC 1841(a), a savings bank holding company under 12 USC 1841(l), or a savings and loan holding company under 12 USC 1467a(a)(1)(D) or direct or indirect subsidiary of such company; except not including any entity that is organized under the laws of another jurisdiction and that primarily holds and manages investments of a bank, subsidiary, or affiliate.

Other exceptions and special rules regarding Condition C are presented next:

Exception for Interest on Acquisition of Stock. Under sec., 71.80(23)(a)1., Wis. Stats., Condition C does not apply to interest expense in connection with any debt that is used to acquire the taxpayer's own stock or assets under section 368 of the Internal Revenue Code.

CAUTION: Condition C does not apply to interest on debt used to acquire the taxpayer's own stock.

Same Taxable Year. In order for Condition C to apply, the related entity must pay, accrue, or incur the expense to the unrelated third party in the same taxable year as the taxpayer paid, accrued, or incurred the expense to the related entity. The "taxable year" used in applying this test is the taxpayer's taxable year.

However, if the related entity pays the expense to the unrelated third party after the taxpayer's taxable year ends but before the unextended due date of the taxpayer's Wisconsin income or franchise tax return, the expense incurred to the unrelated third party may be considered incurred during the taxpayer's recently ended taxable year. If so considered, the related entity's payment to the unrelated third party can't be counted again for the subsequent taxable year. For an example, see *Wisconsin Tax Bulletin* #158, page 19, Question C2.

Less Than 100% of Interest Expense Paid to Unrelated Third Party. If less than 100% of the total interest expense paid, accrued, or incurred to the related entity from the taxpayer and all other related entities is paid, accrued, or incurred to the unrelated third party, a pro rata share of the taxpayer's expense is considered to meet Condition C. For an example, see *Wisconsin Tax Bulletin* #158, page 20, Question C3.

What if the Expense Isn't Deductible?

If any portion of the expenses you "added back" does not qualify for a Wisconsin deduction, you should do the following:

- Review your prior years' returns and amend them as necessary. If you had similar transactions in those years, the Department may audit those transactions and make adjustments under its authority in secs. 71.30(2) and 71.80(1)(b), Wis. Stats.
- If the related entity files Wisconsin returns, prepare Schedule RT-1 to notify the related entity of the amount of expense that isn't deductible to you. The related entity may then subtract that amount from its taxable income. See the Schedule RT-1 instructions for details.

(See next page for Worksheet 1, which you may use to compute aggregate effective tax rates for purposes of determining if Condition B applies)

Worksheet 1: Computation of Aggregate Effective Tax Rates

CAUTION: Before using this worksheet, read the exceptions on page 5.

Taxpayer's Aggregate Effective Tax Rate

(a) State or other jurisdiction where taxpayer is subject to tax on or measured by net income or receipts	**(b)** Highest statutory tax rate in state or jurisdiction	**(c)** Apportionment[1] percentage in state or jurisdiction	**(d)** Effective tax rate (b) x (c)
Taxpayer's aggregate effective tax rate (sum of amounts in column d)			

Related Entity's Aggregate Effective Tax Rate

(Prepare separately for each related entity to which the taxpayer incurred the "added back" expenses)

(a) State or other jurisdiction where related entity is subject to tax on or measured by net income or receipts	**(b)** Highest statutory tax rate in state or jurisdiction	**(c)** Apportionment percentage in state or jurisdiction	**(d)** Effective tax rate (b) x (c)
Related entity's aggregate effective tax rate (sum of amounts in column d)			

Subject to the limitations described on pages 4 and 5, if the related entity's aggregate effective tax rate is at least 80% of the taxpayer's aggregate effective tax rate, the taxpayer may deduct the expenses incurred to that entity that were "added back."

[1] If the income from the transaction is nonapportionable income, use 100% or 0%. If a portion of the income is nonapportionable, you will need to prorate the apportionment percentage based on the ratio of apportionable income to nonapportionable income.

Additional Information and Assistance

Web Resources. The Department of Revenue's web page has a library of common questions on general business tax topics, including the addback and Schedule RT filing requirements. The FAQs are available at: revenue.wi.gov/faqs/index.html.

You can also find additional FAQs on the addback and Schedule RT filing requirements in the *Wisconsin Tax Bulletin* quarterly publication, issues #158 (October 2008) and #159 (January 2009). The *Wisconsin Tax Bulletin* is available on the Department's web site at: revenue.wi.gov/ise/wtb/index.html.

NOTE: *Wisconsin Tax Bulletins* #158 and #159 were published before 2009 Act 2. Prior to 2009 Act 2, only interest and rent expenses were required to be added back. However, the guidance in *Wisconsin Tax Bulletins* #158 and #159 applies equally to interest expenses, rent expenses, management fees, and intangible expenses.

Contact Information. If you cannot find the answer to your question in the resources available on the Department of Revenue's web page, contact the Department using any of the following methods:

- E-mail your question to DORFranchise@revenue.wi.gov
- Call (608) 266-2772
  (Telephone help is also available using TTY equipment. Call the Wisconsin Telecommunications Relay System at 711 or, if no answer, (800) 947-3529. These numbers are to be used only when calling with TTY equipment.)
- Send a fax to (608) 267-0834
- Write to the Audit Bureau, Wisconsin Department of Revenue, Mail Stop 3-107, PO Box 8906, Madison, WI 53708-8906