Wisconsin Department of Revenue

Frequently Asked Questions: Addback of Related Entity Interest and Rental Expenses

In 2007 Wisconsin Act 226, the Wisconsin Statutes were amended to require taxpayers to "add back" to their federal income certain expenses paid, accrued, or incurred to a related entity when computing their Wisconsin income. The Act provides that these "added back" expenses may then be subtracted if certain conditions are met.

The expenses subject to this new law are interest expenses and rental expenses. The law is effective for taxable years beginning on or after January 1, 2008.

Below are answers to frequently asked questions about the new addback provisions. The questions are broken down into four categories:

A. Taxpayers Subject to Addback
B. Expenses Subject to Addback
C. Conditions Necessary to Deduct Expenses Added Back
D. Nondeductible Related Entity Expenses

A. Taxpayers Subject to Addback

Question A1. **"Related Entity."** Who is a "related entity?"

Answer A1: For purposes of the addback requirement, a "related entity" is a related person under section 267 or 1563 of the Internal Revenue Code (IRC). For relationships that involve ownership of stock, assets, or net profits, the constructive ownership rules of section 318(a) of the IRC apply. A "related entity" also includes certain real estate investment trusts (REITs) if they are not "qualified REITs."

Section 267, IRC, provides that the following relationships are "related persons":

- Members of a family, namely, brothers and sisters, half-brothers and half-sisters, spouse, ancestors, and lineal descendants.
- An individual and a corporation of which more than 50% of the outstanding stock is owned (directly or indirectly) by or for the individual.
- Two corporations which are members of the same controlled group as defined in section 1563(a), IRC, except that 50% is substituted for 80% wherever it appears in sec. 1563(a).
- A grantor and fiduciary of any trust.
- A fiduciary of a trust and a fiduciary of another trust, if the same person is the grantor of both trusts.
- A fiduciary of a trust and a beneficiary of such trust.
- A fiduciary of a trust and a beneficiary of another trust, if the same person is a grantor of both trusts.
- A fiduciary of a trust and a corporation more than 50% of the value of which is owned (directly or indirectly) by or for the trust or the grantor of the trust.
- A person and an exempt organization under sec. 501, IRC, which is controlled directly or indirectly by the person or (if the person is an individual) the person's family.
- A corporation and a partnership if the same persons own more than 50% of the outstanding value of the corporation's stock and more than 50% of the capital interest or profits interest in the partnership.

- An S corporation and another S corporation if the same persons own more than 50% in value of the outstanding stock of each corporation.

- An S corporation and a C corporation if the same persons own more than 50% in value of the outstanding stock of each corporation.

- An executor of an estate and a beneficiary of such estate.

Question A2: **"Qualified REIT."** A "qualified REIT" is not considered a related entity for purposes of the addback provisions. What is a "qualified REIT?"

Answer A2: A "qualified REIT" is any of the following:

- Any publicly traded REIT.

- Any REIT which is not owned (directly or indirectly) more than 50% by an entity taxable as a corporation. The 50% ownership test is based upon the voting power or value of any class of the beneficial interests or shares. If more than 50% of the voting power of any class, or more than 50% of the value of any class is held (directly, indirectly, or constructively) by an entity taxable as a corporation, then the REIT is not a qualified REIT under the statute.

Under the statute, the following are not considered entities taxable as a corporation:

- An entity exempt from federal and Wisconsin tax;
- An entity that is a "qualified REIT" itself;
- A qualified REIT subsidiary under sec. 856(i), IRC; or
- A foreign entity substantially similar to a "qualified REIT," which is true if all of the following are true:
  - At least 75% of the entity's total asset value consists of real estate assets, cash and cash equivalents, and U.S. Government securities;
  - The entity is not taxed at the entity level;
  - The entity annually distributes at least 85% of taxable income to shareholders;
  - The entity is not owned more than 10% by a single organization or individual or the entity is publicly traded; and
  - The entity is organized in a country that has a tax treaty with the U.S.

Question A3: **Partnership Interest Owned by Qualified REIT.** If a qualified REIT is a partner of a partnership which owns a subsidiary treated as a taxable REIT subsidiary (TRS), are interest and rental expenses paid by the TRS to the partnership subject to the addback?

Answer A3: Interest and rental expenses paid, accrued, or incurred from the TRS to the partnership will generally be not subject to the addback to the extent the partnership income flows through to a qualified REIT. However, in cases where a flow-through entity does not have a legitimate purpose other than tax avoidance, lacks economic substance, or results in distortion of income or evasion of taxes, the Department of Revenue has authority under secs. 71.30(2) and 71.80(1)(b), Wis. Stats., to distribute, apportion, or allocate gross income, deductions, credits, or allowances in order to prevent evasion of taxes or to more clearly reflect the taxpayer's income.

B. Expenses Subject to Addback

Question B1: **"Interest Expenses."** What are "interest expenses" for purposes of the addback requirement?

Answer B1: For purposes of the addback requirement, "interest expenses" means interest that would otherwise be deductible under section 163 of the Internal Revenue Code (IRC) and otherwise deductible in the computation of Wisconsin income.

Expenses that are deductible as "interest expenses" under section 163, IRC, may include:

- All interest paid or accrued within the taxable year on indebtedness.
- Original issue discount.
- Nonseparately stated interest included in carrying charges for installment purchases.
- Redeemable ground rents, excluding amounts paid in redemption.
- Premiums paid or accrued for mortgage insurance.

Question B2: **Capitalized Interest.** Does the interest subject to addback include capitalized interest under section 263A of the Internal Revenue Code?

Answer B2: No. The interest expense must be deductible as an expense within the taxable year under section 163 of the Internal Revenue Code to be subject to the addback requirement.

Question B3: **"Rental Expenses."** What are "rental expenses" for purposes of the addback requirement?

Answer B3: For purposes of the addback requirement, "rental expenses" means expenses for the use of (or the right to use) real property or tangible personal property in connection with real property, regardless of how computed and regardless of how reported for financial accounting purposes.

Services furnished or rendered in connection with rented property are also considered "rental expenses" if the services are furnished by a related entity in connection with property rented from a related entity. Such services would constitute "rental expenses" regardless of whether the same related entity furnished the services as rented the property.

Question B4: **Capital Leases.** If a lease from a related entity is treated as a capital lease for financial accounting purposes, does the lease result in "rental expenses" subject to addback?

Answer B4: Yes. The method used to compute the expense and the manner in which it is reported for financial accounting purposes have no effect on whether the expense is a "rental expense" under the addback statute. Although amounts expensed attributable to capital leases may not be called "rental expenses" in the financial accounting records, they are considered "rental expenses" for purposes of the addback requirement.

C. Conditions Necessary to Deduct Expenses Added Back

Question C1: **General Conditions (i., ii., and iii.).** Under what conditions may interest or rental expenses added back to income be deducted on a Wisconsin return?

Answer C1: All taxpayers who wish to deduct an interest expense or rental expense paid, accrued, or incurred to a related entity must disclose the expense on Wisconsin Schedule RT as prescribed in the instructions to Schedule RT. Additionally, the expense must meet one of three conditions provided in sec. 71.80(23)(a), Wis. Stats., which are presented below (described here as Condition i., Condition ii., and Condition iii.)

Condition i. The expense meets Condition i. (sec. 71.80(23)(a)1., Wis. Stats.) if **either** of the following is true:

- The taxpayer paid, accrued, or incurred the expense to a related entity which paid, accrued, or incurred that expense to an unrelated entity during the same taxable year (in other words, the related entity merely acted as a conduit).

- The taxpayer paid, accrued, or incurred the expense to 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. However, as set forth below, interest paid, accrued, or incurred to bank investment subsidiaries does not qualify for deduction under Condition i. unless it qualifies under the previous bullet point.

Expenses Specifically Ineligible for Condition i. Section 71.80(23)(a)1., Wis. Stats., provides that the following expenses are never eligible to meet Condition i.:

- 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.

- Interest expense or rental expense paid, accrued, or incurred directly or indirectly to any entity organized under the laws of another jurisdiction and that primarily holds and manages investments of a bank, subsidiary, or affiliate.

For more information on Condition i., see Questions C2 and C3.

Condition ii. The expense meets Condition ii. (sec. 71.80(23)(a)2., Wis. Stats.) if **both** of the following are true:

- The expense was paid, accrued, or incurred to a related entity that included the corresponding interest income or rental income in its tax base for any tax on (or measured by) its net income or receipts in Wisconsin or another state, U.S. possession, or foreign country, and

- The related entity's "aggregate effective tax rate" applied to that corresponding income was at least 80% of the taxpayer's "aggregate effective tax rate." The "aggregate effective tax rate" is the sum of the entity's effective tax rates for each applicable state, U.S. possession, or foreign country. The "effective tax rate" is the maximum tax rate imposed by the state, U.S. possession, or foreign country, multiplied by the entity's apportionment percentage in that jurisdiction. Special rules apply in determining an entity's aggregate effective tax rate.

For more information on Condition ii. and an explanation of the special rules, see Questions C4 through C9.

Condition iii. The expense meets Condition iii. (sec. 71.80(23)(a)3., Wis. Stats.) if the taxpayer establishes any other conditions the department considers relevant, based on the facts and circumstances, to determine that **all three** 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 interest expenses or rental expenses were paid, accrued, or incurred using terms that reflect an arm's-length relationship.

For more information on Condition iii., see Questions C10 and C11.

***Question C2:* "Taxable Year" for Taxpayer Using Related Entity as a Conduit.** For purposes of determining if the related entity paid, incurred, or accrued the expense to an unrelated entity in the same taxable year, what is considered the same taxable year?

Answer C2: For purposes of applying Condition i., "taxable year" refers to the taxable year of the taxpayer who wishes to claim the deduction for the expense paid, accrued, or incurred to the related entity. The department will consider an expense the related entity pays, accrues, or incurs to an unrelated entity by the unextended due date of the taxpayer's income or franchise tax return to be paid, accrued, or incurred within the taxpayer's "taxable year." However, such expenses that occur after the end of the taxpayer's tax year may not then be counted again as occurring in the subsequent taxable year.

Answer C2 Example:

- Corporation A, the taxpayer, borrows money from related Corporation B. No portion of the debt was used to acquire the taxpayer's own stock or assets under section 368, IRC. In order to obtain the funds to loan to Corporation A, Corporation B borrows money from unrelated Bank C.

- Corporation A is a calendar year taxpayer, while Corporation B is on a fiscal year beginning July 1 and ending June 30.

- During the calendar year 2008, Corporation A accrued $100,000 of interest expense attributable to the loan from Corporation B. Corporation B accrued $90,000 of interest expense attributable to the loan from Bank C during that same time period (January 1, 2008 through December 31, 2008).

- During the period of January 1, 2009 through March 15, 2009, Corporation B accrued $10,000 of interest expense to Bank C.

- For purposes of determining if Condition i. applies to Corporation A's interest expense, Corporation B may be considered to have accrued $100,000 of interest expense ($90,000 + $10,000) to Bank C in Corporation A's 2008

taxable year. However, in Corporation A's 2009 taxable year, it cannot consider the $10,000 of interest expense accrued by Corporation B to Bank C during the period of January 1, 2009 through March 15, 2009 to be accrued during its 2009 taxable year.

Question C3: **Allocation of Expenses Passed Through to Unrelated Entity.** What happens if the taxpayer and affiliated companies pay interest or rental expenses to a related entity, and that entity passes some, but not all, of those expenses through to an unrelated entity during the same taxable year?

Answer C3: A pro rata share of the taxpayer's expense is considered paid, accrued, or incurred to the unrelated entity.

Answer C3 Example:

- Taxpayer A made a $200,000 interest payment to Related Entity B. No portion of the underlying debt was used to acquire the taxpayer's own stock or assets under section 368, IRC.

- Related Entity B received a total of $800,000 of related entity interest income during Taxpayer A's taxable year. $200,000 of this amount was from Taxpayer A and $600,000 was from other related entities.

- In Taxpayer A's taxable year, Related Entity B paid $400,000 of interest expense to unrelated third parties.

- In this case, $100,000 (($200,000/$800,000) x $400,000) of the interest Taxpayer A paid to Related Entity B would be considered paid, accrued, or incurred to an unrelated entity in Taxpayer A's taxable year.

Question C4: **Documentation of Aggregate Effective Tax Rate.** To substantiate that Condition ii. applies, do I need to submit my aggregate effective tax rate computation with Schedule RT?

Answer C4: No, you are not required to submit your aggregate effective tax rate computation to the department with Schedule RT. However, if you claim on Schedule RT that the expense is deductible because it meets Condition ii., you must maintain supporting schedules to substantiate your deduction.

Question C5: **Related Entity Is a Pass-Through Entity.** How are pass-through entities treated in the aggregate effective tax rate computation?

Answer C5: Only taxes imposed at the entity level that are on (or measured by) net income or receipts may be included in the pass-through entity's effective tax rate for a particular jurisdiction. For example, Wisconsin's recycling surcharge, which is imposed on partnerships and tax-option (S) corporations in sec. 77.93 (1), (3), and (5), Wis. Stats., may be included in the Wisconsin effective tax rate of a pass-through entity.

Withholding taxes paid on income distributable to members may be considered entity-level taxes if the state, U.S. possession, or foreign country imposes the withholding as a tax on the income of the pass-through entity. For example, sec. 71.775, Wis. Stats., imposes a withholding tax on a pass-through entity for the privilege of doing business in Wisconsin or deriving income from property located in Wisconsin. The tax is equal to each nonresident member's share of Wisconsin distributable income multiplied by the highest tax rate applicable to the nonresident member.

A pass-through entity's aggregate effective tax rate cannot include taxes imposed on the entity's members. If a pass-through entity elects to file a composite return in a state on behalf of some or all of its members, the tax rate applicable to that composite return cannot be included in the entity's effective tax rate for that state.

Question C6: **Related Entity Files Combined or Consolidated Return.** For purposes of determining the related entity's aggregate effective tax rate, what happens if the related entity includes the interest or rental income in a combined or consolidated return in a particular state?

Answer C6: Section 71.80(23)(a)2., Wis. Stats., specifically provides that any state, U.S. possession, or foreign country where the taxpayer or related entity files a combined or consolidated report or return may not be included in the computation of the aggregate effective tax rate if the combined or consolidated re-

turn results in eliminating the tax effects of the transaction between the taxpayer and the related entity.

Question C7: **Related Entity Has Loss or Credit Carryforwards.** For purposes of determining whether a related entity's interest or rental income is included in its tax base for any tax on (or measured by) its net income or receipts in a particular state, what happens if the related entity pays no tax in a state because it has loss carryforwards or credit carryforwards?

Answer C7: The income is still considered to be included in the entity's tax base in that state. The maximum statutory tax rate and the entity's apportionment percentage in that state may be included in the computation of the aggregate effective tax rate.

Answer C7 Example: Taxpayer A makes a $500,000 interest payment to Corporation C, a related corporation. Corporation C has no other income and is engaged in business only in State X. Corporation C has a $1,000,000 loss carryforward in State X and uses this carryforward to offset the $500,000 related entity interest income from Taxpayer A. Therefore, Corporation C owes no tax to State X. State X has a maximum corporation income tax rate of 6.2%. Corporation C's aggregate effective tax rate would be 6.2%.

Question C8: **Related Entity Eligible for Dividends Paid Deduction.** For purposes of determining whether a related entity's interest or rental income is included in its tax base for any tax on (or measured by) its net income or receipts in a particular state, what happens if the related entity is eligible for a dividends paid deduction in that state?

Answer C8: If the related entity is not taxed on some or all of its income in a state or jurisdiction because the entity is eligible for a dividends paid deduction under the laws of that jurisdiction, the amount considered to be included in the entity's tax base is the amount taxable to the entity after application of the dividends paid deduction. If the dividends paid deduction is less than 100% of the total income of the entity, a pro rata share of the interest or rental expense is deemed to be excluded from the related entity's tax base in that jurisdiction.

However, sec. 71.80(23)(a)2., Wis. Stats., provides that interest or rental expense paid to a REIT that does not meet the definition of a "qualified REIT" (i.e., interest or rental expenses paid to a "captive" REIT) cannot be deducted under Condition ii. for any amount of interest or rental expenses paid to the REIT.

Question C9: **Aggregate Effective Tax Rate for Differing Taxable Years.** For purposes of determining the related entity's aggregate effective tax rate, what happens if the related entity's taxable year is different than the taxpayer's?

Answer C9: Determine the related entity's aggregate effective tax rate based on the related entity's most recently ended taxable year. If the related entity is on a taxable year that ends after the taxpayer's taxable year, the taxpayer may not know what the related entity's apportionment percentages and taxing states will be. In this case, the aggregate effective tax rate may be determined as follows:

- If in the related entity's most recently ended taxable year it was subject to a tax on or measured by net income or receipts in a state, U.S. possession, or foreign country, the related entity's aggregate effective tax rate may be computed based on the related entity's most recently ended taxable year.

- If the related entity was not subject to such tax for its most recently ended taxable year, you may modify the computation of the aggregate effective tax rate as shown below.
  - Use 100% as the related entity's apportionment percentage.
  - Use the statutory tax rate of the state where the related entity is incorporated, organized, formed, or (if the related entity is an individual), where the individual resides.

Question C10: **Factors Relevant to Determining Deductibility.** For purposes of determining if sec. 71.80(23)(a)3., Wis. Stats. (Condition iii.) applies, what factors will the department consider relevant to establish that the primary motivation for the transaction was a business purpose(s) other than state tax avoidance, that the transaction changed the economic position of the taxpayer in a meaningful way apart from tax effects, and that the expenses

were paid, accrued, or incurred using terms that reflect an arm's-length relationship?

Answer C10: Following is a list of factors that the department may deem relevant in determining if a related entity interest or rental expense may be deducted under sec. 71.80(23)(a)3. *This list is not all-inclusive.* In general, if one or more of these factors are present, it is more likely that a deduction may not be allowed:

1) 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.

2) If the transaction was entered into on the advice of a tax advisor, the advisor's fee was determined by reference to the tax savings.

3) The related entity does not regularly engage in similar transactions with unrelated parties on terms substantially similar to those of the subject transaction.

4) The transaction was not entered into at terms comparable to arm's-length as determined by Treas. Reg. 1.482-1(b).

5) There was no realistic expectation of profit from the transaction apart from the tax benefits.

6) The transaction resulted in improper matching of income and expenses.

7) An expense for the transaction was accrued under FIN 48.

8) The taxpayer is not sufficiently capitalized or has no reasonable expectation to make payment on the debt underlying the interest expense.

9) There is no written contract that reflects an arm's-length interest rate.

10) Interest expense is attributable to any of the following:
   - An unpaid charge that is not an allowable expense, such as an expense that may have any of the characteristics of 1) through 9) above or 11) in the next column.
   - 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.

11) Rental expense is paid, accrued, or incurred to a "captive" REIT.

Question C11: **Documentation to Support Deduction.** What documentation must I provide to the Department of Revenue to prove that a related entity interest or rental expense is deductible under sec. 71.80(23)(a)3., Wis. Stats. (Condition iii.)?

Answer C11: You are not required to submit specific documentation with your return (other than a properly completed Schedule RT) to substantiate a related entity interest or rental expense. However, you must maintain adequate documentation to be able to substantiate your deductions. Specific evidence that adequately supports that a deduction is allowable under sec. 71.80(23)(a)3., Wis. Stats., will vary based on the facts and circumstances.

Question C12: **Safe Harbors and Department's Authority.** If I qualify for a deduction for related entity interest or rental expenses under one of the three specific conditions provided in sec. 71.80(23)(a), Wis. Stats., and properly file Schedule RT, could the Department of Revenue still challenge the deduction?

Answer C12: In general, if a taxpayer meets one of the conditions specified in sec. 71.80(23)(a)1., 2., or 3., Wis. Stats., the department will allow the deduction. However, the Department of Revenue has express statutory authority in secs. 71.30(2) and 71.80(1)(b), Wis. Stats., to distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among two or more related entities in circumstances where it is necessary to prevent evasion of taxes or to clearly reflect the income of the related entities. This authority is in addition to, and not a limitation of or dependent upon, the provisions requiring addback of related entity interest and rental expenses.

D. Nondeductible Related Entity Expenses

Question D1: **Similar Expenses Deducted In Tax Years Before 2008.** If I have related entity interest or rental expenses in 2008 that are not eligible for a deduction, and I had deductions from substantially identical transactions in prior years, will the deductions reported in those prior years be allowed since they took place before the addback provisions were effective?

Answer D1: The department would generally disallow those same expenses for prior years under its express statutory authority in secs. 71.30(2) and 71.80(1)(b), Wis. Stats. Thus, if you have related entity interest or rental expenses in 2008 which are ineligible for a deduction under the addback provisions, and you had substantially identical transactions in prior years, you should amend your returns for those prior years under voluntary disclosure. See *Wisconsin Tax Bulletin* 151 (April 2007), page 30, for a description of the department's voluntary disclosure program.

Question D2: **Adjustment to Related Entity's Income.** If a related entity expense is not deductible to a taxpayer because it does not meet the necessary conditions for deduction, can the related entity exclude the corresponding income from its Wisconsin income?

Answer D2: Yes, if a taxpayer cannot deduct an interest or rental expense paid to a related entity because it does not meet any of the conditions required in sec. 71.80(23)(a), Wis. Stats., the related entity may subtract the corresponding income from its Wisconsin income.

Question D3: **Documentation for Adjustment to Related Entity's Income.** If a taxpayer (the payee) is subtracting income from Wisconsin income because it corresponds to an expense that couldn't be deducted by a related entity (the payor), what documentation does the payee need in order to substantiate the subtraction from income?

Answer D3: The payee must file Schedule RT-1 as an attachment to its Wisconsin return. Schedule RT-1 is completed by the payor and provided to the payee as supporting documentation for the subtraction. Additionally, the payee should maintain its own supporting documentation to permit the department to verify the Schedule RT-1, which will vary depending on the facts and circumstances.