Addback of Related Party Interest and Rent Expenses

Provisions of 2007 Wisconsin Act 226 require interest and rent expenses paid, accrued, or incurred to a related party ("related entity") to be added back to income. However, the Act allows a deduction for those expenses if certain requirements are met.

This law change applies to corporations, tax-option (S) corporations, partnerships, LLCs, individuals, fiduciaries, and insurance companies. The change is effective for taxable years beginning on or after January 1, 2008.

This article presents the following:

A. A description of transactions affected by this law change.
B. The definition of "related entity."
C. Requirements that must be met in order to deduct related party interest or rent expenses.
D. Details and examples of what is considered a "related entity."

A. Transactions Affected By Law Change

The law change applies to interest expenses or rental expenses which taxpayers (directly or indirectly) pay, accrue, or incur to a related entity or in connection with transactions with a related entity.

"Interest expenses" means interest that would otherwise be deductible under section 163 of the Internal Revenue Code (IRC) and deductible in the computation of Wisconsin taxable income.

"Rental expenses" means amounts otherwise deductible under the IRC, as modified for Wisconsin purposes, for the use of (or the right to use) real property, including tangible personal property and services furnished in connection with real property, regardless of how the expenses are computed or how they are reported for financial accounting purposes.

B. Who is a "Related Entity?"

A "related entity" is either of the following:

- Any person related to the taxpayer under section 267 or 1563 of the IRC during all or a portion of the taxpayer's taxable year.

- Any real estate investment trust (REIT) that is not a "qualified REIT," if more than 50% of any class of the beneficial interests or shares of the REIT are owned directly, indirectly, or constructively by the taxpayer during all or a portion of the taxpayer's taxable year.

Details and examples of the above definition of "related entity" (including the definition of "qualified REIT") are in section D. of this article.

C. Requirements for Deduction

In order to deduct related entity interest or rental expenses, taxpayers must 1) disclose the transactions on Wisconsin Schedule RT and 2) meet one of the conditions specified in sec. 71.80(23), Wis. Stats., as enacted by 2007 Act 226.

Details of the conditions necessary to claim the deduction are shown below. **Note:** If a deduction is not allowed because of the provisions of 2007 Act 226, the related entity to whom the taxpayer paid the expenses may exclude the corresponding interest or rental income from Wisconsin taxable income.

1. Wisconsin Schedule RT

Taxpayers who wish to take a deduction from Wisconsin income for related entity interest or rental expenses must complete Wisconsin Schedule RT, Related Entity Transactions Disclosure Statement, and submit it with the Wisconsin income or franchise tax return for the year in which the expenses were paid, accrued, or incurred. **Note:** Schedule RT will be available on the Department's web site, at www.revenue.wi.gov/html/formpub.html, around July 31, 2008.

2. Conditions Specified in Sec. 71.80(23), Wis. Stats.

In addition to completing Schedule RT, taxpayers must meet ***one*** of the conditions in a. through c. below (in its entirety) in order to deduct related entity interest or rental expenses:

a. Reimbursement of expenses paid to unrelated entity. This condition is met to the extent the taxpayer's expenses paid, accrued, or incurred to the related entity are to reimburse the related entity for expenses paid, accrued, or incurred to an unrelated entity. There are two exceptions:

- This condition is automatically met for expenses paid, accrued, or incurred to a bank holding company, savings bank holding company, or savings and loan holding company (as defined by 12 USC 1841(a) or (l) or 12 USC 1467a(a)(1)(D)), or a direct or indirect subsidiary of such holding company, not including an entity organized under the laws of another jurisdiction which primarily holds and manages investments of a bank, subsidiary, or affiliate.

- This condition cannot be met for interest expense that is paid by a taxpayer in connection with debt incurred to acquire the taxpayer's assets or stock under section 368, IRC.

b. Related entity subject to tax on the income. This condition is met if ***all*** of the following are true:

- The related entity to which the taxpayer paid, accrued, or incurred the interest or rental expenses is subject to tax on (or measured by) net income or receipts in Wisconsin or another state, U.S. possession, or foreign country and the tax base includes the income or receipts attributable to such transactions. This does not include jurisdictions where the taxpayer or the related entity files a consolidated or combined tax return which eliminates the income attributable to the taxpayer's interest or rental expenses.

- The related entity's aggregate effective tax rate applied to such income or receipts is at least 80 percent of the taxpayer's aggregate effective tax rate. The related entity's "effective tax rate" in each state, U.S. possession, or foreign country is the statutory tax rate times the related entity's apportionment percentage (if any) under the laws of that jurisdiction. The related entity's "aggregate effective tax rate" is the sum of the effective tax rates for all jurisdictions (except those where a consolidated or combined tax return is filed as described above). The same computation is used for the taxpayer's aggregate effective tax rate, using the jurisdictions and apportionment percentages applicable to the taxpayer.

- The related entity is not a REIT, other than a qualified REIT (see section D.2.).

c. Transaction not primarily for tax avoidance. This condition is true if the transaction satisfies any conditions other than a. or b. above which establish 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.

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

D. Details and Examples of What Is Considered a "Related Entity"

1. Related Persons Under Sections 267 and 1563, IRC

For purposes of 2007 Wisconsin Act 226, "related entity" is defined as a related person under sections 267 and 1563, IRC. Section 267, IRC provides that related persons may have any of the following relationships:

- Members of a family, including 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 owned more than 50% (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 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.

A "controlled group" of related taxpayers under section 267, IRC includes controlled groups of corporations, as follows:

- *Parent-subsidiary controlled group:* One or more chains of corporations connected through stock ownership with a common parent corporation if:

- At least 50% of the total combined voting power or value of all classes of stock of each of the corporations (except the common parent) is owned by one or more of the other corporations, and

- The common parent corporation owns stock possessing at least 50% of the total combined voting power or value of all classes of stock of at least one of the other corporations (excluding stock owned directly by such other corporations).

- *Brother-sister controlled group:* Two or more corporations if 5 or fewer individuals, estates, or trusts own stock possessing more than 50% of the total combined voting power or value of all classes of stock of each corporation, taking into account only the stock ownership of each person to the extent such stock ownership is identical with respect to each such corporation.

- *Combined controlled group:* Three or more corporations each of which is a member of a parent-subsidiary controlled group or brother-sister controlled group and one of which is both 1) a common parent corporation in a parent-subsidiary controlled group and 2) included in a brother-sister controlled group.

Section 1563, IRC, also provides that two or more insurance companies taxable under section 801, IRC, which are members of a controlled group as described above are considered a controlled group separate from any members of the controlled group which are not insurance companies.

2. "Qualified REIT"
A taxpayer and a "qualified REIT" are ***not*** considered related entities. A "qualified REIT" is any of the following:

- A REIT which is not owned (directly or indirectly) more than 50% by an entity taxable as a corporation.
- A publicly traded REIT.
- A REIT owned more than 50% by any of the following:

  - 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.
  - A foreign entity for which 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.
    - Not taxed at the entity level.
    - Annually distributes at least 85% of taxable income to shareholders.
    - Not owned more than 10% by a single entity, or is publicly traded.
    - Organized in a country that has a tax treaty with the U.S.

3. Constructive Ownership
The constructive ownership rules of section 318(a), IRC (as modified by section 856(d)(5)) determine stock ownership for purposes of determining whether taxpayers are related in any of the ways described above. Generally, these rules provide the following:

- An individual is considered to own the stock owned directly or indirectly by or for his spouse, children, grandchildren, and parents.

- Stock owned directly or indirectly by or for a partnership, trust, or estate is considered to be owned proportionately by its partners, grantors, or beneficiaries. A person who directly or indirectly owns 50% or more of a corporation's stock value (10% if the person is a REIT) is also considered to own a proportionate share of the stock owned by that corporation.
- Stock owned directly or indirectly by or for a partner, grantor, or beneficiary of a partnership, trust, or estate is considered owned by the partnership, trust, or estate.
- Stock owned directly or indirectly by or for a person who owns more than 50% of a corporation's stock value (10% if the person is a REIT) is considered owned by the corporation.