

Deductibility of Interest
Expense by Corporate Taxpayers

Question

Must a corporation add back 90% of its Federal deduction for interest paid or accrued on indebtedness to a shareholder owning more than 5% of the stock of such corporation?

Answer

Yes. Article 9-A of the Tax Law imposes the state's franchise tax on business corporations which tax is computed on one of four alternative bases. Many taxpayers compute their tax on the basis of entire net income, which is defined as Federal taxable income with certain modifications.

Section 208.9(b)(5) of the Tax Law states, in pertinent part:

"(b) Entire net income shall be determined without the exclusion, deduction or credit of:

(5) ninety per centum of interest on indebtedness directly or indirectly owed to any stockholder or shareholder (including a subsidiary of a corporate stockholder or shareholder), or members of the immediate family of an individual stockholder or shareholder, owning in the aggregate in excess of five per centum of the issued capital stock of the taxpayer, except that such interest may, in any event, be deducted

(i) up to an amount not exceeding one thousand dollars,

(ii) in full to the extent that it relates to bonds or other evidences of indebtedness issued, with stock, pursuant to a bona fide plan of reorganization, to persons who, prior to such reorganization, were bona fide creditors of the corporation or its predecessors, but were not stockholders or shareholders thereof,

(iii) in full where the investment allocation percentage is applied to entire net income, and

(iv) in full to the extent that it is paid to a federally licensed small business investment company; . . . "

Thus, the modification set forth in section 208.9(b)(5) of the Tax Law disallows 90% of a corporation's Federal deduction for interest paid or accrued on indebtedness to a shareholder owning more than 5% of the stock of the taxpayer, the only exceptions being those situations which come within the provisions of the above cited section 208.9(b)(5)(i) through (iv).

On several occasions in the past, taxpayers have requested a full deduction for such interest where it was found that a more than 5% shareholder of a corporation (usually a parent corporation) had borrowed money solely to re-lend to such corporation (usually a subsidiary corporation) so that the interest paid by such corporation to the shareholder was considered to have been "passed through" the shareholder, as through a "conduit", to the outside lender. Since such interest does not fall within the ambit of the exceptions to the add back rule, it must be added back pursuant to section 208.9(b)(5) of the Tax Law.

To the extent any prior publications of this Department are not in accord with the foregoing statements, they are overruled.