

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

TSB-H-81(21)C
Corporation Tax
April 14, 1981

STATE OF NEW YORK
STATE TAX COMMISSION

ADVISORY OPINION

PETITION NO. C810225B

On February 25, 1981, a Petition for Advisory Opinion was received from MC Minerals Corporation, 277 Park Avenue, New York, N.Y. 10172, and Mitsubishi International Corporation, 277 Park Avenue, New York, N.Y. 10172.

At issue is the deductibility, under Article 9-A of the Tax Law, by a taxpayer of interest paid to a stockholder which owns more than 5% of the taxpayer's issued capital stock, and whether money borrowed by a parent corporation for the purpose of lending these same funds to a subsidiary, and which is so lent, would constitute part of the subsidiary capital of the parent corporation.

MC Minerals Corporation (MCM) is a Delaware corporation that will be doing business in New York. MCM will be involved in a copper mining operation and will be a general partner, together with an unrelated corporation, in a copper mining joint venture in New Mexico.

Mitsubishi International Corporation (MIC), a New York corporation, owns 51% of the issued capital stock of MCM. Mitsubishi Corporation (MC), a Japanese corporation not required to file a New York State Franchise Tax Report, owns 49% of the issued capital stock of MCM. MIC is a wholly owned subsidiary of MC.

According to Petitioners, MCM's operations create financial requirements that must be met by outside borrowings, consisting of both long-term and short-term loans. MIC, its parent, and MC, its minority stockholder, can secure funds at a lower rate of interest than that available to MCM. It is anticipated that in certain instances MC will lend such funds to MCM at the same rate of interest which it paid to obtain the funds. In other instances, both MC and MIC will obtain external borrowings and, in turn, advance the proceeds to MCM at an interest rate that is slightly higher than their respective annual average external interest rates, to cover the estimated costs associated with the external borrowings.

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.")

Section 208.9(b)(6) of the Tax Law provides, in pertinent part, that in arriving at entire net income the Tax Commission, in its discretion, may require an addition to Federal taxable income of interest expense directly or indirectly attributable to subsidiary capital.

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:

JAMES H. TULLY., COMMISSIONER

LOUIS M. JACOBSON, DEPUTY COMMISSIONER

FRANK J. PUCCIA, DIRECTOR

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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" and the corporation are related as parent and subsidiary, the "stockholder" may not deduct the interest paid and deducted by its subsidiary in the computation of its entire net income because this income, by virtue of the subsidiary's deduction, would constitute income from business capital rather than from subsidiary capital. Tax Law §208.4. 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. Where such corporation is a subsidiary of the "stockholder," within the meaning of section 208.3 of the Tax Law, the "stockholder" is permitted to subtract the 1%, as income from subsidiary capital, on its corporation franchise tax report.

A corporation claiming a deduction for interest paid to its "stockholder", as described herein, must attach a rider to its corporation franchise tax report providing sufficient information to substantiate such 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.

In the present instance, where MIC borrows funds for the purpose of lending these funds to MCM, its subsidiary, as herein described, the amounts owed to MIC by MCM, the interest on which is deducted by MCM, as provided for herein, will not constitute part of MIC's subsidiary capital. Accordingly, any interest paid by MIC to obtain these funds from outside sources will not constitute "interest directly or indirectly...attributable...to subsidiary capital" for purposes of section 208.9(b)(6) of the Tax Law.

DATED: March 27, 1981

s/LOUIS ETLINGER
Deputy Director
Technical Services Bureau