

NOTICE OF INTENT

Department of Revenue Policy Services Division

Corporate Deductions; Add-Back of Certain Intangible Expenses; Interest and Management Fees
(LAC 61:I.1115)

Under the authority of R.S. 47:1511 and in accordance with the provisions of R.S. 47:287.82 and the Administrative Procedure Act, R.S. 49:950 et seq., the Department of Revenue, Policy Services Division, proposes to adopt LAC 61:I.1115.

The primary purpose of this proposed regulation is to implement Act 16 of the 2016 First Extraordinary Session of the Louisiana Legislature.

Title 61

REVENUE AND TAXATION

Part I. Taxes Collected and Administered by the Secretary of Revenue

Chapter 11. Corporation Income Tax

§1115. Corporate deductions; add-back of certain intangible expenses; interest and management fees

A. General. R.S. 47:287.82 provides that otherwise deductible interest expenses and costs, intangible expenses and costs, and management fees directly or indirectly paid to a Related Member shall be added-back to the corporation's gross income.

B. Exceptions. The taxpayer shall make the add-back unless:

1. The item of income corresponding to the taxpayer's expense, cost, or fee, was in the same taxable year subject to a tax based on or measured by the related member's net income in Louisiana or any other State; or

2. The item of income corresponding to the taxpayer's expense, cost, or fee, was in the same taxable year subject to a tax based on or measured by the related member's net income in a foreign nation which has in force an income tax treaty with the United States, if the recipient was a "resident" as defined in the income tax treaty with the foreign nation; or

3. The transaction giving rise to the expense, cost, or fee between the taxpayer and the related member did not have as a principal purpose the avoidance of any Louisiana tax; or

4. The expense, cost, or fee that was paid or accrued to a related member was "passed through" by the related member or members to an unrelated third party in an arms-length transaction via a corresponding expense, cost, or fee payment; or

5. The add-back is unreasonable. The add-back will be considered unreasonable if the taxpayer establishes that, based on the entirety of the taxpayer's particular facts and circumstances, the add-back adjustments would increase the taxpayer's Louisiana income tax liability to an amount that bears no reasonable relation to the taxpayer's Louisiana presence.

C. Definitions.

Indirectly Paid—interest expenses and costs, intangible expenses and costs, and management fees subject to add-back include expenses, costs, and fees incurred by a taxpayer if the expense is related to an intermediate expense, cost, or fee incurred in a transaction between one related member and a second related member.

a. EXAMPLE. Corporations B and C are related members with respect to Corporation A. Corporation A is a Louisiana taxpayer that sells products it purchases from Corporation B on a cost plus basis. Corporation B licenses intangible property from Corporation C and makes intangible expense payments to Corporation C based in part on the sales Corporation B makes to Corporation A. To the extent the intangible expenses Corporation B pays to Corporation C are reflected in the costs of the products Corporation A purchases from Corporation B, the direct intangible expenses of Corporation B are considered to be indirect intangible expenses of Corporation A. Furthermore, Corporation A is deemed to directly pay an intangible expense to Corporation B and indirectly pay an intangible expense to Corporation C.

Intangible Expenses—includes but is not limited to:

a. Expenses, accruals, and costs for, related to, or directly or indirectly incurred in connection with the acquisition, use, maintenance, management, ownership, sale, exchange, or any other disposition of intangible property. "Intangible property" includes stocks, bonds, financial instruments, patents, patent applications, trade names, trademarks, service marks, copyrights, mask works, trade secrets, "know how", and similar types of intangible assets.

b. Costs related to, or incurred in connection directly or indirectly with, factoring transactions or discounting transactions.

c. Royalty, patent, technical, and copyright fees.

d. Licensing fees.

e. Other similar expenses, accruals, and costs.

Management Fees—includes but is not limited to expenses and costs, including intercompany administrative charges, pertaining to accounts receivable, accounts payable, employee benefit plans, insurance, legal matters, payroll, data processing, including assembled workforce and/or employment data processing, purchasing, procurement, organizational matters, business structuring matters, taxation, financial matters, securities, accounting, marketing, reporting, and compliance matters or similar activities.

Related Entity—means (1) a stockholder who is an individual, or a member of the stockholder's family set forth in 26 U.S.C. 318 if the stockholder and the members of the stockholder's family own, directly, indirectly, beneficially or constructively, in the aggregate, at least 50 percent of the value of the taxpayer's outstanding stock; (2) a stockholder, or a stockholder's partnership, limited liability company, estate, trust or corporation, if the stockholder and the stockholder's partnerships, limited liability companies, estates, trusts and corporations own directly, indirectly, beneficially or constructively, in the aggregate, at least 50 percent of the value of the taxpayer's outstanding stock; or (3) a corporation, or a party related to the corporation in a manner that would require an attribution of stock from the corporation to the party or from the party to the corporation under the attribution rules of the Internal Revenue Code if the taxpayer owns, directly, indirectly, beneficially or constructively, at least 50 percent of the value of the corporation's outstanding stock. The attribution rules of the Internal Revenue Code shall apply for purposes of determining whether the ownership requirements of this definition have been met.

Related Member—means a person that, with respect to the taxpayer during all or any portion of the taxable year, is: (1) a related entity, (2) a related party, (3) a component member as defined in subsection (b) of 26 U.S.C. 1563; (4) a person to or from whom there is attribution of stock ownership in accordance with subsection (e) of 26 U.S.C. 1563; or (5) a person that, notwithstanding its form of organization, bears the same relationship to the taxpayer as a person described in (1) to (3), inclusive.

Related Party—means any member of a controlled group of corporations as defined in 26 U.S.C. 1563, or any other person that would be a member of a controlled group if rules similar to those of 26 U.S.C. 1563 were applied to that person.

Reported And Included In Income For Purposes Of A Tax On Net Income—means to the extent reported and included in post-allocation income or apportioned income for purposes of a tax applied to the net income apportioned or allocated to the taxing jurisdiction.

State—means a State of the United States, the District of Columbia, Puerto Rico, the United States Virgin Islands, or any territory or insular possession subject to the jurisdiction of the United States.

Subject To A Tax Based On Or Measured By The Related Member's Net Income—means that the receipt or accrual of the payment by the recipient related member is reported and included in income for purposes of a tax on net income, and not offset or eliminated in a combined or consolidated return which includes the payor.

D. Operating Rules

1. Upon request by the Secretary of the Louisiana Department of Revenue, the taxpayer shall produce documentation substantiating any exceptions to add-back claimed by the taxpayer.

2. The exceptions described in sections B.1. and B.2. (corresponding item of income subject to tax) are allowed only to the extent the recipient related member includes the corresponding item of income in post-allocation income or apportioned income reported to the taxing jurisdiction or jurisdictions. Income offset or eliminated in a combined reporting regime would not qualify for the subject to tax exception.

a. EXAMPLE. Corporation A, a Louisiana taxpayer, incurs a \$100 intangible expense in a transaction with Corporation B, a related member with respect to Corporation A. Corporation B files an income tax return in State B where it apportions and/or allocates 5 percent of its income, but files no other income tax returns. Only \$5 of the intangible expense was allocated/apportioned to State B. Corporation A must add-back \$95 of the otherwise deductible \$100 intangible expense incurred in the transaction with Corporation B.

3. Upon request of the Secretary of the Louisiana Department of Revenue, the exception described in section B.3. (non-tax business purpose for conducting a transaction) must be supported by contemporaneous documentation. Documentation shall be considered contemporaneous if the documentation is in existence and compiled before the due date (including extensions) for the filing of a return containing the transaction(s). Mere statements or assertions that a transaction was intended to allow for better management or greater utilization of intangible assets, or similarly unsubstantiated claims are not sufficient to establish a principal non-tax business purpose. Examples of principal non-tax business purposes include:

a. EXAMPLE. Taxpayer purchases administrative services such as accounting, legal, human resources, purchasing, etc., from a Related Member and does so at rates comparable to rates that would be charged by third party service providers.

b. EXAMPLE. Taxpayer borrows funds from a Related Member and does so at an interest rate and with other terms that are comparable to rates and terms that would be required by an unrelated third party lender.

c. EXAMPLE. Taxpayer incurs royalty expense in connection with the use of intangible assets provided by a Related Party. The royalty rates and other terms of agreement are comparable to rates and terms that would be required by an unrelated third party.

4. The exception described in section B.4. (expense "passed through" to an unrelated third party) is limited if the expenses, costs, and fees paid to a related member are greater than the expenses, costs, and fees the related member pays to unrelated third parties because only a portion of the expenses, costs, and fees incurred in connection with a transaction with a related member is considered to have "passed through" to the unrelated third parties.

a. EXAMPLE. Taxpayer A, a Louisiana taxpayer, incurs a \$100 management fee to Related Member B. Related Member B receives a total of \$400 of related member management fee income (\$100 from Taxpayer A plus \$300 from other related payors). Related Member B pays \$200 of management fees to unrelated third parties. Related Member B will be deemed to have passed through to unrelated third parties only 50 percent of the interest expense/income it received from Taxpayer A. Only \$50 of Taxpayer A's \$100 related member management fee payment to Related Member B will be deemed to have been passed through to unrelated third parties and qualify for the exception described in section B.4. (expense "passed through" to an unrelated third party).

5. With respect to both interest and intangible expenses, if the interest or intangible expense rate charged the taxpayer by the related member exceeds the interest or intangible expense rate charged the related member by unrelated third party payees, then the excess expense will not qualify for the exception described in section B.5. (add-back is unreasonable) and must be added back. If multiple transaction arrangements exist between the taxpayer and the related member, or the related member and the unrelated third-party, then a weighted average rate should be calculated by dividing total expense by total amounts of each base amount used to determine the expense amounts. The weighted average rate should then be used to determine the existence of non-qualifying excess interest or intangible expense.

a. EXAMPLE. Taxpayer B incurs interest expense of \$100 during its taxable year to its parent Company A (a related member) in order to service a \$1,000 debt between B and A. Company A's related member interest rate is 10 percent calculated by dividing its related

member interest expense (\$100) by its related member debt (\$1000). Company A makes interest expense payments of \$200 to Unrelated Lenders C and D to service the \$4,000 of total debt existing between A and Unrelated Lenders C and D. A's weighted average unrelated third party interest rate is five percent (5 percent) calculated by dividing total unrelated third party interest expense (\$200) by total unrelated third party interest bearing debt (\$4,000). Company B's non-qualifying excess interest is \$50. Company B's debt to company A (\$1,000) is multiplied by the excess interest rate Company B incurred over Company A's average interest rate to unrelated lenders (10 percent-5 percent).

6. With respect to interest expense, if the taxpayer's debt over asset percentage exceeds the consolidated unrelated third party debt over asset percentage of its federal consolidated group (as represented by interest bearing debt reported on the Schedule L balance sheet(s) included in the consolidated and pro forma federal income tax returns), then the interest expense associated with the excess debt must be added back and cannot qualify for the exception described in section B.5. (add-back is unreasonable). The debt over asset test only applies to the unreasonable exception.

a. EXAMPLE. Company A and Taxpayer B are related members. Taxpayer B's separate company federal income tax return Schedule L balance sheet shows \$1,500 of assets and \$1,000 of interest bearing debt which produces a debt over asset percentage of 66.7 percent. The Company A and Subsidiaries' federal consolidated income tax return Schedule L balance sheet shows \$6,000 of assets and \$3,000 of unrelated third party interest bearing debt which produces a debt over asset percentage of 50 percent. Because Taxpayer B's debt over asset percentage of 66.7 percent, exceeds the group's unrelated third party debt over asset percentage, 50 percent, the amount of Taxpayer B's related member interest expense that may qualify for the exception described in section B.5. (add-back is unreasonable) is limited. The limitation is calculated by multiplying B's assets (\$1,500) by the lower of the taxpayer's debt over asset percentage or the group's unrelated third party debt over asset percentage (50 percent) and then multiplying the product (\$750) by the lower of the taxpayer's related member interest rate or the related member's unrelated third party interest rate (5 percent), which yields an ultimate limitation of \$37.50.

AUTHORITY NOTE: Promulgated in accordance with R.S. 47:1511.

HISTORICAL NOTE: Promulgated by the Department of Revenue, LR 44:

Family Impact Statement

The proposed adoption of LAC 61:I.1115 regarding corporate deductions; add-back of certain intangible expenses; interest and management fees, should not have any known or foreseeable impact on any family as defined by R.S. 49:972(D) or on family formation, stability and autonomy. Specifically, the implementation of this proposed rule will have no known or foreseeable effect on:

1. The stability of the family.
2. The authority and rights of parents regarding the education and supervision of their children.
3. The functioning of the family.
4. Family earnings and family budget.
5. The behavior and personal responsibility of children.
6. The ability of the family or a local government to perform this function.

Poverty Statement

The proposed regulation will have no impact on poverty as described in R.S. 49:973.

Small Business Statement

It is anticipated that the proposed Rule should not have a significant adverse impact on small businesses as defined in the Regulatory Flexibility Act. The agency, consistent with health, safety, environmental and economic factors has considered and, where possible, utilized regulatory methods in drafting the proposed Rule to accomplish the objectives of applicable statutes while minimizing any anticipated adverse impact on small businesses.

Provider Impact Statement

The proposed regulation will have no known or foreseeable effect on:

1. The staffing levels requirements or qualifications required to provide the same level of service.
2. The total direct and indirect effect on the cost to the provider to provide the same level of service.
3. The overall effect on the ability of the provider to provide the same level of service.

Public Comments

Any interested person may submit written data, views, arguments, or comments regarding this proposed regulation to David M. Hansen, Attorney, Policy Services Division, Office of Legal Affairs by mail to P.O. Box 44098, Baton Rouge, LA 70804-4098. All comments must be received no later than 4:00 p.m. on February 23, 2018.

Public Hearing

A public hearing will be held on February 26, 2018, at 10:00 a.m. in the LaBelle Room, on the first floor of the LaSalle Building, 617 North Third Street, Baton Rouge, LA 70802.

Kimberly Lewis Robinson
Secretary, Department of Revenue

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3. The transaction giving rise to the expense, cost, or fee between the taxpayer and the related member did not have as a principal purpose the avoidance of any Louisiana tax; or

4. The expense, cost, or fee that was paid or accrued to a related member was "passed through" by the related member or members to an unrelated third party in an arms-length transaction via a corresponding expense, cost, or fee payment; or

5. The add-back is unreasonable. The add-back will be considered unreasonable if the taxpayer establishes that, based on the entirety of the taxpayer's particular facts and circumstances, the add-back adjustments would increase the taxpayer's Louisiana income tax liability to an amount that bears no reasonable relation to the taxpayer's Louisiana presence.

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c. EXAMPLE. Taxpayer incurs royalty expense in connection with the use of intangible assets provided by a Related Party. The royalty rates and other terms of agreement are comparable to rates and terms that would be required by an unrelated third party.

4. The exception described in section B.4. (expense "passed through" to an unrelated third party) is limited if the expenses, costs, and fees paid to a related member are greater than the expenses, costs, and fees the related member pays to unrelated third parties because only a portion of the expenses, costs, and fees incurred in connection with a transaction with a related member is considered to have "passed through" to the unrelated third parties.

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Poverty Statement

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Public Comments

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Public Hearing

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Kimberly Lewis Robinson
Secretary, Department of Revenue

Fiscal and Economic Impact Statement For Administrative Rules

Person preparing statement:	<u>Ed Landry</u>	Department:	<u>Revenue</u>
Phone:	<u>(225) 219-2797</u>	Office:	<u>Tax Administration Division</u>
Return Address:	<u>617 North Third Street</u>	Rule Title:	<u>LAC 61:I.1115</u>
	<u>Baton Rouge, LA 70802</u>	Date Rule Takes Effect:	<u>April 20, 2018</u>

Summary

In accordance with Section 953 of Title 49 of the Louisiana Revised Statutes, there is hereby submitted a fiscal and economic impact statement on the rule proposed for adoption, repeal or amendment. The following summary statements, based on the attached worksheets, will be published in the ***Louisiana Register*** with the proposed agency rule.

I. ESTIMATED IMPLEMENTATION COSTS (SAVINGS) TO STATE OR LOCAL GOVERNMENTAL UNITS (Summary)

Implementation costs to the Department of Revenue (LDR) will be relatively small, and will be absorbed in LDR's budget allocation. These costs will include computer system modification and testing, tax form redesign, and taxpayer inquiries.

The purpose of the proposed rule is to implement the provisions of R.S. 47:287.82, enacted by Act 16 of the 2016 First Extraordinary Session of the Louisiana Legislature. This new statute and this proposed rule provide that when computing Louisiana net income a corporation shall add back, subject to certain exceptions, otherwise deductible interest expenses, intangible expenses, and management fees resulting from transactions with related entities. The proposed rule provides guidance and clarification in the form of definitions and operating rules, for taxpayer compliance with the statute.

II. ESTIMATED EFFECT ON REVENUE COLLECTIONS OF STATE OR LOCAL GOVERNMENTAL UNITS (Summary)

The proposed rule will result in an increase of indeterminable magnitude in net corporate income tax receipts by requiring corporate tax filers to add back various deductions to their net income reported on state tax returns. LDR does not electronically capture the return information necessary to quantify an estimate of the likely fiscal effect of the proposed rule.

III. ESTIMATED COSTS AND/OR ECONOMIC BENEFITS TO DIRECTLY AFFECTED PERSONS OR NON-GOVERNMENTAL GROUPS (Summary)

Louisiana corporate taxpayers that incur expenses that will be required to be added back to net income would be affected by increased tax liabilities of an indeterminable amount. Other costs have not been determined but are expected to be relatively minor. LDR does not electronically capture the return information necessary to estimate the likely fiscal effect of the proposed rule.

IV. ESTIMATED EFFECT ON COMPETITION AND EMPLOYMENT (Summary)

The proposed rules will affect corporate tax filers differently, resulting in shifts in the corporate tax burden among firms, consequently affecting competition and employment among them. However, the degree to which these shifts will affect aggregate competition and employment is indeterminable.

Signature of Agency Head or Designee
Kimberly Lewis Robinson, Secretary

Typed Name and Title of Agency Head or Designee

Legislative Fiscal Officer Designee
Greg Albrecht, Chief Economist

Typed Name of Legislative Fiscal Officer Designee

Date of Signature

Date of Signature