



STATE OF CONNECTICUT
DEPARTMENT OF REVENUE SERVICES

SN 2003(22)

25 Sigmourney Street
Hartford CT 06106-5032

SPECIAL NOTICE

Interest Expense Add Back

Purpose: This Special Notice summarizes the 2003 legislative change that requires corporations to add back otherwise deductible interest expenses and costs paid to a related member.

Effective Date: Effective from passage and applicable to income years beginning on or after January 1, 2003.

Statutory Authority: 2003 Conn. Pub. Acts 6 (June 30 Spec. Sess.), §78.

Definitions:

Interest expenses and costs means amounts directly or indirectly allowed as deductions under I.R.C. §163.

Related member means a person that, with respect to the taxpayer during all or any portion of the taxable year is: (A) a related entity; (B) a component member, as defined in I.R.C. §1563(b); (C) a person to or from whom there is attribution of stock ownership in accordance with I.R.C. §1563(e), other than a statutory business trust of which each beneficiary is not a related entity to the taxpayer; **or** (D) a person that, notwithstanding its form of organization, bears the same relationship to the taxpayer as a person described in (A) through (C) above.

Related entity means (A) a stockholder who is an individual, or a member of the stockholder's family enumerated in I.R.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% of the value of the taxpayer's outstanding stock; (B) a stockholder, or a stockholder's partnership, limited liability company,

state, 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% of the value of the taxpayer's outstanding stock; **or** (C) 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% 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 have been met.

Required Add Back of Interest Expenses and

Costs: For purposes of computing its net income under Conn. Gen. Stat. §12-217, a corporation must add back otherwise deductible interest expenses and costs that are allowed as a deduction under I.R.C. §163 where the interest expenses and costs are directly or indirectly paid, accrued, or incurred to a related member. The add back of interest expenses and costs is applicable to income years beginning on or after January 1, 2003.

To ensure compliance, the Department of Revenue Services (DRS) requires all interest expenses and costs that are paid, accrued, or incurred to a related member to be added back to income prior to claiming an exception to the add back. Any corporation that paid, accrued, or incurred interest expenses and costs to a related member must complete **Form CT-1120AB, Add Back and Exceptions to Add Back of Interest and Intangible Expenses**. An exception and a corresponding deduction from income is allowed pursuant to the statute in five specifically enumerated instances. The five exceptions are discussed separately below.

Exception One: The adjustment requiring the add back of otherwise deductible interest expenses and costs paid to a related member in computing net income does not apply, and thus the corporation is entitled to a corresponding deduction, if the corporation establishes by clear and convincing evidence, as determined by the Commissioner of Revenue Services (the Commissioner), that:

- (1) A principal purpose of the transaction giving rise to the payment of interest was not to avoid payment of corporation business taxes;
- (2) The interest is paid pursuant to a written contract that reflects an arm's length rate of interest and terms; **and**
- (3) Either: (A)(i) the related member was subject to tax on its net income in this state or another state or possession of the United States or a foreign nation; (ii) a measure of the tax included the interest received from the corporation; and (iii) the rate of tax applied to the interest received by the related member is no less than the statutory rate of tax applied to the corporation under Conn. Gen. Stat. §12-214, minus three percentage points, or (B) the related member is a company subject to tax under Chapter 207 or comparable tax under the laws of another state.

It is important to note that the principal purpose of the transaction giving rise to the payment of interest must not be to avoid the payment of corporation business tax and the interest must be paid pursuant to a written contract that reflects an arm's length rate of interest and terms. As provided in the statute, failure to meet these first two conditions will disqualify the corporation from claiming the exception, even if the related member pays tax on the net interest income received at a rate of tax that is no less than the statutory rate of tax applied in Connecticut minus three percentage points, or if the interest income is paid to a related member that is a company subject to the tax under Chapter 207 (Insurance Companies, Hospital and Medical Services Corporations Taxes) or to a comparable tax under the laws of another state.

Moreover, this exception requires that the rate of tax applied to the interest that is received by the related member be no less than the statutory rate of interest under Conn. Gen. Stat. §12-214 minus three percentage

points. Currently, the statutory rate of the corporation business tax is 7.5%. Thus, in order for a taxpayer to qualify for this exception, the taxpayer must establish that the interest paid to the related member was actually taxed at a rate no less than 4.5% (7.5% - 3%). If the related member was taxed at a rate less than 4.5%, this exception does not apply. The rate of tax is determined by dividing the amount of tax actually paid (after credits are applied) by the taxable income before apportionment and application of operating loss carryforwards.

Additionally, this exception does not apply to transactions with a related member when the related member files in another jurisdiction with the corporation on a combined, consolidated, or unitary basis where the interest expense of the taxpayer and the interest income of the related member is offset or eliminated. In the case of interest paid to a related member that files a return with the corporation in a jurisdiction on a combined, consolidated, or unitary basis, the interest income reported by the related member is eliminated and thus not taxed. Similarly, this exception does not apply to interest expenses and costs that are paid to a related member when the related member has a net operating loss or pays tax on a basis other than net income including, but not limited to, a gross receipts tax, capital base tax, or a business and occupational tax. Where the interest expenses and costs are paid to a related member that has a net operating loss or the related member is taxed on a basis other than net income, the statutory requirement that the related member was subject to tax on its net income in this state or another state or possession of the United States or a foreign nation is not met.

Below are two examples that illustrate how to calculate whether the rate of tax applied to the interest paid to a related member was taxed at a rate that is no less than 4.5% (the statutory rate minus 3%). In the two examples below, assume that a principal purpose of the transaction giving rise to the payment of interest was not to avoid payment of corporation business taxes; interest is paid by the corporation to the related member pursuant to a written contract that reflects an arm's length rate of interest and terms; the related member is **not** a company subject to tax under Chapter 207 or comparable tax under the laws of another state; and the related member was subject to tax on its net income in this state or another state or possession of the United States or a foreign nation, and a measure of the tax included the interest received from the corporation.

Example 1:

Line 1. Amount of deductible interest claimed by the corporation and paid to a related member\$ 10,000

Line 2. The taxable income before apportionment and application of net operating losses (NOLs) of the related member in this state, another state, or a foreign nation\$1,000,000

Line 3. The tax after application of credits, paid by the related member in this state, another state, or a foreign nation\$ 60,000

Line 4. Divide Line 3 by Line 2 6%

Line 5. Exception Amount. Since Line 4 is equal to or greater than 4.5% (.045), the amount from Line 1 is the exception amount.....\$ 10,000

To claim this exception, the corporation must complete **Form CT-1120AB** and attach the form to the taxpayer’s corporation business tax return.

Example 2:

Line 1. Amount of deductible interest claimed by the corporation and paid to a related member\$ 10,000

Line 2. The taxable income before apportionment and application of NOLs of the related member in this state, another state, or a foreign nation\$1,500,000

Line 3. The tax after application of credits, paid by the related member in this state, another state, or a foreign nation\$ 60,000

Line 4. Divide Line 3 by Line 2..... 4%

Line 5. Exception Amount. Since Line 4 is less than 4.5% (.045), the corporation does not qualify for this exception\$ 0

Exception Two: The adjustment requiring the add back of otherwise deductible interest expenses and costs paid to a related member in computing net income does not apply, and thus the corporation is entitled to a corresponding deduction, if the corporation establishes by clear and convincing evidence, as determined by the Commissioner, that the adjustment is unreasonable.

To claim this exception, the corporation should submit a petition in writing to the Commissioner, prior to filing its corporation business tax return for the year in which the exception is claimed. The petition must set forth the applicable facts and provide clear and convincing evidence that the add back adjustment is unreasonable. The Commissioner will grant or deny approval of the use of this exception.

Clear and convincing evidence is evidence that is so "clear, direct, and weighty" that it will permit the Commissioner to "come to a clear conviction, without hesitancy" of the validity of the corporation's claim. *See United States v. Goba*, 220 F. Supp. 2d 182, 188 (W.D.N.Y. 2002).

This exception may only be claimed where the corporation has obtained prior written approval from the Commissioner that requiring the add back of interest expenses and costs would be unreasonable. A copy of the Commissioner’s determination that an adjustment would be unreasonable must be attached to **Form CT-1120AB**.

Below is an example of what the Commissioner may consider to be clear and convincing evidence that the adjustment required by the statute is unreasonable.

Z Corporation is a corporation engaged in business in Connecticut and is taxed at a statutory rate of 7.5%. Y Corporation is a related member corporation that loans funds to Z Corporation. Y Corporation apportions its income to each of the following states and is effectively taxed on the interest income as follows: Massachusetts (1.75%), New Jersey (1.50%), Vermont (2.0%); and Maine (1.50%). Y Corporation's total actual tax rate, determined by adding the four actual state rates, is 6.75%. Upon presentation of proof to the Commissioner that Y Corporation is actually taxed on the interest income in question at a total tax rate equal to or greater than 4.5% (7.5% statutory rate – 3% points = 4.5%), the Commissioner may determine that the taxpayer is entitled to a full exception to the statutory add back.

As previously explained, any corporation claiming this exception must have obtained prior written approval from the Commissioner. The corporation business tax return of any corporation that has claimed the exception for an unreasonable add back without receiving prior approval will be closely scrutinized. If the Commissioner issues a deficiency assessment for failure to comply with the add back adjustment, the Commissioner has the authority to impose a penalty equal to 25% of the amount of the deficiency for fraud or intent to evade under Conn. Gen. Stat. §12-233.

Exception Three: The third exception applies if a corporation paid, accrued, or incurred interest expenses and costs to a related member, but instead elects, on **Form CT-1120U**, *Unitary Corporation Business Tax Return*, to calculate its tax on a unitary basis including all members of the unitary group provided there are substantial intercorporate business transactions among such included corporations. The election to file on a unitary basis is irrevocable for and applicable for five successive income years.

The unitary return must comply with the following:

- The unitary group must meet the definition of a unitary business as provided in the instructions to **Form 1120U**;
- The unitary group must use a three factor apportionment formula consisting of property, payroll, and double weighted gross receipts under Conn. Gen. Stat. §12-218(c);
- Each corporation included in the unitary group is subject to the minimum tax under Conn. Gen. Stat. §12-219;
- The unitary group is subject to the surtax;
- The unitary group cannot use NOLs that have been carried forward from returns that were filed prior to the establishment of the Connecticut unitary group. Only losses incurred by the unitary group in the first year of the unitary return (and thereafter) can be utilized by the unitary group;
- The unitary group cannot use tax credits that were earned prior to the establishment of the Connecticut unitary group. Only tax credits earned by the unitary group in the first year of the unitary return (and thereafter) can be taken on the unitary return;

- The unitary group is required to calculate the capital base tax on a unitary basis. In calculating the capital base tax, intercompany stockholdings should be eliminated;
- The unitary group must complete and attach **Form CT-1120Q**, *Corporate Unitary Questionnaire*, located on the DRS Web site at www.ct.gov/DRS, to **Form CT-1120U**; and
- The election is irrevocable for five successive income years.

The taxpayer must complete **Form CT-1120AB** to claim this exception.

Exception Four: The fourth exception applies if the corporation paid, accrued, or incurred interest expenses and costs to a related member that is located in a country with which the United States has a comprehensive income tax treaty. This exception, unlike the first exception, does not consider the rate of tax paid on the interest income by the related member located in a foreign country.

The taxpayer must complete **Form CT-1120AB** to claim this exception.

Exception Five: The final exception to the add back of otherwise deductible interest expenses and costs paid to a related member applies if, sixty days prior to filing a combined return, the corporation submits a petition in writing to the Commissioner for approval of an alternate method of determining the combined measure of tax. The Commissioner may approve such petition only in the event that the petitioners have clearly established that there are substantial intercorporate business transactions between the included corporations and the proposed alternate method accurately reflects the activity, business, income, or capital of the petitioners.

Commissioner's Authority: Nothing in 2003 Conn. Pub. Acts 6 (June 30 Spec. Sess.), §78 shall be construed to limit or negate the Commissioner's authority to make adjustments under Conn. Gen. Stat. §§12-221a or 12-226a of the general statutes.

Effect of This Document: A Special Notice is a document that announces a new policy or practice in response to changes in State or federal laws or regulations or judicial decisions. A Special Notice indicates an informal interpretation of Connecticut tax law by DRS and may be referred to for general guidance by taxpayers or tax practitioners.

For Further Information: Call DRS during business hours, Monday through Friday:

- **1-800-382-9463** (in-state), or
- **860-297-5962** (from anywhere)

TTY, TDD, and Text Telephone users only may transmit inquiries anytime by calling 860-297-4911.

Forms and Publications: Forms and publications are available anytime by:

- **Internet:** Preview and download forms and publications from the DRS Web site at www.ct.gov/DRS
 - **DRS TAX-FAX:** Call **860-297-5698** from the handset attached to your fax machine and select from the menu.
 - **Telephone:** Call **860-297-4753** (from anywhere), or **1-800-382-9463** (in-state) and select **Option 2** from a touch-tone phone.
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Paperless Filing Methods (fast, easy, free, and confidential):

- **For business returns:** Use *Fast-File* to file sales and use taxes, business use tax, room occupancy tax, or withholding tax returns over the Internet or telephone. Visit the DRS Web site at www.ct.gov/DRS and click on *File Returns On-Line* or call **860-947-1988**.
- **For resident income tax returns:** Use *WebFile* to file personal income tax returns over the Internet. Visit the DRS Web site at www.ct.gov/DRS and click on *File Returns On-Line*.