

SECTION 26000 PROGRAM AREA NET INTEREST DEDUCTION

References (Repealed Sections) 17231; 24384

Repealed California Revenue & Taxation Code (CR&TC) Sections 17231 and 24384 provided for the deduction of net interest income from loans made to a trade or business located solely within a Program Area. The net interest deduction is for interest payments received after the designation of the Program Area and before taxable or income years beginning before January 1, 1997.

For income and taxable years beginning on or after January 1, 1997, Program Areas were converted to Enterprise Zones (EZs) and are entitled to the benefits available to EZs (see CR&TC §17235 and 24384.5). Loans previously qualifying a creditor for the Program Area net interest deduction convert to the EZ net interest deduction.

The following Program Area discussion relates to income and taxable years beginning prior to January 1, 1997.

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| EDAM 26100 | GEOGRAPHIC BOUNDARIES AND DESIGNATION DATES |
| EDAM 26200 | QUALIFIED TAXPAYER |
| EDAM 26300 | QUALIFIED DEBT |
| EDAM 26400 | DEFINITION OF "QUALIFIED BUSINESS/DEBTOR" |
| EDAM 26500 | DEFINITION OF A "TRADE OR BUSINESS" |
| EDAM 26600 | DEFINITION OF "LOCATED SOLELY WITHIN" |
| EDAM 26700 | NET INTEREST DEDUCTION – COMPUTATION |
| EDAM 26800 | REPEAL OF PROGRAM AREAS |
| EDAM 26900 | RECORD KEEPING |

26100 Geographic Boundaries and Designation Dates

For a listing of Program Areas and designation dates, refer to EDAM 1360. To verify an address, refer to EDAM 1300.

26200 Qualified Taxpayer

References (Repealed Sections) 17231(a); 24384(a)

EDAM 26210 Pass-Through Entities

For purposes of the program area net interest deduction, a qualified taxpayer includes a person or entity (creditor) that loans funds on or after the designation of the Program Area, to a qualified business/debtor and receives interest payments thereon. The loan advanced to the qualified business/debtor must also meet the requirements as discussed in EDAM 26300.

The creditor does not have to be located in the Program Area to take advantage of the net interest deduction. Only the debtor needs to operate in the Program Area.

26210 Pass-Through Entities

In the case of any "pass-through entity", the determination of whether a taxpayer is a qualified taxpayer is made at the entity level.

26300 Qualified Debt

References (Repealed Sections) 17231(b); 24384(b)

EDAM 26310 Security/Collateral

To claim the net interest deduction for creditors, the following requirements must be met at the time the indebtedness is incurred:

- The trade or business (*qualified business/debtor*) to which the loan is made, is located solely within a Program Area;
- The indebtedness is incurred solely in connection with activity within the Program Area; and
- The creditor has no equity or other ownership interest in the debtor.

NOTE: Repealed CR&TC §17231(b) & 24384(b) require that the creditor have no equity or other ownership interest in the debtor at the time the loan is made. However, the CR&TC does not provide for any limitation after the loan is made. For example, assume that two years after the qualified loan is made the debtor contacts the creditor to renegotiate the loan terms due to the debtor's poor financial condition. The creditor agrees to take an equity interest in the debtor in exchange for reducing the amount due from the debtor. Net interest received from the remaining portion of the qualified loan is still deductible.

To claim the net interest deduction for creditors, the following requirements must be met annually:

- The qualified business/debtor that the loan was made to and interest payments are received from must be conducting business in the program area.

Example: Two years after the qualified loan is funded, the qualified business/debtor moves their operations entirely outside of the Program Area geographic boundaries. The net interest deduction is no longer allowed because the trade or business is not located within the designated program area.

26310 Security/Collateral

The statute does not require that the security or collateral for the loan be located in the Program Area. For example, a sole proprietor can use its personal residence as collateral for the Program Area business loan and the creditor would still be allowed the net interest deduction assuming all other qualifications are met.

26400 Definition of "Qualified Business/Debtor"

The definition of a *qualified business* in Section 7082 of the Government Code requires inquiry at the entity level. The business activity of the entity (entirely or a portion thereof as relevant) must be conducted within a Program Area.

26500 Definition of a "Trade or Business"

Black's Law Dictionary defines *trade or business* as follows:

"Any business or professional activity conducted by a taxpayer, the objective of which is to earn a profit. The general test for determining whether a person is engaged in "trade or business" so as to be entitled to deduct expenses as trade or business expenses under the Internal Revenue Code is whether the taxpayer's primary purpose and intention in engaging in the activity are to make a profit."

26600 Definition of "Located Solely Within"

References (Repealed Sections) 17231(b)(1); 24384(b)(1)

In order to claim the net interest deduction, the loan must be made to a qualified business *located solely within* a Program Area. Generally, one looks to the presence of tangible property in order to determine the place, site, or limits of a business. Intangible property by definition cannot be located by reference to physical presence. The presence of all of the qualified trade or business' payroll and tangible property within a Program Area would be a strong indication that they meet the test. The fact that sales are delivered by common carrier outside of the Program Area should not cause the borrower to fail the "*located solely within*" requirement.

26700 Net Interest Deduction – Computation

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| EDAM 26710 | Gross Interest |
| EDAM 26720 | Cost of Funds |
| EDAM 26730 | Other Related Expenses |
| EDAM 26740 | Non-Bank & Non-Financial Lenders |

For purposes of determining the net interest deduction, *net interest* is gross interest received less related interest expense (cost of funds) and any other directly related expenses.

26710 Gross Interest

Substantial differences may exist between *tax* and *book* accounting methods. Consequently, the amount of gross interest income included in the computation of net interest is determined using the creditor's tax accounting method (i.e., the gross interest income included in the computation of net interest corresponds to the gross interest income included in the determination of taxable income). Gross interest income should not include items that are *not* in the nature of interest.

Interest is defined as an amount paid for the use or forbearance of money.

Gross interest is determined by referencing the loan contract. A contract between a creditor and a qualified trade or business may include all of the following:

- A stated rate of interest;
- Points;
- Commitment fees (fees for entering into an agreement that obligates the lender to make funds available for an agreed period at a stated rate of interest - see Rev. Rul. 70-540)*;
- Service fees (fee charged for processing a loan); and
- Escrow interest.

Analysis of each of the above items is necessary to determine which are in the nature of interest. For example, commitment fees and service fees are not included in gross interest for purposes of determining the net interest deduction as they are fees earned when establishing the loan and are not monies paid for the use of the loaned funds.

Points are a charge by the lender, in addition to the stated rate of interest, to reflect the actual cost of borrowing money. Thus, points as here described, are for the use or forbearance of money and are considered interest. Escrow interest is interest from the date the loan is funded until 30 days before the borrower's first loan payment. Original issue discount (OID) is another form of interest. Stated interest, points, escrow interest, and OID are all items that may be included in gross interest for purposes of determining the net interest deduction.

***NOTE:** Revenue Ruling 70-540, 1970-2 CB 101 discusses the character of commitment fees from the lender's point of view. The commitment fee is a charge for agreeing to make funds available rather than for the use or forbearance of money, and therefore, is not interest. Other revenue rulings discuss commitment fees from the point of view of the borrower. To the extent of any discussion concerning the treatment of points by the lender, Rev. Rul. 70-540 was made obsolete by Rev. Proc. 94-29, 1994-1 CB 616; this does not affect its relevance in regards to commitment fees.

CALIFORNIA FRANCHISE TAX BOARD

26720 Cost of Funds

A reasonable amount of interest expense is assigned to the interest income. One method of determining a reasonable cost of funds is the following formula:

$$\frac{\text{Interest Expense}}{\text{Funding Sources}} = \text{Cost of Funds}$$

Funding sources are equal to average liabilities plus owners' equity less average non-interest earning assets.

The ratio from the above formula is multiplied by the average loan principal outstanding for the year. All amounts are on a tax basis.

For example, assume the following is from the tax return of a financial institution:

| | | |
|---|-------------------------|---------|
| Average liabilities and owners' equity | \$53,000,000,000 | |
| LESS: Average non-interest earning assets | <u>7,000,000,000</u> | |
| Funding Sources | \$46,000,000,000 | |
| | | |
| Total Interest Expense | <u>\$ 1,500,000,000</u> | |
| Funding Sources | \$46,000,000,00 | = 3.26% |

Assume that an average principal amount of \$10 million was outstanding during the year for loans made to businesses within a Program Area. A reasonable amount of interest expense to assign to the loans is \$326,000 (\$10 million times 3.26%).

Taxpayers may also use an independent cost of funds index such as the prime index rate or the London Interbank Offered Rate (LIBOR), which is the rate banks use to place Eurodollars with one another in London. If an independent index is used, that index must approximate the taxpayer's cost of funds.

The annual report of many banks or savings and loan associations provides the average cost of funds. The net interest margin (the difference between interest income and interest expense) is usually of interest to shareholders and other users of the annual report. The net interest margin should be similar to that used for the calculation of the net interest deduction.

The information provided in the Franchise Tax Board's internal procedure manuals does not reflect changes in law, regulations, notices, decisions, or administrative procedures that may have been adopted since the manual was last updated

26730 Other Related Expenses

"Net interest" is interest received less the cost of funds and direct expenses incurred in earning such interest. An example of a direct expense is commission paid to a loan representative. Expenses that are not directly attributable to the loan in question are not subtracted for purposes of determining the net interest deduction.

All reasonably identifiable direct costs applicable to acquiring or making a loan are capitalized and written off over the life of the loan. The amortization method should reflect the nature of the loan. It is reasonable to use straight line or principal reduction methods of amortization (see Rev. Proc. 94-29 for application of the principal reduction method).

26740 Non-Bank & Non-Financial Lenders

Non-financial corporations and individuals usually do not have all of the various income and expense items referred to previously.

Generally, gross interest of non-bank or non-financial creditors is the interest income as stated in the loan. For example, an individual creditor will generally avoid escrow interest by establishing the monthly due date of the loan as the day of the month the loan was funded, or the day escrow closed, whereas mortgages carried by a commercial lender generally have a common due date, i.e., the beginning of the month.

Related expenses, such as the cost of funds, are determined in order to compute the deduction of net interest income. Non-bank or non-financial lenders who make loans to qualified businesses located solely within the program area may incur investment interest expense related to such loans. The interest tracing rules under Treas. Reg. 1.163-8T are appropriate for determining related interest expense for these taxpayers.

26800 Repeal of Program Areas

For income and taxable years beginning on or after January 1, 1997, Program Areas were converted to Enterprise Zones (EZs) and are entitled to the benefits available to EZs (see CR&TC §17235 and 24384.5). Loans previously qualifying a creditor for the Program Area net interest deduction convert to the EZ net interest deduction.

26900 Record Keeping

The qualified taxpayer/creditor should maintain records on each loan (loan agreements) for which a deduction of net interest is taken, that identifies or describes:

- The debtor,
- The debtor's location (at the time of indebtedness and annually),
- The debtor's mailing address,
- The purpose/use of the loan,
- The stated interest,
- Other items included in gross interest,
- Any direct expenses associated with the loan, and
- Any property securing the loan.