6000 ENTERPRISE ZONE NET INTEREST DEDUCTION

California Revenue & Taxation Code (CR&TC) Sections 17235 and 24384.5 provide for the deduction of net interest income for loans made to a trade or business located solely within an Enterprise Zone (EZ). The net interest deduction is for interest payments received after the designation of the EZ and before its expiration.

6100 Geographic Boundaries and Designation Dates

For a listing of EZs and designation dates, refer to Section 1310. To verify an address, refer to Section 1300.

6200 Qualified Taxpayer

References 17235(a)&(b); 24384.5(a)&(b)

For purposes of the EZ net interest deduction, a qualified taxpayer (creditor) is defined as a person or entity that loans funds on or after the designation date of the EZ to a qualified business (debtor) and receives interest payments thereon. The loan advanced to the qualified business must also meet the requirements as discussed in Section 6300.

The taxpayer (creditor) does not have to be located in the EZ to take advantage of the net interest deduction. Only the debtor needs to operate within the EZ (see Section 6600).

6210 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.

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6300 Qualified Debt

References 17235(b); 24384.5(b)

In order for the taxpayer (creditor) 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 an EZ.
- The indebtedness is incurred *solely* in connection with activity within the EZ.
- The creditor has no equity or other ownership interest in the debtor.

> **Note:** The requirements of CR&TC §17235(b) & 24384.5(b) are only tested at the time the loan originated. The CR&TC does not provide for any limitation after the loan is made. For instance, if 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 would still be deductible because the creditor's equity interest occurred subsequent to loan origination.

The debtor however, must satisfy the requirements of CR&TC §17235(a) & 24384.5(a) annually.

- The debtor must continue to conduct business in the EZ annually.

Example*:* Two years after the qualified loan is funded, the qualified business/debtor moves their operations entirely outside of the EZ. The net interest deduction is no longer allowed because the trade or business is not located within the EZ. CR&TC §17235(a) & 24384.5(a) is an annual test that only requires that *a business be engaged in a trade or business within the zone*. It does not use the more restrictive language of CR&TC §17235(b)(1) & 24384.5(b)(1) that require that the business be *solely located with the zone* which is checked at the time the debt is incurred.

6310 Security/Collateral

The statute does not require that the security or collateral for the loan be located in the EZ. For example, a sole proprietor can use its personal residence as

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collateral for the EZ business loan and the creditor is still allowed the net interest deduction assuming all other qualifications are met.

6400 Definition of "Qualified Business/Debtor"

The definition of a qualified business/debtor requires a review of the debtor. The business activity of the debtor (entirely or a portion thereof as relevant) must be conducted within the EZ; this is an annual test. This should not be confused with the *Solely Located* requirement (refer to Section 6600), required at the time the loan is originated.

6500 Definition of a "Trade or Business"

Black’s Law Dictionary defines "trade or business" as “any business or professional activity conducted by a taxpayer, the objective of which is to earn a profit.” The Internal Revenue Code (IRC) and the R&TC also reference the definition of a trade or business as an activity engaged in for profit. The statute uses the broad term "trade or business," the plain meaning of which includes all types of conduct in furtherance thereof. A logical reading of "any business or professional activity conducted by a taxpayer" requires that all of the taxpayer's activities (passive or active) connected to the conduct of a trade or business are a part of the trade or business. Accordingly, personnel and assets involved in the administration and management of assets, manufacture of goods, sale of goods, shipment of goods, delivery of goods and services, etc., are a part of a trade or business.

6600 Definition of "Business Located Solely Within"

References 17235(b)(1); 24384.5(b)(1)

In order to claim the net interest deduction at the time the loan is originated, the loan must be made to a qualified business *located solely within* (and for an activity solely in connection with; see Section 6650) an EZ. Whether or not the debtor is engaged in a trade or business located solely within the enterprise zone is determined by examining:

- The physical location *and* use of the debtor's business assets.
- The physical locations at which the debtor's employees perform services for the debtor.

The presence of the qualified trade or business' payroll and tangible property exclusively within an EZ would be a strong indication that they meet the test. The

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fact that sales are delivered by common carrier outside of the EZ would not cause the borrower to fail the located solely within requirement.

Example: The debtor operates a retail convenience store located within the EZ as a sole proprietorship. The store conducts all of its business with its customers on a retail basis within the store. The store makes no deliveries. The creditor provides a loan to the debtor for upgrades to the store's refrigeration units. The loan qualifies the creditor to take the net interest deduction. The debtor operates a trade or business located solely within an EZ.

6650 Definition of "Activity Solely Within"

References 17235(b)(2); 24384.5(b)(2)

The indebtedness is incurred solely in connection with activity within the EZ. The borrowed funds must be used for the business activity entirely within the EZ.

6700 Net Interest Deduction - Computation

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.

6710 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 may be 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

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- 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)
- 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 described here, are for the use or forbearance of money and are considered to be 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.

* 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.

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6720 Cost of Funds

A reasonable amount of interest expense must be 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	7,000,000,000
Funding Sources	$46,000,000,000

$$\frac{\text{Total Interest Expense}}{\text{Funding Sources}} \quad \frac{\$\ 1{,}500{,}000{,}000}{\$46{,}000{,}000{,}000} = 3.26\%$$

Assume that an average principal amount of $10 million was outstanding during the year for loans made to businesses within an EZ. 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.

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6730 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 should not be subtracted for purposes of determining the net interest deduction.

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

6740 Non-Bank & 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 will be 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, must be 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 EZ 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.

6800 Expiration Of EZ Designation

References 17233; 24385

Generally, once the EZ designation expires, becomes inoperative, or ceases to exist, the net interest deduction is not allowed because the trade or business is no longer located within the designated EZ (See Section 1200 for a complete listing of expired EZs).

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However, for purposes of conditionally designated enterprise zones, wherein the conditionally designated zone includes the debtor's business location and the designation date of the new loan immediately follows the expiration of the new zone, the net interest deduction can continue as a qualified deduction amount under the new enterprise zone.

6900 Record Keeping

The qualified taxpayer/creditor should maintain records on each loan (loan agreements) for which a deduction of net interest is taken. The records should identify or describe:

- 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.
- Any property securing the loan.

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