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La. Taxpayers Deserve Opportunity To Support Deductions

By **Jaye Calhoun, William Kolarik and Michael McLoughlin** (December 8, 2020, 4:28 PM EST)

The Louisiana Department of Revenue has recently significantly increased its use of one of its corporate income tax regulations to disallow legitimate interest expense deductions. Clients have recently been reaching out to us concerned with outsized audit adjustments based on the disallowance of interest expense deductions clearly incurred to produce apportionable income.

Jaye Calhoun

Similar to other states, Louisiana law permits the department to attribute a taxpayer's interest expense deductions to different classes of income, e.g., nontaxable, allocable and apportionable income. As a result, a corporate taxpayer undergoing a Louisiana income tax audit is frequently confronted with preliminary workpapers that disallow interest expense deductions.

While these types of adjustments are not new, in the past it was not always a significant issue. More recently, it appears the department has begun to take a more aggressive approach with these adjustments.

William Kolarik

As it is developing, the department is relying on its interest expense attribution regulation more often to deny net operating loss carryforwards or otherwise significantly increasing apportionable income by disallowing interest expense deductions.

Often during the audit process, a taxpayer is not provided with a substantive opportunity to prove that the interest expense is directly attributable to the production of apportionable income and therefore properly deductible. When a taxpayer protests the unreasonableness of the denial of its interest expense deductions, the department typically denies the taxpayer's protest and notes that it is only following its regulation.

Michael McLoughlin

The department's refusal to reconsider whether its regulation was appropriately applied during the audit has created a backlog of otherwise unnecessary protests that have been filed by taxpayers, many of which now appear to be destined for the Board of Tax Appeals.

The department takes the position, based on what appears to be an incorrect interpretation of the applicable law, that it is not possible for a company to ever directly trace expenses to apportionable income because money is fungible. Therefore, interest expenses must always be indirectly traced to all classes of Louisiana income, i.e., apportionable, allocable and nontaxable, and taxpayers will be required to add back legitimate deductions that nonetheless, clearly relate to apportionable income.

This narrow reading of the state's expense allocation provisions, and the federal tax laws on which they are based, often produces incongruous results and assessments which, even auditors may agree, are not logical and don't make good business sense.

That being said, the department's regulations provide formulas that auditors feel bound to follow

even when the result is problematic and likely wrong, for example, where a corporate taxpayer is deemed to have incurred a very large amount of interest expense over a number of years in order to generate a very small amount of allocable income.

Such a result ignores the realities of how businesses operate under the premise of defeating tax arbitrage, even where no such attempt has been made.

Applicable Louisiana Law

The Louisiana corporation income tax is based on a corporation's Louisiana taxable income,[1] which is defined as "Louisiana net income, after adjustments, less the federal income tax deduction allowed by Louisiana Revised Statutes Section 47:287.85."[2]

The net income of a corporation is defined in Louisiana law as:

> the taxable income of the corporation computed in accordance with federal law for the same accounting period and under the same method of accounting, including statutorily required accounting adjustments, subject to the modifications specified.[3]

A taxpayer is allowed the same deductions allowed under Internal Revenue Code Section 163 unless a specific statutory modification exist under Louisiana law.

A multistate business operating in Louisiana is taxed on the combination of its Louisiana net apportionable income and its Louisiana net allocable income. In addition, Louisiana specifically exempts interest and dividend income from tax.[4]

Louisiana net apportionable income is calculated by subtracting the following amounts from the taxpayer's gross apportionable income:

- Expenses, losses and other allowable deductions which are directly attributable to gross apportionable income; and
- A ratable portion of allowable deductions which are not directly attributable to any item or class of gross income.[5]

Louisiana's interest expense attribution provisions are intended to prevent taxpayers from receiving a double tax benefit through engaging in a type of tax arbitrage, e.g., using borrowed capital to fund activities that produce nontaxable income while using equity capital to fund taxable operations.

Thus, the taxpayer would receive a deduction in determining state taxable income for interest expense incurred to generate income that is not subject to tax in the state. If the expenses related to generating tax-exempt income are deductible, the taxpayer may be able to generate a tax loss even when there has been an economic gain in the state.

While the policy of requiring an addback of expenses related to income not taxable in the state makes sense, and is adopted by many states, the department has taken such a narrow view of the statutory provisions addressing interest expense allocation, both in its regulations and on audit, that the end result is that taxpayers are paying tax on income that is simply not taxable under Louisiana law.

Interest Expense Attribution

The department determines the ratable portion of allowable deductions not directly attributable to any item or class of gross income under Louisiana Revised Statutes Title 47, Section 287.93(B)(2), based on its allocation regulation, Louisiana Administrative Code Title 61, Part I, Section 1130(B), which provides a formula for allocating interest expense within and without Louisiana.

The allocation regulation is based on the theory, taken from federal income tax law, that money is fungible and the debt of a multistate business will always be used, to some extent, to generate both

allocable and apportionable income.

Even though the allocation regulation is specifically limited by its title[6] to the computation of allocable income, the regulation states that the same formula for allocating interest expense also applies to deductions disallowed under Louisiana Revised Statutes Title 47, Section 287.81 as being related to nontaxable income.[7]

Under the asset-based formula for indirectly attributing expenses, interest expense is allocated through a ratio

> the numerator of which is the average value of assets that produce or that are held for the production of Louisiana allocable income and the denominator of which is the average value of assets that produce or that are held for the production of allocable income within and without Louisiana.[8]

The Louisiana expense attribution provisions outlined above are based on federal tax provisions aimed at preventing U.S. taxpayers from claiming deductions for amounts incurred to generate income not included in federal taxable income by the U.S.[9]

There are two Internal Revenue Code provisions on which the Louisiana law is based: Section 265, which addresses the treatment of interest expense incurred to generate income that is not taxed by the U.S., e.g., government bond income, as well as Internal Revenue Code Section 861, which addresses interest expenses related to income that would be taxable in the U.S. but is allocated outside of the U.S. based on the source of the income.

Application of Section 265

While the Louisiana law and regulations only specifically incorporate Section 861 by reference, it is clear that Internal Revenue Code Section 265 is the basis for attributing interest expense to nontaxable interest and dividend income in Louisiana.

While the application of Section 265 has not been addressed by the Louisiana courts, the application of Section 265 to a very similar California interest expense attribution provision was addressed in Appeal of Zenith National Insurance Corp.[10]

In Zenith, the California State Board of Equalization held that the fact that "Section 265(a)(2) and its supporting regulatory scheme concern the allocation of interest expense between taxable and nontaxable activities" indicates that it applies to California's expense attribution provisions even though Section 265 "by its terms, applies to tax exempt obligations and does not necessarily apply to [tax exempt income]."

On the other hand, Section 861 cannot be the basis for Louisiana's attribution of expenses to exempt dividend and interest income because it does not apply to tax exempt income. Therefore, it makes sense that the federal basis of Louisiana's attribution of interest expense to nontaxable income must be Section 265.

Because its Louisiana statutory counterpart appears to be based on this federal provision, the principles developed under Section 265 can be very helpful in interpreting the Louisiana statute so as to accomplish its objectives without taxing income that is simply not taxable by the state.

In fact, in applying Section 265 principles to California's comparable statute attributing expenses to nontaxable income, in Zenith, the Board of Equalization stated that it is necessary to "determine whether the totality of the facts and circumstances establish a sufficiently direct relationship between the borrowing and the investment to allow for a direct allocation between those two items."

Further, it was only required that the taxpayer establish that the dominant purpose for the borrowing was to generate taxable income in order to overcome the California Franchise Tax Board's assertion that the use of an indirect allocation method was required to attribute the expense to taxable and nontaxable income.

There is no reason that the principles espoused in the well-reasoned Zenith decision should not be

helpful to a Louisiana court interpreting the almost identical expense attribution provisions in Louisiana. But fundamentally, Louisiana can only tax income that has a connection with the state and, in fairness, a taxpayer must be given the opportunity on audit to demonstrate that the dominant purpose of a particular borrowing was to produce apportionable income.

The department's goal is to get it right under the law and, accordingly, the department serves taxpayers and the system best by never refusing to acknowledge the reality of any particular situation in which there is no tax avoidance motive and in which imposition of tax ignores both the letter and spirit of the federal law on which Louisiana law is based.

Application of Section 861

With respect to the attribution of interest expense to allocable income, the federal predicate for the Louisiana provisions, Section 861(b) addresses whether the expenses of a U.S. company with international operations are related to the production of U.S. income or foreign source income, i.e., it prevents a U.S. taxpayer from receiving a deduction for expenses paid that are related to non-U.S. activities that are not subject to U.S. income tax.

Section 861 provides that, from items of gross income specified as income from sources within the U.S., there shall be deducted the expenses, losses and other deductions properly apportioned or allocated thereto and a ratable part of any expenses, losses or other deductions which cannot definitely be allocated to some item or class of gross income.

The IRS regulations enumerate specific classes of gross income, e.g., rents, royalties, interest and compensation for services, to which a company's deductions must be allocated. The deductions can be directly allocated to a specific class of gross income or, in the alternative, the related federal regulations provide a mechanism for the allocation and apportionment of expenses among classes of income.

The department has narrowly interpreted Section 861 to require that indirect attribution always be used in regard to interest expense deductions based on the concept that money is fungible and a particular expense can never be attributed to a specific item of income. But this overly broad application of fungibility was struck down by the Board of Tax Appeals in Ampacet Corp. v. Cynthia Bridges, Secretary, Department of Revenue and Taxation.[11]

In Ampacet, the taxpayer borrowed the funds at issue to purchase industrial revenue bonds that were used to build a manufacturing facility in Deridder, Louisiana, and deducted the related interest expense in computing its net apportionable income in Louisiana. On audit, the department required the taxpayer to instead indirectly allocate the expense to all classes of income using the asset method set out in the regulations.

The board, however, found that an indirect attribution of the interest expense was not applicable to the industrial revenue bonds at issue because the taxpayer successfully demonstrated that the money was borrowed for a specific purpose and there were rules requiring that the money to be used for that purpose.

The board stated that if the taxpayer can demonstrate that the specified purpose for the borrowing was to generate a particular class of income, the expense can be directly traced to that income. While the department has since interpreted[12] the Ampacet decision to apply only to expenses related to industrial revenue bonds, there is no justification for the department's narrow view.

Such an interpretation is not supported by state law and directly conflicts the federal application of Section 861, which requires that a taxpayer be provided the opportunity to show that the specified purpose of the borrowing was to produce apportionable income. Only if the taxpayer cannot meet its burden of proof can the department require the use of an indirect attribution method.

Conclusion

While determining what amount of a company's interest expenses were incurred to produce a particular class of income may be complicated, the department needs to make every effort to get to the right result. It cannot fall back on administrative convenience and apply a one-size-fits-all

approach if this approach truly does not fit all.

Based on state and federal precedent, a taxpayer must be given the opportunity to prove that its interest expense can be directly traced to a particular class of income. The premise that money is fungible cannot support an assessment in which the result is an attempt to tax income that is not taxable by the state under applicable law.

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[1] La. R.S. 47:287.11(A).

[2] La. R.S. 47:287.69.

[3] La. R.S., 47:287.65.

[4] La. R.S. 47:287.93(A)(2) and La. R.S. 47:287.738(F). For the period July 1, 2015, through June 30, 2018, Louisiana only allowed a deduction for dividends equal to the amount of 72% of those dividends.

[5] La. R.S. 47:287.94(A).

[6] LAC 61:I.1130 is titled "Computation of Net Allocable Income from Louisiana Sources."

[7] LAC 61.I.1130(B)(1(d)(iv).

[8] LAC 61:I.1130(B).

[9] See Code Section 861 and the regulations thereunder.

[10] Appeal of Zenith National Insurance Corp., 98-SBE-001, 1998 WL 15204 (Cal. St. Bd. Of Equalization 1998). See also Apple, Inc. v. Franchise Tax Bd. 199 Cal.App.4th 1 (Cal. Ct. of App., First District 2011); Appeal of B.B.C.A.F. Inc., OTA Case No. 18011333, 2019 WL 5902553 (Cal.Off.Tax App. 2019).

[11] Ampacet Corp. v. Cynthia Bridges, Secretary of the Department of Revenue and Taxation, BTA Docket No. 4975 (Sept. 27, 2004).

[12] http://revenue.louisiana.gov/LawsPolicies/SOA05001.pdf.

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