Historical Note: Act 10 of the 2008 Second Extraordinary Session accelerated the phase out of borrowed capital from the franchise tax base as follows:

2008 income/2009 franchise tax return—44% of total debt included,
2009 income/2010 franchise tax return—30% of total debt included,
2010 income/2011 franchise tax return—no debt included.

Revenue Information Bulletin No. 05-026
October 12, 2005
Corporation Franchise Tax

Application of R.S. 47:605.1

Act 2 of the First Extraordinary Session, 2004, amended and reenacted R.S. 47:601(A), 602(A), (B), and (E)(1), 603(A), and 606(A) and (C); enacted R.S. 47:602(G) and 605.1, and repealed R.S. 47:601(D) and 603 to phase out the debt portion of the corporation franchise tax base. Act 355 of the 2005 Regular Session further amended R.S. 47:605.1. The portion of debt included in the taxable base for calendar year taxpayers will be:

2005 income/2006 franchise tax return—86% of total debt included,
2006 income/2007 franchise tax return—72% of total debt included,
2007 income/2008 franchise tax return—58% of total debt included,
2008 income/2009 franchise tax return—44% of total debt included,
2009 income/2010 franchise tax return—30% of total debt included,
2010 income/2011 franchise tax return—16% of total debt included,
2011 income/2012 franchise tax return and after—no debt included.

Fiscal year taxpayers will include the percent of debt indicated in the above chart for the franchise tax year in which their fiscal year begins. For example, for a fiscal year beginning February 1, 2006, eighty-six percent of total debt would be included in the taxable base.

While the concept of removing debt from the franchise tax base is simple, there is one significant complication. The complication is determining the total amount of debt on a taxpayer's books. When corporations form subsidiaries they have full control of how much is shown on the subsidiary's books as equity and how much is shown as debt. It is not unusual that the parent corporation will form the subsidiary by paying $1,000 for the stock of the subsidiary, and then show all future transfers of funds to the subsidiary as loans to the subsidiary. This is usually done for convenience, not for nefarious purposes. The problem this creates is that over time the books of the subsidiary may reflect amounts of debt that are several hundred or thousand times the amount of equity (capital stock and retained earnings). It has long been recognized that when this occurs, part of what is showing on the books of the subsidiary as debt is actually an equity investment by the parent. Legislation introduced in prior legislative sessions has included provisions similar to provisions in federal law to address the situation. However, those traditional ways of determining the actual amount of debt have the problem of being somewhat subjective. In Act 2 the Legislature desires to create a "bright line test" for determining the amount of debt that is actually equity. The removal of uncertainty is in the interest of both the State and taxpayers.

To that end, as part of Act 2, R.S. 47:605.1 was enacted. The section is effective January 1, 2006, and determines how much, if any, of amounts appearing on a corporation's books as debt owed to affiliates is to be considered equity investments by the affiliates for franchise tax purposes. If

the total of debt to all related parties exceeds capital stock and surplus and undivided profits, then fifty percent of the excess is removed from "debt" and reclassified as capital stock and surplus and undivided profits for franchise tax purposes.

The Section provides that in applying the provisions of R.S. 47:605.1:

- "Related Party" means any member of a controlled group of corporations as defined in 26 U.S.C. Section 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,
- "Debt" shall not include trade debt that is less than 180 days old,
- "Debt" shall not include deposit liabilities to related parties, and
- "Debt" shall not be reduced by receivables.

Application

The following example illustrates the application of R.S. 47:605.1.

Taxpayer XYZ, a calendar year taxpayer, has the following balance sheet on December 31, 2005:

Assets:	
Cash	$ 10,000
Accounts Receivable	$ 90,000
Loan to Related Party (ABC Corp.)	$ 10,000
Land, Buildings, Facilities	$100,000
Inventory	$ 10,000
Total assets	$220,000
Liabilities:	
Accounts Payable to Related Party (ABC Corp. Less than 180 days old)	$ 25,000
Accounts Payable to Related Party (DEF Corp. Over 180 days old)	$ 40,000
Accounts Payable to Unrelated Parties	$ 60,000
Security Deposit on Oxygen Cylinders:	
Related Party—ABC Corp.	$ 1,000
Unrelated Parties	$ 6,000
Mortgages on Facilities—Unrelated Parties	$ 48,000
Loan from Related Party (ABC Corp.)	$ 10,000
Capital Stock	$ 15,000
Retained Earnings	$ 15,000
Total Liabilities	$220,000

Before beginning to compute the franchise tax base the books of the corporation must be correct for franchise tax purposes. If necessary, the provisions of R.S. 47:605.1 are applied to reclassify items of debt. Only after the balance sheets have been corrected for franchise tax purposes is the franchise tax calculated.

In this example the comparison of debt to related parties with capital stock and surplus and undivided profits would be as follows:

Capital Stock, Surplus and Undivided Profits:

Capital Stock	$ 15,000
Surplus and Undivided Profits	$ 15,000
Total	$ 30,000

Debt to Related Parties:

Accounts Payable to DEF Corp.	$ 40,000
Loans from ABC Corp.	$ 10,000
Total	$ 50,000

In this case debt to related parties exceeds capital stock, surplus and undivided profits by $20,000. As a result, capital stock, surplus and undivided profits will be increased by $10,000 and debt will be decreased by $10,000 before further calculation of the franchise tax base begins. The restated liability section of the balance sheet could appear as:

	Original	**Adjustment**	**Adjusted**
Accounts Payable to Related Party (ABC Corp. Less than 180 days old)	$25,000		$25,000
Accounts Payable to Related Party (DEF Corp. Over 180 days old)	$40,000	<$10,000>	$30,000
Accounts Payable to Unrelated Parties	$60,000		$60,000
Security Deposit on Oxygen Cylinders:			
Related Party—ABC Corp.	$1,000		$1,000
Unrelated Parties	$6,000		$6,000
Mortgages on Facilities—Unrelated Parties	$48,000		$48,000
Loan from Related Party (ABC Corp.)	$10,000		$10,000
Capital Stock	$15,000	$10,000	$25,000
Retained Earnings	$15,000		$15,000
Total Liabilities	$220,000		$220,000

The specific item or items of debt and of capital stock, surplus and undivided profits adjusted do not matter as long as the items adjusted are items that would be included in the franchise tax base absent the phase out of debt. This taxpayer's December 31, 2005, balance sheet is used in computing its 2006 franchise tax which is imposed and computed on January 1, 2006. Only 86 percent of debt is included in the franchise tax base for this period, and the taxable base would be:

Liabilities		Debt Excluded 14%	Taxable Base
Accounts Payable to Related Party (ABC Corp.Less than 180 days old)	$25,000		
Accounts Payable to Related Party (DEF Corp.Over 180 days old)	$30,000	$4,200	$ 25,800
Accounts Payable to Unrelated Parties	$60,000		
Security Deposit on Oxygen Cylinders:			
Related Party—ABC Corp.	$1,000		
Unrelated Parties	$6,000		
Mortgages on Facilities—Unrelated Parties	$48,000	$6,720	$41,280
Loan from Related Party (ABC Corp.)	$10,000	$1,400	$8,600
Capital Stock	$25,000		$25,000
Retained Earnings	$15,000		$15,000
Total Liabilities	$220,000		$115,680

Cynthia Bridges
Secretary

History: July 6, 2004 (new document Revenue Information Bulletin No. 04-018); October 12, 2005 (Revenue Information Bulletin 05-026 issued to reflect amendment to La. Rev. Stat. Ann. § 47:605.1 by 2005 La. Acts 355).