Legislative Analysis

Mitchell Bean, Director
Phone: (517) 373-8080
http://www.house.mi.gov/hfa

MBT: DEDUCTIBILITY OF INTERCOMPANY INTEREST PAID TO FOREIGN RELATED ENTITIES

House Bill 6574
Sponsor: Rep. Steve Bieda
Committee: Tax Policy

Complete to 11-11-08

A SUMMARY OF HOUSE BILL 6574 AS INTRODUCED 10-15-08

The Michigan Business Tax Act generally requires that taxpayers add to their business income tax base, any royalty, interest, or other expenses paid to a related entity for use of an intangible asset, to the extent deducted in determining federal taxable income, if the related entity is not included in the taxpayers' unitary business group.

The act provides an exception to this add-back requirement if the transaction has a non-tax business purpose and is conducted at an arm's length, and complies with Sections 482 and 1274(d) of the Internal Revenue Code, 26 USC 482 and 26 USC 1274(d), and meets the other criteria.[1] Specifically, (1) the transaction must be a pass-through of another transaction between a third party and the related entity with comparable rates and terms, (2) the transaction must be taxable in another jurisdiction, or (3) the state treasurer must determine that the addition would be unreasonable given the facts and circumstances of the taxpayer.

House Bill 6574 would add a fourth qualifying criterion where the add-back would not be required—for transactions between related entities in cases where the recipient is organized under the laws of a foreign country that has a comprehensive income tax treaty with the U.S.

Reportedly, the general purpose of the existing add-back requirement is to prevent businesses from deducting interest expenses on intercompany transactions where interest rates do not meet the arm's length standard or where the related entity is not subject to taxation in Michigan. However, some contend that the current provisions do not fully consider interest expenses paid by a Michigan firm to its foreign parent company or affiliate during the normal course of business.

[1] Section 482 and related regulations (26 CFR 1.482) provide for the allocation of income and deductions among controlled groups. There are extensive provisions related to transfer pricing, which generally require that intercompany transactions be priced at an arm's length. Regulation 1.482-2(a) generally provides that when one member of a controlled group makes a loan to another member and charges no interest or charges interest at a rate other than an arm's length rate, the IRS may "make appropriate allocations" to reflect an arm's length rate. The regulations provide guidance on what constitutes an arm's length rate, which is based, in part, on the "applicable federal rate" calculated under Section 1274(d).

FISCAL IMPACT:

A fiscal analysis is in process.

Legislative Analyst: Mark Wolf
Fiscal Analyst: Rebecca Ross
Jim Stansell

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