

701—503.3(422) Application of related expense to allocable interest, dividends, rents and royalties—tax periods beginning on or after January 1, 1978. Rule 701—54.2(422) deals with the separation of “net” income; therefore, determination and application of related expenses must be made, as hereinafter directed, before allocation and apportionment within and without Iowa. Related expenses shall mean those expenses directly related, including related federal income taxes. *Allphin v. Joseph E. Seagram & Sons*, 204 S.W. 2d 515 (Ky. 1956). For tax periods beginning on or after January 1, 2000, related expense includes both directly related expense and indirectly related interest expense. The portion of interest expense indirectly related to allocable interest, other than interest from securities of states and their political subdivisions, dividends, rents and royalties shall be determined by multiplying the net amount of interest expense, after deducting interest directly related to an item of income, by a ratio. The numerator of the ratio is the average value of investments which produce or are held for the production of allocable interest, other than interest from securities of states and their political subdivisions, dividends, rents and royalties. The denominator is the average value of all assets of the taxpayer, less securities of states and their political subdivisions. (*Hunt-Wesson, Inc. v. Franchise Tax Board of California*, No. 98-2043 (U.S. Sup. Ct., filed February 22, 2000)).

A “directly related expense” shall mean an expense which can be specifically attributed to an item of income. Interest expense shall be considered directly related to a specific property which generates, has generated, or could reasonably have been expected to generate gross income if the existence of all of the facts and circumstances described below is established. Such facts and circumstances are as follows: (1) the indebtedness on which the interest was paid was specifically incurred for the purpose of purchasing, maintaining, or improving the specific property; (2) the proceeds of the borrowing were actually applied to the specified purpose; (3) the creditor can look only to the specific property (or any lease or other interest therein) as security for the loan; (4) it may be reasonably assumed that the return on or from the property will be sufficient to fulfill the terms and conditions of the loan agreement with respect to the amount and timing of payment of principal and interest; and (5) there are restrictions in the loan agreement on the disposal or use of the property consistent with the assumptions described in (3) and (4) above.

A deduction for interest may not be considered definitely related solely to specific property, even though the above facts and circumstances are present in form, if any of such facts and circumstances are not present in substance. Any expense directly or indirectly attributable to allocable interest, dividends, rents and royalties shall be deducted from such income to arrive at net allocable income.

EXAMPLE (i): For purposes of this example, it is assumed that the taxpayer has nonbusiness rental income. The taxpayer invests in a 20-story office building. Under the terms of the lease agreements, the taxpayer provides heat, electricity, janitorial services and maintenance. The taxpayer also pays the property taxes. Construction of the building was funded through borrowings which meet the criteria of a direct expense under the provisions of this paragraph. The directly related expenses to the operation of the property are:

Interest expense	\$1,200,000
Property taxes	500,000
Depreciation	500,000
Electricity	300,000
Heat	200,000
Insurance	150,000
Janitorial services	100,000
Repairs	50,000
Total expense	<u>\$3,000,000</u>

The directly related expense of the allocable nonbusiness rental income is \$3,000,000.

EXAMPLE (ii): For purposes of this example, it is assumed that the taxpayer has nonbusiness income. The taxpayer is a multistate manufacturer of processed foods. It has a nonbusiness investment portfolio which is managed by an investment firm for a fee. The fee paid for the management of the portfolio is a directly related expense to the dividends and interest income received. The fee is attributed to the various types of income on the ratio that the various types of income bear to the total income produced.

EXAMPLE (iii): Same as example (ii), except that in addition to the investments described, the taxpayer also has investments in oil properties. The depletion expense is a directly related expense to the oil royalty income.

This rule is intended to implement Iowa Code section 422.33.

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