

# BILL ANALYSIS

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Department, Board, Or Commission	Author	Bill Number
<b>Franchise Tax Board</b>	<b>Feuer</b>	<b>AB 1618</b>

## SUBJECT

Repeal Interest Offset

## SUMMARY

This Franchise Tax Board (FTB) sponsored bill would repeal a portion of a section of the Corporation Tax Law (CTL) declared unconstitutional by the United States Supreme Court.

## PURPOSE OF THE BILL

The purpose of this bill is to accomplish the following:

- Reflect the determination of the U.S. Supreme Court, and
- Remove grounds for constitutional challenges that the provision discriminates in favor of corporations domiciled in California.

## EFFECTIVE/OPERATIVE DATE

This bill, if enacted in 2007, would be effective and operative January 1, 2008.

## BACKGROUND

Corporations that do business both within and without California determine their net income attributable to California by dividing income into two classes:

1. Business income that is subject to apportionment by formula, and
2. Nonbusiness income that is allocated (assigned) to a specific state.

Corporations are allowed to deduct from their gross income the interest expense incurred on indebtedness to determine the net income of that corporation.

For purposes of determining the amount of income that is taxable in California, business income is apportioned to California based on an apportionment formula and nonbusiness income is generally assigned to California if the recipient's commercial domicile is California. Subdivision (b) of Revenue and Taxation Code (R&TC) section 24344 (interest offset provision) provides a mechanical dollar-for-dollar matching method for corporations to follow when allocating (or assigning) interest expense to specified types of gross income (i.e., business or nonbusiness income). Interest expenses allocated to a specified type of income reduces that income and the resulting tax liability of the corporation.

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### ***Hunt-Wesson***

On February 22, 2000, the U.S. Supreme Court, in *Hunt-Wesson, Inc. v. Franchise Tax Board* (2000) 528 U.S. 458, held that the interest offset provision is unconstitutional on facts specific to a non-California domiciliary corporation. The Court found that because the provisions of R&TC section 24344, subdivision (b), unreasonably assigned interest expense on a dollar-for-dollar basis to nonbusiness interest and dividends, the method prescribed by that subdivision resulted in taxation of extraterritorial income in violation of both the Commerce Clause and the Due Process Clause of the United States Constitution.

### **FTB Policy**

At its meeting on September 19, 2000, the FTB adopted a narrow interpretation of the *Hunt-Wesson* decision to do the following:

- Still apply the interest offset provision to corporations domiciled in California,
- Apply the regulations on allocating expenses to business and nonbusiness income to corporations domiciled outside of California.

### **Legislative Counsel Opinion**

On August 10, 2001, the California Legislative Counsel offered an opinion concerning the question of whether, in light of the U.S. Supreme Court decision in *Hunt-Wesson*, FTB may continue to enforce the interest offset provision. It was the opinion of the Legislative Counsel that the interest offset provision is void and FTB may not continue to apply the interest offset provision to California domiciled corporations or corporations domiciled outside of California.

## **ANALYSIS**

### **FEDERAL LAW**

Federal law generally allows a deduction for interest paid or accrued during the taxable year on a corporation's indebtedness. That deduction is reduced to the extent such interest expense is attributable to the production of tax-exempt income (e.g., interest incurred on a loan where the funds are used to purchase or carry tax-exempt obligations that generate tax-exempt interest).

Federal law lacks business/nonbusiness income concepts because those concepts were developed by the states in response to constitutional limitations on state taxation. Therefore, there are no requirements under federal law to make expense allocations between business and nonbusiness income. Federal law makes expense allocations between foreign (non-U.S.) and domestic income and, by regulation, uses methods similar to California law.<sup>1</sup>

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<sup>1</sup> California Code of Regulations (CCR), title 18, section 25120, subsection (d).

## STATE LAW

### Business/Nonbusiness Income

Under California law, a corporation deriving income from sources both within and outside California is required to measure its California tax liability by reference to income derived from or attributable to sources within California. The amount of income derived from California is calculated by first characterizing income as either business or nonbusiness.

**Business income** is defined as income arising from transactions and activities in the regular course of the corporation's trade or business<sup>2</sup>. To determine the portion of *business* income that is attributable to California, an apportionment formula is used. For most corporations, this formula is worldwide income multiplied by the average of the factors of property, payroll, and double-weighted sales. Each of these factors is the ratio of in-state activity to worldwide activity. Business income assigned to California is determined by multiplying total *business income* by the California apportionment percentage.

**Nonbusiness income** is all income that is not *business income*, and it is assigned by statute to a specific state. Nonbusiness income from intangible property is generally allocated to the taxpayer's commercial domicile.<sup>3</sup> Nonbusiness income from tangible property is generally allocated to the physical location of the property.

### Interest Expense

With certain limitations not relevant here, current state law provides a deduction for interest paid or accrued on the indebtedness of a corporation incurred in the production of income subject to taxation. An expense is deducted from gross income to determine net income. There are generally two methods used to assign interest expense to business and nonbusiness income: interest offset and direct tracing/proration method.

#### **Interest Offset Method**

At its meeting on September 19, 2000, the FTB adopted a narrow interpretation of the Hunt-Wesson decision and provided that the interest offset provision would still apply to California domiciled corporations. The interest offset provision requires interest expense to be deducted using the following rules in order:

1. Interest expense is deducted from business interest income.
2. To the extent the amount of interest expense exceeds the amount of business interest income, the excess is deducted from nonbusiness interest and dividend income.

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<sup>2</sup> This definition also includes income from tangible and intangible property if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations.

<sup>3</sup> Commercial domicile is defined in Revenue & Taxation Code section 25120, subdivision (b), to mean the principal place from which the trade or business of the taxpayer is directed or managed

3. If there is any remaining interest expense, it will be allowed as a deduction in computing net business income.

Appendix A provides an example illustrating the mechanics of the dollar-to-dollar matching interest offset method for assigning interest expense to business and nonbusiness income.

### **Direct Tracing/Proration Method**

In light of the *Hunt-Wesson* Court decision, corporations domiciled outside of California are required to use direct tracing or a proration method for assigning interest expense to business and nonbusiness income. Direct tracing involves actually tracing the interest expense specifically to business or nonbusiness income. To the extent that interest expense is applicable to both business and nonbusiness income, interest expense shall be prorated among business and nonbusiness income in a manner that fairly distributes the deduction.<sup>4</sup> The use of a proportional method will be accepted unless the corporation's method is unreasonable.

### **THIS BILL**

This bill would repeal the interest offset provision of the CTL to reflect the U.S. Supreme Court's decision in *Hunt-Wesson*.

### **OTHER STATES' INFORMATION**

The states surveyed include *Florida, Illinois, Massachusetts, Michigan, Minnesota, and New York*. These states were selected due to their similarities to California's economy, business entity types, and tax laws. These states lack a comparable provision to the California interest offset method of allocating interest expense to business and nonbusiness income.

*Illinois* provides that expenses attributable to nonbusiness income must be offset against the related nonbusiness income. If an expense is attributable to both business and nonbusiness income, the expense will be prorated in a manner that fairly distributes the expense to each class of income. *Illinois's* law is similar to California's direct tracing/proration method.

*Minnesota* disallows deductions for expenses associated with income that is exempt from taxation by Minnesota. If an expense is attributable to both taxable and non-taxable income, taxpayers must make a reasonable allocation to prorate the expense. *Minnesota's* law is similar to California's direct tracing/proration method.

*New York* allows for interest expense adjustments attributable to interest not previously deducted from federal taxable income.

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<sup>4</sup> CCR, tit. 18, § 25120, sub. (d).

**FISCAL IMPACT**

This bill would not significantly impact the department's costs.

**ECONOMIC IMPACT**

**Revenue Estimate**

Based on data and assumptions discussed below, this bill would generate the following revenue gains.

Estimated Revenue Impact of AB 1618 Operative for Taxable Years BOA 1/1/08 Enactment Assumed After 6/30/07		
2007-08	2008-09	2009-10
+ < \$250,000	+ \$1 Million	+ \$2 Million

Revenue Discussion

The revenue impact of this bill would be determined by the amount of interest expense assigned to business income that otherwise would be assigned to nonbusiness income under current departmental practice, and the average apportionment percentage for corporations with such interest expense.

Using the most recent corporate sample data (2004), the interest offset allocated to nonbusiness income allocable to California was identified on California Schedule R (Apportionment and Allocation of Income) of Form 100 (California Corporation Franchise or Income Tax Return). These amounts would be assigned to business income and apportioned rather than fully deducted under current departmental practice. Identified interest-offset amounts were multiplied by the average apportionment percentage of each corporation reporting such interest offset and multiplied by the franchise tax rate. This methodology derived a revenue gain of \$2 million at the 2004 level.

The annual taxable year gain of \$1.6 million was rounded to \$2 million and converted to the fiscal year cash flow estimate indicated in the table.

The California Legislative Counsel offered an opinion concerning the question of whether FTB should continue to enforce any portion of R&TC section 24344 in light of the U.S. Supreme Court decision in *Hunt-Wesson*. The role of the Legislative Counsel is to provide legal advice to the Legislature. It was the opinion of the Legislative Counsel that FTB may not continue to enforce any portion of R&TC section 24344, subdivision(b). Based on the Legislative Counsel's opinion, there would be no revenue change, because it is an unenforceable provision.

## **VOTES**

Assembly Floor – Ayes: 45, Noes: 33  
Senate Floor – Ayes: 22, Noes: 14

## **LEGISLATIVE STAFF CONTACT**

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**APPENDIX A  
INTEREST OFFSET METHOD  
AS CURRENTLY APPLIED TO CALIFORNIA-DOMICILED TAXPAYERS**

Facts

- Y Corporation is commercially domiciled in California
- Total interest expense = \$50 million
- Total business interest income = \$10 million
- Other business income = \$100 million
- Total nonbusiness interest and dividend income = \$35 million
- Other nonbusiness income = \$10 million
- California apportionment percentage = 75%

Interest offset rules of assigning interest expense

First Step:	Total interest expense	\$ 50 million
	Total business interest income	<u>( 10) million</u>
	Excess interest expense	<u>\$ 40 million</u>
Second Step:	Excess interest expense	\$ 40 million
	Match to nonbusiness interest and dividend income	<u>( 35) million (Interest Offset)</u>
	Excess interest expense	<u>\$ 5 million</u>
Third Step:	Excess interest expense of \$5 million is allowed as a deduction against other business income	

- \$15 million of interest expense is assigned to business income. (\$10 million plus \$5 million)
- \$35 million of interest expense is assigned to nonbusiness interest and dividend income.

Calculation of California taxable income

Other business income	\$ 100 million
Plus: business interest income	10 million
Less: Interest expense assigned to business income	<u>( 15) million</u>
Total net business income	\$ 95 million
Times: 75% apportionment	<u>x 75%</u>
Net business income apportioned to CA	\$ 71 million
Plus nonbusiness income:	
Other nonbusiness income	\$ 10 million
Nonbusiness interest & dividends	35 million
Less: Interest expense assigned to nonbusiness income	<u>( 35 ) million</u>
Total CA nonbusiness income	<u>10 million</u>
Total CA taxable income	<u>\$ 81 million</u>