

CALIFORNIA FRANCHISE TAX BOARD

Legal Ruling No. 129

June 20, 1958

INTEREST EQUIVALENT: EXEMPT INTEREST

Syllabus:

Constitutionally exempt income must be included in the computation of the interest equivalent under section 24121(b) of the 1954 Bank and Corporation Tax Law.

Taxpayer, a trust taxable under Chapter 3 of the Bank and Corporation Tax Law derives its entire income from California sources. Taxpayer erroneously included income of exempt United States Bond interest for the 1951 tax year for which a claim was filed, also during the same year certain interest expense was deducted. Advice is requested whether exempt interest income may be used to measure the amount of interest expense not deductible under section 24121(b) of the Bank and Corporation Tax Law.

Section 7(b) of the Corporation Income Tax Act (section 24121(b) of the 1954 Bank and Corporation Tax Law) was enacted in 1937. The purpose of the limiting provisions of this section was to eliminate a double exemption which certain foreign corporations were obtaining by investing their own funds in nontaxable securities and borrowing money to finance operations. The inequity to be corrected lay in the fact that a corporation would not dispose of its intangible investments to finance its business operations and thus eliminate the interest expense being deducted. For this reason the Legislature had no intention of excluding constitutionally exempt income from the computation under Section 7(b). Therefore, the word "exempt" as used in this section encompasses all income not includible in taxable income, and not merely income with a situs outside this state. A contrary conclusion would be difficult in view of the provision of Section 6(b)(3) which defined "exempt" income to include income constitutionally exempt from tax.

The same result follows for the years in which section 24121(b) was operative and under it constitutionally exempt income is not excluded in the interest equivalent computation. Therefore, such interest income may be used to measure the amount of interest expense not deductible under section 24121(b).