

CALIFORNIA FRANCHISE TAX BOARD

Legal Ruling No. 424

August 3, 1983

MODIFICATION OF LR-374

Syllabus:

Legal Ruling 374 discussed the deductibility of interest expense by a parent corporation, a California taxpayer, when an indebtedness which gave rise to an interest deduction was incurred for the purpose of acquiring nonunitary subsidiaries. In reaching its conclusion, the prior ruling considered the application of Revenue and Taxation Code Sections 24438, 24425, and 24344(b).

Reconsideration of the prior conclusion was requested. The prior ruling, after summarizing the application of Section 24438, concluded that Section 24344 controlled, but that Section 24425 would be applied to disallow interest expense allocable to any class of income not included in the measure of tax.

Question:

If a taxpayer's income is determined by the application of Section 25101 (income derived from sources within and without this state), is the amount of interest deductible limited by Section 24425 if all income of the taxpayer is business or nonbusiness income as defined in Section 25120 of the Revenue and Taxation Code, i.e., not exempt from the taxes imposed by this part?

Decision:

No. The amount of interest deductible for such taxpayers is determined by the application of Section 24344(b). See discussion.

Discussion:

Section 24438, as provided in Legal Ruling 374, resolves the deductibility of certain interest expenses for "corporate acquisition indebtedness" incurred after December 31, 1970, in excess of \$5,000,000. The section is applied as summarized therein.

The predecessor to Section 24344(b) was added in 1937, Ch. 836 (8(b)). At the time the section was added, the predecessor of Section 24425 existed, and provided no deduction is allowed for any amount otherwise allowable as a deduction which is allocable to one or more classes of income not included in the measure of the tax imposed by this act (Sec. 8 bas enacted by Stats. 1929, p. 24). The purpose of the 1937 amendment to what is now Section 24344(b) is

explained in Altman and Keesling Allocation of Income In State Taxation, 2nd Ed 1950, pp 182-185, summarized as follows:

Example:

A corporation is incorporated under the laws of State "X" where it has its principal place of business. It does business in a number of states including State "Y." Its net income in a particular year, computed without any deduction for interest, amounts to \$1,000,000. Under the method of apportionment employed in State "Y," one-half or \$500,000 of the income would be attributed to the business conducted in that state. The company has, from time to time, borrowed money, either from a bank, through issuance of bonds, or otherwise, and consequently has an interest expense of \$900,000. It has also, from time to time, purchased stocks and bonds of other corporations from which it derives a net income of \$800,000. The corporation is a foreign corporation as far as State "Y" is concerned, and under the laws and regulations in effect in that state the income from intangibles, i.e., stocks and bonds, is segregated from the total income and allocated to State "X." Under these circumstances, how much of the interest expense should be considered an expense of carrying on the business allowable as a deduction in computing the net income to be apportioned among the states in which the business is conducted?

It may be contended that the answer to this question depends on the purpose for which the interest expense was incurred. Thus, to the extent the money was borrowed for financing the company's business activities, the interest would be considered a deduction in arriving at apportionable income. On the other hand, to the extent the money was borrowed to purchase stocks and bonds, the interest would be considered an expense of earning the income therefrom. This contention, if followed, would give rise to serious administrative difficulties in determining the precise purpose for which the interest expense was incurred. Such a determination would at least require a laborious and detailed analysis of the corporation's entire financial history. Even such an analysis might leave open many questions which could be answered only on the basis of hypothesis and conjecture, particularly where the financial transactions are involved and extended over a number of years.

Two of the states, however, California and Wisconsin, have amended their laws specifically to provide that in cases of this character interest is deductible only to the extent in excess of income from intangibles not subject to tax. If such a provision were in force in State "Y" in the above example, only \$100,000 of the interest expense, i.e., the extent to which the \$900,000 interest expense exceeds the \$800,000 income from intangibles not taxable by State "Y," would be deductible in computing the apportionable business income; hence, the net business income would amount to \$900,000 (\$1,000,000 minus \$100,000), half or \$450,000 of which would be attributable to State "Y." Without such a provision the entire interest expense might be deductible, provided the taxpayer could establish that as a matter of financial history the money was borrowed to

finance the company's business activities. If so, the apportionable income would be only \$100,000 (\$1,000,000 minus \$900,000 interest expenses) and hence only half or \$50,000 thereof would be attributable to State "X."

Section 24344(b) was substantially revised in 1957. However, the purpose of the 1957 amendment was to equalize the amount of interest deductible by corporations deriving income from sources within and without this state regardless of the place of their principal location and the amendment did not change the purpose of the 1937 amendment.

In view of the fact that the basic purpose of the section was to provide a statutory formula for matching income and expenses, it is concluded that if a corporation derives income from sources within and without this state, its interest deduction is provided for by Section 24344(b), subject of course to the limitations imposed by Section 24438. It is Section 24344(b) which attributes interest expense first to interest income subject to apportionment, then to dividend and interest income not subject to apportionment, and the balance, if any, is then deductible from income subject to apportionment. Thus, Section 24344(b) accounts for, matches, and provides for the deduction of all deductible interest expense.

It is noted that in the Appeal of Signal International, Cal. St. Bd. of Equal., January 4, 1966, CCH 203-151, P-H 13,379, it was concluded that Section 24425 controlled over Section 24344(b). The results of that decision are correct because all income was either derived "without California" or "within California." If, however, the income had been derived from sources "within and without" California so that income was subject to apportionment, it is concluded that Section 24344(b) would have controlled.

In view of the above, Legal Ruling 374 is hereby modified insofar as it would apply to Section 24425 with respect to income derived from sources within and without this state.