

**STAFF REQUEST FOR PERMISSION TO PROCEED ON PROPOSED CHANGES  
TO CALIFORNIA CODE OF REGULATIONS, TITLE 18, SECTION 24344(c) --  
OFFSET OF INTEREST EXPENSE INCURRED FOR FOREIGN INVESTMENT**

Pursuant to Board Resolution 98-7, staff is requesting permission of the Board to notice proposed changes to California Code of Regulations, title 18, section 24344(c).

The primary proposed change is to the definition of "commonly controlled group" as used in the current regulation. The current definition of "commonly controlled group" was based upon the prior version of Revenue and Taxation Code section 25105 and the case law decided thereunder. Revenue and Taxation Code section 25105 was amended in 1994 to provide a statutory standard to replace the judicial and administrative interpretations of what constitutes a "commonly controlled group." Additionally, Revenue and Taxation Code sections 24411 and 25110 and the regulations thereunder, relating to the computation of the California tax liability of a unitary group the members of which are affiliated with foreign corporations, have been amended to refer to Revenue and Taxation Code section 25105 rather than to set forth a separate definition of a "commonly controlled group."

In addition, staff proposes one minor clarifying change. California Code of Regulations, title 18, sections 24344 (c)(2)(A)1.a. and b., currently define a foreign investment for purposes of the regulation as stock or other equity investment in "a. an entity whose dividends would be qualifying dividends for purposes of Revenue and Taxation Code section 24411, and b. a nonaffiliated corporation which is organized under the laws of a country or political subdivision of a country other than the United States." However, these two types of entities are mutually exclusive such that there could not be an investment that satisfied both requirements. Consequently, the proposed change would substitute the word "or" for "and."

Staff believes that the proposed changes to the existing regulation involve only procedural matters and should not raise substantive objections. Therefore, staff requests the Board's permission to proceed directly to the formal regulatory process without the scheduling of a symposium.

March 6, 2002

Section 24344(c) is amended to read:

Section 24344(c). Offset of Interest Expense Incurred for Foreign Investment.

(1) General. Revenue and Taxation Code section 24344 relates generally to the deductibility of interest expense. Revenue and Taxation Code section 24344, subdivision (c)(1), provides that interest expense allowable pursuant to Internal Revenue Code section 163 that is incurred for purposes of foreign investment may be offset against dividends deductible pursuant to Revenue and Taxation Code section 24411. Because all business activities require funds, and common ownership allows a business's management substantial flexibility both as to the source of funds and as to the use of funds, it is difficult if not impossible to specifically assign the cost of funds to specific activities. Normally, creditors of a taxpayer subject the money advanced to the taxpayer to the risk of the taxpayer's entire activities and look to the general credit of the taxpayer for payment of the debt. When money is borrowed for a specific purpose, such borrowing will generally free other funds for other purposes, and it is reasonable to attribute part of the cost of borrowing to such other purposes. Interest expense shall therefore be attributed to foreign investment pursuant to the rules set forth in subsection (3) of this regulation.

(2) Definitions.

(A) Foreign investment.

1. Except as provided in subsection (2)(A) 3. of this regulation, for purposes of this regulation foreign investment means stock or other equity investment, regardless of when it was made, in:

a. an entity whose dividends would be qualifying dividends for purposes of Revenue and Taxation Code section 24411, **or**

b. a nonaffiliated corporation which is organized under the laws of a country or political subdivision of a country other than the United States.

2. Foreign investment includes only that portion of the equity described in subsections (2)(A) 1.a. and 1.b. of this regulation which is included in total assets pursuant to subsection (2)(C) of this regulation.

(B) Interest expense. Except as provided in subsection (2)(B) 3. of this regulation, for purposes of this regulation, interest expense includes:

1. all allowable interest expense incurred or paid within the taxable year by a corporation included in a combined report by reason of Revenue and Taxation Code section 25110, subdivisions (a)(1), (2), (3) or (5), and

2. a portion of the interest expense incurred or paid within the taxable year by a corporation, a portion of whose net income and apportionment factors are included in a

combined report by reference to Revenue and Taxation Code section 25110, subdivisions (a)(4), (6) or (7)(B).

a. For purposes of a corporation described in Revenue and Taxation Code section 25110, subdivisions (a)(4) or (7)(B), such portion will be the interest expense reflected on the books of account maintained with respect to the activities conducted within the United States.

b. For purposes of a corporation described in Revenue and Taxation Code section 25110, subdivision (a)(6), such portion shall bear the same relationship to its total interest expense as the portion of the income of such corporation taken into account under Revenue and Taxation Code section 25110 bears to its total income.

3. Notwithstanding subsections (2)(B) 1. and 2. of this regulation, intercompany accounts of interest of a corporation in a second corporation will be eliminated from total interest expense to the extent that the second corporation is included in the combined report. In making such elimination, the provisions of California Code of Regulations, title 18, section 25106.5-1, will be followed.

(C) Total assets. Except as provided in subsection (2)(C) 3. of this regulation, for purposes of this regulation “total assets” includes:

1. all of the assets of a corporation included in a combined report by reason of Revenue and Taxation Code section 25110, subdivisions (a)(1), (2), (3), or (5), and

2. a portion of the assets of a corporation, a portion of whose net income and apportionment factors are included in a combined report by reference to Revenue and Taxation Code section 25110, subdivision (a)(4), (6) or (7)(B).

a. For purposes of a corporation described in Revenue and Taxation Code section 25110, subdivisions (a)(4) or (7)(B), such portion will be the total assets reflected on the books of account maintained with respect to the activities conducted within the United States.

b. For purposes of a corporation described in Revenue and Taxation Code section 25110, subdivision (a)(6), such portion shall bear the same relationship to its total assets as the portion of the income of such corporation taken into account under Revenue and Taxation Code section 25110, bears to its total income.

3. Notwithstanding subsections (2)(C) 1. and 2. of this regulation, intercompany accounts of assets, including equities, of a corporation in a second corporation will be eliminated from total assets to the extent that the second corporation is included in the combined report. In making such elimination, the provisions of California Code of Regulations, title 18, section 25106.5-1, will be followed.

4. Assets relating to both business and nonbusiness income will be considered in total assets.

(D) Member of the water's-edge group. A member of the water's-edge group is an entity which is described in Revenue and Taxation Code section 25110, subdivision (a), whose income and apportionment factors are to be taken into account in computing the taxpayer's income derived from or attributable to sources within California. Entities which are described in Revenue and Taxation Code section 25110 must be affiliated and, in general, include corporations incorporated in the United States, corporations incorporated without the United States but with 20 percent or more of the average of their property, payroll and sales in the United States, DISC's and FSC's, export trade corporations, foreign incorporated banks, or foreign corporations with less than 20 percent of the average of their property, payroll and sales in the United States to the extent such entities are within the United States or have Subpart F income. For a more specific description, see Revenue and Taxation Code section 25110 and the regulations adopted pursuant thereto.

(E) United States. For purposes of this section, the "United States" means each of the states of the United States and the District of Columbia.

(F) Dividends deductible under section 24411. For purposes of Revenue and Taxation Code section 24344, subdivision (c), "dividends deductible under section 24411" means the deduction calculated pursuant to Revenue and Taxation Code section 24411, subdivision (a). It does not mean qualifying dividends as used in Revenue and Taxation Code section 24411.

(G) Affiliated corporation. An "affiliated corporation" is **a corporation that is a member of a commonly controlled group as defined by Revenue and Taxation Code section 25105.**

*EXAMPLE 1:*

Corporation A owns 60% of Corporation B's voting stock and 30% of Corporation C's voting stock. Corporation B owns 30% of Corporation C's voting stock. A, B and C are affiliated.

*EXAMPLE 2:*

Corporation A owns 40% of Corporation B's voting stock and 30% of Corporation C's voting stock. Corporation B owns 60% of Corporation C's stock. A is not affiliated with B and C.

(3) Calculation of amount to be offset.

(A) Calculation of interest. The amount of interest expense attributable to foreign investment shall be equal to the amount of interest expense specifically assignable to foreign investment pursuant to subsection (4) of this regulation plus the amount of interest expense assigned to foreign investment pursuant to subsection (5) of this regulation, but in no event any

amount greater than the total deduction allowed for the taxable year pursuant to Revenue and Taxation Code section 24411. If no deduction is allowed pursuant to Revenue and Taxation Code section 24411, no interest will be offset pursuant to Revenue and Taxation Code section 24344, subdivision (c).

(B) Amount of offset.

1. For taxable years beginning prior to January 1, 1997, the amount of interest expense calculated pursuant to subsection (3)(A) of this regulation shall be offset against the dividend deduction allowed pursuant to Revenue and Taxation Code section 24411, and shall not otherwise be taken into account in computing the taxpayer's net income derived from or attributable to sources within California.

2. For taxable years beginning on or after January 1, 1997, the amount of interest expense calculated pursuant to subsection (3)(A) shall be multiplied by the same percentage used to determine the dividend deduction pursuant to Revenue and Taxation Code section 24411, to determine the amount of interest that shall be offset against dividends deductible pursuant to section 24411, and that amount shall not otherwise be taken into account in computing the taxpayer's net income derived from or attributable to sources within California.

(C) Amount in excess of offset. To the extent interest expense assignable to foreign investment as calculated pursuant to subsections (4) and (5) of this regulation exceeds the total deduction allowed for the income year pursuant to Section 24411 of the Revenue and Taxation Code, it shall be subject to the applicable provisions Revenue and Taxation Code section 24344..

EXAMPLE 1: Corporation A has interest expense of \$100, of which \$15 is assignable to foreign investment pursuant to subsections (4) and (5) of this regulation.

A receives qualifying dividends in the amount of \$10 of which \$7.50 ( $\$10 \times 75\% = \$7.50$ ) is deductible pursuant to Revenue and Taxation Code section 24411.

For taxable years beginning prior to January 1, 1997, the amount of interest offset pursuant to Revenue and Taxation Code section 24344, subdivision (c), shall be \$7.50.

For taxable years beginning on or after January 1, 1997, the amount of interest offset pursuant to Revenue and Taxation Code section 24344(c) shall be \$5.63.

Qualifying dividends defined in Revenue and Taxation Code section 24411	\$ 10
Multiply by applicable section 24411 percentage	75%
Equals dividends deductible under section 24411	\$7.50
Interest expense assignable to foreign investments	\$15
Enter lesser of dividend deductible under section 24411 or interest expense assignable to foreign investments	\$7.50
Multiply by applicable section 24411 percentage	75%
Equals section 24344 (c) foreign investment interest offset	\$5.63

EXAMPLE 2. Assume the same facts as in Example 1, except Corporation A receives qualifying dividends of \$30, of which \$22.50 ( $\$30 \times 75\% = \$22.50$ ) is deductible pursuant to Revenue and Taxation Code section 24411.

For taxable years beginning prior to January 1, 1997, the amount of interest expense pursuant to Revenue and Taxation Code section 24344, subdivision (c), shall be \$15.

For taxable years beginning on or after January 1, 1997, the amount of interest offset pursuant to Revenue and Taxation Code section 24344, subdivision (c), shall be \$11.25.

Qualifying dividends defined in section 24411	\$ 30
Multiply by applicable section 24411 percentage	75%
Equals dividends deductible under section 24411	\$ 22.50
Interest expense assignable to foreign investments	\$ 15
Enter lesser of dividend deductible under section 24411 or interest expense assignable to foreign investments	\$ 15
Multiply by applicable section 24411 percentage	75%
Equals section 24344 (c) foreign investment interest offset	\$ 11.25

(4) Allocation of interest to specific property.

(A) If the existence of all of the facts and circumstances described below is established, interest expense shall be considered to be related solely to specific property, which may be either a foreign investment or other property.

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; and,
3. The creditor can look only to the specific property (or any lease or other interest therein) as security for payment of the principal and interest of the loan and, thus, has no secured interest in any other property of the borrower or the borrower itself with respect to repayment of the loan.

Even though the above facts and circumstances are present in substance as well as in form, a deduction for interest shall not be considered definitely related to specific property where the motive for structuring the transaction in the manner described above was without any economic significance.

(B) Exclusion. Where an interest deduction is definitely related solely to specific property pursuant to subsection (4)(A) of this regulation, such interest deduction and such property, or the portion thereof to which such interest deduction relates, shall not be included in the allocation described in subsection (5) of this regulation.

(5) Otherwise unassigned interest expense attributable to foreign investment. The amount of unassigned interest expense attributable to foreign investment shall be calculated in the following manner.

(A) Otherwise unassigned interest. Otherwise unassigned interest expense shall be calculated by reducing total allowable interest expense by the amount specifically assigned pursuant to subsection (4) of this regulation.

(B) Interest expense paid on debt incurred prior to January 1, 1988. Otherwise unassigned interest expense paid on debt incurred prior to January 1, 1988 shall be assigned as follows:

1. Assignment to foreign investment. The amount calculated pursuant to subsection (5)(A) of this regulation shall be multiplied by the ratio of the value of foreign investment to the total value of all assets as determined pursuant to subsection (6) of this regulation.

2. Assets not considered. In calculating the ratio required by subsection (5)(B), foreign investment and assets to which interest expense has been specifically assigned pursuant to subsection (4) of this regulation shall not be considered.

EXAMPLE: Corporation A has total interest expense of \$1,200. Specifically assigned interest expense is \$200. A has foreign investments valued at \$500 and total assets valued at \$5,600. The \$200 of specifically assigned interest expense relates to assets of \$600, none of which is foreign investment. Corporation A receives qualifying dividends as defined by Revenue and Taxation Code section 24411 of \$50 of which \$37.50 ( $\$50 \text{ dividends} \times 75\% = \$37.50$ ) is deductible.

The amount of unassigned interest expense attributable to foreign investment is calculated as follows: total interest expense less specifically assigned interest expense equals unassigned interest expense ( $\$1,200 - \$200 = \$1,000$ ). Unassigned interest expense multiplied by the ratio of the value of unassigned foreign investment to the value of unassigned total assets equals Interest Expense Assignable to foreign investment ( $\$1,000 \times (\$500/\$5,000) = \$100$ ).

The amount of unassigned interest expense subject to offset against dividends deductible pursuant to Revenue and Taxation Code section 24411 is \$100.

Only \$37.50 of the qualifying dividends received was deductible pursuant to Revenue and Taxation Code section 24411.

For taxable years beginning prior to January 1, 1997, the interest offset pursuant to Revenue and Taxation Code section 24344, subdivision (c), is limited to \$37.50 (the lesser of the \$100 interest expense assignable to foreign investment or \$37.50 dividend deductible pursuant to Revenue and Taxation Code section 24411).

For taxable years beginning on or after January 1, 1997, the interest offset pursuant to Revenue and Taxation Code section 24344, subdivision (c), is limited to \$28.13.

Qualifying dividends defined in Revenue and Taxation Code section 24411	\$50
Multiply by applicable section 24411 percentage	75%
Equals dividends deductible under section 24411	\$37.50
Interest expense assignable to foreign investments	\$100
Enter lesser of dividend deductible under section 24411 or interest expense assignable to foreign investments	\$37.50
Multiply by applicable section 24411 percentage	75%
Equals section 24344 (c) foreign investment interest offset	\$28.13

(C) Interest expense paid on new debt incurred on or after January 1, 1988.

Otherwise unassigned interest expense paid with respect to debt incurred on or after January 1, 1988, shall be assigned pursuant to subsection (5)(B) of this regulation except for interest expense paid with respect to the proceeds of debt which is paid into an account which is restricted as to its purpose so as to preclude its use for foreign investment and which account is not in fact used for foreign investment. Debt, the majority of which was used to refinance debt incurred prior to January 1, 1988, or debt arising pursuant to a line of credit or similar account or arrangement, shall not be treated as debt incurred on or after January 1, 1988.

1. Use of funds deposited in such restricted account for purposes of foreign investment shall cause the account to be viewed as unrestricted only for the year in which such use occurs.

2. The transfer of funds to or through an unrestricted account or accounts from which proceeds are disbursed for purposes of foreign investment within 60 days, both prior to and subsequent to, of the transfer shall be disregarded and the disbursement shall be treated as being made from the restricted account and shall be subject to the provisions of subsection (5)(C) 1. of this regulation.

(6) Asset value. A deduction for interest expense relates more closely to the amount of capital utilized or invested in an activity or property than to the gross income generated therefrom; therefore, the deduction for interest shall be apportioned on the basis of asset values.

(A) Assets other than stock or other equity investment. For purposes of this regulation, all assets other than stock in an affiliated corporation shall be taken into account at federal tax book value (original cost for federal tax purposes less depreciation, amortization or depletion allowed for such purposes).

(B) Stock or other equity investment. For purposes of this regulation, stock or other equity investment in an affiliated corporation shall be taken into account at its adjusted basis for federal tax purposes--

1. increased by the amount of the earnings and profits of such corporation attributable to such stock or other equity investment and accumulated during the period the stock or other equity investment was owned by another affiliated corporation, or

2. reduced (but not below zero) by any deficit in earnings and profits of such corporation attributable to such stock or other equity investment for such period.

(C) Average values of assets. For purposes of determining values of assets under subsection (6)(C) of this regulation, an average of values shall be computed for the year on the basis of values of assets at the beginning and end of the year. The Franchise Tax Board may permit or require the averaging of monthly values during the taxable year if reasonably required to reflect properly the average value of the assets of the corporation included in a combined report.

Note: Authority cited: Section 19503, Revenue and Taxation Code.  
Reference cited: Section 24344, Revenue and Taxation Code.

March 6, 2002