

DISCUSSION POINTS REGARDING INTEREST OFFSET GUIDELINES

(a) Basic Principles.

(1) Staff will not enforce the interest offset.

(2) Where appropriate, some interest expense will continue to be assigned to nonbusiness income. The authority for making the interest expense allocation is found in subsection (d) of Regulation section 25120.

(3) Assignment of interest will be done on a group basis. The residual nonbusiness interest expense will be assigned to the nonbusiness income or asset(s) to which it is allocated.

(4) If direct tracing (of the type described in *Appeal of Zenith National Insurance Corp.*, 98-SBE-001, Jan. 8, 1998) can be accomplished, that is the appropriate method of assigning interest expense. Direct tracing must be established through affirmative evidence (e.g., the absence of direct loans with respect to the acquisition of nonbusiness assets does not establish that all interest expenses are allocable to business assets). To the extent that interest cannot be directly traced, a proportional method, such as the ratio of gross income (as defined under Treasury Regulation section 1.861-2(c)(4)) or ratio of assets (as provided by Regulation section 24344(c)(6)), will be used, depending on the facts and circumstances of the case. Facts and circumstances to consider include materiality and whether assets are generating receipts on a proportional basis.

(5) The taxpayer's use of a particular proportional method will be accepted unless staff can show that the taxpayer's method is unreasonable. Use of a proportional asset rule as provided by Regulation section 24344(c)(6) is presumed to be reasonable.

(6) Direct tracing is a facts and circumstances inquiry; therefore, it is possible that a change in circumstances will give rise to the use or non-use of direct tracing (see e.g., *Appeal of Zenith National Insurance Corp.*, supra).

(b) Current inventory.

(1) Audit. Staff will not conduct re-audits based solely on interest offset. The interest offset issue will be raised during the normal course of an audit and adjustments made in accordance with the Guidelines set forth above.

(2) Protests. Staff will not raise the interest offset issue to set off unrelated protested issues. However, because interest offset or expense allocation is a transactionally related adjustment to the business/nonbusiness classification of income,

it will be raised when that classification issue is involved in the protest. If the taxpayer raises interest offset as a new issue, staff may also raise other issues. Similarly, if the taxpayer raises other new issues, staff can raise the interest offset issue.

(3) Claims.

(A) The interest offset/allocation issue can be raised to reduce a claim for refund.

(B) Existing claims which have raised the interest offset issue will be allowed with an adjustment made under direct tracing and/or proportional allocation. To the extent information exists to make an asset allocation, that will be used as the preferred proportional allocation method. If asset allocation information is not available, a gross income allocation method will be used.

(C) Existing claims cannot be amended to include an interest offset issue unless the statute for filing a claim is otherwise open.

(c) Future.

(1) The issue of matching nonbusiness income and expense will be addressed by amending the combined report regulations and/or subsection (d) of Regulation section 25120. The regulation process will allow public comment. The above Guidelines are intended to apply to the current inventory of cases and will not be binding for purposes of drafting any regulations or regulatory amendments.

(2) The department will issue a public notice as to how it intends to treat existing claims pending adoption of a regulation.