



Franchise Tax Board's Attempt to Apply Expense Attribution is Soundly Rejected

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In a significant taxpayer victory involving expense attribution issues, the California State Board of Equalization ("SBE"), in the *Appeal of Beneficial California, Inc.*, No. 203445, CCH California Tax Rptr. ¶ 403-851, rejected the Franchise Tax Board's ("FTB") attempt to disallow interest expense deductions solely because the taxpayer received deductible dividends from an insurance affiliate.

On August 31, 2005, the SBE heard an appeal by Beneficial California, Inc., a subsidiary of Beneficial Corporation, of the denial of claims for refund of California corporation franchise tax for 1987-1989. The appeal, which was handled by the authors, involved expense attribution issues and presented the question whether Revenue and Taxation Code ("RTC") section 24425 should be applied to disallow interest expense deductions given the facts and circumstances of the case.

RTC section 24425 provides that no deduction shall be 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 part, regardless of whether such income was received or accrued during the taxable year.

The purpose of RTC section 24425 is to prevent taxpayers from receiving a double benefit. Expenses which are incurred to generate nontaxable income should not be deductible. In *Beneficial*, no such double benefit existed because the uncontroverted evidence demonstrated that none of the interest expense at issue was incurred to produce the deductible dividends.

During the appeal years, Beneficial, which was engaged in the consumer finance business, received dividends from its wholly owned insurance subsidiary, the Central National Life Insurance Company of Omaha ("CNL"). Subsequent to the decision in *Ceridian Corp. v. Franchise Tax Board*, 85 Cal.App.4th 875 (2000), a full dividends received deduction under RTC section 24410 was allowed by the FTB at protest. However, the FTB then took the position that a portion of the unitary group's interest expense was allocable to the CNL dividends and

thus no longer deductible under RTC section 24425. In determining what portion should be disallowed, the FTB applied an asset-based formula times the unitary group's interest expense.

Beneficial disagreed and asserted that under the facts and circumstances of the case and the SBE's 1998 decision in *Appeal of Zenith National Insurance Corp.*, 98-SBE-001 (June 25, 1998), no portion of the Beneficial unitary group's interest expense should be disallowed. Beneficial presented uncontroverted evidence that none of the interest expense was incurred to produce the CNL dividends. There was no direct or indirect connection between Beneficial's borrowing and CNL. There were several key facts: (1) CNL, which Beneficial owned for nearly 30 years, was an integral part of Beneficial's unitary operations; (2) CNL was self-sufficient and extremely profitable and did not need nor obtain funds from Beneficial's unitary group or from third parties; (3) there was no flow of funds from Beneficial to CNL as there were no loans, advances, capital contributions, guarantees or letters of credit from Beneficial to CNL; (4) Beneficial did not use CNL as collateral for any of its borrowings; (5) Beneficial relied on CNL's dividends, which averaged \$34 million per year from 1981-1998, to reduce its overall borrowings; and (6) the dominant purpose of Beneficial's borrowings was to provide funds for its consumer loan and credit card businesses that produced taxable income.

The FTB relied on Revenue Procedure 72-18 and took the position that the fact Beneficial incurred debt and held the CNL stock simultaneously showed it was "carrying" the investment. In effect, the FTB contended that Beneficial should have divested itself of CNL in order to avoid disallowance of a part of its interest expense. Beneficial responded by pointing the SBE to *Hunt-Wesson, Inc. v. Franchise Tax Board*, 528 U.S. 458

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(2000), where a similar argument was rejected by the U.S. Supreme Court in connection with California's interest offset rule which the Court held to be unconstitutional.

The SBE rejected the FTB's arguments and unanimously held in favor of Beneficial and found no interest expense should be disallowed.

What is the impact of the *Beneficial* decision? In California, the expense attribution issue has become much more important in light of the *Ceridian* and *Farmer Brothers*¹ decisions in which the dividends received deduction statutes, RTC sections 24410 and 24402, respectively, were held to be unconstitutional.² The FTB is routinely disallowing interest expense deductions under RTC section 24425 in virtually every instance where a dividends received deduction is allowed under either RTC section 24410 or 24402.³ The importance of *Beneficial* is that it underscores the fundamental requirement that before any expense deductions (interest or otherwise) can be disallowed under RTC section 24425, there must be a linkage or connection between the deductible dividend and the expenses themselves. In other words, interest expense and other deductions are not automatically disallowed

solely because deductible dividends are received. As was held in *Zenith*, each case must be decided on its own merits. It is a facts and circumstances determination. *Beneficial* reinforces that conclusion.

What should taxpayers do? Whether worldwide or water's edge, taxpayers should carefully review any proposed expense disallowance under RTC section 24425 or under the foreign investment interest offset provisions of RTC section 24344. If under the taxpayer's specific facts and circumstances there is no connection between the deductible dividend and the subject expenses, no expense attribution should be applied.

¹ *Farmer Bros. v. Franchise Tax Board*, 108 Cal. App. 4th 976 (2003), cert. denied, 540 U.S. 1178 (2004).

² On April 26, 2002 and May 17, 2004, the FTB issued policy memoranda describing their procedures regarding post-*Ceridian* and post-*Farmer Brothers*. For tax years ending prior to December 1, 1997, the FTB will allow a deduction for all dividends received from an 80-percent insurance subsidiary. For tax years ending prior to December 1, 1999, the FTB will allow a deduction for all dividends received from non-insurance corporations subject to the ownership limitations of RTC section 24402(b). In both instances, the FTB has indicated that RTC section 24425 will be applied to deny expenses incurred to earn income not included in the measure of tax under RTC sections 24410 and 24402.

³ On April 28, 2005, a California trial court rejected the FTB's attempt to disallow interest expense deductions where the taxpayer received deductible dividends from an insurance company. See *American General Realty Investment Corp., Inc. v. Franchise Tax Board*, No. CGC-03-425690, CCH California Tax Rptr. ¶ 403-794. The FTB did not appeal the adverse decision. Another case which is pending on a petition for rehearing at the SBE is *Mercury General Corp.*, No. 145450. In *Mercury General*, the issue is whether a portion of the taxpayer's interest, administrative and operating expenses should be disallowed where the taxpayer received deductible insurance company dividends.

