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Nonprecedential

OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

In the Matter of the Appeal of:	) OTA Case No. 18011333
B.B.C.A.F. INC.	) Date Issued: September 6, 2019

OPINION

Representing the Parties:

For Appellant: Edward I. Kaplan, Esq.
Daniella M. Caldwell, PwC

For Respondent: Irina Iskander K., Tax Counsel III
Craig Swieso, Assistant Chief Counsel

J. MARGOLIS, Administrative Law Judge: Pursuant to California Revenue and Taxation Code section 19045,[1] B.B.C.A.F. Inc. (BBCAF) appeals actions by the Franchise Tax Board (FTB) proposing: $74,228 of additional tax for the 2005 tax year; $173,719 of additional tax for the 2006 tax year; $99,913 of additional tax for the 2007 tax year; and $132,694 of additional tax for the 2008 tax year.[2]

Office of Tax Appeals (OTA) Administrative Law Judges Jeffrey I. Margolis, Kenneth Gast, and Tommy Leung held an oral hearing in this matter in Sacramento, California, on May 29, 2019. At the end of the hearing, the record was closed and the matter submitted for decision.

[1] Unless otherwise indicated, all "Section" references are to sections of the California Revenue and Taxation Code (R&TC).

[2] BBCAF also attempted to appeal from a Notice of Proposed Overassessment that FTB issued with respect to BBCAF's 2009 tax year. That notice determined a $105,926 overassessment. However, by letter dated November 23, 2015, our predecessor, the California State Board of Equalization (SBE), informed the parties that it had no jurisdiction over BBCAF's 2009 year because FTB had not issued a Notice of Action or a Denial of a Claim for Refund for that year. (See generally Cal. Code Regs., tit. 18, § 5412 [listing types of matters SBE had jurisdiction to decide]; see also Cal. Code Regs., tit. 18, § 30103 [listing types of matters OTA has jurisdiction to decide].)

ISSUES

1. Whether OTA should prohibit FTB from raising a new position that would disallow, in part, BBCAF's interest deductions; if not, whether FTB's new position constitutes "new matter" that requires the burden of proof be shifted to FTB.
2. Whether, and how, BBCAF's interest expense should be allocated between its California source and non-California source income.
3. Whether BBCAF is entitled to a suspension (or abatement) of interest on any tax deficiencies determined to be due.

FACTUAL FINDINGS

1. BBCAF is a Nevada corporation. At all times relevant hereto, BBCAF's sole shareholder was the BBC Pension Trust Limited (the Trust), located in the United Kingdom. BBCAF's sole business purpose was to act as a holding company to make investments in U.S. real property for the benefit of the Trust. BBCAF typically invested in commercial rental properties. BBCAF had no employees during the years at issue, nor did it maintain a business office in the United States.
2. BBCAF used the services of an unaffiliated U.S.-based firm, Grosvenor USA Limited (Grosvenor), to identify, acquire, and manage interests in U.S. real property on its behalf. BBCAF relied upon functionaries of Grosvenor to serve as its officers for statutorily required purposes. BBCAF's three directors made all significant business decisions regarding BBCAF's investments. Two of BBCAF's directors were partners in a California law firm specializing in real estate transactions; the third was an employee of the Trust.
3. BBCAF's commercial domicile during the years at issue was in California.
4. BBCAF's investments in U.S. real property were made in conjunction with Grosvenor. Typically, BBCAF and Grosvenor would acquire pass-through interests (PTIs) in entities that held U.S. real property.[3] Grosvenor would become (or supply) the general partner or managing member in each entity; BBCAF relied upon Grosvenor to manage all the U.S. properties in which BBCAF invested.

[3] The investments we refer to as PTIs were investments BBCAF and Grosvenor made together in limited liability companies, limited partnerships, and by taking tenancy-in-common interests in U.S. real property.

5. For California tax purposes, BBCAF treated itself as being engaged in a unitary business with all its PTIs for tax years prior to those at issue in this appeal.

6. Commencing in 2005, however, BBCAF changed how it reported its income for California tax purposes. For tax years 2005 through 2008 (the years at issue), BBCAF treated each of the PTIs as conducting a separate trade or business, none of which were unitary with BBCAF. BBCAF treated its share of income from each PTI as being sourced to the state where the PTI's real property was located. Thus, BBCAF did not treat its share of rental income and loss from a PTI as being subject to California tax if the PTI's real property was located outside California, but it did treat such income and loss as being subject to California tax if the PTI's real property was located within California. BBCAF also reported interest income it earned through short-term investments of excess funds in its bank account(s). To the extent that BBCAF's interest income was earned by BBCAF itself, that income was treated as being subject to California tax.[4]

7. BBCAF reported owing only the $800 minimum franchise tax on its California returns for each of the years at issue.

8. During the period October 29, 1998, through October 18, 2004, BBCAF borrowed a cumulative total of $156,207,500 from its sole shareholder (the Trust) through a series of eight separate loans (the loans). Each loan was evidenced by a separate promissory note. Each promissory note called for quarterly interest payments; principal repayment was to become due after ten years. However, loan refinancings could, and did, occur.[5] BBCAF made no principal repayments on the loans during the years at issue.

[4] BBCAF also may have included in its California income its allocable shares of interest income earned by the PTIs that held California real property; the record is unclear on this issue. However, the parties agree on the amounts of interest income that BBCAF included in its California income for the years at issue. Those amounts are the amounts that BBCAF seeks to offset pursuant to Section 24344(b), discussed below.

[5] Two of the eight notes were refinanced upon maturity in 2008. The repayment periods were extended and the interest rates adjusted to reflect the current market rate.

9. The parties agree that BBCAF used the proceeds from its shareholder loans to invest in U.S. properties through PTIs.[6] But none of the loans were expressly linked to any particular PTI or secured by any of the PTIs' real property.

10. Of the $156,207,500 of shareholder loans, BBCAF used approximately $43.1 million to acquire its PTIs in real properties located in California.[7] BBCAF's real property investments in California represented approximately 27.6 percent of its total U.S. total property interests (i.e., $43.1 million / $156,207,500).[8]

11. During the years at issue, BBCAF used income received from its PTIs to make interest payments on the notes. BBCAF paid the following amounts of interest to the Trust during the years at issue: $10,037,194 in 2005; $9,330,734 in 2006; $9,555,745 in 2007; and $8,673,964 in 2008.

12. BBCAF deducted 100 percent of the interest payments on the notes against its California taxable income.[9]

13. This appeal arises from two separate audit cycles, 2005-2006 and 2007-2009, that ultimately were consolidated at protest before FTB. Several adjustments proposed by FTB during the audits were conceded by BBCAF prior to protest. In both audit cycles and at protest, FTB took the position that: (i) BBCAF and the PTIs were part of a single unitary business; and (ii) the loans from the Trust were not bona fide indebtedness and should be recharacterized for tax purposes as capital contributions (resulting in the interest thereon being disallowed). There also was a like-kind exchange transaction in 2006 that FTB contested in its NPA, but conceded at protest.

[6] FTB alleges that "all loans were used solely to invest in U.S. real estate [and] evidence on file establishes [a] direct relationship between [BBCAF's] loans and real estate." However, some of the evidence suggests otherwise. (See fn. 8, below.)

[7] The parties' filings occasionally refer to these figures as $43 million instead of $43.1 million and $156 million instead of $156,207,500. The correct figures are $43.1 million and $156,207,500.

[8] For purposes of this appeal, we accept the parties' apparent agreement on this point, although the record does not fully support it. The parties' agreement appears to be based upon the fact that BBCAF's cost basis in PTIs owning California real property ($43,100,000) represents approximately 27.6 percent of the amount BBCAF borrowed from its shareholder ($156,207,500), which the parties assume all went to acquire U.S. real property. However, the record suggests that one of the properties BBCAF owned during the years at issue was acquired before the first the shareholder loan.

[9] BBCAF's taxable income for the years at issue essentially consisted of BBCAF's interest income and its shares of income or losses from PTIs holding real property in California.

14. FTB began its audit of BBCAF's 2005 and 2006 tax years in October 2008, and issued its Notices of Proposed Assessments (NPAs) on February 11, 2011. FTB's NPAs did not state the basis for FTB's determination. Instead, they referred to a letter and schedules that had been provided to BBCAF's representative on July 30, 2010. By these references, BBCAF was made aware of the basis for FTB's position.
15. BBCAF timely protested the NPAs for 2005 and 2006 on April 18, 2011, and a protest hearing was held on May 15, 2012.
16. FTB began its audit of BBCAF's 2007, 2008, and 2009 tax years in April 2011, and issued NPAs for the 2007 and 2008 tax years, and a Notice of Proposed Overassessment (NPO) for the 2009 tax year, on May 9, 2012. The NPAs issued for 2007 and 2008, and the NPO issued for 2009, did not state the basis for FTB's determination. Instead, they referred to audit schedules that had been provided to BBCAF's representative (with an explanatory cover letter) on January 30, 2012. By these references, BBCAF was made aware of the basis for FTB's position.
17. BBCAF timely protested FTB's notices for 2007, 2008, and 2009 on June 26, 2012.
18. FTB consolidated both protests and issued its preliminary position letter on April 24, 2015, inviting BBCAF to provide additional documents to substantiate its position.
19. In its final determination on BBCAF's protests, FTB reversed its disallowance of like-kind exchange treatment for 2006 and affirmed the NPAs' and NPO's positions on the unitary issue and the loan/capital contribution issue.
20. On September 28, 2015, FTB issued Notices of Action (NOAs) for 2005, 2006, 2007 and 2008, and a Reissued NPO for 2009, affirming FTB's position on the unitary issue and the loan/capital contribution issue. These notices did not state the basis for FTB's determination. Instead, they indicated that the previously issued NPAs and NPO were affirmed on the grounds set forth in a letter dated July 17, 2015, from FTB to BBCAF's representative.
21. FTB raised no back-up or alternative positions in its NOAs, Reissued NPO, or in its predecessor NPAs and NPO.

22. After the issuance of the NOAs and Reissued NPO, BBCAF timely appealed to the SBE. In its appeal letter dated October 28, 2015,[10] BBCAF contested both adjustments raised in FTB's NOAs. BBCAF argued that: (i) it was not engaged in a single unitary business that encompassed its PTIs; and (ii) the advances it received from its sole shareholder were bona fide loans that generated deductible interest expense. BBCAF also asked that interest be suspended on any deficiencies determined to be due for the years at issue.

23. By letter dated November 23, 2015, the SBE informed the parties that it would not assume jurisdiction over BBCAF's 2009 year because FTB had not issued a NOA or a Notice of Denial of a Claim for Refund for that year.

24. On December 20, 2016, FTB filed its opening brief. In it, FTB conceded the two adjustments it had raised in its NOAs. We accept, for purposes of this appeal, FTB's concessions that (i) BBCAF was not engaged in a single unitary business that included its PTIs, and (ii) the interest expense disallowed in the NPAs and NOAs resulted from bona fide indebtedness.

25. However, FTB alleged in its opening brief that: "[I]t is the amount of the interest expense that [BBCAF] is properly entitled to deduct against its California-source income which is in dispute now." FTB alleged that BBCAF's interest expenses from the shareholder loans "must be first allocated between assets that produce taxable and non-taxable income, with the deductible portion of the interest being used to offset (BBCAF's) interest income, if any, included on the California return." In "prorat[ing] the [interest] expense between the assets that generate income both taxable and nontaxable in California," FTB stated it would apply Internal Revenue Service (IRS) Rev. Proc. 72-18, 1972-1 C.B. 740, which allegedly "results in attributing from 14 to 28 percent of the interest expense to California investments based on annually calculated, averaged adjusted basis of the real estate [BBCAF] owned in and outside of California in each year at issue." FTB did not, however, attach any revised deficiency computations to its opening brief, nor did it provide computations showing how it arrived at its "14 to 28 percent" interest allowance amounts.

[10] BBCAF's appeal letter was treated as its opening brief by the SBE.

26. FTB acknowledged in its opening brief that "it is undisputed that the sole purpose of [BBCAF's shareholder] indebtedness was to enable [BBCAF] to invest in U.S. real estate in and outside of California . . . ."

27. On November 27, 2017, BBCAF filed a reply to FTB's opening brief. In it, BBCAF contended that FTB should be barred from raising its new position because the statute of limitations had expired. BBCAF also contended that if FTB were allowed to raise its new position, the burden of proof on that position must be shifted to FTB. And if an allocation of its interest expense was required, BBCAF claimed that the interest offset provisions of Section 24344(b) should be applied before the application of any allocation formula.

28. On August 1, 2018, FTB filed a reply to BBCAF's reply brief. In it, FTB alleged that its "raising of the deduction limitation issue does not increase [BBCAF's] deficiency and does not require any new evidence" and, therefore, is not a "new issue." However, FTB still did not identify the specific amounts of interest expense that it was proposing to disallow for the years at issue. Instead, it merely reiterated its position that only "14 to 28 percent" of the interest upon the shareholder loans was deductible by BBCAF.

29. On September 28, 2018, BBCAF filed a supplemental brief replying to FTB's reply brief. BBCAF contested all the arguments raised by FTB in its reply brief, but alleged that if an allocation of interest expense was required, it should be based upon the ratio between BBCAF's California source income and its total income, not upon FTB's formula (which compared the adjusted bases of BBCAF's in-state assets to its total assets). BBCAF also reiterated its position that any allocation of its interest expense should be made after application of the interest offset rules contained in Section 24344(b), under the policy announced by FTB in FTB Notice 2000-9.[11]

30. On April 10, 2019, OTA held a prehearing conference in this matter. At the conference, the parties were asked to provide OTA with (among other documents) computations of the interest disallowances and tax amounts due from BBCAF pursuant to the various positions they had taken in this matter. Pursuant to this request, on May 2, 2019, the parties submitted computations regarding their positions to OTA.

[11] See <https://www.ftb.ca.gov/tax-pros/law/ftb-notices/2000-9.html>, accessed July 31, 2019.

31. FTB's submission included a spreadsheet showing how it computed its proposed disallowances of BBCAF's interest expenses. It showed that FTB calculated the disallowances using information from BBCAF's financial statements and tax returns. In computing the allocation, FTB first determined the asset values, as reported for financial statement purposes, of BBCAF's in-state PTIs, its out-of-state PTIs, and its "total assets" (which included the PTIs and other assets owned by BBCAF). Then, it determined a disallowance percentage for each year, by dividing the aggregate average values of the out-of-state PTIs by the average values of BBCAF's total assets. This disallowance ratio (a percentage) was then inverted (i.e., subtracted from 1.00) to arrive at an allowance ratio that was then applied to (i.e., multiplied by) the amount of interest BBCAF paid to its shareholder each year to determine how much of that amount should be attributed to California source income and allowed as a deduction from BBCAF's California taxable income. The table below summarizes FTB's computations.

	TYE 12/04	TYE 12/05	TYE 12/06	TYE 12/07	TYE 12/08	TYE 12/09
Sub-Total: CA PTI Investments	35,460,503	43,064,121	48,029,521	105,188,001	101,376,244	51,756,142
Sub-Total: Out-of-State PTI Investments	209,308,848	204,859,464	244,555,465	687,282,142	671,769,456	536,809,779
Subtotal: All PTI Investments	244,769,351	247,923,585	292,584,986	792,470,143	773,145,700	588,565,921
Total Assets (Per Financial Statements)	271,077,256	283,874,795	336,822,278	852,517,479	822,580,170	625,768,190
Average Out-of-State Investment Value for the Year ((Beg + End) / 2)		207,084,156	224,707,465	465,918,804	679,525,799	604,289,618
Average Total Assets for the Year ((Beg + End)/2)		277,476,026	310,348,537	594,669,879	837,548,825	724,174,180
Ratio of Out-of-State Investment Value to Total Asset Value		74.63%	72.40%	78.35%	81.13%	83.45%
Disallowed Portion of Interest Expense %		74.63%	72.40%	78.35%	81.13%	83.45%
Allowed Portion of Interest Expense %		25.37%	27.60%	21.65%	18.87%	16.55%

32. BBCAF's submission included several spreadsheets, each representing a different "scenario." Scenario #1 computed BBCAF's interest disallowance (and resulting tax liabilities) using a uniform 28 percent interest allowance ratio (which is the 27.6 percent

figure discussed at paragraph 10, above, rounded up to 28 percent in the spreadsheet). Scenario #1a took the allowance percentages determined by FTB (summarized in the chart above) and determined BBCAF's resulting tax liabilities. Scenario #2, building on Scenario #1, applied a uniform 28 percent allowance ratio but allowed BBCAF's claim for interest offset under FTB Notice 2000-9.[12] Scenario #2a, building on Scenario #2, applied FTB's allowance percentages from the table above, and allowed BBCAF's claim for interest offset. Scenario #3 allowed BBCAF's claim for interest offset and allocated the remaining interest expense based upon the ratio of the California income reported by BBCAF for each year to the total income earned everywhere by BBCAF for each year.[13] Scenario #4 disallowed interest offset, but allocated BBCAF's interest based upon the same ratio employed in Scenario 3.

33. At the hearing, FTB submitted one additional computation. It contained the same data as is reflected in the table above, but it computed BBCAF's interest allowance percentage using the ratio of BBCAF's in-state asset values compared to its total asset values. This resulted in significantly lower allowance percentages for BBCAF (between 10.57 percent and 14.68 percent). FTB indicated that it was not advancing this computation as its position; it was merely providing them for "illustration purposes," to show that it could have computed an allocation formula under Rev. Proc. 72-18 in a manner that was significantly less "favorable" to the taxpayer than the approach it has taken.

[12] BBCAF contends that, under FTB Notice 2000-9, all of the amounts it reported as interest income sourced to California should be offset, dollar for dollar, before there is any allocation of the residue of its interest expense between its California and non-California source income. During the years at issue, the parties agree that BBCAF reported the following amounts of interest income sourced to California: $983,424 in 2005, $2,541,182 in 2006, $2,049,912 in 2007, and $802,181 in 2008.

[13] This allocation formula results in the following percentages of BBCAF's interest expense (after interest offset) being allocated to California (i.e., allowed as a deduction against California income) for the years at issue: 18.46 percent for 2006, 18.30 percent for 2006, 50.73 percent for 2007, and 14.20 percent for 2008.

DISCUSSION

Issue 1 – Whether OTA should prohibit FTB from raising a new position that would disallow, in part, BBCAF's interest deductions; if not, whether FTB's new position constitutes "new matter" that requires the burden of proof be shifted to FTB.

In its opening brief, FTB conceded the two principal issues raised in its NOAs. FTB now admits that BBCAF's shareholder loans were bona fide indebtedness, not capital contributions. It also admits that BBCAF was not unitary with its PTIs during the years at issue. FTB's concessions, however, have not resolved this appeal. In its opening brief, FTB raised a new position, claiming that BBCAF's interest expenses, which it now admits arose from bona fide indebtedness, must be allocated between BBCAF's California and non-California source income pursuant to R&TC section 24425(a).

FTB alleged (in its opening brief) that its new position results in only 14 to 28 percent of the interest claimed on BBCAF's California returns as being deductible against BBCAF's California income. But neither FTB's opening brief, nor its reply brief, identified the amount of interest expense (or the percentage by year) that would be allowed under FTB's position. It was not until four weeks before the hearing date that FTB provided OTA with computations underlying its position. In those computations, FTB proposed to allow 18.87 to 27.60 percent of BBCAF's interest expense to be deducted against BBCAF's California income (depending on the year at issue).[14]

BBCAF counters that we should prohibit FTB from raising its new position. BBCAF argues that unless this is done, FTB will have circumvented the expiration of the statute of limitations (R&TC, § 19057) because FTB did not put BBCAF on notice of its new position until after the statute of limitations for proposing deficiencies for the years at issue had expired.[15] Alternatively, BBCAF contends that, "[i]f the FTB is allowed to pursue this new issue, it unequivocally has the burden of proof to establish its position is correct." For the reasons

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[14] In these computations, FTB proposes to allow the following percentages of BBCAF's claimed interest expense for the years at issue: 25.37 percent for 2005, 27.60 percent for 2006, 21.65 percent for 2007, and 18.87 percent for 2008.

[15] BBCAF also asserted that FTB violated the requirement a notice of a proposed deficiency assessment must "set forth the reasons for the proposed deficiency assessment and the computation thereof." (R&TC, § 19034(a); see also R&TC, § 19033.) BBCAF also notes that FTB's opening brief "contains no underlying support for this calculation of tax due." Neither did FTB's reply brief.

expressed below, we reject BBCAF's position that FTB should be prohibited from raising its new position, but agree that FTB's new position constitutes "new matter" upon which FTB bears the burden of proof.

FTB is required to timely issue a notice of proposed assessment advising a taxpayer of the basis for a proposed assessment. (R&TC, §§ 19033, 19034, 19057.) That was done here. FTB's notices, together with the materials referenced therein (which had previously been provided to BBCAF), satisfied these statutory requirements. Moreover, it is well established that FTB is permitted to change the basis for its deficiency assessment, so long as the amount due from its new position does not result in a tax assessment that is greater than the amount proposed in a timely issued NPA.[16] (See, e.g., *Appeal of Mendelsohn* (85-SBE-141) 1985 WL 15923 (*Mendelsohn*).) We note that BBCAF does not claim that it has been prejudiced by FTB's failure to raise its new position as an alternative position in its original NPAs and NOAs, and we see no evidence in the record of any prejudice to BBCAF. Both parties have been able to produce facts supporting their positions concerning how an appropriate allocation of BBCAF's interest expense should be made, assuming one is required. Accordingly, we will not prohibit FTB from raising its new position. (See *Appeal of Sierra Pacific Industries* (94-SBE-002) 1994 WL 14076 [rejecting taxpayer's claim that it was prejudiced by new issues raised in an NOA issued 10 years after FTB issued its NPA, where both notices related to the same underlying transaction].)

FTB's new position, however, constitutes "new matter" upon which FTB bears the burden of proof. In *Mendelsohn*, the SBE expressly adopted the U.S. Tax Court's "new matter" rule, as formulated in *Achiro v. Commissioner* (1981) 77 T.C. 881 (*Achiro*). In *Achiro*, the Tax Court held that, "[i]f [the taxing agency's] position on appeal either alters the original deficiency or requires the presentation of different evidence, then a new matter has been introduced and the burden of proving that new position shifts to [the taxing agency]." (*Achiro*, *supra*, 77 T.C. at p. 890; see also *Dagres v. Commissioner* (2011) 136 T.C. 263, 277-279 (*Dagres*) [to same effect]; cf. *Appeal of Sierra Pacific Industries* (94-SBE-002) 1994 WL 14076 ["If respondent's position on appeal results in a larger deficiency . . . or requires the presentation of different evidence, then a new matter has been introduced and the burden of proving that new position

[16] In this regard, we note that FTB has represented that it will not seek to assess or collect any tax amounts that exceed the tax amounts reflected in the original NPAs, as revised by FTB's NOAs for the years at issue.

shifts to respondent."].) Under the new matter rule, "a new position taken by respondent is not necessarily a 'new matter,' especially when it merely clarifies or develops the original determination without being inconsistent or increasing the amount of deficiency." (*Estate of Jayne et al. v. Commissioner* (1974) 61 T.C. 744, 748 (*Jayne*), citing *McSpadden v. Commissioner* (1968) 50 T.C. 478, 492-493.)[17]

The determination of whether a new position constitutes "new matter" will sometimes involve making "Solomonic and subtle distinctions" in order to properly assign the burden of proof. (*Dagres*, *supra*, 136 T.C. at p. 279.) For example, in *Jayne*, a decedent elected to defer the gain realized from the sale of a commercial riding stable facility under threat of condemnation pursuant to Internal Revenue Code (IRC) section 1033. In its notice of deficiency (the federal analog to an FTB NPA), the IRS determined that the decedent had not met the requirements of IRC section 1033, stating as follows: "It is determined that [the deferred gain] is recognized and is includible in your income for the year 1966 because of your failure to replace with property similar or related in service or use to [the property sold] prior to termination on October 28, 1970 of the extension of time to replace the said property without recognition of the gain, under the provisions of section 1033 of the [IRC]." (*Jayne*¸ *supra*, 61 T.C. at p. 748.) The decedent's executrix/surviving spouse petitioned the Tax Court to review the IRS's notice of deficiency. Before the Tax Court, the IRS filed an amended answer alleging that "the acquisition of the [purported replacement property and the improvements thereon] were those of [decedent's surviving spouse] in her individual capacity and not as a personal representative of the decedent." (*Ibid.*) The taxpayer/petitioner claimed that the IRS's position in its amended answer constituted "new matter" upon which the IRS bore the burden of proof. The Tax Court rejected this argument, explaining as follows:

> The notice of deficiency informed petitioner of respondent's position that the nonrecognition provisions of section 1033 did not apply to the gain realized on

[17] The new matter rule has been expressed in slightly different ways in different cases. In *Achiro*, the Tax Court stated that "[t]he assertion of a new theory which merely clarifies or develops the original determination without being inconsistent or increasing the amount of the deficiency is not a new matter requiring the shifting of the burden of proof," however, new matter has been introduced, requiring a shifting of the burden of proof, if the tax agency's new position "*either alters* the original deficiency *or* requires the presentation of different evidence." (*Achiro*¸ *supra*, 77 T.C. at p. 890, italics added.) The SBE has stated that new matter has been introduced when the tax agency's position "results in a *larger* deficiency . . . *or* requires the presentation of different evidence." (*Sierra Pacific, supra*, italics added.) Inasmuch as FTB generally may not increase the amount of an income tax deficiency beyond the amount proposed in a timely issued NPA, our focus is upon whether FTB's new position requires the presentation of new or different evidence, and whether its new position merely clarifies or develops FTB's original determination without being inconsistent therewith. (See generally *Mendelsohn*, *supra*; *Jayne*, *supra*.)

> the sale of [the property]. Petitioner then had the burden of proving that section 1033 did apply, which necessarily requires proof that decedent had met all the prerequisites of section 1033. . . . The arguments raised in respondent's amended answer involve the same Code section, are consistent with his original determination, and do not affect the amount of the deficiency. Respondent's amended answer merely questions some of the elemental facts that petitioner must prove under section 1033. Petitioner retains the burden of proof.

(*Jayne*, *supra*, 61 T.C. at pp. 748-749.)

These same principles were applied by the Tax Court to a different set of facts in *Shea v. Commissioner* (1999) 112 T.C. 183 (*Shea*), and generated a different result. In *Shea*, the taxpayer's 1992 return was filed as a joint return. The IRS issued a notice of deficiency determining that the taxpayer's filing status should be "married filing separately," and that he had substantially underreported his business gross receipts. However, the IRS computed the taxpayer's underreported gross business receipts without making any adjustment for California's community property laws. In its notice of deficiency, the IRS did "not refer to California community property law, any exceptions to such law, or any facts that might support such exceptions." (*Shea*, *supra*, at p. 189.) The taxpayer's position was that one half of his underreported gross receipts were taxable to his spouse, not to him. He relied upon IRC section 66(b), which provides as follows:

> The Secretary may disallow the benefits of any community property law to any taxpayer with respect to any income if such taxpayer acted as if solely entitled to such income and failed to notify the taxpayer's spouse before the due date (including extensions) for filing the return for the taxable year in which the income was derived of the nature and amount of such income.

He argued that because the IRS's notice of deficiency made no determination disallowing, pursuant to IRC section 66(b), the benefits of California's community property law, the IRS's subsequent reliance on IRC section 66(b) constituted new matter. The Tax Court agreed.

> Here, the relevant issues raised by respondent's notice of deficiency are the total amount of business gross receipts and whether petitioner is entitled to deductions that he claimed were incurred in his business during 1992. The only explanation stated in the notice of deficiency for increasing 1992 gross receipts is that the adjustment was based on bank deposits. All these deposits were to the business account used for petitioner's consulting business. The only reason for disallowing business deductions was that petitioner had not substantiated their deductibility.

> Respondent now acknowledges that petitioner is entitled to the benefits of community property law, unless those benefits can be disallowed pursuant to section 66(b). Respondent argues that invocation of section 66(b) is necessarily implicit in the notice of deficiency. We disagree. The notice of deficiency makes absolutely no mention of community property law, section 66(b), or facts which would allow respondent to invoke section 66(b).

(*Shea*, *supra*, at p. 191, fn. omitted.)

Applying these principles to the situation before us, FTB's position clearly constitutes new matter. A determination as to whether BBCAF's shareholder advances constitute debt versus equity looks to the factors set forth in *Hardman v. United States* (9th Cir.) 827 F.2d 1409, and *Laidlaw Transp., Inc. v. Commissioner,* T.C. Memo. 1998-232. On the other hand, a determination as to whether and how interest expense should be allocated among BBCAF's various income streams requires different evidence, concerning *how* the borrowed funds were used, *where* BBCAF's operations and investments were located, BBCAF's adjusted *basis* in its asset holdings (according to FTB) and BBCAF's income from its in-state and out-of-state investments (according to BBCAF). Different evidence is involved.[18]

FTB claims its new position is not new matter because it already possessed the evidence it wishes to use to support its new position, having acquired that evidence in the course of its audit of BBCAF. That is of no consequence. In determining whether a new position constitutes new matter, one looks to whether the evidence required to prove the tax agency's new position is *different from the evidence that was needed to prove its original position*, not whether the taxing agency already possessed the evidence that supports its new position. The fact that one, or even both, of the parties already possessed the evidence needed to support their position(s) does *not* affect whether a new position constitutes new matter. Instead, one applies the test enunciated by the Tax Court in *Achiro* (and its progeny) as adopted by the SBE in *Mendelsohn*. (See also *Zarin v. Commissioner* (1989) 92 T.C. 1084, 1089, revd. on other grounds (3d Cir. 1990) 916 F.2d 110 [Tax Court rejects argument that the burden of proof should not be shifted to tax

[18] We also note that: (i) FTB's new position, that BBCAF's shareholder loans generated deductible interest expense that must be allocated between California and non-California income *is inconsistent with* FTB's original position that the loans were not bona fide debt; and (ii) FTB's new position is based upon an entirely different Code section (Section 24425) than its original position. (See *Shea, supra*, 112 T.C. at pp. 193-196 (lead opn. of Ruwe, J.), and p. 202 (conc. opn. of Halpern, J.); *Jayne, supra*, 61 T.C. at pp. 748-749; *McLarney v. Commissioner*, T.C. Memo. 1982-461.)

agency because the parties had stipulated to all the relevant facts. "That the case is fully stipulated does not change the burden of proof."].)[19]

FTB also claims that its new position is not new matter because:

> [The] facts did not change from audit, [FTB's] assessment of the same facts changed, not the facts. Therefore, by enforcing California law and the correct tax consequence, [FTB] is not raising . . . a new issue.

But one would not expect the facts to have "changed" after the close of the tax years involved. In any event, a "change in facts" is not the test for whether a new position constitutes new matter.

FTB argues it has not raised new matter because requiring an allocation under Section 24425(a) is simply a "tax consequence" that "follow[s] naturally based on governing law." We disagree. Formulating and applying an allocation formula to determine how much of BBCAF's interest expenses should be allocated to income that was not subject to California taxation is *not* a purely mathematical computation that is based upon the same facts that would have been required to determine whether BBCAF's interest expenses were bona fide.[20] Determining the bona fides of a debt owed by a corporation to its sole shareholder does not necessarily (or even typically) involve the same factual showing that is required to make an allocation of a taxpayer's interest expense between its California source income and its non-California source income. Moreover, an interest allocation determination usually cannot be made simply by looking at the items reported on a taxpayer's return. Making a proper allocation typically requires additional evidence and involves tracing a taxpayer's use of the borrowed funds. For these reasons, we shift the burden of proof to FTB on its position that an allocation of BBCAF's interest expense between BBCAF's California source and non-California source income is required, and the amount of any such allocation.

[19] Although it is not determinative to our ruling shifting the burden of proof, we note that FTB was not in any way precluded from raising its interest allocation position as an alternative position in its originally issued NPAs and NOAs. It simply failed to do so.

[20] In this regard, it may be contrasted with imposing the 2 percent adjusted gross income limitation upon the amount of taxpayer's miscellaneous itemized deductions after adjustments have been proposed to the amount of a taxpayer's adjusted gross income. (See R&TC, § 17076.) That is something that can be computed mathematically based upon the facts shown in a taxpayer's return, and would automatically follow from an adjustment to theamount of a taxpayer's itemized deductions.

Issue 2 – Whether, and how, BBCAF's interest expense should be allocated between its in-state and out-of-state income.

A. The matching rule.

The principle that a taxpayer may not deduct expenses attributable to income that is not included in the measure of tax (what FTB refers to as the "matching" principle) is reflected both in Section 24425(a) and in California Code of Regulations, title 18, section (Regulation) 25120(d).[21] Section 24425(a) provides, in pertinent part, 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 . . . .

Regulation 25120(d) provides, in pertinent part, that:

> In some cases an allowable deduction may be applicable to the business incomes of more than one trade or business and/or to several items of nonbusiness income. In such cases the deduction shall be prorated among such trades or businesses and such items of nonbusiness income in a manner which fairly distributes the deduction among the classes of income to which it is applicable.

Although BBCAF objects to the manner in which FTB raised this allocation issue and the methodology it employed, BBCAF largely accepts the basic principle that an allocation is appropriate.[22] And we agree—BBCAF is not entitled to deduct 100 percent of the interest expense from its shareholder loans when only a portion of those loans was utilized to acquire assets whose income was included in BBCAF's California taxable income. In fact, at the hearing BBCAF admitted that it made allocations of its interest expense between its in-state and out-of-state income sources, under Regulation 25120(d), on its returns for years subsequent to the years at issue. So we find that FTB has satisfied its burden of proving that an allocation is required. But in computing the amount of such allocation, the burden of proof remains upon FTB.

[21] All subsequent "Regulation" references are to regulation sections contained in title 18 of the California Code of Regulations.

[22] At the hearing, BBCAF's sole witness, an accountant, testified that "[h]ad it been timely raised, there should have been an allocation under [Regulation] 25120(d)."

B. The applicability of Section 24425(a) and Regulation 25120(d).

FTB relies on Section 24425(a), not Regulation 25120(d), as the basis for its interest expense allocation. BBCAF takes a contrary position, contending that, if an allocation is required, it may only be imposed under Regulation 25120(d)—which it notes FTB has not invoked—not under Section 24425(a). However, in determining whether FTB's allocation should be upheld (in whole or in part), we are not limited to considering the particular code section FTB relies upon as the basis for its disallowance. As noted in *Appeal of Great Northern Railway Co.* (39-SBE-009) 1939 WL 310 (*Great Northern I*), in reviewing a proposed deficiency determination, our primary concern is "with the question whether under the law that additional amount of tax is due," and we are not limited to considering the FTB's theories and "the manner in which [it] determined an additional amount of tax to be due." (*Great Northern I*, *supra,* at p. *1; see generally Section 21002 ["the purpose of any tax proceeding between the Franchise Tax Board and a taxpayer is the determination of the taxpayer's correct tax liability"].) Thus, FTB's allocation would not be barred even if we were to determine that FTB relied upon the wrong code section as the basis for its allocation. In any event, we conclude that either provision may be used to support an allocation of interest expense in this matter.[23]

(i) Section 24425(a).

BBCAF contends an allocation under Section 24425(a) may not be applied to the situation presented here. It claims Section 24425(a) only applies when expenses are attributable to tax-exempt income, and BBCAF reported no tax-exempt income. According to BBCAF, "FTB makes the fundamental error of equating taxable income allocated to another state to tax-exempt income." We disagree.

Section 24425(a) does not use the term "tax-exempt," and its application is not limited to situations involving tax-exempt income. Instead, it uses broader terminology, requiring the disallowance of all deductions "allocable to one or more classes of income not included in the measure of the tax." (R&TC, § 24425(a).) The California Supreme Court has noted that "Section 24425 is operative whenever income is eliminated from the measure of the tax under

[23] We note that the goal of both provisions, Section 24425(a) and Regulation 25120(d), is the same—to implement the matching principle by allocating a taxpayer's deductible expenses among various classes of income. Neither party has suggested that a different tax liability would result depending upon which provision is applied.

any authority or for any purpose; it states with incontestable clarity that items are nondeductible when allocable to income 'not included in the measure of the tax.' " (*Great Western Financial Corp. v. Franchise Tax Bd.* (1971) 4 Cal. 3d 1, 6.) The income BBCAF treated as non-California source income by allocating it outside of California was "not included in the measure of [BBCAF's] tax." Accordingly, all deductions allocable to that income potentially are subject to disallowance under Section 24425(a).

(ii) Regulation 25120(d).

BBCAF contends that an allocation could have been made under Regulation 25120(d), but FTB disagrees. FTB contends that Regulation 25120(d) has no applicability to this matter because Regulation 25120(d) was promulgated under the UDITPA, and FTB believes BBCAF is not subject to the UDITPA. FTB argues that only unitary businesses are subject to the provisions of the UDITPA, and since it has conceded that BBCAF was not engaged in a unitary business, none of the UDITPA's provisions (including Regulation 25120(d)) are applicable here. BBCAF contends that it is subject to the UDITPA because it had income from sources both within and without California.

Under Section 25101, the provisions of the UDITPA are made to applicable corporations that have income "derived from or attributable to sources both within and without the state." Section 25101 provides, in pertinent part, as follows:

> When the income of a taxpayer subject to the tax imposed under this part is derived from or attributable to sources both within and without the state the tax shall be measured by the net income derived from or attributable to sources within this state in accordance with the provisions of Article 2 (commencing with Section 25120) [i.e., the UDITPA].

(R&TC, § 25101.) At first glance, it would seem relatively easy for us to conclude that BBCAF had income "derived from or attributable to sources both within and without the state" since the parties agree that some of BBCAF's income should be sourced within California and some without. FTB contends otherwise, however, relying on language from *Appeal of Holloway Investment Co.* (83-SBE-176) 1983 WL 15561, mod. (83-SBE-177) 1983 WL 15562 (*Holloway*).

In *Holloway,* a California-domiciled corporation (Holloway) had ceased operating its multistate unitary business operation prior to the years under consideration, 1974 and 1975, but continued to own various interests in real estate and intangible assets, both within and without California. In 1974, Holloway sold real estate (a parking lot) located in Illinois. During both 1974 and 1975, Holloway held income-generating intangible assets (stocks, bonds, option contracts, savings certificates and cash deposits).[24] It also earned income from its interests, as a general or limited partner, in five partnerships. Four of the five partnerships owned and operated real property located in California. Holloway held a limited partnership interest in the fifth, Market Basket Shopping Center, which owned and operated a shopping center in Illinois. In 1975, that partnership sold its assets and liquidated. Holloway reported the gains realized from the 1975 shopping center sale (and partnership liquidation) and the 1974 sale of the Illinois parking lot as "nonbusiness income" allocable to their Illinois situs.

FTB audited Holloway and determined that it was engaged in a single unitary business that consisted of investing in securities, real property, and real property partnerships. Thus, FTB added Holloway's gains from the Illinois partnership and the sale of the Illinois parking lot (the Illinois gains) to the gains Holloway earned from its investments in securities and California-based partnerships, treated them all as "business income" from a single unitary business, and applied the UDITPA's formulary apportionment rules to determine the portion of Holloway's income that was subject to California franchise tax. Holloway appealed FTB's determination to the SBE, which reversed FTB's position. It held that Holloway was not engaged in a unitary business within and without California. Thus, the Illinois gains, which Holloway had treated as "nonbusiness income" and allocated to Illinois, were held by the SBE to have been "properly reported . . . as being specifically allocable to their Illinois situs."

FTB contends that *Holloway* stands for the proposition that a taxpayer is not subject to the UDITPA unless it is engaged in a unitary business, noting that the decision states:

> Before it becomes necessary to consider whether the gains in question constitute business or nonbusiness income, however, we must be able to conclude that appellant is engaged in a unitary business. . . . [T]here must be an underlying unitary business before the question arises. Unless a unitary business exists there is no need for the "business income" "nonbusiness income" dichotomy; the income in question would merely be assigned to the appropriate taxing jurisdiction in accordance with accepted sourcing principles. Therefore, the threshhold inquiry in this appeal is whether appellant is engaged in a unitary business. Before it becomes necessary to consider whether the gains

[24] Although the opinion does not expressly state how appellant reported its income from stocks, bonds, options contracts, savings certificates and cash deposits, we presume it was treated as nonbusiness income allocable to California, Holloway's commercial domicile.

> in question constitute business or nonbusiness income, however, we must be able to conclude that appellant is engaged in a unitary business.

(*Holloway*, *supra*, as modified in 1983 WL 15562.) However, we view this language as dicta, since it was not necessary to the SBE's conclusion that Holloway's income from its out-of-state investments was not subject to California tax. There was no deficiency regardless of whether the Holloway's filing position (that the income was nonbusiness income allocated outside of California) was accepted, or the income was treated as non-California source income without becoming subject to the UDITPA.[25] In any event, we reject the conclusion that FTB draws from *Holloway*, that a taxpayer cannot be viewed as having income "derived from or attributable to sources both within and without the state" within the meaning of R&TC section 25101 unless it is also engaged in a unitary business. That conclusion is inconsistent with the plain language of Section 25101. Nothing in Section 25101 requires that a taxpayer be engaged in a unitary business for the provisions of Section 25101 to apply. By its terms, Section 25101—and through it, the entire panoply of allocation and apportionment rules contained in the UDITPA—become applicable if a corporate taxpayer has income from "sources both within and without the state."

It should be emphasized that the allocation provisions contained in the UDITPA (and the regulations thereunder) are more comprehensive and detailed than those contained outside it (in Section 23040 and the regulation thereunder). Plus, the non-UDITPA sourcing rules contained in Regulation 23040 themselves give priority to the UDITPA's allocation rules, by indicating that the provisions of Regulation 23040 apply "except as provided in Chapter 17 [the UDITPA]." For these reasons, we conclude that FTB's narrow reading of Section 25101 is unwarranted. The Legislature intended that the provisions of Section 25101 and, through it, the UDITPA, be applied *whenever* a corporation has income from sources within and without this state, not just when those sources arise from the conduct of a unitary business.[26] Thus, BBCAF is subject to

[25] Even if the Holloway's income from its out-of-state partnerships had been treated as generating "business income" from separate trades or businesses within the meaning of the UDITPA (see R&TC, § 25120(a); see also Regulation 25137-1), and not as nonbusiness income allocable to Illinois, none of that income would have been apportioned to California, since all of the apportionment factors relating to those businesses were located outside California.

[26] FTB's position in this appeal, that Section 25101 only applies to corporations engaged in a unitary business, also would create some tax anomalies if we were to accept it. For example, FTB contends that the interest offset rule of Section 24344(b) has no applicability to a taxpayer that is not engaged in a unitary business. But the interest offset rule presumably would spring into full effect if even a minor portion of a taxpayer's total income arose from the conduct of a unitary business.

the UDITPA, and the provisions of Regulation 25120(d) may be applied in computing BBCAF's income.

C. Determining the allocation percentage.

FTB contends that the interest expense allocation computation required in this matter should be based upon the principles and methodology set forth in IRS Rev. Proc. 72-18. That revenue procedure was developed to apply to situations where a portion of a taxpayer's interest expense is associated with the taxpayer's acquisition of tax-exempt obligations. It has somewhat different rules for different types of taxpayers, but in general it attempts to determine a taxpayer's motivation for its borrowings, and to trace a taxpayer's use of borrowed funds. The critical question is whether the evidence is sufficient to establish that a taxpayer's borrowings are traceable to the purchasing or carrying of tax-exempt obligations. When interest is to be disallowed under its provisions, but there is no "direct evidence" that a particular borrowing is "directly traceable" to the holding of a particular tax-exempt obligations, it permits, at section 7.02 of Rev. Proc. 72-18, a pro rata disallowance of the interest deduction based upon the ratio of the average amount of a taxpayer's tax-exempt obligations held during the year to the average amount of a taxpayer's total assets held during the year.

In *Appeal of Zenith National Insurance Corp.* (98-SBE-001) 1998 WL 15204 (*Zenith*), the SBE applied the principles of Rev. Proc. 72-18 in determining the amount of a taxpayer's (Zenith's) interest expense that should be allocated, under Section 24425, to the dividend income Zenith had excluded from the measure of its tax. Applying the principles of Rev. Proc. 72-18, the SBE held that for three of the four years at issue, the evidence clearly established that the dominant motivation for the taxpayer's borrowings was to acquire preferred stock that generated taxable income.[27] Accordingly, for those years, no interest disallowance was required. For the fourth year, the SBE was "not satisfied" with the evidence purporting to show that the dominant purpose of the taxpayer's borrowings was to invest in securities that generated taxable income. Accordingly, for that year it upheld FTB's determination and disallowed a portion of the taxpayer's interest deductions. The SBE explained the rationale for its decision as follows:

[27] That evidence included uncontroverted evidence showing that Zenith used all of the indebtedness to acquire a portfolio of preferred stock within six months, that the preferred stock generated taxable income, declarations from Zenith, and testimony from its president.

> It is our opinion that the principles set forth in Revenue Procedure 72-18 best implement all of [the parties' "meritorious"] considerations, will provide the most workable solution over the long term, and are not inconsistent with our existing opinions in this area. Revenue Procedure 72-18 focuses on the taxpayer's dominant purpose for incurring and continuing the subject indebtedness, but also considers the actual use of the debt funds as strong evidence of that purpose. . . . In the absence of direct evidence linking indebtedness with a particular purchase, the IRS, and this Board, will determine whether the totality of the facts and circumstances establish a sufficiently direct relationship between the borrowing and the investment to allow for a direct allocation between those two items. (Rev. Proc. 72-18, *supra*, § 3.04.) Unless the taxpayer can establish its dominant purpose and a sufficiently direct relationship between the expense and the income, respondent's allocation formula will provide the best means to allocate interest expense between taxable and nontaxable activities."

(*Zenith, supra,* 1998 WL 15204 at p. *5.) The principles and procedures set forth in Rev. Proc. 72-18 also have been applied in other California cases, most recently in *Apple, Inc. v. Franchise Tax Bd.* (2011) 199 Cal.App.4th 1, 22-26. Similar principles also were applied in *Appeal of Mission Equities Corp.* (75-SBE-002) 1975 WL 3263 (*Mission Equities*), although that decision involved tax periods which predated the revenue procedure.

Although we agree with FTB that the principles discussed in the foregoing authorities are applicable to this matter, we find that FTB has misapplied those principles in the situation before us. As the SBE explained in *Zenith*, the purpose of Rev. Proc. 72-18 is to determine "the taxpayer's dominant purpose for incurring and continuing the subject indebtedness." (*Zenith, supra,* 1998 WL 15204 at p. *5.) "Strong evidence of that purpose" is the taxpayer's actual use of the borrowed funds. (*Ibid.*; see also *Mission Equities, supra*, 1975 WL 3263 at p. *2 ["the question is what income did the expenses in controversy help to produce"].) Here, we know the purpose of BBCAF's borrowings. As FTB's counsel stated at the hearing:

> What's the purpose of the loan? The purpose of the loan here we know [is] to invest in the real estate properties on behalf of the BBC Trust.

However, FTB's proposed allocation does not satisfactorily take that purpose into account. Instead of applying a formula based upon the amount of borrowed funds that went to BBCAF's in-state properties versus its out-of-state properties, FTB applies a mathematical formula that compares the "average adjusted basis of the real estate [BBCAF] owned in and outside of California in each year at issue."

FTB contends that its formula is the "easiest to administer under the facts." However, ease of administration is not a sufficient basis for adopting FTB's formula. FTB's formula focuses not on how the borrowed funds were used by BBCAF, but on the "adjusted basis" of BBCAF's PTIs. BBCAF correctly notes that "[r]eferencing interest expense to the adjusted basis of properties is possible, but illogical and susceptible to producing bizarre results." This is because a property's basis may be adjusted for items having nothing to do with the taxpayer's use of borrowed funds. Although adjusted basis works well for the types of assets that were the subject of Rev. Proc. 72-18 (a portfolio of tax-exempt bonds, assets for which one would expect a taxpayer's adjusted basis to closely approximate, if not equal, the original cost), it does not work well here, where the assets at issue are illiquid PTIs in real property.

We find BBCAF's proposed allocation formula unsatisfactory as well. BBCAF proposes an allocation formula that is based upon the amount of income BBCAF earned from in-state sources versus its total income. BBCAF contends that "[i]f it is the income that leads to allocation, it is the income that must be at the heart of the method of expense allocation." BBCAF cites no authority for this proposition, and we reject it as being contrary to *Zenith* and the general thrust of Rev. Proc. 72-18, under which we are instructed to look to the taxpayer's dominant purpose for, and use of, the borrowed funds. Here, we know that the borrowed funds were used to acquire, directly or indirectly, real estate within and without California. Although the loans were not secured by particular properties, the parties agree that 27.6 percent of the loan proceeds were invested, through PTIs, in California real property.[28] Thus, we conclude that 27.6 percent of the interest expense paid with respect to the shareholder loans is allocable to the income that BBCAF reported as California source income.

D. <u>Whether BBCAF is entitled to interest offset</u>.

The parties also disagree as to whether the interest offset rules of Section 24344(b) have any applicability to this matter. BBCAF contends interest offset under Section 24344(b) is applied *first*, generating a dollar-for-dollar offset against the interest income BBCAF reported as

[28] Although the parties agree the borrowed funds were used to acquire U.S. real property (27.6 percent of which was located within California), we note that one of BBCAF's PTIs acquired property in California *before* the first of the loans. Because FTB has the burden of proof on the allocation issue, we do not adjust the 27.6 percent allocation figure for this amount; instead we assume that even if proceeds from the first loan were not directly used to acquire California real property, they were used to acquire other assets that generated California source income, perhaps those generating the interest income that BBCAF treated as California source income.

California source income, *before* any allocation is made (under either Section 24425(a) or Regulation 25120(d)) of the remaining, unallocated interest expense.

FTB contends that interest offset under Section 24344(b) is inapplicable for two reasons.[29] First, FTB notes that Section 24344(b) only applies to taxpayers whose income "is derived from or attributable to sources within this state [that] is determined pursuant to [R&TC] Section 25101 or 25110," and it contends that BBCAF's tax liability is not determined under those sections. We reject FTB's argument because, as we explain above in Issue 2(B)(ii), BBCAF's income is determined under Section 25101. Second, FTB contends that even if the interest offset rules of Section 24344(b) apply, the provisions of Section 24425(a) take precedence and override those of Section 24344(b). FTB relies upon *Appeal of Signal International* (66-SBE-018) 1966 WL 1373 (*Signal*) for this proposition.

In *Signal*, the taxpayer (Signal), apparently a California-domiciled corporation, borrowed funds (1) to acquire an interest in Iranian oil properties, (2) to acquire capital stocks in companies associated with the operation of those properties, and (3) for working capital and general corporate purposes. Signal reported significant gross profit from its oil properties as being non-California source income. It reported as California source income the dividends it received from one of its capital stocks. It offset that dividend income with its interest expenses pursuant to the interest offset provision of Section 24344(b), which provided as follows:

> If income of the taxpayer is determined by the allocation formula contained in Section 25101, the interest deductible shall be an amount equal to interest income subject to allocation by formula, plus the amount, if any, by which the balance of interest expense exceeds interest and dividend income (except dividends deductible under the provisions of Section 24402) not subject to allocation by formula. Interest expense not included in the preceding sentence shall be directly offset against interest and dividend income

[29] Neither of them is the fact that the U.S. Supreme Court struck down Section 24344(b) as unconstitutional—at least in part—in *Hunt-Wesson, Inc. v. Franchise Tax Bd.* (2000) 528 U.S. 458 (*Hunt-Wesson*). After *Hunt-Wesson*, FTB issued Notice 2000-9, in which it adopted the following "policy" regarding application of Section 24344(b).

> 1. For all taxpayers subject to Division 2, Part 11 of the Revenue and Taxation Code ("Bank and Corporation Tax Law"), [FTB] will continue to apply Rev. & Tax. Code § 24344(b) (the"interest offset" rule).
>
> 2. For all tax years beginning on or after February 22, 2000, and for prior periods if the taxpayer assertsa constitutional violation by the application of Rev. & Tax. Code § 24344(b) based upon *Hunt-Wesson* . . . no interest expense deduction will be disallowed through application of Rev. & Tax. Code § 24344(b) as an offset against interest and/or dividend income not subject to apportionment by formula and not allocable to California (i.e., interest and/or dividend income allocable outside of California).

> (except dividends deductible under the provisions of Section 24402) not subject to allocation by formula.

In *Signal*, FTB disallowed the deduction for two independent reasons. First, FTB argued that Section 24344(b) was inapplicable because Signal's income "was determined by separate accounting and not by the allocation formula" of Section 25101. The SBE did not rule on this argument (and we have rejected it in Issue 2(B)(ii), above). FTB's "primary argument" in *Signal*, however, was that "the deduction is prohibited by [S]ection 24425 of the Revenue and Taxation Code." The SBE found in FTB's favor on this argument, reasoning as follows:

> The overriding language of [S]ection 24425 compels us to conclude that the section is controlling over [S]ection 24344. We have previously reached the same conclusion with respect to the predecessors of these two sections. (*Appeal of Great Northern Railway Co.*, Cal. St. Bd. of Equal., June 14, 1943.) Since the interest expense here in question was allocable to income which was not included in the measure of the tax it may not be deducted.

Because the *Signal* decision contains little explanatory reasoning other than its cite to its decision in *Appeal of Great Northern Railway Co.* (43-SBE-003) 1943 WL 270 (*Great Northern II*), we look to that decision for guidance. In *Great Northern II*, the taxpayer (Great Northern), a foreign corporation domiciled outside California, incurred significant interest expense on bonds, the proceeds of which were used to acquire an out-of-state railroad company, the Chicago, Burlington & Quincy Railroad Company (CB&G RR). On its 1937 and 1938 tax returns, Great Northern deducted against its California income all the interest expense attributable to the bonds. However, Great Northern appears not to have included either the income of CB&G RR or the dividends it received from CB&G RR in the measure of its California franchise tax. Thus, the SBE framed the issue before it as follows:

> Is a foreign corporation, not domiciled within the State and conducting part of the unitary business in California, entitled to deduct interest on bonds, the proceeds of which were used to acquire stock in another corporation, where such stock does not have a business situs in California and where such interest is not an expense of the unitary business. It is the position of the Franchise Tax Commissioner that as the dividends received on such stock were not included in the measure of the franchise tax, the interest expense allocable thereto is not deductible from California income.

Great Northern claimed that the interest expense was deductible under the then-applicable interest offset provision, section 8(b) of the Bank and Corporation Franchise Tax Act (as amended by Stats. 1937, p. 2326), a precursor to current Section 24344. It provided for a deduction of "[a]ll interest paid or accrued during the income year on indebtedness of the taxpayer to the extent in excess of income of the taxpayer from interest and dividends . . . which is not included in the measure of the tax imposed by this Act." The SBE noted that it had held, in an earlier decision involving the same taxpayer's prior years, *Great Northern I*, *supra*, that despite the existence of a statute that authorized the deduction of all of a taxpayer's interest expenses, Great Northern was not entitled to deduct the entirety of its interest expense. That decision contained the following reasoning:

> In the determination of the amount of the net income attributable to California, of the unitary business of a foreign corporation such as Appellant, not having a commercial domicil[e] here, the state must exclude from that net income all income from sources outside the state and which does not arise from the conduct of the unitary business. (*Fargo v. Hart*, 193 U.S. 490.) Such income may be excluded either through its omission from the gross income of the corporation in the computation of the tax or by its inclusion in gross income and its subsequent deduction from the net income of the corporation. If the tax is to be measured by the net income of the corporation from business done within the state, it necessarily follows that the expense incurred with respect to the income arising from sources without the state and not incurred in the conduct of the unitary business must not be deducted from gross income, and if it has been deducted it must be added back to the net income figure obtained by making the deduction.

(*Great Northern I*, 1939 WL 310, at p. *2.) It is noteworthy that the SBE required an allocation in *Great Northern I* in the absence of a specific statute requiring that expenses attributable to income excluded from the measure of tax be disallowed. It found that this principle was inherent in the allocation formula itself. When Great Northern appealed its subsequent tax years (1937 and 1938) to the SBE, the result was the same, despite significant changes in both the statutory landscape and the parties' arguments. In 1937, the interest offset statute was amended, and the precursor to what is now R&TC section 24425 (then section 9 of the Bank and Corporation Franchise Tax Act) had become effective. Section 9 of the Bank and Corporation Franchise Tax Act provided as follows:

> In computing net income no deduction shall be allowed for:
>
> * * *
>
> (d) 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.

In *Great Northern II*, the taxpayer contended that the interest offset statute (section 8) permitted its interest deduction and should control over section 9, because section 8 was the more specific statute, dealing only with interest, whereas section 9 was a general statute that applied to all types of deductions. The SBE, however, rejected this contention, finding that: “Section 8(b) is not the more specific. The two sections must be read together and Section 9(d) limits the deductions which may be taken under Section 8.” (*Great Northern II*, 1943 WL 270, at p. *2.) The SBE also reaffirmed its prior holding that, even if section 9(d) of the Bank and Corporation Franchise Tax Act had not been enacted, an allocation of the deduction would be required, to be consistent with the general principles underlying section 10 of the Bank and Corporation Franchise Tax Act (the precursor to current Section 25101), which required the allocation and apportionment of the income of entities that have multistate operations. The SBE stated:

> [U] nder Section 10, as amended by Statutes of 1935, page 965, “if the entire business . . . is not done within this State, the tax shall be according to or measured by that portion thereof which is derived from business done within the State” which shall be determined by a “method of allocation as is fairly calculated to assign to the State the portion of net income reasonably attributable to the business done within this State and to avoid subjecting the taxpayer to double taxation.” The tax would not be measured by net income from business done within this State if in arriving at that income a deduction were allowed for interest and other expenses incurred in connection with the earning of income having no relation to California business.

(*Great Northern II*, *supra*, 1943 WL 270 at p. *2.)

BBCAF’s principal objection to FTB’s position, as noted earlier, is that Section 24425(a) has no applicability here since BBCAF’s non-California income was not “tax-exempt income.” We rejected this argument above. BBCAF does not directly confront the SBE’s holding in *Signal*, that Section 24425(a), when it apples, overrides Section 24344(b). We presume, however, that BBCAF would make the same arguments that the SBE rejected in *Signal*, *Great Northern I*, and *Great Northern II*.

If we were writing on a clean slate, it would not be unreasonable for us to conclude that Section 24344(b), which specifically deals with allocating interest expense for multistate businesses, should take precedence over Section 24425(a), which is a general override provision, applicable to all corporations and all types of deductions. But we are not writing on a clean slate.

Long-standing SBE precedents have held that Section 24425(a) overrides Section 24344(b). We see no reason to overturn those precedents in the circumstances presented here. For one thing, the rationale for giving precedence to Section 24344(b) would be that the Legislature would have intended for us to give it precedence over Section 24425(a). But here BBCAF is not asking us to apply Section 24344(b) as it was drafted by the Legislature. That version of the statute was declared unconstitutional in *Hunt-Wesson*. BBCAF is asking for us to apply a policy adopted by FTB after *Hunt-Wesson* in an attempt to reform the statute so that it would survive (or at least avoid) further constitutional scrutiny.[30] In light of the significant changes to Section 24344(b) brought about by *Hunt-Wesson* and FTB Notice 2000-9, we see no compelling reason to overturn our longstanding precedents so as to give precedence to Section 24344(b) over Section 24425(a). We also note (consistent with the SBE's decision in *Great Northern II*) that if we were to apply interest offset prior to making the allocation that is required in this matter under Section 24425(a), it would cause the allocation that we conclude is required to be applied in this matter to become less accurate in attributing BBCAF's interest deductions to the income it has excluded from the measure of its tax. Accordingly, pursuant to *Signal*, we find that BBCAF is not entitled to application of interest offset under Section 24344(b) and FTB Notice 2000-9.

Issue 3 – Whether BBCAF is entitled to a suspension or abatement of interest.

Interest is automatically imposed on late-paid tax liabilities, and neither FTB nor the OTA may abate interest without statutory authorization. (*Appeal of Myers* (2001-SBE-001) 2001 WL 37126924.) BBCAF asks that interest be suspended for the period from 18 months after the dates BBCAF filed its returns for the years at issue until December 20, 2016, when FTB filed its opening brief that notified BBCAF of the ultimate basis for FTB's position in this matter. BBCAF relies upon R&TC section 19116 as the basis for its request. That section

[30] That policy, set forth in FTB Notice 2000-9, makes no mention of either Section 24425 or *Signal*. Furthermore, we note that the California Legislative Counsel's Office has issued an opinion that *rejected* FTB's reasoning in FTB Notice 2000-9, and concluded that Section 24344(b) may *not* be applied in the manner set forth in that notice. (See Assem. Rev. & Tax Com., Analysis of A.B. 1618 (2007-2008 Reg. Sess.), available at: <http://www.leginfo.ca.gov/pub/07-08/bill/asm/ab_1601-1650/ab_1618_cfa_20070509_165845_asm_floor.html>, accessed Aug. 15, 2019.) We also note that in 2007, FTB sponsored legislation that would have "[d]eleted language determined to be unconstitutional, and therefore void, by the United States (U.S.) Supreme Court." (<http://www.leginfo.ca.gov/pub/07-08/bill/asm/ab_1601-1650/ab_1618_cfa_20070503_165415_asm_comm.html>, accessed Aug. 29, 2019.) That legislation passed the Legislature, but was vetoed by Governor Schwarzenegger. (<http://www.leginfo.ca.gov/pub/07-08/bill/asm/ab_1601-1650/ab_1618_vt_20071011.html>, accessed Aug. 29, 2019.)

permits, in specified circumstances, the suspension of interest for taxpayers that are subject to the Personal Income Tax Law (R&TC sections 17001 et seq.). However, that section has no applicability whatsoever to corporate taxpayers subject to the Corporation Tax Law (R&TC sections 23001 et seq.) such as BBCAF. Hence, BBCAF is not entitled to interest suspension under its provisions.

BBCAF also asks that interest be abated because of FTB's purported failure to diligently proceed in this matter, by failing to promptly analyze BBCAF's arguments, concede the original basis for its deficiency determination, and raise its new position. BBCAF also asks that interest be abated with respect to any deficiencies determined to exist with respect to BBCAF's second audit cycle (the 2007 and 2008 years) due to FTB's purported "total and complete inactivity" with respect to the audit adjustments raised for those years.

We construe BBCAF's allegations as a request for abatement of interest under Section 19104(a), which provides, in pertinent part, as follows:

> (a) The Franchise Tax Board may abate all or any part of any of the following:
>
> (1) Any interest on a deficiency or related to a proposed deficiency to the extent that interest is attributable in whole or in part to any unreasonable error or delay by an officer or employee of the Franchise Tax Board (acting in his or her official capacity) in performing a ministerial or managerial act.
>
> * * *

An FTB refusal to abate interest under Section 19104(a) (and its federal counterpart, IRC section 6404(e)) is reviewed under an abuse of discretion standard.[31] (R&TC, § 19104(b)(2)(B); *Lee v. Commissioner* (1999) 113 T.C. 145, 149.) Although BBCAF faults FTB's handling of this matter, and alleges that there was no activity by FTB during a lengthy multi-year period, BBCAF has not proven that FTB's failure to make more timely progress in this matter was attributable to "unreasonable error or delay by an officer or employee of the Franchise Tax Board (acting in his or her official capacity) in performing a ministerial or managerial act." In this regard, we note that the audits involved multiple years and issues, and those issues were highly technical and complex in nature. The fact that it took a considerable period of time for

[31] Although BBCAF has not submitted a separate request for abatement of interest to FTB, it included a request for abatement in its appeal letter, and FTB responded to the substance of BBCAF's request in its opening brief. Thus, we conclude we have jurisdiction to review FTB's denial of BBCAF's request for interest abatement. (See generally R&TC, § 19104(b)(2).)

FTB to audit, analyze, and review those issues—and ultimately to concede several of its audit determinations—does not establish that there was an "unreasonable delay" by FTB personnel in "performing a ministerial or managerial act." (See generally *Appeal of Kishner* (99-SBE-007) 1999 WL 1080250.) And although BBCAF contends there was "total and complete inactivity" with respect to the unity and interest issues that were raised in BBCAF's 2007-2009 years, at the time that audit cycle commenced, FTB's prior audit cycle was well underway. Since both audit cycles involved the same issues, it was not unreasonable for FTB to focus its efforts on attempting to develop and, hopefully, resolve the earlier audit cycle first, believing that its resolution would provide the basis for resolving the later audit cycle. Thus, BBCAF's allegation of FTB inactivity with respect to BBCAF's 2007-2009 audit cycle is not sufficient, in and of itself, to warrant interest abatement under Section 19104(a)(1).

HOLDINGS

1. FTB is entitled to raise its position that an allocation of BBCAF's interest expense is required, but FTB's new position constitutes "new matter" upon which FTB bears the burden of proof.
2. BBCAF is entitled to deduct 27.6 percent of the interest it paid on its shareholder loans for the years at issue.
3. BBCAF is not entitled to a suspension or abatement of interest.

DISPOSITION

The concessions by the parties in this matter are accepted, and 27.6 percent of the interest expense claimed by BBCAF from its shareholder loans for the years at issue are deductible against BBCAF's California source income.

DocuSigned by:
Jeffrey Margolis
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Jeffrey I. Margolis
Administrative Law Judge

K. GAST, concurring in part and dissenting in part:

I concur with the foregoing opinion (hereafter the majority opinion) in its holding and disposition of Issues 1 and 3, as well as most of Issue 2. However, I respectfully dissent with respect to Issue 2(D), above, that BBCAF is not entitled to interest offset under Section 24344(b). Rather, I find BBCAF is entitled to offset interest expenses against interest income *before* application of either Section 24425(a) or Regulation 25120(d).[1] I would have also gone further than the majority and held that, under the facts of this case, BBCAF's remaining interest expenses, after interest offset, are subject to allocation under Regulation 25120(d), not Section 24425(a).

This case presents a complex question: When, if at all, do three potentially conflicting provisions apply with respect to interest deductions—Section 24344(b), Section 24425(a), and Regulation 25120(d)? As discussed below, I would resolve the conflict by harmonizing all three, giving force and effect to each: (1) Section 24344(b) applies first to allow interest expenses to offset interest and dividend income included in the measure of tax; (2) remaining, unallocated interest expenses, if any, are then subject to Section 24425(a) (if the expenses relate to income excluded *before* apportionment and allocation); and (3) leftover unallocated interest expenses, if any, are then subject to Regulation 25120(d) (if the expenses relate to income excluded *after* apportionment and allocation).[2] I believe this approach provides a workable and predicable framework for both FTB and taxpayers.

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[1] However, I share my co-panelists' doubts as to whether Section 24344(b) still applies after the U.S. Supreme Court's decision in *Hunt-Wesson, Inc. v. Franchise Tax Bd.* (2000) 528 U.S. 458 (*Hunt-Wesson*). Contrary to the policy position set forth in FTB Notice 2000-9, a more plausible reading of *Hunt-Wesson* is that it effectively rendered the entirety of Section 24344(b) unconstitutional, not just that portion applicable to non-California domiciliaries. For that reason, I believe the policy adopted in Notice 2000-9—i.e., its attempt to save Section 24344(b) by severing the offending language and reforming the statute—is of questionable validity. (See generally *Ventas Finance I, LLC v. Franchise Tax Bd.* (2008) 165 Cal.App.4th 1207, 1224 [noting that "[i]n the context of cases involving tax statutes that violate the Commerce Clause, the courts have consistently declined to exercise the power of judicial reformation to cure the constitutional violation"].) But since neither of the parties before us contends that Notice 2000-9's policy for applying what remains of Section 24344(b) after *Hunt-Wesson* is invalid, my dissent assumes that policy is valid, and applies it to BBCAF's situation.

[2] Of course, direct tracing of interest expense deductions may be consistent with Section 24425(a) in appropriate situations. (See *Apple, Inc. v. Franchise Tax Bd.* (2011) 199 Cal.App.4th 1, 22-26 (*Apple*).)

A well-established rule of statutory construction is that specific provisions take precedence over more general ones.[3] (See *People v. Gilbert* (1969) 1 Cal.3d 475, 479.) Here, Section 24344(b) is a specific statute that applies "[i]f income of the taxpayer which is derived from or attributable to sources within this state is determined pursuant to *Section 25101 . . ., the interest deductible shall be* . . . ." (Emphasis added.) On the other hand, Section 24425(a) is much more general in scope: "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 . . . ." (Emphasis added.) Because Section 24344(b) is more specific than Section 24425(a)—the former explicitly dealing with taxpayers subject to Section 25101 incurring interest expenses, while the latter dealing more generally with "any amount otherwise allowable as a deduction"—I conclude Section 24344(b) controls.[4]

In reaching this conclusion, I am influenced by the fact that applying Section 24425(a) before Section 24344(b) would have the absurd result of rending the latter a nullity. Stated differently, once Section 24425(a) operates to allocate interest expenses to taxable or nontaxable income not included in the measure of tax, there can never be any such expenses left over to assign under Section 24344(b) or Regulation 25120(d).

FTB's heavy reliance on—and the majority's reaffirmation of—SBE's decision in *Appeal of Signal International* (66-SBE-018) 1966 WL 1373 (*Signal*) is misplaced. That case dealt with tax years prior to California's adoption of the UDITPA. This may have been why the taxpayer's income was subject to separate accounting—apparently not Section 25101, which the majority concludes, and I agree, applies here, along with the UDITPA. Although the SBE did conclude that Section 24425(a) controls over Section 24344(b), it performed no analysis to reach that conclusion, as the majority concedes. Also, while not clear from the case, it appears the taxpayer sought to deduct interest expenses against California source income, when those expenses related to dividend income deducted from the California tax base. In contrast, here, BBCAF is only

[3] I employ this familiar rule of statutory construction even though it generally applies only if provisions cannot be harmonized. (See *State Dept. of Public Health v. Superior Court* (2015) 60 Cal.4th 940, 955.) In any event, to the extent the provisions at issue are irreconcilable, the rule that specific provisions take precedence over more general ones is directly applicable here and aids in the analysis.

[4] Section 24344(b) essentially has three steps: (1) interest expense is first deducted against business interest income; (2) any leftover interest expense is then deducted against nonbusiness interest income and dividend income (whether or not allocated to California, under the policy set forth in Notice 2000-9); and (3) interest expense remaining after step 2 is then deducted against all other business income subject to apportionment. (These steps will be referred to hereafter as steps 1, 2, and 3.)

seeking to deduct interest expenses against interest income that was included in its measure of tax.

For the unexplained proposition that Section 24425(a) controls, *Signal* cited to *Appeal of Great Northern Railway Co.* (43-SBE-003) 1943 WL 270 (*Great Northern II*). But, similar to *Signal*, *Great Northern II* involved a taxpayer that sought to offset non-unitary interest expense against California source income, when that expense related to dividend income not included in the measure of tax. Like *Signal*, that case performed no analysis for its conclusory holding that "[i]t appears, however, that Section 8(b) [a predecessor to Section 24344(b)] is not the more specific. The two sections must be read together and Section 9(d) [a predecessor to Section 24425(a)] limits the deductions which may be taken under Section 8." (*Great Northern II*, *supra*, 1943 WL 270 at p. *2.) The case also based its conclusion on the fact that the taxpayer's allocation percentage only assigned income derived from sources within California, and the taxpayer's "tax would not be measured by net income from business done within this State if in arriving at that income a deduction were allowed for interest and other expenses incurred in connection with the earning of income having no relation to California business." (*Ibid.*) Again, unlike *Great Northern II*, BBCAF's interest income was included in its measure of tax.

In fact, the California Supreme Court itself—albeit in dicta—strongly suggested that Section 24344(b) overrides Section 24425(a). (*Pacific Telephone & Telegraph Co. v. Franchise Tax Bd.* (1972) 7 Cal. 3d 544, fn. 7.)[5] I would also note that neither *Hunt-Wesson* nor Notice 2000-9 even mention Section 24425—much less insinuate that it applies over Section 24344(b).

But, to the extent *Signal* or *Great Northern II* conflict with the conclusion herein that Section 24344(b) controls over Section 24425(a), I would decline to follow them as outdated (and bad) law.[6] FTB itself has historically wavered on its current litigating position here, at one

[5] The referenced footnote from *Pacific Telephone & Telegraph Co.* states, in full, the following: "It has been suggested that the possible loophole would be closed in any event by [S]ection 24425 which disallows deductions allocable to one or more classes of income not included in the measure of the tax. (Cf. *Great Western Financial Corp. v. Franchise Tax Bd.*, 4 Cal.3d 1, 5-6 [92 Cal.Rptr. 489, 479 P.2d 993].) However, subsection (b) deals specifically with the allowability of the interest deduction of corporations which allocate by formula; whereas [S]ection 24425 deals with the allowability of deductions generally. Thus, if, contrary to the views expressed herein, subsection (b) were construed as prohibiting the reduction of the interest expense deduction by nontaxable dividends, *this construction of subsection (b) might prevail over [S]ection 24425*." (Emphasis added.)

[6] For the same reasons, I would also find *Appeal of Great Northern Railway Co.* (39-SBE-009) 1939 WL 310, distinguishable and/or I would decline to follow it.

point concluding Section 24344(b) takes precedence over Section 24425(a). (See, e.g., Legal Rulings 374 (May 2, 1974) [withdrawn] & 424 (Aug. 3, 1983) [also withdrawn, but it distinguished *Signal* and concluded that for apportioning taxpayers, "Section 24344(b) would have controlled"].) Accordingly, Section 24344(b) controls over Section 24425(a).

In applying Section 24344(b) first, all of BBCAF's interest income is included in its measure of tax, as noted above.[7] Therefore, under either step 1 or 2 of Section 24344(b), BBCAF is entitled to deduct interest expenses against interest income, whether or not those expenses are directly or indirectly traceable to that income.[8]

However, under step 3 of Section 24344(b)—i.e., interest expenses remaining after step 2 that are deductible against all other business income subject to apportionment—I would conclude that an allocation of such expenses may be required when those expenses are traceable (directly or indirectly) to income not includible in the measure of tax. For example, this could occur when the taxpayer generates income not included in the tax base prior to apportionment and allocation, income from non-unitary separate trades or businesses, nonbusiness income (other than interest and dividends that have already been offset under step 2), or some combination thereof. Under these circumstances, this approach would require an allocation under Section 24425(a) and/or Regulation 25120(d), which would harmonize the three potentially conflicting provisions. It would also avoid taxpayers obtaining a windfall by deducting from income included in the measure of tax remaining interest expenses properly traceable (directly or indirectly) to income excluded from that measure.[9]

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[7] Even though I join in the majority's conclusion for Issue 2(B)(ii) that BBCAF is subject to Section 25101, it arguably still may not have business income for purposes of Section 24344(b), because BBCAF was a passive holding company that conducted all of its own separate trade or business activities wholly within California. (See Regulations 25121(b) & 25122(a).) However, by its terms, Section 24344(b) applies to taxpayers subject to Section 25101, and, in my view, it would make little sense to apply the interest offset rule to apportioning trades or businesses, but not to wholly intrastate businesses, such as BBCAF, whose interest income is taxed in California.

[8] Indeed, the taxpayer-friendly treatment of Notice 2000-9—i.e., the ability of taxpayers to obtain a dollar-for-dollar offset of interest expenses against business interest income and nonbusiness interest and dividend income, regardless of direct tracing of those expenses—is why BBCAF seeks to invoke its provisions first. Hypothetically, if a taxpayer's business interest income (and/or nonbusiness interest or dividend income) exceeded interest expenses, then Section 24344(b) (as applied by Notice 2000-9) would allow all of those expenses to be deducted, even if they were traceable to income not subject to tax.

[9] I do note in passing that there are circumstances in which a taxpayer can generate business or nonbusiness interest expense deductions for purposes of the UDITPA (i.e., Section 25120(a) or (d)) that cannot be associated (directly or indirectly) with any particular income stream. However, that is not the situation here.

Under the present facts, step 3 would not entitle BBCAF to deduct all of its remaining, unallocated interest expenses against the rest of its income, because a portion of that income (or losses) is *not* included in the measure of tax. In fact, the majority of BBCAF's income was derived from its distributive shares of income (or losses) from non-California, non-unitary partnerships, sourced to locations outside of California. Therefore, even though I agree with the majority's conclusion that only 27.6 percent of BBCAF's interest expenses can be deducted against its California source income, I would have multiplied that percentage against its remaining, unallocated interest expenses, after application of Section 24344(b).[10]

Finally, I would have gone further than the majority and found that the 27.6 percent allocation, after interest offset, is computed under Regulation 25120(d), not under Section 24425(a)—even though I agree that application of either provision achieves the same result here. While Section 24425(a) disallows otherwise allowable deductions allocable to income "not included in the measure of the tax," I believe that it applies to deductions related to items of excludible income *prior to* apportionment and allocation. This conclusion is consistent with how Section 24425(a) has historically been applied by the California courts and our predecessor agency, the SBE. (See, e.g., *Great Western Financial Corp. v. Franchise Tax Bd.* (1971) 4 Cal. 3d 1 [interest expenses related to dividend income deducted under former Section 24402]; *Apple, supra,* 199 Cal.App.4th 1 [same]; *Anaheim Union Water Co. v. Franchise Tax Bd.* (1972) 26 Cal.App.3d 95 [expenses related to income excluded under Section 24405]; *Appeal of Zenith National Insurance Corp.* (98-SBE-001) 1998 WL 15204 [interest expenses related to dividend income from insurance subsidiary deducted under Section 24410]; *Appeal of Mission Equities Corp.* (75-SBE-002) 1975 WL 3263 [expenses related to dividend income deducted under former Section 24402].)

This conclusion also gives force and effect to Regulation 25120(d), which requires the proration of deductions related to income excluded from the tax base *after* apportionment and allocation, i.e., those deductions related to "*the business incomes of more than one trade or*

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[10] However, I acknowledge my position might require an adjustment to the 27.6 percent to take into account a portion of the interest expenses allocated first to the assets that generated the interest income.

business and/or to several items of nonbusiness income."[11] (Regulation 25120(d), emphasis added.)[12] Because the UDITPA treats BBCAF's distributive shares of income (losses) from its non-unitary partnerships as derived from separate trades or business (see Regulation 25137-1(g)), Regulation 25120(d) should apply to allocate the remaining interest expense deductions to those separate trades or businesses within and without California.

For the foregoing reasons, I respectfully dissent with respect to Issue 2(D).

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Kenneth Gast
Administrative Law Judge

[11] Indeed, "the [UDITPA] assumes that the existing state legislation *has defined the base of the tax* and that the only remaining problem is the amount of the base that should be assigned to the particular taxing jurisdiction. Thus, [unlike Section 24425(a)] the statute does not deal with the problem of ascertaining the items used in computing income or the allowable items of expense." (*Appeal of Crisa Corp.* (2002-SBE-004) 2002 WL 1400003, p. *8, quoting Pierce, *The Uniform Division of Income for State Tax Purposes* (1957) 35 Tax Magazine 747, emphasis in original.)

[12] In other words, I believe income from a separate trade or business, or nonbusiness income, is initially included in the measure of tax *prior* to apportionment and allocation, but the income gets removed from that measure *after* application of the UDITPA if it is not sourced to California. Section 24425(a) simply disallows expenses allocable to income not included in the measure of tax *prior* to apportionment and allocation, such as deductible dividend income and income generated by insurance companies exempt from California franchise/income tax. Section 24425(a) already accounts for the disallowance of expenses in the determination of "net income" under Section 24341, which is a figure containing the taxpayer's net income from whatever source derived, *prior* to apportionment and allocation. (See R&TC, § 24341 ["Net income" means "gross income" from whatever sourced derived under Section 24271 et seq., less the deductions under Section 24401 et seq., and in computing that "net income," no deduction is allowed for the items specified in Section 24421 et seq., which includes Section 24425(a)].) Thus, if Section 24425(a) disallows the expenses, they would not have been included in "net income" (or the measure of tax) *prior* to apportionment and allocation and therefore would not be subject to proration under Regulation 25120(d). But if allowed, they would be subject to proration under Regulation 25120(d) if they relate to income from a separate trade or business or nonbusiness income. (See R&TC, § 25101 [where the UDITPA, including Regulation 25120(d), applies to compute that portion of "the net income," determined under Section 24341, that is derived from sources within California].)

T. LEUNG, concurring in part and dissenting in part:

I agree with the ultimate outcome of this appeal as set forth in the Disposition above, but write separately to express my disagreement with two aspects of the reasoning of the above opinions.

Burden of proof.

The burden of proof did not shift to FTB. Even under *Shea v. Commissioner* (1999) 112 T.C. 183 (*Shea*), the "new matter" needs to be beyond the scope of the deficiency notices (in this case, the NPAs, as affirmed or revised in the NOAs) before the burden of proof is shifted. Hence, in *Shea*, the court held that the IRS's disallowance of a community property deduction was beyond the scope of a deficiency notice imposing tax on unreported income. Likewise, in *Evans v. Commissioner*, T.C. Memo. 2010-62, the court shifted the burden of proof to the IRS where the IRS raised the issue of unreported rental income and bank deposits after the notice of deficiency had only raised the issue of the taxpayer's failure to report income from the disposition of stocks and bonds. When the government refines its original theory, there is no new matter and no shifting of the burden of proof, especially when the original theory, as set forth in the government's statutory notice of deficiency, is worded broadly. (See *Cavallaro v. Commissioner* (1st Cir. 2016) 842 F.3d 16 [IRS use of different valuation in gift tax case not a new matter].)

In this appeal, the NPAs challenge BBCAF's filing on a separate accounting basis and disallow its interest expense deduction because the $156,207,500 in loans that generated the interest expense were capital contributions and not bona fide debt. For purposes of Part 11 of the R&TC, the starting point for determining whether an interest expense is deductible is Section 24344(a), which cross references IRC section 163. But the inquiry does not stop there as not every dollar of interest expense is treated the same; there are, for example, timing differences, sourcing issues, and outright disallowances (see, e.g., R&TC, § 24425; IRC, § 265). Here, FTB, after conceding that the $156,207,500 was bona fide debt, then sought to "refine" the issue by limiting the amount of deductible interest expense to those expenses that are attributable to activities subject to California tax. Even BBCAF's witness, an accountant, testified that she would have looked at Regulation 25120(d) to allocate the interest expense after it switched from a unitary business filing position to a nonunitary filing position. Simply put, FTB's action began as an interest expense denial case, and it remains an interest expense denial case. Thus, the burden of proof remains with BBCAF.

Section 24425 controls because *Hunt-Wesson* held interest offset (Section 24344(b)) unconstitutional.

Regardless of whether BBCAF and its PTIs are engaged in an apportioning unitary business, the interest offset cannot apply over Section 24425. Twenty years ago, when the interest offset was not deadwood, there was a robust debate over which of these provisions applied first. In the aftermath of *Hunt-Wesson, Inc. v. Franchise Tax Bd.* (2000) 528 U.S. 458 (*Hunt-Wesson*), and the relegation of the interest offset to the status of an FTB Notice, there is no doubt that a validly enacted statute (Section 24425) prevails over a void provision that is given vitality via a notice that was not vetted in accordance with the California Administrative Procedure Act (Gov. Code, §§ 11340 et seq., hereafter, the APA).

Traditionally, "[a]n unconstitutional act is not a law; it confers no rights; it imposes no duties; it affords no protection; it creates no office; it is, in legal contemplation, as inoperative as though it had never been passed." (*Norton v. Shelby County* (1886) 118 U.S. 425, 442; see also *Kopp et al. v. Fair Political Practices Commission* (1995) 11 Cal.4th 607, 623 (*Kopp*).) The modern principle is that a statute declared unconstitutional is void in the sense that it is inoperative or unenforceable, but not void in the sense that it is repealed or abolished. Two parallel and related concepts have been used by the courts to allow portions of statutes declared to be invalid as unconstitutional to continue to be applied—severability and reformation. (See *Kopp, supra; Abbott Laboratories v. Franchise Tax Bd.* (2009) 175 Cal.App.4th 1346.)

Severability and reformation are not pertinent here because they are judicial remedies, and FTB Notice 2000-9 was an attempt by the executive branch to resuscitate a void statute, Section 24344(b). While courts have concluded that a court may reform a statute without invading on the powers granted to the Legislature, FTB is part of the executive branch, and the executive branch has no apparent "permission" to exercise legislative powers.[1]

[1] The adoption or amendment of statutes is a legislative prerogative. Article III, section 3, of the California Constitution provides as follows: "The powers of state government are legislative, executive, and judicial. Persons charged with the exercise of one power may not exercise either of the others except as permitted by this Constitution." Legislative power is vested in the Legislature and the people, and executive power is vested in the Governor and the executive branch. (See Cal. Const., art. IV, section 1; Cal. Const., art. V, section 1.)

FTB's extra-judicial attempt to reform Section 24344(b) through FTB Notice 2000-9 fails to comply with the APA. FTB Notice 2000-9 lacks many of the basic elements prescribed by the rulemaking provisions of the APA. Thus, as adopted, FTB Notice 2000-9 is nothing more than an underground regulation. (See Cal. Code Regs., tit. 1, §§ 250 et seq.)

Compliance with the rulemaking requirements of the APA is mandatory, and all regulations are subject to the APA, unless expressly exempted by statute. (Gov. Code, § 11346; *Armistead v. State Personnel Bd.* (1978) 22 Cal.3d 198 (*Armistead*); *Engelmann v. State Bd. of Education* (1991) 2 Cal.App.4th 4.) Any doubt as to the applicability of the APA should be resolved in favor of the APA being applied. (*Grier v. Kizer* (1990) 219 Cal.App.3d 422.)

> "Regulation" means every rule, regulation, order, or standard of general application or the amendment, supplement, or revision of any rule, regulation, order or standard adopted by any state agency to implement, interpret, or make specific the law enforced or administered by it, or to govern its procedure.

(Gov. Code, § 11342.600.)

If a rule looks like a regulation, reads like a regulation, and acts like a regulation, it will be treated by the courts as a regulation. (*State Water Resources Control Bd. v. Office of Admin. Law* (1993) 12 Cal.App.4th 697.)

> No state agency shall issue, utilize, enforce, or attempt to enforce any guideline, criterion, bulletin, manual, instruction, order, standard of general application, or other rule, which is a regulation [under the APA unless it] has been adopted as a regulation and filed with the Secretary of State pursuant to [the APA].

(Gov. Code, § 11340.5(a).)

In summary, FTB Notice 2000-9 is a rule of general application (see *Roth v. Department of Veterans Affairs* (1980) 110 Cal.App.3d 622) purporting to reform the interest offset provision that was held to be unconstitutional in *Hunt-Wesson*. In addition to impermissibly reforming Section 24344(b) as described above, FTB Notice 2000-9 was not promulgated pursuant to the APA and, therefore, has no legal effect. (See *Armistead*, *supra*.) Deductions from gross income are a matter of legislative grace and a taxpayer has the burden of proving entitlement to all of the deductions claimed. (*New Colonial Ice Co. v. Helvering* (1934) 292 U.S. 435, 440; *Appeal of Walshe* (75-SBE-73) 1975 WL 3557.) To carry the burden of proof, a taxpayer must point to an applicable statute and show by credible evidence that the deductions claimed come within its terms. (*Appeal of Telles* (86-SBE-061) 1982 WL 11930.) In this appeal, the taxable years at issue are post *Hunt-Wesson*, and for application of the interest offset BBCAF relies on FTB Notice 2000-9, which is neither a statute nor a properly promulgated regulation. At the end of the day, the only valid statute that can be used to allocate BBCAF's interest expense is Section 24425.

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Tommy Leung
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Tommy Leung
Administrative Law Judge