



BEFORE THE STATE BOARD OF EQUALIZATION OF THE STATE OF CALIFORNIA.

In the Matter of the Appeal of) KROEHLER MFG. CO,)

Appearances:

For Appellant: Jack W. Nake11, Certified Public Accountant

For Respondent: Crawford H. Thomas, Associate Tax Counsel

O P I N I O N

This appeal is made pursuant to section 25667 of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protest of Kroehler Mfg. Co.. against a proposed assessment of additional franchise tax in the amount of \$2,214.16 for the income year 1959.

Appellant is a foreign corporation engaged in the manufacture of furniture with principal offices located in Naperville, Illinois. During the year under review, appellant, and the Kroehler Mfg. Co. of Canada, a wholly owned Canadian subsidiary, conducted a unitary business, Their combined unitary income was apportioned to California by the usual three-factor formula of property, payroll and sales. The subsidiary did no business in California and had no California allocation factors.

Appellant received a dividend in the amount of \$300,389.06 in 1959 from its Canadian subsidiary. Neither this dividend, nor an additional \$2,173.93 in dividend and interest income, was unitary income subject to allocation by formula, Appellant also, received unitary interest income in the amount

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of \$14,594.83 which was subject to allocation. Since appellant was a foreign corporation, none of the dividends or interest was includible in the measure of its **franchise tax** as separate, in contrast with allocable, income.

In computing its unitary income for 1959, appellant included the above unitary interest income of \$14,594.83 and deducted interest expense amounting to \$347,801.54. On the basis of section 24344, subdivision (b), of the Revenue and Taxation Code, however, the Franchise Tax Board disallowed \$302,562.99 of the interest expense claimed by appellant. This **disallowance** equals the total amount of appellant's non-allocable dividend and interest income (\$300,389.06 plus \$2,173.93)

Section 24344, which allows, generally, a deduction for **all interest** paid or accrued during the year on indebtedness of the taxpayer, specifically provides:

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

Respondent allowed as deductible interest expense the sum of \$45,238.55, consisting of that amount equal to allocable interest income (\$14,594.83) plus the amount (\$30,643.72) by which the balance of the interest expense (\$333,206.71) exceeded interest and dividend income not subject to allocation by formula (\$302,562.99). The last sentence of the statute has no application here since none of the interest or **dividend income** not subject to allocation was included in the measure of appellant's tax and thus was not available for direct set off **against the nondeductible** interest expense.

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Appellant objects to that portion of the proposed assessment which accrues from the disallowance of interest expense in an amount equal to the dividend it received from its Canadian subsidiary. It urges that the dividend should be disregarded in making the computation because the income of its subsidiary which gave rise to the dividend was included in unitary income. By excluding interest in an amount equal to the dividend and thereby increasing taxable income, appellant contends that the same income has been taxed twice.

Appellant's argument is founded upon two misconceptions: first, because the income of its Canadian subsidiary was included in the combined report, appellant assumes that such income was taxed by California; and second, it is assumed that the effect of the combined report is to tax appellant and its subsidiary as a single entity. The combined report of income is merely a means of securing the information required to ascertain that portion of unitary income arising from sources within this state. It does not constitute a true consolidated return upon which a single tax would be based nor does respondent's method of apportioning combined income disregard, for tax purposes, the separate corporate entities of appellant and its subsidiary. (Edison California Stores, Inc. v. McColgan, 30 Cal. 2d 472 [183 P.2d 16]; Appeal of Dohrmann Commercial Co., Cal. St. Bd. of Equal., Feb. 29, 1956.) The payment and receipt of a dividend within the unitary group may not, therefore, be disregarded. Consistent with this principle, we have previously held that such a dividend is includible in the measure of the tax of a corporate recipient which has its domicile in California. (Appeal of Dohrmann Commercial Co., ¹¹⁻⁹² supra; Appeal of Safeway Stores, Inc.,⁸⁻²⁷ Cal. St. Bd. of Equal., March 2, 1962.) It is correspondingly appropriate to give effect to the receipt of a similar dividend by a foreign corporation, for purposes of limiting the interest expense deduction under section 24344.

In calculating appellant's interest expense deduction, respondent has followed section 24344 to the letter. Whether it may or should proceed beyond the terms of that section in order to avoid double taxation of the same income, we need not decide here, since appellant has not demonstrated that double taxation exists. The obvious prerequisite for any showing of double taxation is the establishment of the fact that a part

