BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
JACKSON APPLIANCE, INC.)

For Appellant: Harry D. Martin
Attorney at Law

For Respondent: Crawford H. Thomas
Chief Counsel

Jack E. Gordon
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 Jackson Appliance, Inc., against a proposed assessment of additional franchise tax in the amount of $18,333.74 for the income year 1965.

The sole question for decision is whether appellant was entitled to an interest expense deduction in the amount of $275,000 for the income year 1965.

Appellant, a California corporation, was a wholly-owned subsidiary of M. S. Clark Enterprises, Inc. Appellant utilized the cash receipts and disbursements method of accounting. Its sole asset was some 5,000 acres of unimproved real property located in Ventura County, California, which it had acquired in 1961. Between 1961 and November 1965, when that property was sold by appellant, it was the subject of extensive litigation involving questions of title and alleged liens against the land. In order to finance the defense of

its title and to pay property taxes and interest incidental to its ownership, appellant had borrowed substantial sums from its parent company.

In 1964 appellant borrowed $275,000 from Snap-Tite, Inc., another subsidiary of M. S. Clark Enterprises, Inc., and paid it over to its parent company as interest on its indebtedness. Appellant claimed this interest payment as an interest expense deduction on its 1964 state and federal tax returns. M. S. Clark Enterprises, Inc., reported the payment as interest income on its 1964 federal income tax return, offsetting a net operating loss carryover (Int. Rev. Code of 1954, § 172) which was to expire in that year.

The Internal Revenue Service audited appellant's federal income tax returns for 1964, 1965 and 1966. Ultimately it determined that due to appellant's net operating loss deductions there was no federal tax liability for those years. A part of that determination resulted from the allowance of the $275,000 interest payment as a deduction in 1964.

Respondent adopted the final federal determination and, to the extent allowable under California law, revised appellant's franchise tax liability. Since the California tax law contains no net operating loss carryback and carryover provisions, the federal adjustments agreed to by appellant produced the major part of the 1965 deficiency assessment here at issue. The correctness of the remainder of that assessment has apparently been conceded by appellant.

The gist of appellant's argument seems to be that since it was absolved of all federal income tax liability for 1965, the same result should be achieved under California law. Appellant would accomplish this by treating the 1964 interest payment as having been made in 1965. In this connection appellant urges that "the $275,000.00 was never actually paid on a cash basis until 1965, which was the first year that it [the appellant] truly had cash in a real sense with which to pay its interest expense."

It is well established that a deficiency assessment issued by respondent on the basis of a federal audit report is presumed to be correct, and the burden is on the taxpayer to show that it is incorrect. (Todd McColgan, 89 Cal. App. 2d 509 [201 P.2d 414]; Appeal of Nicholas H. Obritsch, Cal. St. Bd. of Equal., Feb. 17, 1959; Appeal of Affiliated Government Employees' Distributing Co., Cal. St. Bd. of Equal., Sept. 12, 1968.) In the instant case appellant agreed to the federal government's resolution of its tax dispute, including the allowance of the $275,000 interest deduction in 1964. Respondent's proposed additional assessment for 1965 was based entirely upon the final federal determination. The assessment at issue resulted from differences in the state and federal laws, and this board has no power to change the existing law. The presumption of correctness attaching to the assessment must therefore prevail.

Appellant argues that the interest payment which it concededly made in 1964 nevertheless should be allowed as an expense deduction in 1965. Section 24344 of the Revenue and Taxation Code provides, in subdivision (a), "... there shall be allowed as a deduction all interest paid or accrued during the income year on indebtedness of the taxpayer." Interest expense is generally deductible by a cash basis taxpayer in the year in which it is actually paid. (Eli D. Goodstein, 30 T.C. 1178, aff'd, 267 F.2d 127; Hart v. Commissioner, 54 F.2d 848; Harchester Realty Corp., T.C. Memo., June 21, 1961.) The fact that such an expense is paid with borrowed funds, as in the instant case, does not alter this rule. (Hazel McAdams, 15 T.C. 231, aff'd, 198 F.2d 54; Robert B. Keenan, 20 B.T.A. 498.) Furthermore, appellant and its parent corporation both reported the $275,000 interest payment as a 1964 transaction in their tax returns for that year. Under the above mentioned established principles of law, appellant's argument for deduction in 1965 is totally untenable.

ORDER

Pursuant to the views expressed in the opinion of the board on file in this proceeding, and good cause appearing therefor,

Appeal of Jackson Appliance, Inc.

IT IS HEREBY ORDERED, ADJUDGED AND DECREED, pursuant to section 25667 of the Revenue and Taxation Code, that the action of the Franchise Tax Board on the protest of Jackson Appliance, Inc., against a proposed assessment of additional franchise tax in the amount of $18,333.74 for the income year 1965 be and the same is hereby sustained.

Done at Sacramento, California, this 6th day of November, 1970, by the State Board of Equalization.

_____, Chairman

_____, Member

_____, Member

_____, Member

_____, Member

ATTEST: _____, Secretary