



BEFORE THE STATE BOARD OF EQUALIZATION
OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
SIGNAL INTERNATIONAL)

Appearances:

For Appellant: Loren P. Oakes
Tax Counsel

For Respondent: Peter S. Pierson
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 protests of Signal International against proposed assessments of additional franchise tax in the amounts of \$822.87 and \$423.56 for the income years 1957 and 1958, respectively.

The issue presented concerns the deduction of interest expense.

Appellant, a California corporation, borrowed certain funds which were used (1) to acquire an interest in Iranian oil properties, (2) to acquire capital stocks in certain companies associated with the operation of those properties, including capital stock of Iranian Oil Participants, Ltd., and (3) as working capital and for general corporate purposes. The interest expense on the borrowed funds amounted to \$21,344 in 1957 and \$11,689 in 1958.

For each of the years involved appellant reported on its franchise tax returns "Gross profit from sales" of

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approximately \$1,500,000 from "Without California." It also reported as gross income from "Within California," dividends from Iranian Oil Participants, Ltd., in the amounts of **\$21,255** and **\$11,447** for the respective years. The interest expense was offset against the dividends and, as a result, none of appellant's net income of approximately **\$1,000,000** for each of the years was attributed to California.

Although specific details are lacking, we shall proceed upon the following assumptions, which appear to be accepted by both parties: (1) of the reported gross income, only the dividends are **includible** in the measure of California tax; (2) **the amount** of the borrowed funds used to purchase the stock that produced those dividends is insignificant; and (3) the reported gross income other than dividends was produced by properties and operations financed by the borrowed funds.

Relying upon subdivision (b) of section 24344 of the Revenue and Taxation Code, appellant **contends** that the interest expense was properly offset against the dividends. Section 24344 provides:

(a) Except as limited by subsection (b), there shall be allowed as a deduction all interest paid or accrued during the income year **on** indebtedness of the taxpayer.

(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. I n t e r e s t 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 argues that subdivision (b) of section 24344 does not apply to appellant since its income **was** determined

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by separate accounting and not by the allocation formula, Its primary argument, however, is that the deduction is prohibited by section 24425 of the Revenue and Taxation Code.

Section 24421 of the Revenue and Taxation Code provides that "... no deduction shall be allowed for the items specified in this article." One of the items specified as nondeductible is described in section 24425 as:

Any amount otherwise allowable as a deduction which is allocable to one *or more* classes of income not included in the measure of the tax imposed by this part, regardless of whether such income was received or accrued during the income year,

The overriding language of section 24425 compels us to conclude that the section is controlling over *section 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,

O R D E R

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

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 protests of Signal International against proposed assessments of additional

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franchise tax in the amounts of \$822.87 and \$423.56 for the income years 1957 and 1958, respectively, be and the same is hereby sustained.

Done at Sacramento, California, this 4th day of January, 1966, by the State Board of Equalization.

Geoffrey, Chairman
John W. L..., Member
Richard C..., Member
_____, Member
_____, Member

ATTEST: [Signature], Secretary