

California's Interest Offset Provision Found Unconstitutional

The U.S. Supreme Court has held that California's interest offset provision contained in California Revenue and Taxation Code section 24344, which limits interest expense deductions for corporations, impermissibly allowed California to tax indirectly a corporation's nonunitary dividend and interest income which California could not tax directly. In *Hunt Wesson, Inc. v. Franchise Tax Board of California* (No. 98-2043) ___ U.S. ___ (2000), the Court held that California's rules authorizing a deduction for interest expense but only to the extent that the amount exceeds certain out-of-state income arising from the unrelated business activity of a discrete business enterprise, *i.e.*, income that the State could not otherwise tax, violated the U.S. Constitution's Due Process and Commerce Clauses. The Court observed that in other contexts the federal government and other states employed reasonable efforts to properly allocate a deduction between taxable and nontaxable income. The Court concluded that California's interest offset rule was not a reasonable attempt at allocation.

The case was remanded to the trial court for further proceedings consistent with the Court's opinion. The

New Independent Contractor Reporting Begins in 2001

Beginning January 1, 2001 California Unemployment Insurance Code section 1088.8 (SB 542, Ch. 99-480) will require businesses to notify the California Employment Development Department when using the services of an independent contractor. The provision applies even to businesses that are not employers. The new law provides that effective January 1, 2001, any service-recipient "who makes or is required to make a return to the Internal Revenue Service, in accordance with paragraph (A) of subdivision [sic] (a) of Section 6041 of the Internal Revenue Code (relating to payments made to service providers as compensation for services) shall file with the department information as required ..."

This new provision only applies to service recipients engaged in business in California, deriving trade or business income from sources within California, or in any manner in the course of a trade or business subject to the laws of California. *CUIC § 1088.8(b)(1)*. A business must report when aggregate payments equal or exceed \$600 in any year or when entering into a contract or contracts for payments that in the aggregate equal or exceed \$600.

Franchise Tax Board at oral argument indicated that the Revenue and Taxation Code already provides alternative methods to allocate expenses between taxable and nontaxable income. For example, Revenue and Taxation Code section 24425 disallows the deduction for expenses that are allocable to one or more classes of income not included in the measure of the tax. In *Appeal of Zenith National Insurance Company*, No. 98-SBE-001, January 8, 1998, a case handled by Pillsbury Madison & Sutro LLP, the taxpayer successfully overcame the application of the Franchise Tax Board's general asset allocation formula and proved that certain interest expense was incurred for the purpose of producing taxable income and, thus, the taxpayer was able to claim the full interest deduction. In anticipation of its defeat in *Hunt-Wesson*, the Franchise Tax Board on audit has been performing calculations under both Section 24344 and an alternative asset allocation formula, such as that which was put forth in *Zenith*.

Taxpayers should review the impact of interest offset on past filings as well as on their 1999 return and file refund claims if appropriate.

San Francisco Business and Payroll Taxes under Attack

Following the appellate court rulings in favor of General Motors concerning the invalidity of the Los Angeles and San Francisco business taxes many entities engaged in business in San Francisco have been filing refund claims and refund lawsuits seeking recoupment of past paid business taxes as well as challenging the imposition of the payroll tax. Pillsbury Madison & Sutro LLP has assisted taxpayers in filing the appropriate refund and appeal documents before the Tax Collector and Board of Review and ultimately in filing a refund lawsuit. There are several lawsuits pending in the San Francisco Superior Court and taxpayers should consider filing protective refund claims.

Taxpayers should be aware that as a result of the then pending San Francisco appellate case, San Francisco in January 1998 attempted to shorten its statute of limitations from a three-year period to a ninety-day period.

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