HUNT-WESSON (RUMBLE IN THE JUNGLE)

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RUMBLE IN THE JUNGLE
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I. Summary of Hunt-Wesson, Inc. v. Franchise Tax Board of California

A. What the case was about.

Hunt-Wesson is a corporation incorporated in Delaware and domiciled in Illinois. Hunt-Wesson was a diversified food company producing a wide range of food and food-related products and services for worldwide markets. It is engaged in business both in California and throughput the world.

During fiscal years ended 1980 through 1982, Hunt-Wesson received income in the form of interest from its unitary business operations in the amounts of approximately $10 million, $21 million and $83 million, respectively. During these same years, Hunt-Wesson incurred interest expense from loans in the approximate amounts of $80 million, $55 million and $137 million. Thus, during the three years in question Hunt-Wesson incurred business interest expense in excess of its business interest income in the amounts of $70 million, $34 million and $57 million, respectively.

Hunt-Wesson owned a number of dividend-paying subsidiaries, which were not members of its unitary business. These subsidiaries paid dividends to Hunt-Wesson during the three years in issue in the amounts of approximately $27 million, $29 million and $19 million, respectively. Hunt-Wesson reported all these dividends on its California franchise tax returns as nonbusiness income not subject to California franchise tax. None of the interest expense incurred was reported by Hunt-Wesson as assignable to this $75 million of nonbusiness dividend income. Rather, Hunt-Wesson claimed that the entire amount of the approximately $273 million of interest expense incurred during the years in issue was attributable to, and fully deductible against, its apportionable business income.

On audit, the California Franchise Tax Board allowed Hunt-Wesson to deduct approximately $198 million of the approximately $273 million of interest expense against its apportionable business income, and allocated approximately $75 million of interest expense to the nonbusiness dividend income not subject to tax in California. This allocation was done under the authority of the California interest offset provision.

The computation of Hunt-Wesson's approximate $198 million allowable interest expense deduction under the interest offset provision was done by taking the sum of the amount of interest expense equal to its business interest income (approximately $114 million), plus the amount by which the remaining interest expense exceeded its nonbusiness dividend income ($84 million - $114 million less $75 million). The balance, $75 million was attributed to and offset by the amount of Hunt-Wesson's nonbusiness dividend income.

As a result of this audit adjustment, a proposed deficiency assessment was issued to Hunt-Wesson. Hunt-Wesson paid the proposed deficiencies and filed an administrative claim for refund with the California franchise Tax Board. The claim for refund was denied.

Hunt-Wesson filed a refund suit in the California Superior Court. In its complaint, Hunt-Wesson challenged the constitutionality of the interest offset provision (Revenue and Taxation Code section 24344(b)) on the grounds that it violated the Due Process Clause, Commerce Clause and Equal Protection Clause of the Federal Constitution. After trial, judgment was entered in favor of Hunt-Wesson on several grounds. First, although acknowledging that the U.S. Supreme Court has historically paired income and expenses so that a taxpayer should not be permitted to deduct expenses related to generating income exempt from taxation, the superior court found a due process violation because the statute attributed interest expense to non-taxable dividend income without regard to whether such interest was related to the dividend income. Second, because Hunt-Wesson's nonbusiness dividend income was taxable only by Illinois, its state of domicile, the superior court found the statute operated impermissibly to tax a foreign corporation more than a similarly situated domestic corporation, thus interfering with interstate commerce. Last, the superior court found the statute applied unequally to domestic and foreign corporations, thus violating the equal protection clause. The Franchise Tax Board appealed the trial court decision.

On appeal, and relying in large part on the California Supreme Court decision in <u>Pacific Tel. & Tel. Co</u>. v. <u>Franchise Tax Bd</u>., 7 Cal3d 544, 498 P.2dd 1030 (1972), the California Court of Appeal ruled that the interest offset provision was constitutional and reversed the lower court's decision. The appellate court first acknowledged the interest offset theory that a corporation should not be able to borrow money to purchase nonbusiness stocks that pay dividends, then get a

deduction for the interest expense related to income not subject to tax in California. Consistent with this theory, the court of appeal observed the Pacific Telephone case had decided that the California Legislature has acted reasonably in treating interest expense as the opposite of dividend income, and by requiring the offset of one against the other. By force of Pacific Telephone, the appellate court found in the favor of the Franchise Tax Board on the basis that a tax loophole would be created to the extent that interest expense deductions could result from money borrowed to generate tax-exempt income.

The appellate court rejected Hunt-Wesson's contention that the interest offset statute operated to tax indirectly income not subject to California franchise taxation, relying on the finding in Pacific Telephone that inclusion of non-taxable dividends in the statutory computation did not constitute taxation of the dividends themselves. Hunt-Wesson's claim that the interest offset statute facially discriminated against interstate commerce was also rejected, looking to the holding in Pacific Telephone that the interest offset statute does not operate to impose a tax on tax exempt income.

The appellate court also distinguished several of the U.S. Supreme Court's decisions dealing with facially discriminatory statutes, including Fulton Corp. v. Faulkner, 516 U.S. 325 (1996), in which that court invalidated North Carolina's intangibles tax.

The appellate court rejected Hunt-Wesson's claim that the interest offset provision discriminated by parenthetically omitting from the interest offset computation dividends declared from income already taxed to the payor by California. As the state had already taxed the dividends once, no constitutional discrimination resulted from California's efforts to refrain from taxing the dividends a second time. In contrast to Fulton, the deductible dividend exclusion in the interest offset provision did not waive an otherwise uniform intangibles tax based entirely on the percentage of the underlying corporate income taxed by the state. Rather, the interest offset provision operated as part of an overall apportionment scheme, matching expenses with income in a manner that the California Supreme Court had determined to be reasonable.

Finally, Hunt-Wesson's equal protection claim was rejected. The court of appeal determined that the interest offset provision did not create an arbitrary classification based on domicile, but rather was rationally related to California's need to address a tax loophole. Hunt-Wesson sought review of the California Court of Appeal's decision.

On March 24, 1999, the California Supreme Court denied Hunt-Wesson's petition for review. Hunt-Wesson proceeded on writ of certiorari to the United States Supreme Court. The United States Supreme Court granted review.

B. What the court did.

The United States Supreme Court decided that the California interest offset provision violated the Federal Constitution's Due Process and Commerce Clauses, thereby reversing the California Court of Appeal.

The Court began its opinion by generally discussing the concepts of unity, formula apportionment and business and nonbusiness income. It then went into a discussion of how net income is determined, including the deduction for interest expense, and focused on the limitation at issue contained in the interest offset provision (i.e., interest deductible shall be the amount by which interest expense exceeds interest and dividend income not subject to allocation by formula).

The Court then focused on the issue before it: Does the Constitution permit California to carve out an exception to its interest expense deduction, which it measures by the amount of nonunitary dividend and interest income that the nondomiciliary corporation has received?

The court began its analysis by stating that the California interest offset provision violates the Due Process and Commerce Clauses of the Federal Constitution based on relevant precedent such as Container Corp. of America v. Franchise Tax Bd., 463 U.S. 159 (1983), Exxon Corp. v. Department of Revenue of Wis., 447 U.S. 207 (1980), Mobil Oil Corp. v. Commissioner of Taxes of Vt., 445 U.S. 425 (1980) and Allied-Signal, Inc. v. Director, Div. Of Taxation, 504 U.S. 768 (1992). The Due Process and Commerce Clauses do not allow a State to tax income arising out of interstate activities – even on a proportional basis – unless there is a "minimal connection" or "nexus" between the interstate activities and the taxing state, and "a rational relationship between the income attributed to the State and the intrastate values of the enterprise." The parties had conceded the nonbusiness income in question did not bear a "rational relationship" or "nexus" to California. The nonbusiness income could not constitutionally be taxed by a State other than the corporation's commercial domicile, unless there was some other connection between the taxing state and the income.

The Court continued by concluding the interest deduction limitation contained in the interest offset provision seemed to amount to an impermissible tax. Essentially, the Court reasoned that the provision increases the business income of a taxpayer through the reduction of its interest expense deduction in an amount precisely equal to the amount of nonbusiness interest and dividend income. Although not a direct tax on nonbusiness income, the interest offset provision resulted in an indirect tax of income that did not bear a rational relationship or nexus to California.

The Court went on to examine the justification offered by the State for its position on the propriety of attributing interest expense to nonbusiness income. The state argued that money is fungible and that is difficult to identify the purpose of any particular borrowing, whether it was for a unitary or non-unitary investment purpose. The concern was that a corporation could borrow on the assets of unitary business, use the funds to invest in nonbusiness investments generating nontaxable income, and secure an interest deduction against business income. The state argued this "tax arbitrage" problem is why the U.S. Supreme Court upheld the precursor of 26 U.S.C. section 265(a)(2) which denies an interest deduction insofar as the interest expense was incurred or continued to purchase or carry tax-exempt obligations or securities. The U. S. Supreme Court had consistently upheld deduction denials that represent reasonable efforts to properly attribute a deduction between taxable and tax-exempt income, even though such denials meant that a taxpayer would owe more tax than would be owed without the denial.

The Court commented that if the state could show that its deduction limitation actually reflected the portion of expense properly related to nonbusiness income, the limitation would not be a tax on nonbusiness income – it would instead be a proper allocation of a deduction. The problem was that the deduction limitation pushed this proper allocation concept beyond reasonable bounds. The assumption that borrowings were made and interest expense incurred for nonbusiness purposes, to the extent that nonbusiness interest and dividends were produced, was unrealistic. This lack of practical realism, the court stated, helps explain why the California rule went too far and, citing Container, failed to actually reflect a reasonable sense of how income was generated resulting in taxing constitutionally protected income.

The Court noted that no other taxing jurisdiction has taken so absolute an approach to the tax arbitrage problem that the state presented. Comparatively speaking, the federal rules are much more

reasonable. One set of rules allocates interest expense between domestic and foreign source income by using a ratio of assets and gross income to allocate a corporation's total interest expense. Another set of rules use a kind of modified tracing approach. Other states used one or the other, or a combination of both, to attribute interest expense between business and nonbusiness income. It was reasonable to expect that, over time, these approaches reflected approximately the amount of borrowings that firms have actually devoted to generating each type of income.

Because California's interest offset provision was not a reasonable allocation of expense deductions to the income that the expense generated, it constitutes impermissible taxation of income outside its jurisdictional reach, thus violating both the Due Process and Commerce Clauses of the Federal constitution.

II. Efforts to Address Interest Expense Assignment

A. Outcome of Symposium.

On May 19, 2000, a symposium was held in Sacramento to discuss proposed guidelines for handling interest offset issues following the Hunt-Wesson decision. Discussion points included basic principles such as enforcement of the statute itself, assignment of interest expense to nonbusiness income under the authority of Regulation section 25120 (d), assignment of interest on a group basis, direct tracing, and use of proportional methods such as assets or gross income. Discussion points also included how staff would treat current audit and protest inventory and claims.

Staff prepared a report on the symposium and that report was discussed at the July 5, 2000, three-member Franchise Tax Board meeting. Staff recommended that the interest offset statute – Revenue and Taxation Code, section 24344 (b) - be treated as invalidated in total. Staff further recommended that it rely on Regulation section 25120(d) to allocate interest expense between business and nonbusiness income. The methodology staff proposed to use would be a combination of direct tracing, asset ratio, and gross income ratio. Staff's proposal would give taxpayers an opportunity to present their own allocation, which staff would accept unless the department could show that the taxpayer's method was unreasonable. If it could be accomplished, staff preferred direct tracing; however, either an asset ratio or a gross income ratio could be used. Procedurally,

staff would not conduct re-audits solely on the interest offset issue. At the protest and appeal levels, the interest offset would not be an issue unless that taxpayer raises it, the business/nonbusiness classification of income is at issue, or the taxpayer raises new issues.

Other parties made written proposals to the Board which, generally, would either allow California domiciled corporations to continue to use the interest offset provision, or would allow taxpayers the option to use interest offset, direct tracing and/or ratio allocation.

The Board voted to put the matter over to its next scheduled meeting to allow it more time to reflect on the Hunt-Wesson decision.

B. Three-Member Board Direction

At its September 19, 2000 meeting, the issue of the treatment of interest offset as a result of the Hunt-Wesson decision was again before the Board. Staff and the California Taxpayers' Association presented proposals for implementation of the Hunt-Wesson decision, including application of that decision to entities domiciled in California and other states. Four individuals testified in support of the Cal-Tax proposal. With one modification, the Board voted favorably towards the Cal-Tax proposal. Staff recommended that guidelines regarding the implementation of the decision in Hunt-Wesson be adopted until such time as legislation could be enacted. Consistent with this recommendation and Board direction to go forward with proposed legislation, staff drafted an FTB Notice reflecting the Board's vote on the implementation of the Hunt-Wesson decision. As of the date of this writing, the draft FTB Notice has been forwarded for the Board's customary review.

What May States Do to Combat Tax Arbitrage After *Hunt Wesson*?

by Michael J. McIntyre*

In the *Hunt-Wesson* case,[1] the taxpayer argued that California's rule for directly allocating certain interest deductions to a taxpayer's nonbusiness income without apportionment was an indirect and constitutionally prohibited method for taxing extraterritorial values. Accepting this characterization of California's direct allocation rule, a unanimous U.S. Supreme Court held that the rule violated the Due Process Clause and the dormant Commerce Clause of the U.S. Constitution. It is fair to conclude that *Hunt-Wesson* imposes some new limitation on State taxing power. The extent of that new limitation, although uncertain, is probably quite limited.

In section 1, below, I summarize the facts in the case and present a brief discussion of some of the issues raised by the taxpayer and California in *Hunt-Wesson*. I do not reargue that case, which was decided nine to zero in the only forum that matters. I also do not disguise my view that the case was wrongly decided. In section 2, I suggest some steps that progressive States might take to limit the ability of corporate taxpayers to use tax arbitrage to minimize their State corporate income taxes in the aftermath of *Hunt-Wesson*.

1. Summary of Arguments

1.1. Facts of Case

California's rule for directly allocating interest expense to certain nonbusiness income is referred to in California tax parlance and by the Court in *Hunt-Wesson* as the interest-offset rule. That rule applies in allocating interest expense to business interest income and to nonbusiness interest and dividend income.[2] Under that rule, interest expense is first allocated to business interest

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[1]Hunt-Wesson, Inc. v. Franchise Tax Board of California, 528 U.S. 458 (2000) (hereafter "*Hunt-Wesson*").

[2]The interest-offset rule is set forth in Cal. Rev. and Tax Code, sections 24344(a)-(b). That provision states as follows:

Sec. 24344. Interest; restrictions

(a) Section 163 of the Internal Revenue Code, relating to interest, shall apply, except as otherwise provided.

(b) If income of the taxpayer which is derived from or attributable to sources within

income. If the interest expense exceeds business interest income, that excess is directly allocated to nonbusiness interest income and, with exceptions,[3] to nonbusiness dividend income. If the interest expense exceeds the sum of business interest income and nonbusiness interest and dividend income, that excess is allocated to the taxpayer's remaining income.

A typical example of nonbusiness dividend income is dividends paid with respect to preferred stock. That was the type of nonbusiness dividend income that was subject to the interest-offset rule in *Hunt-Wesson*. In *Pacific Telephone*, the California Supreme Court characterized preferred dividends as interest equivalents. It is fair to say that the California interest-offset rule applied primarily to allocate interest expense directly to business interest income and nonbusiness interest and interest-equivalent income. The following example illustrates the rule's operation.

> TCo is a company that is commercially and corporately domiciled in State A and is engaged in extensive business activities in California. TCo borrows $1 million from a bank, which it commingles with its other business assets and uses for sundry corporate purposes. It pays $100,000 of annual interest on the loan. TCo earns $10,000 of apportionable interest income from its cash-reserve account, used for business purposes. It earns gross income of $300,000 from the sale of artificially flavored puddings and microwave popcorn. It also earns $50,000 of nonbusiness dividend income on a minority holding of preferred stock. Due to competitive pressures, State A does not attempt to tax those dividends under its rules for taxing domiciliary companies. Under these facts, TCo would calculate its California franchise tax by allocating its interest expense deduction of $100,000 as follows:

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this state is determined pursuant to Section 25101 or 25110, the interest deductible shall be an amount equal to interest income subject to apportionment by formula, plus the amount, if any, by which the balance of interest expense exceeds interest and dividend income (except dividends deductible under Section 24402 and dividends subject to the deductions provided for in Section 24411 to the extent of those deductions) not subject to apportionment by formula. Interest expense not included in the preceding sentence shall be directly offset against interest and dividend income (except dividends deductible under Section 24402 and dividends subject to the deductions provided for in Section 24411 to the extent of those deductions) not subject to apportionment by formula.

[3]The interest-offset rule does not apply to dividends paid out of previously taxed income, as specified in Cal. Rev. and Tax Code, section 24402, and certain water's edge dividends, as specified in section 24411.

Step 1: Interest expense of $10,000 would be allocated to the interest income derived from the cash-reserve account, thereby sheltering that income from tax. No direct linkage between the borrowing and the assets in the cash-reserve account is required.

Step 2: Interest expense of $50,000 is allocated to the $50,000 in tax-exempt nonbusiness dividends. Again no direct linkage between the original loan and the preferred stock is required.

Step 3: The remaining interest expense of $40,000 is allocated to the business income of $300,000 from sale of pudding and popcorn. The deduction reduces TCo's apportionable sales income to $260,000. The portion of that net income apportioned pro rata to California under California's apportionment formula is subject to California's franchise tax.[4]

The taxpayer in *Hunt-Wesson* was a domiciliary of Illinois.[5] It received substantial business interest income during 1980 to 1982, the three years at issue in the case.[6] During that period, it also received even more substantial nonbusiness preferred dividends[7] from sources outside California that it claimed to be nonbusiness income on its California tax return.[8] It also made substantial interest

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[4]The example is drawn from Michael J. McIntyre, "Constitutional Limitations on State Power to Combat Tax Arbitrage: An Evaluation of the Hunt-Wesson Case," 18 STATE TAX NOTES 51-64 (January 3, 2000), reprinted with addendum in 86 TAX NOTES 1907-1922 (March 27, 2000) (hereafter "McIntyre, Tax Arbitrage").

[5]For simplicity, I refer to the taxpayer as Hunt-Wesson. In fact, the taxpayer that earned the nonbusiness dividends and engaged in tax arbitrage was Beatrice Foods Co. Hunt-Wesson is the successor by merger to Beatrice.

[6]The amounts of business interest income for the three years were $10 million, $21 million and $84 million respectively.

[7]The amounts of nonbusiness preferred dividends for the three years were $27 million, $29 million and $19 million, respectively.

[8]I understand that the taxpayer reported the preferred dividends to Illinois, its domiciliary State, as apportionable business income, thereby avoiding tax on them in both States by taking inconsistent positions in its tax return in those States. See Walter Hellerstein, Counsel for Petitioner, Transcript of the Oral Argument in Hunt Wesson, 2000 U.S. TRANS LEXIS 17, at 21 ("Illinois had a regulation . . . during those years that actually allowed a domiciliary corporation like Beatrice . . . to apportion its income.").

payments during the tax years at issue.[9] California applied the interest-offset rule to *Hunt-Wesson*. There was no dispute that this application was proper under the California tax code. As a result of that rule, California reduced the amount of interest expense that the taxpayer claimed against its business income by the amount of its nonbusiness interest and dividend income.

Hunt-Wesson challenged the constitutionality of the interest-offset rule in the California courts. It won at the trial level and lost on its in-state appeal. The California Supreme Court declined to hear the case. The taxpayer petitioned for certiorari in the U.S. Supreme Court. The petition was granted and the taxpayer ultimately prevailed. The terse, unanimous opinion in the case was signed by Justice Stephen Breyer.[10]

1.2. Argument for California

California's central argument before the Court was that it was not attempting through its direct allocation rule to tax extra-territorial income — that is, nonbusiness income arising outside its borders. It contended that its direct allocation rule for interest payments was adopted in good faith to prevent taxpayers from artificially inflating the deduction against apportionable business income, thereby artificially deflating their taxable income subject to California tax. In 1972, the California Supreme Court rebuffed a challenge to the direct allocation rule in the *Pacific Telephone* case.[11] In upholding that rule, the court found that the legislative purpose of the rule was to prevent tax avoidance and that the rule was reasonably designed to achieve that purpose. The following example, similar in structure to an example provided by the California Supreme Court in *Pacific*

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[9]The taxpayer claimed a deduction for interest expense from loans during the three years in issue in the amounts of $80 million, $55 million and $137 million respectively. On its tax return, it directly allocated all of the deduction to its business income, contrary to the California statute and contrary to its legal position before the Supreme Court.

[10]This is not the first time that I have found fault with Justice Breyer's reasoning in a State tax case. See Walter Hellerstein, Michael J. McIntyre, and Richard D. Pomp, "Commerce Clause Restraints on State Taxation After *Jefferson Lines*," 51 TAX LAW REVIEW 47 (1995) (suggesting, politely, that Justice Breyer's dissenting opinion — his first opinion in a tax case after joining the bench — was out of step with the Court's State taxation jurisprudence).

[11]Pacific Tel. & Tel. Co. v. Franchise Tax Bd., 7 Cal.3d 544, 498 P.2d 1030 (1972) (hereafter "Pacific Telephone"). This case involved construction of the California tax statute. The constitutionality of that statute was not at issue.

Telephone, illustrates the type of tax avoidance scheme that the direct allocation rule was designed to defeat.

> *Example #1*. TCo is a corporation that is domiciled in State D. TCo earns business income of $1 million in State B. State B has no equivalent to California's direct allocation rule for interest. On advice of tax counsel, TCo borrows $2 million from a bank at 5 percent annual interest. It also purchases $2 million of preferred stock that pays annual dividends of 5 percent. To avoid a direct tracing of the loan to the investment in preferred stock, TCo commingles its borrowed funds with its equity capital. The dividends paid with respect to the preferred stock have no nexus with State B. TCo now has an interest deduction of $100,000 a year and has dividend income of $100,000 a year that is exempt from tax in State B. If State B is constitutionally required, as the *Hunt- Wesson* decision indicates, to allow TCo to deduct its annual interest payments of $100,000 from its business income, then TCo will have been able through this device to reduce its taxable income in State B by $100,000. Indeed, by increasing the amount of its borrowing and lending, TCo would be able to reduce its taxable business income to zero.

Engaging in a transaction of the type illustrated above is referred to as tax arbitrage. As I have argued elsewhere, direct allocation of interest is the only effective mechanism available to governments for combating tax arbitrage.[12] It is used commonly by the federal government in various rules designed to combat tax arbitrage.[13] One of those federal rules, the CFC netting rule, was discussed briefly by Justice Breyer in his opinion in *Hunt-Wesson*. Breyer incorrectly characterized

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[12]See McIntyre, *Tax Arbitrage*, supra note 4, at 52; Michael J. McIntyre, "Tracing Rules and the Deduction for Interest Payments: A Justification for Tracing and a Critique of U.S. Tracing Rules," 39 WAYNE LAW REVIEW 67 (1992), revised and republished as Chapter 17 of TAXATION TOWARDS 2000, John G. Head and Richard Krever, Eds. (1997). See also Stanley Koppelman, "Tax Arbitrage and the Interest Deduction," 61 SOUTHERN CALIFORNIA LAW REVIEW 1143 (1988).

[13]Id. at 55-61. See IRC §§ 163(j) (income stripping rules applicable to interest paid to related foreign entities). 265(a)(2) (anti-arbitrage rules relating to tax-exempt interest); Treas. Reg. §§ 1.882-5 (apportioning interest of a foreign corporation between U.S. and foreign sources using a complex mixture of a tracing rule and a pro rata rule); 1.861-10 (CFC Netting Rule).

the rule as a tracing rule.[14] States necessarily have some direct allocation rules through their conformity to the federal tax code.

A pro rata rule for allocating interest cannot block tax arbitrage. It simply provides a pro rata — and thereby limited — solution to the problem. Consider, for example, the impact of a pro rata rule on TCo in the example above. In that example, TCo reduced its State D taxable income by $100,000 by borrowing money on which annual interest payments of $100,000 was due, commingling the borrowed money with its equity capital, and then acquiring interest-producing property yielding $100,000 per year. A pro rata rule would reduce the encroachment on the State D tax base somewhat by allocating a portion of the interest expense to the $100,000 nonbusiness interest income. The amount would be determined by multiplying the interest expense of $100,000 by a fraction, the numerator of which would be $100,000 and the denominator of which would be TCo's total gross income ($1 million + $100,000). The result would be that the encroachment on the State D tax base would be reduced from $100,000 to $90,909 ($100,000 minus $100,000 × 100,000/1,100,000). This minor protection, moreover would be short lived, in that TCo could recoup its prior advantage by moderately increasing the amount of its borrowing.

The taxpayer claimed, and the Court agreed, that the interest-offset rule had the economic effect of taxing Hunt-Wesson's nonbusiness income having no nexus with California. California did not dispute this arithmetical relationship. The Court agreed with California that the California tax was imposed on an apportioned share of Hunt-Wesson's business income. The proper question for the Court was whether California's interest-offset rule, although structured as a mechanism for taxing California business income, was in fact a device for imposing tax on nonbusiness income having no nexus with California.

The issue of the case can be stated in general terms as follows. California proposed to tax a non-domiciliary taxpayer on a portion of its California business income (Item X) that it asserts the taxpayer is attempting to shelter from tax by claiming an inappropriate interest deduction. The California statute, clearly and unambiguously, imposes the disputed tax with respect to Item X. Item X, however, is exactly equal to the extra-territorial nonbusiness income earned by the taxpayer

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[14]For a full explanation of the CFC netting rule, see Michael J. McIntyre, THE INTERNATIONAL INCOME TAX RULES OF THE UNITED STATES, 2d edition, Lexis Publishing (2000). My description in that treatise of the CFC netting rule is cited with approval in Walter Hellerstein, "Constitutional Restraints on State Interest Expense Allocation After *Hunt-Wesson*," 92 *Journal of Taxation* 241 (2000) at n. 18.

(Item Y). This equality in the amounts of Item X and Item Y, moreover, is not accidental — California computed the amount of Item X by reference to the amount of Item Y. California claimed that it measured Item X by reference to Item Y because the amount of Item Y served as an appropriate proxy for the amount of the taxpayer's inappropriate interest deduction. The taxpayer claimed that the purported tax on Item X was really a tax on Item Y within the meaning of the Due Process Clause (and sundry other constitutional provisions). The proper question for the Court was whether California, in using the amount of Item Y as a way of measuring Item X, had actually imposed a tax on Item Y.

The question above should not be answered in the abstract, without reference to the facts and circumstances of the particular case. One relevant circumstance is whether the proxy is a good one. For example, assume that a municipality located in a resort area was authorized by the state to impose a property tax but was prohibited from imposing an income tax. In computing the value of a parcel of rental property located within its borders, it used the discounted value of the income that the property was expected to generate over its useful life. In that case, the tax imposed on that parcel should be upheld as a legitimate property tax and not rejected as an impermissible income tax. In contrast, the municipality should be viewed as having imposed an impermissible income tax if it used the amount of the personal income of the absentee owner of the parcel as the measure of the parcel's value. In *Hunt-Wesson*, the parties disagreed as to whether the taxpayer's nonbusiness income (Item Y) was a good proxy for the business income (Item X) that the taxpayer was sheltering from tax by claiming an allegedly improper interest deduction.[15]

Another relevant circumstance is whether the proxy was subject to tax even when it could not serve as a proxy for the properly taxable item. For example, assume that a State imposes a sales tax on gasoline. It asserts that the tax should be considered a benefit tax on persons making use of its roads. If taxpayers are exempt from tax when they buy gasoline for off-highway use, the tax is probably best understood as a benefit tax. If off-highway sales are taxable, however, the tax looks more like a sales tax on gasoline. In *Hunt-Wesson*, nonbusiness income did not trigger California's interest-offset rule unless the taxpayer was claiming an interest deduction against business income. In this respect, therefore, the tax is more plausibly described as a tax on business income than as a tax on nonbusiness income.

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[15]The parties did agree that the interest deduction claimed by the taxpayer on its California tax return was improper. They disagreed as to the amount of the improper deduction.

If the interest-offset rule was in fact a device for taxing extraterritorial values having no nexus with California and also had that economic effect, then the Court was right in deciding against California. The burden of proof was on the taxpayer, however, to prove that the interest-offset rule was such a device.[16] In *Pacific Telephone*, the highest court in California had concluded that the interest-offset rule was not a device for taxing nonbusiness income arising outside of California but rather was a good faith attempt to prevent taxpayers from avoiding California income taxes through what is now called tax arbitrage. One might think that this factual determination would not be second-guessed by the U.S. Supreme Court. If so, one would be wrong.

1.3 Argument for Taxpayer

The taxpayer's central argument was that California was indirectly taxing nonbusiness income over which it had no nexus by denying an interest deduction under the interest-offset rule in the amount of the nonbusiness income. According to the taxpayer, the alleged attempt to tax nonbusiness income indirectly is unconstitutional because a government cannot do indirectly what it is prohibited by the Constitution from doing directly.

Of course governments regularly use indirect means to achieve goals that they are barred by the Constitution from achieving directly. For example, a government cannot give direct financial support to a religious organization under the Establishment Clause of the First Amendment.[17] It can indirectly subsidize religion, however, by giving religions organizations an exemption from property taxes[18] or by dispensing vouchers to students attending church-run schools.[19] To give an example closer to the constitutional issue presented in *Hunt-Wesson*, a State may not impose a sales tax on a sale of goods that takes place outside the State even if the purchaser brings those goods into the State.[20] It can, however,

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[16]Norton Co. v. Dept. of Revenue, 340 U.S. 534, 538 (1951) (limited as to other matters in National Geographic Soc'ty v. California Bd. of Equalization, 430 U.S. 551, 560 (1977); see also General Motors Corp. v. Washington, 377 U.S. 436, 441-42 (1964); Container Corp. of America v. Franchise Tax Bd., 463 U.S. 159, 175-67 (1983).

[17]Lemon v. Kurtzman, 403 U.S. 602 (1971)

[18]Walz v. Tax Commission, 397 U.S. 664, 668 (1970).

[19]Mitchell v. Helms, __ U.S. __, 120 S. Ct. 2530 (2000).

[20]McLeod v. J.E. Dilworth Co., 322 U.S. 327 (1944).

impose a use tax on those goods,[21] although that tax has the identical economic effect as the constitutionally prohibited sales tax.

Stripped of its rhetorical flourishes, the taxpayer's central claim was that California's interest-offset rule was a device for taxing nonbusiness income having no nexus with California. In support of that proposition, the taxpayer made the following arguments:

> (1) The interest-offset rule, by reducing a taxpayer's interest deduction dollar for dollar by the amount of its nonbusiness income, is in fact a tax on non-business income.
>
> (2) The California rule is so "bizarre" and "off the radar screen" that it cannot plausibly be defended as a reasonable method for computing California business income.

The Court accepted these arguments and decided the case for the taxpayer. In reaching its decision, however, the Court stated that the economic equivalence of the denial of a deduction and the taxation of the nonbusiness income was not enough to make the taxing scheme unconstitutional. It also stated that California had a legitimate interest in combating tax arbitrage and that "reasonable" methods for doing so were constitutionally acceptable. It concluded, nevertheless, that California had "gone beyond reasonable bonds" in adopting its interest-offset rule. It did not explain how it determined what the "bonds" were or the criteria state legislatures should apply in determining whether their actions are "reasonable."

2. Mechanisms for Combating Tax Arbitrage that May Have Survived *Hunt-Wesson*

Although the result in *Hunt-Wesson* may be a keen disappointment to California, the holding of that case is remarkably narrow. The Court did not adopt the taxpayer's grand rhetoric about governments not being able to do indirectly what they cannot do directly. It did not expand the protections against State taxation provided under the Due Process Clause or the Commerce Clause. Its holding was based entirely on its conclusion that California's interest-offset rule is a device for taxing extraterritorial values. Assuming the validity of that contested

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[21] General Trading Co. v. State Tax Commission, 322 U.S. 335 (1944).

conclusion, the result reached by the Court is quite limited and unremarkable by due process standards.[22]

In two significant respects, the Court in *Hunt-Wesson* may have clarified the law in a way that is favorable to the States. First, it apparently recognized the validity of State attempts to combat tax arbitrage and suggested that it would uphold such attempts against constitutional attack if those attempts were genuine and not devices for taxing extraterritorial income. Second, it not only declined to impose on the States a requirement of pro rata apportionment of deductions, despite determined efforts by the taxpayer to get it to do so, but it apparently sanctioned use by the States of the direct allocation methods that the federal government uses in various circumstances to combat tax arbitrage.[23]

It is far too early, of course, to determine whether these conclusions about the limited impact of *Hunt-Wesson* are correct. Given its narrow holding and its weak conceptual underpinning, I suspect that its lasting impact on State taxation will be modest at most. In the short run, it probably will not affect States other than California because California is currently the only state that has adopted legislation directly targeted at tax arbitrage.[24]

Perhaps the publicity surrounding *Hunt-Wesson* will educate other States to the need for legislation to combat tax arbitrage. Indeed, if the corporate

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[22]One of the many unhappy legacies of the Court's discovery of a due process element in the dormant Commerce Clause is that it now feels obliged to rest decisions jointly on the Due Process Clause and the Commerce Clause when the rationale of the decision rests exclusively on due process considerations. *Hunt-Wesson* is a case in point.

[23]The two federal methods given implicit approval are the rule of IRC § 265(a)(2) (disallowing a deduction for interest on loans used to "purchase or carry" tax-exempt bonds) and the CFC Netting Rule, contained in Treas. Reg. § 1.861-10(e) (1992). The Court may not have fully understood that both of these rules provide for direct allocation of interest without tracing in appropriate circumstances. For references to the federal methods, see supra, note 13 at 5.

[24]Many states do have rules that require an allocation of deductions to tax-favored income. See Marilyn A Wethekam and Craig B. Fields, "*Hunt-Wesson* and Excessive Disallowance Issues," 19 STATE TAX NOTES 245 (July 12, 2000) (providing a useful compilation of state allocation rules). The Wethekam-Fields compilation was prepared in conjunction with the *Hunt-Wesson* litigation and was submitted with the brief for Petitioner. At that time, the litigating strategy of the business community was to emphasize how different the California rule was from the "reasonable" rules of other States. We can anticipate that practitioners litigating the constitutionality of the expense allowance rules of those other States will now emphasize the similarity of those rules to the rule found to be unconstitutional in *Hunt-Wesson*. The language or holding of *Hunt-Wesson*, however, is not likely to be very helpful to them.

community interprets *Hunt-Wesson* as broadly endorsing tax arbitrage, then the ensuing "gold rush" is likely to have an educative effect on all the States. Even at current high levels of tax arbitrage, however, the States should be motivated to adopt measures to combat this form of tax planning. If the States do decide to act, they will need to tailor their anti-arbitrage legislation to the requirements of *Hunt-Wesson*. I suggest here how that might be accomplished.

As a starting point, I suggest that a State adopt some type of pro rata rule as its general rule. This general rule should be clearly stated in the statute, and exceptions to this general rule to deal with tax arbitrage or other matters should be labeled clearly as exceptions. The California approach of providing a variety of special rules, with no clear hierarchy, is not recommended.[25] The proposed statutory structure, in principle, has no constitutional significance. A clear, hierarchal structure, however, is much easier to explain, and thus to defend, in court. Allocation under a pro rata rule might be made with respect to various measures, including gross income, net income, assets, and factors of production. I suggest a state consider using net income computed without reference to the interest expense as the measure. A taxpayer's net income is a reasonable measure of its cash flow, and it is that cash flow that is typically the source out of which interest payments are made.

As an exception to the general rule providing for a pro rata allocation of interest, I suggest that the States adopt a broad anti-avoidance provision. That might provide that interest expense on a debt instrument is not deductible against income taxable in the State if that debt was "incurred or continued" to "purchase or carry" assets that generate income that is exempt from tax in the State or that does not have a sufficient connection to the State to be taxable there ("untaxed income"). The language, to the extent feasible, should be borrowed from the language of Internal Revenue Code section 265(a)(2).[26] The Court has repeatedly upheld that section against the type of attack brought against California's interest

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[25]Actually, the general rule in California is probably best characterized as a pro rata rule. For example, interest expense attributed to a unitary business is apportioned pro rata by the apportionment formula. In addition, a pro rata rule of some type applies in allocating interest expense between income from two or more unitary businesses. Cal. Code of Regs. Title 18 § 25120(d).

[26]IRC § 265(a)(2) provides as follows:
(a) GENERAL RULE.— No deduction shall be allowed for—
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(2) INTEREST. Interest on indebtedness incurred or continued to purchase or carry obligations the interest on which is wholly exempt from the taxes imposed by this subtitle.

offset rule.[27] In addition, the Court's decision in *Hunt-Wesson* strongly suggests that the use of such a rule would be a permissible way for the States to combat tax arbitrage.

Because of the fungibility of money, the anti-avoidance rule suggested above cannot operate effectively unless the State adopts guidelines for determining when interest expense is to be linked with the acquisition of assets generating untaxed income. These guidelines should not be treated as firm rules of law. In each case, the taxpayer should be given the opportunity to avoid application of the guideline by demonstrating that the linkage it established would result in an unconstitutional tax on extraterritorial values.[28] I suggest the following general guidelines, some or all of which might be adopted by a State:

Suggested Guideline #1. Interest on a loan will be linked to assets producing interest income or interest-equivalent income if that income is untaxed by the State and the loan obligation was incurred within some reasonable period of the acquisition of the assets generating the untaxed income. The "reasonable period" should be no less than two years before or after the acquisition. Interest-equivalent income typically would include dividends paid with respect to preferred stock.[29]

Assume, for example, that TCo borrowed $2 million in year one. In year two, TCo spent $1 million to acquire assets generating untaxed interest or interest-equivalent income. TCo will be treated under the guideline as having used $1 million of its borrowed money to purchase or carry the $1 million of assets producing untaxed interest or interest-equivalent income. The interest on that portion of the loan would be disallowed in computing TCo's income taxable by the State.

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[27]See Denman v. Slayton, 282 U. S. 514 (1931), quoted with approval in *Hunt-Wesson*. See also First Nat'l Bank v. Bartow County Bd. of Tax Assessors, 470 U.S. 583 (1985); United States v. Atlas Life Insurance Co., 381 U.S. 233 (1965) ("We affirm the principle announced in *Denman* and *Independent Life* that the tax laws may require tax-exempt income to pay its way").

[28]The guidelines should make clear that the constitutionality of a guideline would be determined by reference to constitutional doctrines when the guideline was applied rather than when it was adopted.

[29]Additional examples of interest-equivalent income are provided in Treas. Reg. § 1.954-2(h)(2) (1997). The examples include various items that depend predominantly for their rate of return on the time-value of money.

Suggested Guideline #2. Interest paid with respect to a loan will be linked with assets generating untaxed income if those assets were actually acquired with the proceeds of the loan or the assets were pledged, directly or indirectly, as security for the loan. This rule is fully consistent with the rules of Internal Revenue Code section 265(a)(2), which was cited with approval by the Court in *Hunt-Wesson*.

Assume, for example, that TCo borrows $1 million from a foreign insurance company, commingling the proceeds of its loan with its equity capital. Shortly thereafter, it purchases $1 million of preferred stock. Dividends paid with respect to that stock are nonbusiness income under State law. That stock is pledged as security for the loan. Interest on that loan would not be deductible in computing income subject to tax by the State.

Suggested Guideline #3. Interest paid with respect to a loan to a related entity, defined in accordance with federal rules,[30] will be linked with untaxed income earned through that entity (by payment of interest, dividends, rents or royalties, or other investment returns) to the extent that the borrower made a contribution of the loan proceeds, directly or indirectly, to the capital of that entity. This rule is consistent with the CFC Netting Rule, which was cited with apparent approval by the Court in *Hunt-Wesson*.

Assume, for example, that TCo borrows $100 million from an unrelated third party and commingles the proceeds of the loan with its equity capital. It pays annual interest on the loan of $10 million. Two years later, it contributes $50 million to the capital of FCo, an affiliated foreign company that does not file a combined report with TCo in the State. FCo earns income of $40 million annually and distributes it to TCo. If FCo had borrowed the $50 million itself, instead of receiving it from TCo, it would have had an interest expense of $5, reducing its income to $35 million. Under Suggested Guideline #3, TCo will be treated as having borrowed $50 million on behalf of FCo. It will receive no deduction against its apportionable business income for the $5 million treated as a cost of FCo's borrowing.

Suggested Guideline #4. Interest or the equivalent of interest paid with respect to a loan or similar financing arrangement will not be deductible against income taxable in the State if a significant reason for entering into the financing

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[30]See, e.g. IRC §§ 482 and 267(b).

arrangement was to minimize taxes paid to the State. This is a standard anti-avoidance rule that elevates economic substance over form.

Assume, for example, that TCo owns an office building in the State valued at $40 million. It sells the building to BCo, an unrelated commercial bank, for $40 million and, as a step in the same set of transactions, enters into a long-term lease with BCo that permits it to occupy the office building for the term of the lease. Within a reasonable period after the leaseback transaction, TCo invests the proceeds of its sale in assets producing untaxed income. The payments made on the financial lease are not deductible in computing income subject to tax in the State.

Suggested Guideline #5. At the discretion of the tax authorities, a taxpayer may be required to allocate interest expense directly to its investment assets to the extent that those assets represent an unreasonable accumulation of income under federal law.[31] This rule should apply whether or not the assets are used to generate business income or nonbusiness income. The rationale for the rule is that a taxpayer does not have a business need to borrow funds when it has a stock of capital that is available for use in its business. In such circumstances, the debt can reasonably be held to have been incurred or continued to acquire or hold the investment assets. The State tax authorities would be permitted to make the suggested adjustment within a reasonable time of a final determination by the federal government that the taxpayer had accumulated its profits unreasonably, notwithstanding the running of the normal State statutory period for making assessments.

Assume, for example, that the Internal Revenue Service has properly determined that a taxpayer had accumulated $1 beyond the reasonable needs of its business. The taxpayer also has outstanding debt obligations of $2 million. One-half of the debt would be treated as incurred or continued to acquire the $1 million of assets unnecessary for the taxpayer's business. Interest on that portion of the debt would be allocated directly to those assets, and a deduction would be denied if the income from those assets was not being taxed by the state. If the taxpayer has a variety of loans outstanding having different interest rates, a blended interest rate would be used in making the allocation of interest to the assets unnecessary to the taxpayer's business.

In addition to attaching tax arbitrage on the deduction side, states must develop a strategy for dealing with the issue on the income side as well. Actions by

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[31]See IRC §§ 531-537.

the States on the income side of the issue are not constrained by the decision in *Hunt-Wesson*.

States that have not yet adopted combined reporting have many good reasons for doing so. Combating tax arbitrage is an additional reason. For States like California that have a combined-reporting system in place, the primary focus of reform should be on policing the line between business and nonbusiness income. I suggest the following rules to deal with tax arbitrage on the income side.

Suggested Income Rule #1. Income earned by a taxpayer as a result of a transaction or set of transactions having as a significant purpose the reduction of State taxes on business income should be treated, at the discretion of the tax authorities, as apportionable business income taxable by the State. No direct proof of a tax-avoidance motive should be required. The rule should be triggered if the set of transactions would likely result in a reduction of taxes but for the application of the rule.

Assume, for example, that TCo owns a valuable trademark that it uses in its business. It reorganizes its business, transferring a part of the business operating in another State to an affiliated company. It charges that newly-formed company a royalty fee for use of its trademark. The trademark royalty will be characterized as business income.

Suggested Income Rule #2. At the discretion of the tax authorities, a taxpayer's income will be treated as business income subject to apportionment if it is reported as apportionable business income in the taxpayer's State of domicile. The tax authorities may exercise this discretion whenever it learns that the taxpayer has taken inconsistent positions, notwithstanding the running of the normal period for assessing tax.

Assume, for example, that TCo, a corporation domiciled in State D, purchases preferred stock from an offshore affiliate. The affiliate does not file a combined report with TCo in State B. TCo receives $75 million in dividends on the preferred stock. In filing its tax return in the State B, TCo claims that the dividends constitute nonbusiness income. To minimize its allocable income taxable in its domiciliary State, TCo characterizes the dividends in State D as apportionable business income. To prevent being whipsawed in this fashion, the tax authorities in State B can treat the dividends as apportionable business income. The tax authorities, however, may decline to characterize the dividends as business income in order to prevent taxpayers from manipulating the rule to minimize their taxes.

3. Conclusion

Tax arbitrage is a major problem in every State that has a corporate income tax. Solving that problem has become more difficult after the decision of the U.S. Supreme Court in the *Hunt-Wesson* case. Whatever one may think of the reasoning of that case, it presents a reality that States concerned with the problem of tax arbitrage must confront.

Prior to *Hunt-Wesson*, California was the only State that was taking serious measures to combat tax arbitrage. With its defeat in *Hunt-Wesson*, California appears to have lost heart. Its initial response to that defeat has been to devise rules that maximize its revenue losses rather than minimize them. The question is whether any other State is prepared to step forward and show leadership on this matter. If a State is prepared to take a leadership role in combating tax arbitrage, it will find that the Court's opinion in *Hunt-Wesson* is not an overwhelming barrier to effective action.

CONSTITUTIONAL RESTRAINTS ON STATE INTEREST EXPENSE ALLOCATION: AN ANALYSIS OF THE U.S. SUPREME COURT'S DECISION IN *HUNT-WESSON*

by Walter Hellerstein

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When the U.S. Supreme Court intervenes in a state tax controversy, it is ordinarily a matter of some moment. The Court denies certiorari in all but two percent of the cases it considers, so when the Court does grant review, the question presented by the case presumably has broad national significance. The Court's state tax decisions in recent years addressing such issues as the constitutionality of worldwide combined reporting,[1] the limits on state power to require out-of-state mail-order vendors to collect use taxes,[2] and the scope of the unitary business principle[3] fall comfortably within this description.

At first blush, however, the Court's latest state tax decision in *Hunt-Wesson, Inc. v. Franchise Tax Board (2/22/2000)*, appears to deviate from this norm. Rather than raising an issue of self-evident national concern, the case raised the seemingly technical question of the validity of California's method of allocating interest expense to business and nonbusiness income. Moreover, because no other state had an interest-allocation provision like

[1] *Barclays Bank, Ltd. v. Franchise Tax Bd.*, 512 U.S. 298 (1994).
[2] *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992).
[3] *Allied-Signal, Inc. v. Director, Division of Taxation*, 504 U.S. 768 (1992).

California's, a high Court opinion directed to it arguably would have scant relevance to other states.

Nevertheless, there is more to *Hunt-Wesson* than meets the eye. For one thing, beneath the technical veneer of an interest-expense allocation dispute lies a fundamental question of constitutional power: whether a state may tax constitutionally exempt income under the guise of denying a deduction for expenses in an amount equal to such income, when there is no evidence that the expenses relate to the production of the exempt income. For another, the question of interest-expense allocation implicates a number of principles that are central to the constitutional restraints on the states' power to tax a multijurisdictional enterprise. The Court's decision in *Hunt-Wesson* therefore merits serious attention.

The Facts

The essential facts of the case were not in dispute. Hunt-Wesson, Inc. was the successor-in-interest to the Beatrice Foods Company ("Beatrice"), the original taxpayer in the case. Beatrice was a Delaware corporation with its commercial domicile in Illinois. During the years at issue (fiscal years 1980 through 1982), Beatrice was a diversified company engaged in business within and without California, primarily in providing food and food-related products and services for worldwide markets.

Beatrice owned directly and indirectly certain dividend-paying subsidiaries with which it was not engaged in a unitary business (the "nonunitary subsidiaries"). Most of the nonunitary subsidiaries were incorporated in foreign countries, and none was incorporated in California. During the years at issue, the nonunitary subsidiaries paid Beatrice approximately $75 million of dividends (the "nonunitary dividends"). During the same years, Beatrice took out loans in connection with the operation of its business

and incurred approximately $273 million in interest expense. None of the proceeds of the loans on which the interest expense was incurred went directly to any of the nonunitary subsidiaries, which were responsible for their own borrowings.

California's Taxing Scheme

California imposes a franchise tax measured by net income on corporations for the privilege of doing business in California. For a corporation like Beatrice, which was engaged in business within and without the state, California divides the corporation's income into two categories: business income and nonbusiness income. Business income, which is apportioned by formula among all the states in which the taxpayer does business,[4] means "income arising from transactions and activity in the regular course of the taxpayer's trade or business. . . ."[5] Nonbusiness income, which generally is allocated to a particular state depending on its situs, "means all income other than business income."[6] These definitions, as the U.S. Supreme Court has declared, are generally "quite compatible with the unitary business principle."[7] Under this principle, a state may tax an apportioned share of a nondomiciliary taxpayer's income arising from its unitary business, but generally may not tax income that is not connected with its unitary business (for example, dividend income received from nonunitary subsidiaries). It was stipulated in the case that all of the nonunitary dividends Beatrice received from its nonunitary subsidiaries was income that California had no constitutional power to tax.

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[4] The formula determines the portion of the corporation's business income that is fairly attributable to California. During the years at issue, the apportionment percentage was the simple average of three fractions — the taxpayer's in-state property over its total property, its in-state payroll over its total payroll, and its in-state sales over its total sales. *See* Cal. Rev. & Tax. Code § 25128 et seq.
[5] Cal. Rev. & Tax. Code § 25120(a).
[6] Cal. Rev. & Tax. Code §§ 25120(d), 25123-25127.
[7] *Allied-Signal, Inc. v. Director, Div. of Taxation*, 504 U.S. 768, 786 (1992).

California law generally provides that "there shall be allowed as a deduction all interest paid or accrued during the income year on indebtedness of the taxpayer."[8] The dispute in the case centered on California's so-called "interest offset" provision, which disallowed a deduction for interest expense that was otherwise deductible.[9] Specifically, the interest-offset provision disallowed a deduction for any net interest expense[10] to the extent that the taxpayer received nonbusiness interest and dividends---including, as in Beatrice's case, dividends from nonunitary subsidiaries that California lacked constitutional authority to tax. Moreover, the statute disallowed this expense even when the interest expense was unrelated to the production of the dividend income. In substance, then, the interest-offset provision denied a nondomiciliary corporation the benefit of an interest expense deduction by requiring it to allocate its net interest expense to nontaxable income regardless of whether the interest expense bore any relationship to the production of such income.

The Proceedings Below

The California Franchise Tax Board (the "Board") applied the interest-offset provision to deny Beatrice a deduction for its net interest expense on a dollar-for-dollar basis to the extent of the $75 million of constitutionally nontaxable dividends that Beatrice received from its nonunitary subsidiaries. The basis for the Board's denial of Beatrice's interest expense deduction was simply that Beatrice had received nonbusiness dividends from its nonunitary subsidiaries. The Board made

[8] Cal. Rev. & Tax. Code § 24344(a).
[9] Cal. Rev. & Tax. Code § 24344(b).
[10] California permitted a taxpayer to offset its interest expense against its "interest income subject to allocation by formula," Cal. Rev. & Tax. Code § 24344(b), i.e., apportionable or "business" interest income. Hence, it was the "net" business interest expense---the interest expense attributable to business income that remained after subtracting apportionable interest income---that was at issue in the case.

no determination that the interest expense bore any relationship to the constitutionally exempt dividends, and, as noted above, the statute did not require that it do so. As a consequence of the Board's disallowance of Beatrice's interest expense deduction, it increased Beatrice's business income subject to apportionment by California by $75 Million— the amount of Beatrice's nontaxable dividend income.

Beatrice challenged the denial of its interest expense deduction on the ground, among others, that the interest offset-provision violated the Commerce and Due Process Clauses of the United States Constitution by arbitrarily limiting Beatrice's interest expense deduction by the amount of its constitutionally nontaxable dividend income. Beatrice prevailed on these claims in the California trial court, but the California Court of Appeal reversed and sustained the interest expense disallowance. The Court of Appeal relied largely on an earlier decision of the California Supreme Court,[11] which had concluded that disallowance of an interest deduction based on the receipt of nontaxable dividends did not constitute taxation of the dividends themselves, although the court did not reach the constitutional issues. The California Supreme Court denied Hunt-Wesson's petition for review.

The Supreme Court's Opinion

Substance versus Form: Doing Indirectly What One May Not Do Directly. Despite the somewhat technical nature of the controversy before it, the U.S. Supreme Court recognized that the question raised by *Hunt-Wesson* was "reasonably straightforward": whether the Constitution permitted California to "carve out an exception to the interest expense deduction" measured by "the amount of nonunitary

dividend . . . income that the nondomiciliary corporation has received." More fundamentally, the case raised the question whether California could do indirectly what it could not do directly, namely, tax income beyond its constitutional reach by denying an otherwise allowable deduction in an amount precisely equal to the constitutionally nontaxable income.

The law is well settled, of course, that "a State cannot do that indirectly which she is forbidden by the constitution to do directly."[12] The Court has consistently applied this "great principle"[13] to invalidate state exactions that purport to tax indirectly what the Constitution forbids states from taxing directly.[14] Insofar as the practical effect of California's interest-offset provision was to tax indirectly income that California had no power, under the Commerce and Due Process Clauses, to tax---and it was common ground that California had no power to tax Beatrice's nonunitary dividend income---it would seem to have followed as a matter of course that California's interest-offset provision exceeded constitutional bounds.

Indeed, the Court had condemned specifically, in a related context, a mechanism remarkably similar to California's interest-offset provision. In *National Life Ins. Co. v*.

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[11] *Pacific Tel. & Tel. Co. v. Franchise Tax Bd*., 7 Cal. 3d 544, 498 P.2d 1030 (1972).
[12] *Passenger Cases*, 48 U.S. 283, 458 (1848) (plurality opinion).
[13] *Id*. at 459.
[14] *See*, *e.g.*, *id.* (Striking down an exaction on foreign passengers as a prohibited "duty on tonnage," U.S. Const. art. I, § 10, cl. 3); *Guy v. Baltimore,* 100 U.S. 434, 443 (1880) (striking down wharfage fee on vessels carrying out-of-state products "as a mere expedient or device to accomplish, by indirection, what the State could not accomplish by a direct tax"); *Frick v. Pennsylvania*, 268 U.S. 473, 495 (1925) (striking down state estate tax on the ground that "[i]t would open the way for easily doing indirectly what is forbidden to be done directly, and would render important constitutional limitations of no avail"); *Lee v. Osceola & Little River Rd. Improvement Dist. No. 1*, 268 U.S. 643 (1925) (striking down state tax scheme that would "accomplish indirectly the collection of a tax against the United States which could not be directly imposed").

United States,[15] the Court struck down a provision of the federal income tax law which permitted insurance companies to exclude municipal bond interest from their gross income but at the same time required the insurance companies to reduce an unrelated deduction for reserves by the full amount of the exempt interest. In other words, for each dollar of tax-exempt income the taxpayer received, it had to reduce an otherwise allowable deduction by one dollar. Treating the disallowance of the deduction for what it was — a transparent effort to tax exempt income by denying an unrelated deduction in the same amount — the Court ruled that "[o]ne may not be subjected to greater burdens upon his taxable property solely because he owns some that is free."[16]

California's interest offset thus appeared to fall squarely within the prohibition of *National Life* by reducing an otherwise allowable deduction on a dollar-for-dollar basis by the amount of the taxpayer's nontaxable income. Indeed, the Court recognized as much by observing, with a supporting reference to *National Life*, that "that which California calls a deduction would seem, in fact, to amount to an impermissible tax."If this were all there had been to *Hunt-Wesson*, it would hardly have warranted extended discussion. But there was more.

The "Matching" Defense: Allocating Interest Expense to Related Income. Throughout the litigation, the Franchise Tax Board defended the interest-offset provision on the ground that it served to allocate interest expense to related income, *i.e.*, to the income produced by the loans on which the interest was paid. If the Board's view of the interest-offset provision had been accurate, Beatrice would have been hard put to challenge its constitutionality. For, as the Court observed, "[i]f California could show that

[15] 277 U.S. 508 (1928).
[16] *Id.* at 519.

its deduction limit actually reflected the portion of the expense related to nonunitary income, the limit would not, in fact, be a tax on nonunitary income. Rather, it would merely be a proper allocation of a deduction."

But the Board's characterization of the interest-offset rule as a method for "correlating" or "matching" or reflecting the "economic relationship between" interest expense and related income was demonstrably false. The statute required that the interest expense deduction be reduced not just by the interest expense fairly attributable to the taxpayer's nontaxable interest and dividends, but by the full amount of those nontaxable interest and dividends. This reduction of the interest expense deduction by the amount of the nonbusiness interest and dividend income was absolute and unconditional. There was no "matching," no "correlation," no "economic relationship," no anything; just an arbitrary assignment, on a dollar-for-dollar basis, of business interest expense to nontaxable, nonbusiness income.

The "Money-Is-Fungible" Defense. The fact that the interest-offset provision did not require any tracing of the disallowed interest expense to the nontaxable income did not end the argument. Indeed, the heart of the Board's defense was that "California's interest offset statute is based on the rationale that money is fungible and cannot reliably be traced to its ultimate use."[17] The Court acknowledged California's right to treat money as fungible in order to avoid tax arbitrage. Without some rule allocating interest expense to nontaxable income, the Court observed that "firms might borrow up to the hilt to support their (more highly taxed) unitary business needs, and use the freed unitary business resources to purchase (less highly taxed) nonunitary business assets." Moreover, the Court pointed out that it had "consistently upheld deduction denials that represent

reasonable efforts properly to allocate a deduction between taxable and tax-exempt income, even though such denials mean that the taxpayer owes more than he would without the denial."

But this proposition did not justify the interest-offset mechanism. Even if one accepts the notion that "money is fungible and cannot be traced accurately to its ultimate use,"[18] as the Board contended, it did not follow that *any* methodology for assigning interest expense – even one that systematically assigns interest expense to nontaxable income – is constitutionally acceptable. Indeed, the taxpayer showed that the interest-offset provision's mechanical allocation of Beatrice's interest expense to its nontaxable income resulted in the assignment of one dollar of interest expense to each dollar of nonunitary dividend income that lay beyond California's taxing power, but less than thirteen cents of interest expense to each dollar of unitary income that California could tax. California could not explain by what form of alchemy borrowed money miraculously became more productive when used to generate taxable rather than nontaxable income.

This was too much for the Court to swallow. Without denigrating the concept of fungibility on which California's interest expense disallowance was allegedly premised, the Court concluded that "[t]he California statute . . . pushes this concept past reasonable bounds." The assumption underlying the California statute was that a corporation that borrows "any money at all has really borrowed that money to 'purchase or carry' its . . . its nonunitary investments" that generate nontaxable income. But this assumption, the Court continued, was "unrealistic," and "that lack of practical realism explains why California's rule goes too far." A state tax provision that "unrealistically assumes that

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[17] Brief for Respondent at 21, *Hunt-Wesson*; *see also id. passim.*
[18] *Id.* at 30.

every" borrowing by a business with taxable and nontaxable income "first helps" generate the nontaxable income fails to "'actually reflect a reasonable sense of how income is generated'"---the standard the Court articulated in *Container Corporation of America v. Franchise Tax Board*[19] for determining the constitutionality of an apportionment formula.

The Uniqueness of California's Approach to Interest Expense Allocation. Finally, the Court found it significant that "[n]o other taxing jurisdiction, whether federal or state, has taken so absolute an approach to the tax arbitrage problem that California presents." The Court pointed to a variety of approaches that federal and state tax statutes and regulations take to the problem of interest expense allocation including the asset- and income-based tests for allocating interest expense between domestic and foreign source income;[20] similar ratio-based rules employed by many states; and various tracing rules that the federal government and the states employ in particular circumstances.[21]

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[19] 463U.S. 159, 169 (1983). In *Container*, the Court sustained the constitutionality of worldwide combined reporting as applied to a U.S.-based multinational.

[20] See Treas. Reg. §§ 1.861-9T(f), (g).

[21] In this connection, the Court properly gave short shrift to the suggestion advanced in an article published just nine days before the oral argument in the case, and evidently circulated to the Justices, that the Court should rule for California in part because the so-called CFC netting rule (Treas. Reg. 1.861-10), "nicely parallels California's interest-offset rule." Michael J. McIntyre, *Constitutional Limitations on State Power to Combat Tax Arbitrage: An Evaluation of the* Hunt-*Wesson Case,* STATE TAX NOTES, Jan. 3, 2000, pp. 51, 57. The apparent thought underlying the suggestion was that what's good enough for the Federal Government is also good enough for the states. That, of course, is a nonsequitur because the Federal Government is not subject to the same constitutional restraints that limit the states' exercise of their taxing power. The suggestion was also based on a false premise, namely, that the CFC-netting rule bore any reasonable resemblance to California's interest-offset provision. The CFC-netting rule is in fact a highly particularized provision that requires a taxpayer to allocate interest expense to foreign source interest income when a U.S. business group's loans to foreign subsidiaries and the group's total borrowing have increased relative to recent years (subject to a number of adjustments), and both loans and borrowing exceed certain amounts relative to total assets. In effect, the rule is directed to the situation where a U.S. business group borrows money from an unrelated third party and relends it to its foreign affiliate in situations in which, as McIntyre himself acknowledges, the borrowing "is considered to be incurred for tax-avoidance reasons." MICHAEL J. MCINTYRE, THE INTERNATIONAL INCOME TAX RULES OF THE UNITED STATES 3-51e – 3-51f (2d ed. 1992). In striking contrast to such a limited anti-abuse provision, which, if adopted by California would doubtless have passed constitutional muster, the interest-offset provision assigned interest expense to nontaxable income regardless of any circumstantial evidence of tax abuse or of

The Court took comfort in the fact that other jurisdictions had managed to devise reasonable methods for assigning interest expense to interest income even under the assumption that money is fungible. The assumption that tracing is a futile task because money borrowed to support Taxable Activity A can free up resources to support Nontaxable Activity B carries with it no implication that reasonable methods for assigning interest income are unavailable for allocating interest expense under conditions of uncertainty. Ratio-based rules take the reasonable position that interest expense is fairly attributable to all of the taxpayer's activities when one does not (or cannot) know the precise activities---taxable or tax-exempt---to which the loans giving rise to the interest expense should be attributed. Although not perfect, over time such rules will, as the Court noted, "reflect approximately the amount of borrowing that firms have actually devoted to generating each type of income." By contrast, as the Court concluded, "it is simply not reasonable" to expect that a rule that attributes all borrowing first to nontaxable income to reflect fairly the amount of interest expense attributable to taxable and nontaxable income.

California Implications

Although the implications of a U.S. Supreme Court decision for a single state would not usually warrant extended discussion, they do when that state comprises the world's seventh largest economy.[22] In fact, over 40,000 corporations file California franchise tax returns reporting activities both within and without the state,[23] and each one

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a relationship of the interest expense to the interest income. Professor McIntyre and California apparently suffered from similar forms of myopia, namely, that all borrowing should be assumed to support activities generating tax-exempt income regardless of the facts.

[22] California Trade and Commerce Agency, Office of Economic Research, *California: An Economic Profile* 9 (1998).

[23] Letter from California Attorney General Bill Lockyer to Court of Appeal of California, Jan. 4, 1999, reprinted in Petition for Writ of Certiorari App. 39a-42a, *Hunt-Wesson*.

of these corporations could---and many clearly do---have interest-offset issues. Moreover, while the parties stipulated that Hunt-Wesson would be entitled to a refund based on the full deductibility of its interest expense if it prevailed in the litigation, California is not likely take so generous a position with other taxpayers in a post-*Hunt-Wesson* world.

Nondomiciliary Taxpayers. California has already signaled its approach to the interest-expense allocation issue for nondomiciliary taxpayers in the face of a determination that the interest-offset provision was unconstitutional. In a letter to General Electric Company which had challenged the application of the interest-offset provision, a Franchise Tax Board hearing officer wrote that, in the event of a loss in *Hunt-Wesson,* General Electric should allocate its interest expense on the basis of the federal asset allocation method for allocating interest expense between U.S. source and foreign source income set forth in IRC § 864(e) and Treas. Reg. 1.861-9T.[24] Specifically, a California taxpayer would be required to:

(1) Determine the amount of total interest expense.[25]

(2) Determine any interest from qualified nonrecourse debt, which is directly assigned to the asset and excluded (along with the asset) from the asset allocation method.

(3) Determine the asset pool and the asset values[26]

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[24] Brief of General Electric Company as *Amicus Curiae* in Support of Petitioner, App. 1a-4a, *Hunt-Wesson* (reproducing Letter from Penny Celiz, Hearing Officer, California Franchise Tax Board to Frank Yanover, General Electric Company, December 23, 1997).

[25] Total interest expense is the sum of all interest expense for all members of the combined report, less intercompany interest expense. *Id.*

[26] Assets are valued at average federal tax basis net of depreciation and contra asset accounts (such as bed debt reserves), less intercompany accounts and assets associated with qualified nonrecourse debt. Stock basis in subsidiaries owned more than 50 percent but not combined is increased by the subsidiaries' earnings and profits for the period in which the stock was held by more than 50 percent.

(4) Compute the ratio of nonbusiness assets to total assets.[27]

(5) Determine the interest expense assigned to nonbusiness income. The ratio computed in (4) is multiplied by total interest expense determined in (1), less specifically assigned interest determined in (2), to determine the amount of interest expense assigned to nonbusiness income.[28]

In the end, then, the Franchise Tax Board---albeit under constitutional compulsion---has adopted an interest-expense allocation methodology that actually conforms to its theory that money is fungible. The federal interest-expense allocation regulations that underlie the Board's apparent post-*Hunt Wesson* approach to interest-expense allocation explicitly proceed on the premise that "money is fungible and that interest expense is attributable to all activities and property regardless of any specific purpose for an incurring an obligation on which interest is paid."[29] Nondomiciliary California taxpayers with interest-offset issues can reasonably anticipate that the Board will not simply allow the interest expense deduction but will require an allocation of interest expense according to the asset-based method described above, or perhaps to some other ratio-based method.

Domiciliary Taxpayers. Nondomiciliary taxpayers have always complained about the interest-offset provision because it effectively taxed their nonbusiness interest and dividend income that lies beyond California's taxing power. The interest-offset provision accomplished this result by arbitrarily assigning interest expense to nonbusiness interest and dividend income even when the interest expense did not contribute to the production

[27] Nonbusiness assets includes all nonbusiness assets on the balance sheet (other than those associated with qualified nonrecourse debt), not just those assets paying nonbusiness dividends for the current year. *Id.*
[28] *Id.*
[29] Treas. Reg. § 1.861-9T(a).

of the nontaxable income. But the very mechanism that deprives *nondomiciliary* taxpayers of an interest deduction to which they *are* entitled as a matter of sound tax policy, thereby unconstitutionally *increasing* their California income, accords *domiciliary* taxpayers an interest deduction to which they are *not* entitled as a matter of sound tax policy, thereby *decreasing* their California income below that which lies within California's taxing power.

To appreciate the nature of this problem, one must understand how California taxes nonbusiness interest and dividends earned by domiciliary corporations. Under California's rules for allocation of nonbusiness income, "[i]nterest and dividends are allocable to this State if the taxpayer's commercial domicile is in this State."[30] Consequently, all of a domiciliary's nonbusiness interest and dividends are allocable to — and taxable by — California. As discussed above, the interest-offset provision requires taxpayers to offset their net business interest expense by the amount of their nonunitary, nonbusiness interest and dividends. For a nondomiciliary taxpayer, this requirement deprives it of the benefit of an interest expense deduction for California tax purposes by arbitrarily assigning its interest expense to nonbusiness interest and dividends that California does not---and constitutionally cannot---tax. But the opposite is true for a domiciliary corporation, which enjoys the full benefit of an interest expense deduction for California tax purposes. By assigning the domiciliary corporation's interest expense to nonbusiness interest and dividends---income that California fully taxes when earned by domiciliaries,[31] the interest-offset provision reduces the domiciliary taxpayer's taxable California income.

[30] Cal. Rev. & Tax. Code § 25126.
[31] Cal. Rev. & Tax. Code §§ 25123, 25126.

At first blush, one might view this treatment of domiciliary corporations as nothing more than a description of the natural consequences of allowing an interest expense deduction that corresponds to the state's power to tax domiciliary taxpayers' income. Since California has full power to tax all the domiciliary taxpayer's nonbusiness interest and dividends, California's allowance of the interest expense deduction corresponds simply to its power to tax the dividends, not to the taxpayer's domiciliary status. The critical flaw in this analysis, which underlies the Court's decision in *Hunt-Wesson*, is that it is based on the false premise that there is some relationship between the nonbusiness interest and dividend income and the expenses that are being assigned to it. If there is no relationship between the nonbusiness interest and dividends and the interest expenses, then the grant of a deduction for the interest expenses cannot be justified by reference to the state's power to tax the nonbusiness dividends.

Consider, for example, the case of corporation D, a domiciliary of California that carries on a unitary widget manufacturing business in California and Oregon. Assume that D's apportionment factor is 50 percent in each state. Assume further that D has $2,000 of apportionable business income from its widget operations ($1000 of which is assigned to California and Oregon, respectively); $500 of interest expense on a loan whose proceeds were used to purchase widget manufacturing machinery in California and Oregon; and $500 of dividends from a nonunitary subsidiary producing Hula Hoops in Outer Mongolia. Under the interest offset provision, D will be able to deduct the full $500 of interest expense from its California tax base (reducing its tax base to $500), even though a proper application of income apportionment principles would have assigned half of the $500 interest expense to Oregon (reducing D's California interest expense

deduction to $250 and leaving it with a California tax base of $750). Because the interest offset provision in effect transforms business interest expense into nonbusiness interest expense, it permits D to enjoy (albeit under false pretenses) a deduction against its otherwise taxable nonbusiness dividend. Since it is irrelevant under the interest-offset provision whether the interest expense bears any relationship to the production of the income against which the expense is offset, D enjoys an interest expense deduction in California that, under sound tax principles, should be assigned to Oregon.

In *Hunt-Wesson*, the Court struck down California's interest-offset provision in its application to *nondomiciliary* taxpayers because it effectively taxed income that lay beyond California's reach under the Due Process and Commerce Clauses. But that holding has no impact on the interest-offset provision in its application to *domiciliary* taxpayers, because it simply decreases the amount of constitutionally taxable income that California chooses to tax. The question remains as to what California should or must do with respect to domiciliary corporations in light of *Hunt-Wesson*.

First, what *should* California do from the standpoint of sound tax policy? I think the answer to that question is easy. California should apply to domiciliary corporations the same, reasonable asset-based methodology for allocating interest expense that it apparently will now apply to nondomiciliary corporations. There is no more justification as matter of tax policy for permitting domiciliary corporations to deduct interest expense that is properly attributable to nontaxable income than there is for prohibiting nondomiciliary corporations from deducting interest expense that is properly attributable to taxable income.

Second, what *must* California do from the standpoint of federal constitutional law? It is clear that California has no constitutional obligation to tax income that it does not wish to tax. Hence, if California wishes to exempt the nonbusiness interest and dividends of its domiciliary corporations under the guise of allowing them a deduction for interest expense properly attributable to out-of-state activities, it is surely entitled to do so. There is no prohibition in the Constitution for doing indirectly what one can do directly.

Nevertheless, if California were to continue to apply the interest-offset provision to domiciliary corporations, there would still be a constitutional question lurking in the background with respect to the treatment of nondomiciliary corporations. Even if California, in light of *Hunt-Wesson*, will now permit nondomiciliary corporations to deduct interest expense properly attributable to their California operations, nondomiciliary corporations might nevertheless complain that California is discriminating against nondomiciliary corporations by denying them the right to deduct *all* of their interest expense to the extent of their their nonbusiness interest and dividends.

The argument would go something like this. The interest-offset provision discriminates against nondomiciliary corporations for the simple reason that it denies a nondomiciliary corporation, but not a domiciliary corporation, a deduction for interest expense equal to the corporation's nonbusiness interest and dividends. The discrimination cannot be justified as a method for matching a corporation's interest expense to its taxable income, because the interest deduction is denied to the nondomiciliary and granted to the domiciliary regardless of any relationship between the interest expense and the nonbusiness interest and dividends. Consequently, the denial or

grant of the deduction depends entirely on the corporation's domicile in violation of settled Commerce Clause principles.[32]

The taxpayer made such a discrimination argument in *Hunt-Wesson*, but the Court never reached it because it decided the case on the grounds of extraterritorial taxation. The risk that taxpayers will advance such an argument in the post-*Hunt-Wesson* environment counsels strongly in favor of legislation repealing the interest-offset provision altogether and applying the same ratio-based methodology for allocating interest expense to domiciliary and nondomiciliary corporations alike.

General Implications

Although *Hunt-Wesson* does not articulate novel constitutional doctrine limiting the exercise of state tax power, it does reinforce and elaborate upon several constitutional principles that are likely to guide future adjudication of state tax controversies.

The Primacy of Substance Over Form in the Adjudication of the Constitutionality of State Taxes. The Court reiterated the fundamental proposition that states may not do indirectly what they may not do directly. As unexceptional as that proposition may be, it seems that the Court cannot repeat it too often. The fact that California sought to reach extraterritorial values by means of "denying a deduction" rather than "imposing a tax" lacked constitutional significance. As the Court observed, a "tax on sleeping measured by the number of pairs of shoes you have in your closet is a tax on shoes." *Hunt-Wesson*

[32] See, e.g., *South Central Bell Telephone Co. v. Alabama*, 526 U.S. 160 (1999) (invalidating state franchise tax that favored domestic over foreign corporations).

serves as a continuing reminder to of the primacy of substance over form in contemporary analysis of constitutional challenges to state taxes.[33]

The Nondiscrimination Principle Underlying Constitutionally Acceptable Expense Allocation Methodologies. If there was a central message to the Court's opinion disapproving California's arbitrary approach to interest-expense attribution while approving "[r]atio-based rules like the one used by the Federal Government and those used by many states," perhaps it was this: The methods adopted by the federal government and the states for allocating interest when it cannot be directly traced to particular items of income do so in a manner that does not disproportionately assign interest to nontaxable income. The common theme of these other methods was that they spread interest income evenly over all of the income to which it is indirectly related.

Indeed, when the Court has considered analogous questions in the past, it has likewise endorsed an interest expense methodology that assigns interest between taxable and nontaxable income on a nondiscriminatory basis. For example, in *United States v. Atlas Life Ins. Co.*,[34] the Court sustained a pro-rata methodology for determining the extent to which an insurance company could reduce its taxable investment income by its tax-exempt interest. In so holding, the Court articulated the rule that lies at the heart of *Hunt-Wesson* (although the Court in *Hunt-Wesson* did not cite the case): "We see no sound reason, legal or economic, for distinguishing between the taxable and nontaxable dollar . . . ."[35] In *Hunt-Wesson*, there likewise was no sound legal or economic reason for

[33] In unusual circumstances, however, form may still play a significant role in the adjudication of the constitutionality of state taxes. See, e.g., Walter Hellerstein, et al., *Commerce Clause Restraints on State Taxation After* Jefferson Lines, 51 TAX LAW REV. 47 (1995).
[34] 381 U.S. 233 (1965).
[35] *Id.* at 249.

the interest-offset provision's differential treatment of the taxable and nontaxable dollar, assigning a disproportionate amount of interest expense to the latter.[36]

This nondiscrimination principle should be the starting point for analysis of future controversies over the constitutional propriety of expense allocations. If the expense methodology allocates expenses between taxable and nontaxable income on an evenhanded basis, taxpayers should have no legitimate complaint. Even if they can purportedly trace expenses to particular types of income in a manner that produces a result at odds with the expense allocation methodology, states may properly invoke the principle that money is fungible in defending their reliance on a reasonable allocation method. As the Court has declared in the analogous context of income apportionment, and in substance repeated on numerous occasions: "[W]e need not impeach the integrity of [appellant's separate] accounting system to say that it does not prove appellant's assertion that extraterritorial values are being taxed."[37] The fungibility of money, like the unitariness of a business, justifies the application of a reasonable apportionment methodology regardless of the results of tracing or separate accounting.

By contrast, if the expense allocation methodology is not evenhanded, and arbitrarily assigns expense to nontaxable income, its constitutionality should be in jeopardy in application to taxpayers whose expenses are disproportionately assigned to nontaxable values. That is the teaching of *Hunt-Wesson*.

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[36] *See also First Nat'l Bank v. Bartow County Bd. of Tax Assessors*, 470 U.S. 583 (1985) (sustaining pro rata deduction of tax-exempt federal obligations from taxable and nontaxable assets).
[37] *Butler Bros. v. McColgan*, 315 U.S. 501, 507 (1942).

The Availability of Constitutionally Acceptable Alternatives. **There is a final lesson from *Hunt-Wesson* that has general applicability to the constitutional validity of state taxing schemes: The availability of constitutionally acceptable alternatives to the challenged tax statute can significantly influence the judicial determination of the statute's constitutionality. The Court has declared that "[o]ur cases leave open the possibility that a State may validate a statute that discriminates against interstate commerce by showing that it advances a legitimate local purpose that cannot be adequately served by reasonable nondiscriminatory alternatives."[38] Although the Court did not decide *Hunt-Wesson* on grounds of unconstitutional discrimination,[39] the availability of constitutionally palatable alternatives to the interest-offset provision appears clearly to have facilitated the Court's determination to invalidate the application of California's levy.**

[38] *New Energy Co. v. Limbach*, 486 U.S. 269, 278 (1988) (citing cases).
[39] But see the discussion above regarding the discrimination issue that was raised in the case.

In *Hunt-Wesson*, after all, California had a legitimate interest in attempting, as the Franchise Tax Board put it, "to plug a destructive tax loophole"[40] that allows corporations to invest equity capital to generate nontaxable income while investing borrowed funds to generate taxable income. If the interest-offset provision had been the *only* practical way to "plug" that "loophole," the Court might well have been sympathetic to the Board's plea. But such a contention, which the Board advanced by stressing how "difficult" it was a practical matter to determine "the extent to which interest expense is attributable to business income as opposed to nonbusiness income,"[41] was belied by the existence of reasonable nondiscriminatory alternative methodologies adopted by other states and the federal government for allocating expenses to income even when the expenses are not traceable to a particular item or items of income. The Court therefore could strike down the application of California's interest-offset provision knowing that it was not depriving the state of the ability to pursue its legitimate state objective by less burdensome means.

Conclusion

Despite the notorious complexity of interest-expense allocation issues, *Hunt-Wesson* was at bottom a simple case of a state seeking to tax income that lay beyond its constitutional reach. The U.S. Supreme Court's unanimous condemnation of that effort reflects its continuing vigilance over state taxing schemes that offend bedrock constitutional norms. Moreover, the Court's strong endorsement of an evenhanded

[40] Brief for Respondent at 12, *Hunt-Wesson.*
[41] *Id.*

approach to expense allocation provides useful guidance opinion for future judicial, administrative, and legislative action in this domain.