Hunt-Wesson: Rumble in the Jungle

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Facts About the *Real* Rumble in the Jungle

- Contestants: George Foreman (25) v. Muhammad Ali (32)
- Date: Oct. 30, 1974
- Place: Kinshasa, Zaire
- Staged by: President Mobutu Sese Seko
- Winner: Ali (white trunks) in 8 Rounds

Eight Rounds of Questions

Constitutional question under Due Process Clause and due process prong of Commerce Clause:

Did California, under the facts, of the case, tax extra-territorial values by applying its interest offset rule to Hunt-Wesson?

Question 1

1. Is blocking tax arbitrage a legitimate State goal?

YES

Q1: Why States Need to Control Tax Arbitrage

Example # 1: Earnings Stripping

- TCo is domiciled in State D. It earns business income of $300,000 in State B. GCo also earns $300,000 of business income in State B.
- TCo borrows $1 million from a bank at 10 percent annual interest. It also purchases $1 million of nonbusiness preferred stock.
- 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 allows TCo to deduct the interest from business income, then TCo will reduce its taxable income in State B by $100,000, from $300,000 to $200,000, and pay less tax than GCo.

Definition of Tax Arbitrage

The Three Essentials

- (1) The taxpayer borrows money and the loan is outstanding for the taxable year
- (2) The taxpayer deducts some or all of the interest on its loan from income taxable at full rates
- (3) The taxpayer simultaneously earns income that is taxed at a favorable rate (or not taxed at all)

Question 2

2. Was California attempting to stop tax arbitrage?

YES

Q2: Tax Arbitrage and California's Interest-Offset Rule

How the Interest-Offset Works (simplified)

- Applies if the taxpayer (1) Is paying interest on a loan, (2) Otherwise would deduct some or all of that interest from apportionable business income taxable in California, and (3) Is earning nonbusiness income not taxable by California
- Under the interest-offset rule, the taxpayer's interest expense is directly allocated to its nonbusiness interest and dividend income (to the extent thereof)
- Any remaining interest is allocated under a pro rata rule
- As applied to Example #1, the interest-offset rule would allocate TCo's $100,000 of interest expense to the $100,000 of nonbusiness preferred dividends, thereby preserving the California tax base

California Legislature "Intended" to Block Tax Arbitrage

- California Supreme Court, in the *Pacific Telephone* Case, found that the purpose of the rule was to prevent tax avoidance of the type illustrated in Example #1
- The rule is designed in a way that in fact prevents tax arbitrage, and only taxpayers engaging in tax arbitrage are disadvantaged by the rule
- The U.S. Supreme Court, in *Hunt-Wesson*, did not discuss legislative intent
- The taxpayer in *Hunt-Wesson* offered no evidence of a contrary legislative intent

Question 3

3. Was Hunt-Wesson engaging in tax arbitrage?

YES

Q3: Hunt Wesson Was Engaged in Tax Arbitrage

This is Fact, Not Opinion

- H-W borrowed large sums of money and the loans were outstanding for the taxable year
- It wanted to deduct some (at U.S. Supreme Court) or all (on tax return and in State courts) of the interest on its loans from apportionable business income, taxable at full rates
- It simultaneously was earning nonbusiness income that was taxed at a favorable effective tax rate (or not taxed at all)

Question 4

4. Does the direct-allocation rule properly measure business income?

YES

Q4: The Direct-Allocation Rule Properly Measures Business Income

This is Opinion, Not Fact

- Because of the fungibility of money, some policy-driven allocation rule is required to properly measure income
- Nonbusiness income is best understood to be income generated by assets not needed in any of the taxpayer's businesses
- If the taxpayer has a reserve of assets not needed for business purposes, it has no business need to borrow money, up to the amount of those reserve assets
- A direct allocation method rests on the plausible assumption that if a taxpayer borrows money when it has a reserve of assets unneeded in its businesses, it has borrowed to "acquire or carry" those reserve assets, not to earn business income

Home Office Example

Employees Can't Deduct Expense of "Unnecessary" Home Office

- Employer provides fully adequate office for Employee at workplace
- Employee provides herself with fully adequate home office, which she uses regularly
- Is denial of a deduction for the home office "unreasonable"? **NO**, it is sound tax policy.
- Would a Pro Rata rule (allowing deduction for half of the home office expense) be "reasonable"? **NO**, it would permit half of the perceived abuse to continue.

Meaning of Fungible

Fungibility is a Relative Concept

- Few things are absolutely fungible, even money
  - Money is one of the more fungible items
  - If you are feeding a parking meter that takes only coins, however, a dollar is not fungible with four quarters
- Most fungible items are fungible with respect to a particular use:
  - Bruised and unbruised apples are fungible for making cider but not for selling in stores
  - Size 10 shoes are fungible with size 8 shoes for purposes of taking inventory in a shoe store but are not fungible to the wearer
  - Corn and barley are fungible for feeding pigs but not for making beer

Fungibility of Debt & Equity Capital

$$$ It's Not Just About Money $$$

- Everyone agrees that "Money Is Fungible"
- But it is not just money that is fungible — pro rata and direct allocation methods both assume that debt capital and equity capital are fungible
- Most debt capital and equity capital are not held in the form of money; the money is used to buy, for example, tin-can factories and sheep farms
- The assets bought with money are fungible because, with good capital markets, they can be reduced to money fairly easily

Example of Fungibility of Capital

- BCo holds a bond worth $50,000 and a tin-can factory worth $150,000. It acquired the assets with $100,000 of equity capital and $100,000 of debt capital. It wants to raise $25,000 in cash for some venture and wants to retain possession of the bond and tin-can factory. With good capital markets, it has the following choices:
  - Sell an interest in the bond or an interest in the tin-can factory (or a little of both)
  - Borrow $25,000, using the bond and/or tin-can factory as security
  - Stip the bond and/or the tin-can factory (that is, sell an income interest)
  - Sell a remainder interest in bond or tin-can factory (e.g., sale/leaseback)

The Analogy to Inventory Accounting

Inventory Accounting Links Expenses to Sales Proceeds Using an Allocation Rule

- For most types of inventory property, the goods are functionally fungible
- Physical tracing is difficult and often meaningless
- A direct allocation rule, such as FIFO or LIFO, may be a sensible alternative
- Pro rata allocation, such as average costing, also may be a sensible alternative
- The choice of methods depends on policy goals, not on economics

Question 5

5. Was the California rule narrowly tailored to address the perceived abuse?

YES

Q5: The California Rule is Narrow

It Applies Only to Most Pernicious Cases of Tax Arbitrage

- Tax arbitrage threatens the integrity of a tax system when the nonbusiness assets generate enough cash flow to cover borrowing costs
- California's interest-offset rule applies only to nonbusiness property generating interest and dividends
- It applies to stocks and bonds only to extent that the interest and dividends cover the borrowing costs

Question 6

6. Is dollar-for-dollar disallowance of the interest deduction evidence of overreach?

NO

Dollar-for-Dollar = Rope-a-Dope

Pounding Away at the Dollar-for Dollar Relationship Is Wasted Energy

- That relationship is essentially benign — it demonstrates that California either:
  - (1) is attempting to tax nonbusiness income **or**
  - (2) is attempting to block tax arbitrage.
- An argument that supports the position of **both** sides is not a helpful argument for **either** side.

Question 7

7. Can a pro rata rule block tax arbitrage?

NO

Q7: Pro-Rata Allocation Permits Tax Arbitrage

It's part of the Problem, not part of the Solution

Example #2: Pro Rata Allocation

TCo has California business income of $300,000. It borrows $1 million, paying annual interest of $100,000. From its commingled pool of capital, it acquires preferred stock paying annual dividends of $100,000.

Under a pro rata (to income) rule, TCo would deduct interest of $75,000 from its business income ($300,000/$400,000 × $100,000), thereby reducing its taxable business income by that amount.

Indeed, TCo could reduce its taxable business income by the full $100,000 simply by borrowing an additional $500,000, paying an additional $50,000 in interest, and earning an additional $50,000 in nonbusiness dividends.

Review the Numbers

Pro Rata Allocation CANNOT Block Tax Arbitrage

Original Business Net Income = $300,000

Interest Paid = $100,000

Nonbusiness Income = $100,000

Total Income = $400,000

Pro Rata Interest Deduction = $75,000

Revised California Income = $225,000

Reduction in California Tax Base= $75,000

Question 8

8. Is pro rata allocation more "reasonable" than direct allocation?

NO

Q8: Is the California Rule "Reasonable"

U.S. Supreme Court Says "NO"

"The California statute, however, pushes this concept past reasonable bounds. In effect, it assumes that a corporation that borrows any money at all has really borrowed that money to 'purchase or carry' . . . its nonunitary investments. . . . Presumably California believes that, in such a case, the unitary borrowing supports the nonunitary business to the extent that the corporation has any nonunitary investment because the corporation might have, for example, sold the sheep farm and used the proceeds to help its tin can operation instead of borrowing.

"At the very least, this last assumption is unrealistic. And that lack of practical realism helps explain why California's rule goes too far. A state tax code that unrealistically assumes that every tin can borrowing first helps the sheep farm (or the contrary view that every sheep farm borrowing first helps the tin can business) simply because of the theoretical possibility of a hypothetical sale of either business is a code that fails to 'actually reflect a reasonable sense of how income is generated' . . . and in doing so assesses a tax upon constitutionally protected nonunitary income."

Like Homer, the Court Nodded

Actually, It Nodded Thrice

- The Court incorrectly assumed that the California rule applies in allocating interest expenses between separate unitary businesses —e.g., between a tin-can factory and an unrelated sheep farm
- The Court also incorrectly assumed that a pro rata rule does not treat a taxpayer's debt capital and equity capital as fungible
- The Court also misunderstood how the Federal government deals with tax arbitrage in comparable circumstances

Comparisons to Federal Tax Law

Court Falsely Asserted that the Feds Use a Pro Rata Rule in "Comparable Circumstances"

- The Court stated: "Federal law in comparable circumstances (allocating interest expense between domestic and foreign source income) uses a ratio of assets and gross income to allocate a corporation's total interest expense. See 26 CFR §§1.861-9T(f), (g) (1999)."
- The circumstances, however, clearly are not comparable. The U.S. taxes U.S. corporations on their worldwide income, so no opportunity for tax arbitrage arises simply from earning foreign income.
- When the Feds do face a tax arbitrage problem, they typically use a direct allocation rule. The so-called CFC Netting Rule, mischaracterized by the Court as a tracing rule, is an example.

Arguments that the California Rule is "Reasonable"

It is Reasonable Because . . .

- The legislative purpose of the rule, as determined by California's highest court, is to prevent tax avoidance though tax arbitrage, and preventing tax arbitrage is a reasonable goal for a State tax system to pursue.
- Taxpayers holding a reserve of assets unnecessary for their business have no business need to borrow (up to the amount of those reserve assets).
- The California rule under attack applies only to taxpayers, such as Hunt-Wesson, that are engaging in tax arbitrage.
- The disallowance of a deduction for interest expense is exactly proportionate to the degree to which the taxpayer has engaged in tax arbitrage.
- The California rule is targeted at the most pernicious cases of tax arbitrage, and it avoids the complexity and unfairness of rules that depend for their application on a finding of improper motive.

California Rule Is "Reasonable"

It's All Over!!!