

Michael J. McIntyre, "Hunt-Wesson and the Continuing Problem of Tax Arbitrage," 6 *The State and Local Tax Lawyer* 57-87 (2001).

## Summary

In the *Hunt-Wesson* case (*Hunt-Wesson, Inc. v. Franchise Tax Bd.*, 528 U.S. 458 (2000)), the taxpayer argued that California's rule for directly allocating certain interest deductions to a taxpayer's nonbusiness income without apportionment was an indirect method for taxing nonbusiness income having no nexus with California. 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.

California argued before the Court that it was not attempting through its direct allocation rule to tax nonbusiness income arising outside its borders. It contended that the rule was adopted in good faith to prevent taxpayers from artificially inflating their interest deduction, thereby artificially deflating their taxable income subject to California tax. Conduct of the type attacked by California through its direct allocation rule is referred to as tax arbitrage. The taxpayer's victory in *Hunt-Wesson* means that states are limited in their ability to combat tax arbitrage. As explained in Part III, below, direct allocation of interest is the only effective mechanism available to governments for combating tax arbitrage. The Court's decision in *Hunt-Wesson* is sufficiently limited in scope, however, that it has not necessarily left the States defenseless in defending their tax base against taxpayers engaging in tax arbitrage.

Part II describes the direct allocation rule that was held to be unconstitutional in *Hunt-Wesson*. The rule is referred to in California tax parlance and in *Hunt-Wesson* as the "interest-offset rule." Part III discusses the tax policy objectives that should motivate a state to adopt an interest-offset rule or some functional equivalent. The Court paid scant attention to those policy objectives in framing its opinion in *Hunt-Wesson*. The Court's opinion in *Hunt-Wesson* is terse and baffling. Part IV discusses the opinion, with references to the various arguments that the taxpayer and California had made to the Court. Part V suggests some ways that States can address the problem of tax arbitrage within the constraints on State taxation apparently imposed by *Hunt-Wesson*. All of these methods are not unquestionably constitutional. All of them are defensible on policy grounds and are consistent with a reasonable reading of *Hunt-Wesson*.

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.