HUNT WESSON AND THE CONTINUING PROBLEM OF TAX ARBITRAGE

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I. INTRODUCTION

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 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. In 1972, the California Supreme Court rebuffed a challenge to the direct allocation rule in the *Pacific Telephone* case.[2] 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 Telephone*, illustrates the type of tax avoidance scheme that the direct allocation rule was designed to defeat.

> *TCo and GCo are domiciled in State D. They both earn business income of $300,000 in State B. TCo borrows $1 million from a bank at ten 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. State B has no equivalent to California's direct allocation rule for interest. 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, although both companies have the same amount of business income (computed without respect to TCo's interest expense).*

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[1]Hunt-Wesson, Inc. v. Franchise Tax Bd., 528 U.S. 458 (2000).

[2]Pacific Tel. & Tel. Co. v. Franchise Tax Bd., 498 P.2d 1030 (Cal. 1972).

Conduct of the type engaged in by TCo in the above example 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.[3] I believe, however, that the Court's decision in *Hunt-Wesson* is sufficiently limited in scope that it has not necessarily left the States defenseless in defending their tax base against taxpayers engaging in tax arbitrage.

In Part II, below, I describe briefly 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." The petitioner and the respondent in *Hunt-Wesson* did not fully agree as to how that rule operated.[4] The Court, for purposes of its decision, assumed that the respondent's description of the rule was correct. I make the same assumption here.

In Part III, I discuss 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*.[5] On the one hand, the Court did note that protecting itself against tax arbitrage was an appropriate action for a State to take. On the other hand, it held that the California rule "pushes [the] concept [of tax arbitrage] past reasonable bounds." I find it highly unlikely that the Court intentionally adopted a constitutional standard that would lead to the emasculation of the power of States to tax income arising within their borders. As explained in Part III, emasculation of that power is the likely long-term effect of a court-imposed prohibition on state legislation designed to combat tax arbitrage.

The Court's opinion in *Hunt-Wesson* is terse and baffling. In Part IV, below, I discuss the opinion, with references to the various arguments that the taxpayer and California had made to the Court. I do not attempt in that Part or elsewhere to reargue a case that was lost nine to zero in the only forum that matters. My

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[3] *See also* Michael J. McIntyre, *Constitutional Limitations on State Power to Combat Tax Arbitrage: An Evaluation of the Hunt-Wesson Case*, 18 STATE TAX NOTES 51 (January 3, 2000), *reprinted with addendum in* 86 TAX NOTES 1907 (March 27, 2000) [hereinafter *McIntyre, Tax Arbitrage*].

[4] The disagreement about the operation of the interest-offset rule surfaced as a result of allegations made by petitioner after the case was before the U.S. Supreme Court. As a result, the California courts had not been asked to interpret the relevant provisions of California law.

[5] In defending its interest-offset rule, California relied primarily on technical legal arguments rather than broad policy arguments. I do not second-guess that legal strategy. It is clear from the Court's opinion, however, that the Court failed to understand the policy objective of the interest-offset rule, concluding, incorrectly and without proper proof, that it was a mere device for taxing extra-territorial values.

limited goal is to understand the roots of the Court's objections to the interest-offset rule in order to interpret the rule of law that it established.

In Part V, I suggest some ways that States can address the problem of tax arbitrage within the constraints on State taxation apparently imposed by *Hunt-Wesson*. I do not claim that all of these methods are unquestionably constitutional. I do claim, however, that all of them are defensible on policy grounds and are consistent with a reasonable reading of *Hunt-Wesson*. In Part VI, I offer a brief conclusion.

II. CALIFORNIA'S DIRECT ALLOCATION RULE FOR INTEREST EXPENSE

The California rules for taxing interest win no prizes for clarity of expression or logical organizational structure. No general rule is stated in the statute. Instead, there are a series of rules — some statutory, some in the regulations — that are applicable to specific situations.

A pro rata rule applies in allocating interest attributable to the operation of a unitary business having nexus with California. This result is achieved by allowing taxpayers to deduct interest expense attributable to a California unitary business before the application of California's three-factor apportionment formula.[6] Because the California definition of a unitary business is broad, this pro rata apportionment rule applies to most income taxable under the California franchise tax.

A pro rata rule of some type also applies in allocating interest expense between income from two or more unitary businesses.[7] The method of allocation — pro rata to assets, income, or some other measure — depends on the facts and circumstances of the particular case.[8] This same rule applies in allocating interest payments between business income and all types of nonbusiness income except interest income and certain dividend income.[9]

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[6] CAL. REV. & TAX. CODE §§ 25121, 25128 (West 1992 & Supp. 2001). Assume, for example, that BCo has unitary gross income of $120 and an interest expense of $30, for unitary taxable income of $90. Under the apportionment formula, one-third of BCo's unitary income, or $30, is attributable to California. The result is that $10 (1/3 × $30) of the interest income is used to offset the unitary gross income of $40 (1/3 × $120) that is subject to California tax.

[7] CAL. CODE REGS. tit. 18, § 25120(d) (2001).

[8] *Id.* ("[T]he deduction shall be prorated among such trades or businesses and such items of nonbusiness income in a manner which fairly distributes the deduction among the classes of income to which it is applicable.").

[9] *Id.*

A major exception to the ersatz general rule of pro rata allocation is the interest-offset rule, made famous in *Hunt-Wesson*. That rule applies in allocating interest expense to business interest income and to nonbusiness interest and dividend income.[10] It is a direct allocation rule and not a pro rata rule. Under that rule, interest expense is first allocated directly to business interest income. If the interest expense exceeds business interest income, that excess is directly allocated to nonbusiness interest income and, with exceptions,[11] 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. The following example illustrates the operation of the interest-offset rule.

> 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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[10] CAL. REV. & TAX CODE § 24344(a), (b) (West Supp. 2001). The interest-offset provision states as follows:

> Sec. 24344. Interest; restrictions
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> (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 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.

[11] The interest-offset rule does not apply to dividends paid out of previously taxed income, and certain water's edge dividends. CAL. REV. & TAX CODE §§ 24402, 24411 (West Supp. 2001).

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.[12]

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 *Pacific Telephone*. In that case, the California Supreme Court characterized preferred dividends as interest equivalents.[13] It is fair to say that the California interest-offset rule applied primarily to allocate interest expense directly to business interest income and to nonbusiness interest and interest-equivalent income. The rule also applied, however, to allocate interest expense to nonbusiness dividends paid with respect to common stock. In *Hunt-Wesson* itself, the record does not disclose whether the nonbusiness dividends at issue in the case were paid with respect to preferred or common stock.[14]

[12]The example is drawn from *McIntyre, Tax Arbitrage*, *supra* note 3.

[13]Pacific Tel. & Tel. Co. v. Franchise Tax Bd., 498 P.2d 1030, 1036 (Cal. 1972).

[14]At my request, the lawyers representing the California Franchise Tax Board attempted without success to determine the nature of the Hunt-Wesson stock holdings from the record and from the files of the tax department. Fred O. Marcus, counsel for Hunt-Wesson, indicated to me in private conversation that he believed the stock generating the nonbusiness dividends was common stock. The issue is significant because preferred stock typically presents a more pernicious risk of tax arbitrage than common stock. For discussion, see Part III below.

The taxpayer in *Hunt-Wesson* was a domiciliary of Illinois.[15] It received substantial business interest income from 1980 to 1982, the years at issue in the case.[16] During that period, it received even more substantial nonbusiness dividends[17] from some foreign affiliated companies. On its California tax return, it claimed that this dividend income constituted nonbusiness income.[18] Although income is presumed to be business income under California law, California did not challenge this characterization of the dividend income, presumably because it did not result in a reduction in California taxes after application of the interest-offset rule.

The taxpayer also made substantial interest payments during the tax years at issue.[19] California applied the interest-offset rule to Hunt-Wesson. There was no

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[15] *See* Hunt-Wesson, Inc. v. Franchise Tax Bd., No. A079969, slip op. at 1 (Cal. Ct. App. Dec. 11, 1998). 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. Beatrice reported its income in a fiscal year beginning on March 1. The last year at issue in the case began on March 1, 1981, and ended on February 28, 1982. *See* Hunt-Wesson, Inc. v. Franchise Tax Bd., No. 976628, slip op. at 1-2 (Cal. Super. Ct. June 6, 1997).

[16] The amounts of business interest income for the three years were $10 million, $21 million, and $84 million, respectively. Brief for Petitioner at 10, Hunt-Wesson, Inc. v. Franchise Tax Bd., 528 U.S. 458 (2000) (No. 98-2043), 1999 WL 1032813.

[17] The amounts of nonbusiness dividends for the three years were $27 million, $29 million, and $19 million, respectively. Hunt-Wesson, Inc. v. Franchise Tax Bd., No. 976628, slip op. at 2 (Cal. Super. Ct. Jun. 6, 1997).

[18] The taxpayer apparently reported the dividend income to Illinois, its domiciliary state, as apportionable business income. That is, it apparently avoided paying tax on most of the dividends in either state by taking inconsistent positions in its tax returns in those states. *See* United States Supreme Court Official Transcript at 21, Hunt-Wesson, Inc. v. Franchise Tax Bd., 528 U.S. 458 (2000) (No. 98-2043), 2000 U.S. TRANS. LEXIS 17 (Walter Hellerstein, on behalf of the petitioner) ("Illinois had a regulation . . . during those years that actually allowed a domiciliary corporation like Beatrice . . . to apportion its income."). The Illinois regulation referred to by Professor Hellerstein authorized the taxpayer to elect to treat all of its income derived from intangible personal property, such as stock, as apportionable business income without reference to the actual facts. *See* ILL. INC. TAX REG. § 300-2(c)(2)(A)(i) ("In the case of a corporation . . . the consistent treatment as business income . . . of all items of income from [intangible personal property] will be presumed to be correct"). Illinois repealed that regulation for taxable years beginning after December 31, 1981. Under California law, a taxpayer that takes an inconsistent position with respect to the classification of income as business or nonbusiness in California and another state with a similar law is required "to disclose in its return to the state the nature and extent of the inconsistency." CAL. CODE REGS. tit. 18 § 25101(a) (2001). Apparently Hunt-Wesson did not feel obligated to make this disclosure on its California tax return.

[19] The taxpayer claimed a deduction for interest expense from loans during the three years at issue in the amounts of $80 million, $55 million, and $137 million, respectively. *See* Hunt-Wesson, Inc. v. Franchise Tax Bd., No. 976628, slip op. at 3 (Cal. Super. Ct. Jun. 6, 1997). On its

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 unanimous opinion in the case was signed by Justice Stephen Breyer.[20]

III. POLICY ANALYSIS OF THE INTEREST-OFFSET RULE

The interest deduction rule under challenge in *Hunt-Wesson* is designed to block certain types of tax arbitrage. In general, tax arbitrage occurs when a taxpayer borrows money and deducts the interest from taxable income at the same time that it is holding investment assets that are not being taxed or are being taxed at an effective tax rate lower than the rate applicable to the income with respect to which the deduction was taken.[21] For example, assume that HCo borrows $10 million and deducts its interest payments against business income taxed at ten percent. HCo is also holding preferred stock that pays untaxed dividends or dividends taxed at an effective rate below ten percent. In this situation, HCo is engaging in tax arbitrage.

No linkage between the use of loan proceeds and the assets generating tax-favored income is necessary for tax arbitrage to occur. The three elements necessary and sufficient for tax arbitrage to occur are:

> (1) that the taxpayer borrows money and the loan is outstanding for the taxable year;

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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 U.S. Supreme Court.

[20]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 L. REV. 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).

[21]For a full discussion of the economics of tax arbitrage, see C. EUGENE STEUERLE, TAXES, LOANS, AND INFLATION: HOW THE NATION'S WEALTH BECOMES MISALLOCATED (1985). Steuerle was a high-ranking official in the Reagan Treasury Department at the time this book was written.

(2) that it deducts some or all of the interest on its loan from income taxable at full rates, and;

(3) that it simultaneously earns income that is taxed at a favorable rate (or not taxed at all).

If a taxpayer borrows money, deducts the interest from its fully-taxable income, and uses that money to purchase assets generating tax-favored income, it has engaged in tax arbitrage. It has also engaged in tax arbitrage if it uses the borrowed capital in its taxable business and the equity capital to acquire assets generating tax-favored income. Even if the taxpayer proves that its borrowed money was used to acquire assets producing fully-taxable income, it has engaged in tax arbitrage as long as it is taking an interest deduction against the fully-taxed income and is simultaneously earning tax-favored income. In short, tracing of interest to a tax-favored use is not a necessary condition for tax arbitrage to occur, and any anti-arbitrage measure that relies on tracing will not be effective in blocking tax arbitrage.[22]

In the *Hunt-Wesson* case itself, the taxpayer satisfied all three of the conditions set forth above for engaging in tax arbitrage. Neither the taxpayer nor California attempted to trace the proceeds of the taxpayer's loans to a particular use. California did not attempt to show that the taxpayer had used its borrowed money to acquire the stock that was producing nonbusiness income. Relying on the validity of the interest-offset rule, it directly allocated the interest to the tax-favored income without tracing. The taxpayer also failed to offer any evidence that its loan proceeds were used to acquire business assets. On its California tax return, it directly allocated all of the interest expense to business income. In the U.S. Supreme Court, it conceded that its filing position was contrary to California law and had no constitutional basis. It argued that a pro rata rule for allocation was constitutionally mandated. These disputes over the proper interest allocation rule — between the taxpayer and California and between the taxpayer's filing position and its final litigating position — have no bearing on whether the taxpayer in *Hunt Wesson* was engaging in tax arbitrage. It was, without a doubt.

Whatever its merits in certain circumstances, a pro rata rule for allocating interest expense cannot block tax arbitrage. It simply provides a pro rata — and thereby limited — solution to the problem. The claim made to the Court by the

[22] A direct allocation rule of the type used by California is referred to in the tax literature as a strict-stacking rule. *See* Stanley Koppelman, *Tax Arbitrage and the Interest Deduction*, 61 S. CAL. L. REV. 1143 (1988); *see also* 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 L. REV. 67 (1992), *revised and republished as* Chapter 17 of TAXATION TOWARDS 2000 (John G. Head and Richard Krever, eds. 1997).

taxpayer in *Hunt-Wesson* that a pro rata rule can "plug the loophole" is factually inaccurate.[23]

Consider, for example, the impact of a pro rata rule on TCo in the example set forth in Part I, 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 were 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.

A pro rata rule and a direct allocation rule both are grounded on the assumption that debt capital and equity capital are fungible. That is, they both assume that a taxpayer making a new investment is drawing the funds for that investment from a common pool of fungible capital. The amount of money in that pool is the sum of the taxpayer's equity capital and its borrowed capital. This assumption is self-evidently correct when the only capital held by the taxpayer is money. Other forms of capital, however, are not so obviously fungible. For example, if a taxpayer owns a factory valued at $1 million and also holds cash of $1 million, it is not self-evident that the two forms of capital are fungible. Whether they should be treated as fungible depends on the taxpayer's access to capital markets. For a taxpayer with full access to a well-developed capital market, the factory and the money are functionally fungible because the capital represented by the factory can be converted easily into money, by selling the building or borrowing $1 million against it.

Although sharing a common assumption about the fungibility of debt capital and equity capital, a pro rata rule and a direct allocation rule differ in their assumptions about how taxpayers spend out of their fungible capital pool. A pro rata rule treats each dollar of expenditure out of that pool as coming proportionally from equity capital and debt capital. If equity capital is milk and

[23] *See* Reply Brief for Petitioner at 10, Hunt-Wesson, Inc. v. Franchise Tax Bd., 528 U.S. 458 (2000) (No. 98-2043), 1998 U.S. Briefs 2043 ("Indeed, the 'loophole' is easily plugged, as virtually every other State faced with the problem has plugged it, by assigning 'fungible' interest expense to taxable and nontaxable income on an evenhanded basis."). The language quoted from the Petitioner's brief is also inaccurate to the extent it implies that States other than California have made a concerted attack on tax arbitrage.

debt capital is cream, the pro rata rule treats the milk and cream as a homogenized mixture. In contrast, a direct allocation rule uses ordering rules for determining whether an expenditure out of the capital pool comes from debt capital or equity capital. If the direct allocation rule is designed to combat tax arbitrage, it assumes that the capital used to acquire tax-favored assets came from debt capital, to the extent thereof.

From an economic perspective, the choice between a pro rata rule and a direct allocation rule is arbitrary in that both rules are consistent with the assumption that equity capital and debt capital are fungible. From the perspective of tax policy, however, the choice is clearly not arbitrary because it has significant effects on the distribution of tax burdens. That is, economic theory supports the common assumption that debt capital and equity capital form a fungible pool of capital, but it says nothing about how withdrawals from that pool should be characterized for tax purposes.

It is foolish to suggest that a pro rata rule is reasonable and a direct allocation rule is unreasonable. They are both reasonable techniques for achieving particular results and unreasonable techniques for achieving other results. It is unreasonable to use a pro rata rule to block tax arbitrage because, as shown above, it is ineffective for that purpose. It is reasonable, however, to use a pro rata rule to provide some fair sharing of tax revenues among the several States in which a taxpayer is conducting its business. As discussed in Part II, above, California is sensitive to these differences in purpose. It uses a direct allocation rule, in limited circumstances, to combat certain types of tax arbitrage. It uses a pro rata rule, however, to allocate interest expense among the parts of a unitary business and among two or more distinct unitary businesses.

Sharing tax revenue fairly with sister States and preventing tax arbitrage are both legitimate goals for a State to pursue. In principle, overly aggressive steps by a State to combat tax arbitrage could result in an unfair sharing of revenue between that State and some other State. Several features of California's interest-offset rule minimize such potential conflicts.

One important limitation on California's anti-arbitrage rule is that it only applies when the taxpayer engages in tax arbitrage by acquiring assets that are not being used in its business and are superfluous to that business. This result is achieved under the interest-offset rule by denying taxpayers a deduction against business profits for interest payments only when the deduction can be matched with nonbusiness income. Nonbusiness income, under California law and the law of all States that have adopted the Uniform Division of Income for Tax Purposes Act (UDITPA), is a residual concept. In general, it constitutes income generated

by assets that are not used in any business of the taxpayer and are not needed as working capital in any of its businesses.[24]

When a taxpayer asserts that some portion of income constitutes nonbusiness income, it is also asserting implicitly that it is holding a reserve of assets not used or needed for business purposes. The interest-offset rule takes the taxpayer at its word. If the taxpayer truly has this reserve of assets, then to the extent of those assets, it has no business need to borrow money for its business. It could simply drawn down the reserve assets and avoid incurring debt.

As an analogy, consider the federal rule that generally denies an employee a business-expense deduction for a home office if his employer provides him with an office that is fully adequate for his business needs.[25] It would be possible to assert that the office provided by the employer was superfluous and the home office necessary for the business. It would also be possible to allow a deduction for only one office but to allocate the deduction pro rata between the office provided by the employer and the home office. A government, however, cannot be fairly accused of acting unreasonably or unfairly if it simply disallows the deduction for the home office. By so doing, it achieves its purpose of preventing the use of deductible funds to finance private consumption.

Two other limitations on application of the interest-offset rule suggest that California was attempting to limit its scope to the most important cases of potential abuse. Under the first limitation, the interest deduction is disallowed only if the taxpayer's reserve of nonbusiness assets are financial assets generating interest income or dividend income. Under the second limitation, the deduction is disallowed only up to the amount of the taxpayer's nonbusiness interest income and dividend income. For example, under the first limitation, a financial asset producing royalty income is not targeted by the interest-offset rule. Under the second limitation, shares of stock are targeted only to the extent that dividends are actually paid on those shares.

A tax jurisdiction runs the greatest risk from tax arbitrage abuses when taxpayers are able to borrow money, deduct the interest expense from their business income, and then acquire assets generating untaxed nonbusiness income of sufficient amount to cover their borrowing costs. In such situations, the taxpayers can completely hollow out a tax system by generating interest deductions up to the amount of their net business income (computed without reference to the interest deduction). By applying the interest offset rule only to income from financial assets of a type commonly sold on public markets and limiting the

[24]The identification of nonbusiness income under State tax statutes following UDITPA has proven to be difficult. I do not address those definitional problems here.

[25]I.R.C. § 280A(c)(1) (1994) (flush language).

disallowance to the amount of income generated by those assets, California has targeted the most pernicious forms of tax arbitrage.

IV. ANALYSIS OF THE COURT'S OPINION

In Part IV.A, I provide in outline form what I understand to be the underlying logic of the Court's opinion in *Hunt-Wesson*. The Court concluded that California's interest-offset rule was unconstitutional because it was "unreasonable." In Part IV.B, I examine various aspects of this reasonableness requirement. In Part IV.C, I suggest that the Court, in formulating its reasonableness test, improperly shifted from the taxpayer to California the obligation to prove that a State statute has taxed extra-territorial values in violation of the Due Process and Commerce Clauses.

A. *Analytical Framework of the Opinion*

The Court begins its opinion in *Hunt Wesson* by asserting that "[t]he legal issue is less complicated than may first appear, as examples will help to show." The Court never actually states what this "less complicated" issue is, and its examples are flawed to the point of embarrassment. It does suggest, however, that the case presents the following, "reasonably straightforward" question:

> 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?[26]

This question is hardly straightforward. In the context of the Court's opinion, however, it is reasonably clear that the question the Court intends to address is whether California's interest-offset rule, by disallowing a deduction against taxable business income by reference to the amount of the taxpayer's nonbusiness income, has taxed extra-territorial values in violation of the Due Process Clause and Commerce Clause. The concluding paragraph of the Court's opinion is intended to answer this question in the affirmative. It states as follows:

> Because California's offset provision is not a reasonable allocation of expense deductions to the income that the expense generates, it constitutes impermissible taxation of income outside its jurisdictional reach. The provision therefore violates the Due Process and Commerce Clauses of the Constitution.[27]

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[26] Hunt-Wesson, Inc. v. Franchise Tax Bd., 528 U.S. 458, 461 (2000).

[27] *Id.* at 468.

Obviously there are some missing predicates to the above argument. The Court cannot plausibly contend that every "unreasonable" provision of a State taxing statute constitutes "impermissible taxation of income outside its jurisdictional reach" in violation of the Due Process and Commerce Clauses. Nor can the Court rationally argue that the reach of a State's jurisdiction to tax depends on the reasonableness of its exercise of that jurisdiction.

The missing predicates can be educed from a close reading of the body of the Court's opinion. I suggest that the Court is arguing implicitly as follows:

> (1) California's rule for directly allocating interest expense to nonbusiness interest and dividend income appears on its face to be a device for taxing that nonbusiness income.
>
> (2) If the California rule is such a device, then it is a tax on extra-territorial values in contradiction to the Due Process and Commerce Clauses, for the substance of the tax should control and not its label.
>
> (3) California can defend its rule against constitutional challenge by showing that it is a reasonable mechanism for determining the amount of a taxpayer's apportionable business income.[28]
>
> (4) In attempting to meet its burden of proof, California argued that the rule is intended to prevent avoidance of its tax on apportionable business income by preventing taxpayers from engaging in tax arbitrage. Preventing tax arbitrage is a legitimate State objective, and reasonable steps to prevent tax arbitrage do not run afoul of the Due Process Clause or Commerce Clause.
>
> (5) The California rule is "unreasonable," however because it "pushes this concept [of tax arbitrage] past reasonable bounds."
>
> (6) Because California's interest-offset rule is not a reasonable measure for taxing business income, it is held to be a device for taxing nonbusiness income over which California has no nexus, thereby violating the Due Process Clause and the Commerce Clause.

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[28]The Court stated:

> If California could show that its deduction limit actually reflected the portion of the expense properly 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 the deduction. See Denman v. Slayton, 282 U. S. 514 (1931) (upholding federal tax code's denial of interest expense deduction where borrowing is incurred to 'purchase or carry' tax-exempt obligations).

528 U.S. at 465.

Although I may be reading more logic into the Court's opinion than it actually contains, I think the above six items accurately present the gist of the opinion. As explained below, I think the opinion is flawed in two important respects. First, it improperly shifts the burden of proof to the State to disprove the allegations of extra-territorial taxation made by the taxpayer. Under established constitutional principle, that burden rests on the taxpayer.[29] Second, the opinion grossly understates the rationality and reasonableness of the California direct allocation rule. In Part III, above, I argue that the California rule is well designed and narrowly tailored to deal with the most pernicious cases of tax arbitrage. I think it is an excellent rule, and, prior to the Court's decision in *Hunt-Wesson*, I would have recommend it as a model for other States to follow. I can well understand disagreements with my assessment of the rule. Anyone who honestly believes, however, that the rule is irrational or unreasonable has some homework to do.

B. *Reasonableness of the Interest-Offset Rule*

Before concluding that the interest-offset rule was a sham device for taxing extra-territorial values, the Court sought to determine whether it was, as California alleged, a reasonable method for allocating interest expense to nonbusiness income. The Court concluded it was not a reasonable method. Three separate considerations let it to that conclusion.

The major reason for reaching that conclusion was that the interest-offset rule reduced apportionable business income dollar for dollar by the amount of the nonbusiness income. This relationship, the Court argued, strongly indicated that the rule, in substance, is a tax on that nonbusiness income. In Part IV.C.1, below, I explain why that relationship does not impugn the integrity of the California rule as a method for combating tax arbitrage.

The Court apparently gave some weight, in evaluating the reasonableness of the California rule, to the experience of other States and the federal government in dealing with tax arbitrage. In Part IV.C.2, I suggest that the Court was misinformed about the nature and purpose of the federal interest-deduction rules.

In attempting to explain the operation of the California rule, the Court formulated a series of examples, all based on a common fact pattern. In the examples, the Court discussed how the California rule would operate when applied to a taxpayer having two unrelated, nonunitary businesses — a tin-can factory operating partly in California and a sheep farm located exclusively in New Zealand. The Court indicated that the results in some of the examples were unfair

[29]Norton Co. v. Department of Revenue, 340 U.S. 534, 537 (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 Am. v. Franchise Tax Bd., 463 U.S. 159, 175-67 (1983).

and reflected an overreach by California. In Part IV.C.3, I use some of the Court's examples to suggest that the Court misunderstood some important aspects of the case before it.

In its presentations to the Court, California focused primarily on responding to the arguments made by the taxpayer to defeat the tax. It did not offer a sustained affirmative defense.[30] In Part IV.C.4, I briefly sketch some affirmative reasons for believing that California's interest-offset rule is "reasonable."

1. *Dollar-for-Dollar Disallowance of Interest*

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. The arithmetical relationship is clear beyond dispute. Within certain limits, each dollar that California allocated to a taxpayer's nonbusiness income under the interest-offset rule resulted in an additional dollar of apportionable business income taxable on an apportioned basis by California. Thus the California rule, when it applied, had the same economic effect as characterizing the nonbusiness income as apportionable business income.

The Court recognized that this relationship alone did not justify a conclusion that the California rule was a sham. The rule would be sustained, the Court indicated "[i]f California could show that its deduction limit actually reflected the portion of the expense properly related to nonunitary income. . . ."[31] The Court quickly concluded, however, that California's argument in support of its rule was unpersuasive because it pushed the concept of tax arbitrage "past reasonable bounds."[32] It seems clear that the Court made at most a desultory effort at understanding the reason behind the California rule, having concluded that the relationship described above between the disallowance of the deduction and the amount of the taxpayer's nonbusiness income was almost conclusive evidence of a device. Giving great weight to that relationship, however, was inappropriate, for the relationship in fact is benign.

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

[30]For example, the term "tax arbitrage" is not mentioned in its brief.

[31]Hunt-Wesson, Inc. v. Franchise Tax Bd., 528 U.S. 458, 465 (2000).

[32]*Id.* at 466.

(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. The fact that what was taxable under the property tax was exactly equal to the discounted value of what would be taxable under the income tax over the life of the property should not taint the tax as an impermissible tax on income. 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 amount of the taxpayer's nonbusiness income (Item Y) was a perfect proxy for the business income (Item X) that the taxpayer was sheltering from tax by claiming what California asserted was an improper interest deduction. California has concluded, as a matter of tax policy, that it will not permit taxpayers to engage unchecked in certain types of tax arbitrage. The taxpayer in *Hunt-Wesson* was attempting to engage in tax arbitrage. The only effective way for California to block that attempt was to disallow the interest deduction, dollar for dollar, by the amount of the taxpayer's nonbusiness income. The equivalence of Item Y with Item X, therefore, is fully consistent with California's claim that its interest-offset rule was designed to block tax arbitrage.

Another relevant circumstance in deciding whether a tax measured by reference to a proxy is actually a tax on the proxy is the treatment of the proxy when it clearly is not a good proxy for the item ostensibly subject to tax. If the proxy is taxed in cases when it is clearly not a good proxy, then the tax would appear to be a tax on the proxy. 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 like it was intended as a tax on the gasoline itself.

In *Hunt-Wesson*, nonbusiness income did not trigger California's interest-offset rule unless the taxpayer was claiming an interest deduction against apportionable business income. If the taxpayer had no gross income from business activities, the interest-offset rule did not apply. More generally, the California rule applied when the taxpayer was engaging in tax arbitrage and it did not apply when the taxpayer was not engaged in tax arbitrage. In this respect, therefore, the interest-offset rule is more plausibly described as a rule designed to tax apportionable business income than as a device for taxing nonbusiness income.

2. *Federal Analogies*

Towards the end of its opinion, the Court discussed briefly the practices of other States and the federal government in allocating interest expense between taxed and untaxed income. "No other taxing jurisdiction," the Court asserted, "whether federal or state, has taken so absolute an approach to the tax arbitrage problem that California presents."[33] This statement is certainly correct if "absolute" is understood to mean "comprehensive." Indeed, other States have taken virtually no steps to combat tax arbitrage. The federal government has adopted some anti-arbitrage rules that provide for the same dollar-for-dollar matching of interest expense with tax-favored income that characterizes the California rule.[34] The federal rules are much narrower in scope than the California rule because the opportunities for tax arbitrage are far less pervasive under the federal income tax.

The Court does not disclose the reason for its brief discussion of the interest allocation rules of the States and the federal government. The likely reason was to bolster its allegation that the California rule is "unreasonable" by contrasting that rule with the rules used by other States and the federal government.[35] It attempts

[33] *Id.* at 467.

[34] *See McIntyre, Tax Arbitrage*, *supra* note 3, at 55-61; I.R.C. § 163(j) (income stripping rules applicable to interest paid to related foreign entities) (1994); Reg. § 1.861-10(e) (CFC Netting Rule).

[35] Walter Hellerstein, who argued the case before the Court on behalf of Hunt-Wesson, suggests that the Court acknowledged State and federal experience with pro rata rules to show that California had a reasonable alternative to its direct allocation rule to plug the tax-arbitrage loophole. Walter Hellerstein, *Constitutional Restraints on State Interest Expense Allocation After* Hunt-Wesson, 92 J. TAX'N 241, 249 (2000) [hereinafter *Hellerstein, After Hunt Wesson*]. As discussed in Part III above, the pro rata rule favored by Professor Hellerstein and the Court cannot solve the tax-arbitrage problem – at best it provides a partial and temporary solution to that problem. According to Hellerstein, "the availability of constitutionally palatable alternatives to the interest-

to explain the reasonableness of pro rata allocation methods and the unreasonableness of California's direct allocation method in the following paragraph:

> Ratio-based rules like the one used by the Federal Government and those used by many States recognize that borrowing, even if supposedly undertaken for the unitary business, may also (as California argues) support the generation of nonunitary income. However, unlike the California rule, ratio-based rules do not assume that all borrowing first supports nonunitary investment. Rather, they allocate each borrowing between the two types of income. Although they may not reflect every firm's specific actions in any given year, it is reasonable to expect that, over some period of time, the ratios used will reflect approximately the amount of borrowing that firms have actually devoted to generating each type of income. Conversely, it is simply not reasonable to expect that a rule that attributes all borrowing first to nonunitary investment will accurately reflect the amount of borrowing that has actually been devoted to generating each type of income.[36]

The Court does not explain why it believes that "it is reasonable to expect that . . . the ratios used will reflect approximately the amount of borrowing that firms have actually devoted to generating each type of income." No evidence in the record supports that inference, and the Court does not cite any research supporting it. Statistical theory would support the inference if taxpayers decided randomly whether to finance their acquisition of assets with debt capital or equity capital. Taxpayers attempting to engage in tax arbitrage, however, have a strong tax incentive to purchase tax-favored assets out of debt capital. It follows, therefore, that the choice between debt finance and equity finance is far from random, and a pro rata rule, under the Court's reasoning, would not produce a "reasonable" set of outcomes.[37]

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offset provision appears clearly to have facilitated the Court's determination to invalidate the application of California's levy." *Id.* at 249.

[36]Hunt-Wesson, Inc. v. Franchise Tax Bd., 528 U.S. 458, 467-68 (2000).

[37]Consider, for example, the following carnival game. The contestants stand behind a line and attempt to throw pebbles into one of two buckets that are set on stands located exactly ten feet from the line. The buckets are the exact same size and are equidistant from the line. Contestants pay $2 for ten pebbles and receive $1 for each pebble they get into one of the buckets. There is no reason to believe that any one contestant will distribute its pebbles evenly between the two buckets. Over time, however, it is reasonable to expect that each bucket will have around the same number of winning pebbles.

Now change the game so that one bucket has a payoff of $2 and the other a payoff of $1. In that situation, contestants will aim for the $2 bucket, and most of the winning pebbles, over time, will end up in that bucket.

Indeed, the Court's argument for a pro rata rule can be turned on its head to support the reasonableness of a direct allocation rule for taxpayers engaging in tax arbitrage. California's rule applies only to corporate taxpayers. These taxpayers may be presumed to understand tax law and simple economics and to act to maximize their after-tax income. It follows, therefore, that they will engage in tax arbitrage to the extent they are permitted to do so under the law, leaving aside minor constraints based on their own peculiar circumstances. To engage in tax arbitrage, they must borrow money and use the proceeds to earn tax-favored income. It follows, therefore, that, over some reasonable period, the allocations between apportionable business income and tax-favored nonbusiness income resulting from a direct allocation rule "will reflect approximately the amount of borrowing that firms have actually devoted to generating each type of income."[38]

The Court might have detected the flaw in its reasoning if it had better understood how the federal government addresses the problem of tax arbitrage. The Court began its brief discussion of federal interest-deduction rules by asserting that "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."[39] The general description is wrong in one minor respect and one major respect. The minor error is its statement of the ratio. It is not a ratio of "assets and gross income." The actual ratio uses assets only.[40]

The Court's major error is its assertion that the federal government uses a pro rata rule in circumstances that are "comparable" to the circumstances in which California applies its direct allocation rule. The federal rule discussed by the Court applies to U.S. persons earning income within and without the United States. These taxpayers are subject to U.S. tax on their worldwide income, without reference to its source. As a result, they do not have the tax arbitrage opportunities under the federal income tax that are available under California's more limited jurisdiction.

The first version of the game illustrates what would happen under a pro rata rule if no opportunities for tax arbitrage were available. The second version illustrates what would happen under that rule if tax arbitrage opportunities were readily available. California concluded, correctly in my view, that it was in effect playing the second version of the game. To fairly apportion the interest expense deduction in this environment, anti-arbitrage rules were required.

[38] *Hunt-Wesson*, 528 U.S. at 468.

[39] *Id.* at 467.

[40] The ratio for determining the amount of interest expense allocated and apportioned to foreign source income is (1) assets used to generate foreign source income over (2) total assets. *See* MICHAEL J. MCINTYRE, THE INTERNATIONAL INCOME TAX RULES OF THE UNITED STATES § 3/B.2.1.1 (2d ed. 2000) [hereinafter MCINTYRE, INT'L TAX TREATISE].

Notwithstanding its worldwide tax jurisdiction, the federal government does need to distinguish between U.S. source net income and foreign source net income in order to impose limitations on the foreign tax credit. The foreign tax credit is used to relieve double taxation when a U.S. person has actually paid a foreign income tax. The federal government is unwilling, however, to allow U.S. persons to use their foreign tax credits to reduce federal income taxes imposed with respect to U.S. source net income. To compute the limitation on the credit, U.S. persons must determine the amount of their net foreign source income. As part of that computation, they must allocate and apportion interest expense deductions between foreign and domestic sources, and a pro rata rule works nicely for this purpose.

The federal government does face arbitrage problems whenever it does not impose a tax on the foreign income of U.S. persons. Given the general rule that U.S. persons are taxable on their worldwide income, those situations arise only through some quirk in the federal tax law. When that foreign income is exempt, however, a taxpayer could engage in tax arbitrage by borrowing money, deducting some of the interest paid on that money from U.S. source income under the federal pro rata allocation rule, and earning sufficient foreign source income on the borrowed money to pay the debt service.

A U.S. taxpayer that has paid foreign income taxes at a rate in excess of the U.S. rate can earn an additional amount of foreign source income without paying U.S. tax on that income by using its excess foreign tax credit to offset the U.S. tax otherwise due. The following example illustrates this opportunity.

Assume that TCo, a U.S. company, has a wholly-owned foreign affiliate, FCo that is engaged in business in Country F. Country F generally imposes its income tax at a rate of fifty percent on FCo's income. Under its tax treaty with the United States, however, it does not impose any tax on interest or dividend payments made by FCo to TCo. FCo earns business income of $1400, on which it pays Country F tax of $700 and distributes the remaining amount to TCo. TCo is taxable under the federal income tax on the income of $1400 earned by FCo at a rate of thirty-five percent. It is allowed, however, a credit against that tax for the income tax paid to Country F by FCo. The credit eliminates the U.S. tax of $490 (35% of $1400), leaving an excess credit of $210. That credit can offset the U.S. tax otherwise payable on up to $600 of foreign source income ($600 × .35 = $210). As a result, if TCo can earn $600 in foreign source income without paying foreign tax on that income, the income will be free both of foreign and U.S. tax.

The federal government recognized that the opportunity, illustrated above, for earning tax-free money would cause U.S. taxpayers to engage in a variety of transactions designed to pump up their foreign source income. Its primary

response was to modify the credit limitation rules.[41] U.S. corporations subsequently discovered that they could beat the revised limitation rules by engaging in certain tax-arbitrage transactions involving their foreign affiliates. The following example illustrates this gambit.

Assume that TCo, in the example above, has an excess foreign tax credit of $210. Assume also that TCo, for all relevant purposes, would allocate twenty-five percent of its interest deductions to foreign sources under the federal government's pro rata method. TCo goes to an unrelated commercial bank and borrows $8000, on which it pays annual interest of $800. It also lends $8000 to FCo, its wholly-owned subsidiary. FCo agrees to pay interest of $800 on that loan. TCo is careful not to use the borrowed money in making its loan to FCo. The interest paid by FCo to TCo is paid out of FCo's business profits. As a result, it is not subject to the special limitation rules applicable to the credit.[42] Under the pro rata rule for allocating deductions, interest expense of $200 ($800 × .25) is allocated to the foreign source interest. Thus TCo has net foreign source income of $600, subject to a tentative U.S. tax of $210. That tax is eliminated entirely, however, by TCo's excess foreign tax credit of the same amount.

The federal response to this tax arbitrage problem was to adopt by regulation the so-called CFC netting rule.[43] As the name might suggest, the basic mechanism is to require the taxpayer to net its foreign source interest income obtained from its controlled foreign corporation (CFC) against the interest paid on the loan that was deemed to be incurred as part of the tax arbitrage transaction. The Court in *Hunt Wesson* discussed this rule briefly toward the end of its opinion.[44] It characterized it as "a kind of modified tracing approach." It then went on to

[41]For a description of the special limitations on the credit in all their ornate splendor, see *id.* at § 5/E.

[42]*Id.* at § 5/E.3.3 (dealing with look-through rules applicable to interest payments from a foreign affiliate).

[43]Reg. §§ 1.861-10(e), 1.861-10T(e), 1.861-12T(j)(Ex. 1). For an explanation of the rule, see McIntyre, Int'l Tax Treatise, *supra* note 40, at § 3/B.2.1.2.1.

[44]The Court apparently became aware of the CFC netting rule from an article I published shortly before the oral argument in *Hunt-Wesson*. *See McIntyre, Tax Arbitrage*, *supra* note 3, at 57-58. I had presented the gist of my discussion of federal interest allocation rules, however, at the California Tax Policy Conference in 1998. Representatives of both parties to the *Hunt-Wesson* litigation attended that presentation. I wrote my article as a result of my scholarly interest in the case that developed from participation in that conference. I was not encouraged to write it by either party, was not compensated by either party, and did not consult with either party about the positions taken in the article prior to its acceptance for publication. I began writing the article when I learned that certiorari had been granted in *Hunt-Wesson*, and I completed it as soon as my teaching obligations permitted. After it was accepted for publication, I sent copies to both parties and to the Court. California subsequently asked me to meet with its litigating team to discuss my views on tax arbitrage. I did so at my regular hourly billing rate.

equate it with tracing rules used by some States. This characterization is improper. Tracing, as that term is generally understood, is not required for application of the CFC netting rule. As the example above suggests, a taxpayer cannot avoid the rule by commingling its debt capital with its equity capital. All that is required is that the taxpayer increase its third-party debt over some base amount and increase its CFC interest income over a base amount. In this important respect, the CFC netting rule nicely parallels California's direct allocation rule.[45]

3. *Analysis of the Court's Explanatory Examples*

The Court uses a series of examples based on a simple fact pattern to illustrate the issues addressed in its opinion. The continuing examples postulate two separate unitary businesses, a tin-can business that is domiciled in Illinois and engaged in business in California, and a sheep-farming business that is located in New Zealand. The sheep-farming business is organized as a subsidiary of the Illinois corporation. These businesses, the Court postulates, do not have a unitary relationship. As a result, they do not file a combined report under California tax law. The dividends paid by the sheep-farm subsidiary would constitute nonbusiness income under the California tax code and are not subject to tax in California.

Although this example can be used to illustrate an application of California interest-offset rule, it is not well suited for that purpose for two reasons. First, the Court's example is highly atypical of the cases in which the California rule applies. The rule is aimed primarily at investments in bonds, preferred stock, and other financial instruments that generate a return sufficient to cover the debt service on the taxpayers debt obligations. Common stock is also covered by the interest-offset rule, and it probably should be covered to prevent taxpayers from avoiding application of the rule by acquiring common stock that functioned much like preferred stock. In most cases, however, an investment in a controlling interest in a subsidiary is outside the rule because a controlled subsidiary typically has a unitary

[45]The CFC netting rule is not mentioned in the ostensibly comprehensive survey of state and federal allocation rules contained in the Brief for Petitioner. Professor Hellerstein, counsel for Petitioner, does mention the rule in an article written after the case was decided. He accurately describes the rule, correctly notes that it has limited application, and quotes me for the proposition that it is intended as an anti-avoidance rule. He does not correct the Court's erroneous description of the rule as a "modified tracing approach" but does applaud the Court for giving "short shrift" to a suggestion I allegedly made that the Court should rule for California because of the federal CFC rule. *See Hellerstein, After Hunt-Wesson, supra* note 35, at 248 n.19. Hellerstein speculates that I made my alleged argument for deciding the case for California based on the CFC netting rule due to my "myopia" and my mistaken belief that the Commerce Clause applies to the federal government. *Id.* I am not sure what I said in my article to prompt Hellerstein's speculations. I did address the relevance of the federal experience in that article as follows: "California is not free to adopt its strict-stacking allocation rule simply because the federal government has adopted some analogous rules for allocating interest deductions. The federal government, after all, is not subject to Court oversight of its tax policy choices under the negative Commerce Clause." *McIntyre, Tax Arbitrage, supra* note 3, at 60.

relationship with its parent corporation. It is certainly possible for the business of a subsidiary not to be unitary with the business of the parent. Common control of two business activities, however, often leads to common management and common financing, all indicia of a single unitary business.

To stress the separateness of the tin-can business and the sheep-farming business, the Court separated them by over six thousand miles.[46] Distance, however, is largely irrelevant to the unitary issue. A New Zealand goat farm business, for example, probably would be unitary with a commonly controlled California tin-can business, notwithstanding the distance, if the goats had access to the tin cans as a dietary supplement. The Court fails to supply sufficient facts to determine whether the two businesses it postulates are unitary under California law. It could have avoided that entire issue, however, simply by picking a more realistic example.

The second problem with the Court's example is more serious. As discussed in Part II above, the California rule applies primarily to financial instruments producing interest income or interest equivalents. Those shares did not represent an investment in the affiliate; rather, the shares constituted an investment asset in their own right that generated a return closely comparable to interest. By using as its example of an investment asset the common shares of a company, the Court created a risk that readers would confuse the taxpayer's investment in the stock of the sheep-farming business with an investment in the business itself.[47] Indeed, the Court itself fell victim to that confusion.

One paragraph after properly referring to the income from its investment in the stock of its subsidiary as "dividend" income,[48] the Court refers to that same income as "income from the New Zealand sheep farm."[49] Possibly this phraseology was used as an inelegant shorthand for "dividends paid out of the income from the New Zealand sheep farm." If so, no harm, no foul. The problem, however, appears to be more fundamental than simply sloppy terminology. Here is the key section of the opinion, where the Court explains why California loses the case:

> The California statute, however, pushes this concept [of tax arbitrage] past reasonable bounds. In effect, it assumes that a corporation that

[46]At oral argument, the sheep farm was located in Mongolia. United States Supreme Court Official Transcript, *supra* note 18, at 12.

[47]As noted above, the record in the case does not disclose the nature of Hunt-Wesson's stock holding. *See supra* note 14, and accompanying text. For purposes of the case, therefore, the Court should have assumed that the stock might have been preferred stock.

[48]Hunt-Wesson, Inc. v. Franchise Tax Bd., 528 U.S. 458, 462 (2000).

[49]*Id.*

> borrows any money at all has really borrowed that money to "purchase or carry," cf. 26 U. S. C. §265(a)(2), its nonunitary investments (as long as the corporation has such investments), even if the corporation has put no money at all into nonunitary business that year. 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.[50]
>
> 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," Container Corp., 463 U. S., at 169, and in doing so assesses a tax upon constitutionally protected nonunitary income.[51]

What the Court has done is to create an example of a statute that always allocates interest expense to the business in someone else's jurisdiction to the extent of the income from the business in that jurisdiction. Using the Court's numbers,[52] assume that a taxpayer engaging in an in-state tin-can business and an out-of-state sheep-farming business has total interest expense of $150,000, untraced to either business, and income of $100,000 from its sheep-farming business. The Court, in the passage quoted above, is suggesting that California would allocate $100,000 to the out-of-state sheep-farming business under the interest-offset rule. Deciding against the State in this invalid example is intuitively appealing. In addition to being unneighborly, the conduct illustrated is clearly unconstitutional. The unconstitutional result can be reached, moreover, without accusing the State of skullduggery, and without inventing any novel constitutional doctrines.

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[50] California's direct allocation rule is based on an assumption that debt capital and equity capital, even capital held in the form of plant and equipment, are fungible. The pro rata rule advocated by the taxpayer and favored by the Court, however, rests on this identical assumption. *See supra* Part III. Those allocation rules differ only in their assumptions about how fungible assets are drawn from that pool. Reflecting its "practical realism," however, California applies its fungibility theory only to financial assets that generate dividend and interest income — assets that typically are sold through organized markets. The pro rata rule favored by the Court applies to all assets, including sheep farms.

[51] *Hunt-Wesson*, 528 U.S. at 466.

[52] *Id.* at 461. The Court applies its numbers correctly when the numbers are introduced at this point in its opinion.

As should be obvious, the Court's example does not correctly illustration the operation of California's interest offset rule. Under California law, a taxpayer owning two nonunitary businesses would not employ the interest-offset rule in allocating interest expense between those business. As explained in Part II above, it would use a pro rata rule.[53]

Application of the interest-offset rule for allocating interest expense between two businesses would result in an obvious violation of the "fairly apportioned" prong of *Complete Auto*.[54] The primary test of whether the revenues from an income tax are fairly apportioned is the internal consistency test, enunciated by the Court in the *Container* case.[55] To be internally consistent, a tax statute must be designed so that if all the states adopted it, it would not result necessarily in more than all of the income being taxed.[56] The taxpayer conceded that the California tax passed the internal consistency test. The tax apparently described by the Court in the passage quoted above, however, is not internally consistent.

Assume, for example, that a taxpayer operated a tin-can business in California and an unrelated sheep-farm business in Idaho. Each business generated gross revenue of $100,000, and the only deductible expense was $100,000 of interest. If California allocated the entire $100,000 to Idaho and Idaho allocated that same amount to California, then double taxation would be inevitable.

The misuse of an example by the Court probably has no legal significance. An example, after all, is intended to illustrate a point of law, not determine it. Still, the Court stated that California's interest-offset rule went "too far" and thus was unconstitutional because of its "lack of practical realism." The only evidence offered of this failing, however, was the flawed example. It would seem that when the Court chooses to argue by example, the force of its conclusion depends on the validity of its examples.

4. *Points Indicating that the California Rule is "Reasonable"*

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[53] *See* CAL. CODE REGS. title 18 § 25120(d) (2001).

[54] Complete Auto Transit, Inc. v. Brady, 430 U.S. 274 (1977).

[55] Container Corp. of Am. v. Franchise Tax Bd., 463 U.S. 159, 169 (1983).

[56] *Id.* ("The first, and . . . obvious, component of fairness in an apportionment formula is what might be called internal consistency — that is, the formula must be such that, if applied by every jurisdiction, it would result in no more than all of the unitary business' income being taxed.")

The interest-offset rule was adopted by the California legislature in 1955.[57] For over forty years, it has prevented corporate taxpayers from reducing their California franchise tax burdens by engaging in certain forms of tax arbitrage. After analyzing its operative rules, I concluded in Part III that its apparent purpose is to prevent the most pernicious type of tax arbitrage. The California Franchise Tax Board, in its brief in the *Hunt Wesson* case, alleges that the purpose of the rule is to prevent tax avoidance. In the *Pacific Telephone* case, California's highest court concluded that its purpose was to prevent tax avoidance.[58] It also concluded that the rule was "reasonable."[59] The taxpayer in *Hunt-Wesson* alleged that the rule was unreasonable. The U.S. Supreme Court agreed. That conclusion was central to the Court's holding that the interest offset rule is a sham device for taxing extra-territorial values in violation of the Due Process and Commerce Clauses of the U.S. Constitution.

The following points support a conclusion that the California rule under attack in *Hunt-Wesson* is reasonable:

> (1) The legislative purpose of the rule, as determined by California's highest court, is to prevent tax avoidance though tax arbitrage.
>
> (2) The Court and the taxpayer in *Hunt-Wesson* concede, as they must, that preventing tax arbitrage is a reasonable goal for a State to pursue in designing its tax system.

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[57] 1955 Cal. Stat., c. 938, p. 1581, § 20, effective June 6, 1955.

[58] Pacific Tel. & Tel. Co. v. Franchise Tax Bd., 498 P.2d 1030, 1037 (Cal. 1972).

> A foreign corporation could avoid all taxes in California merely by increasing its borrowing to create an interest deduction and then purchasing stocks which pay dividends. Since under the principle of *mobilia sequuntur personam*, the dividends will not be taxed, the corporation would have created a deduction for the interest expense without the offsetting income. To avoid the loophole, the deduction must be reduced by the income even though the income cannot be taxed in California.

Id.

[59] *Id.* at 1036.

> In treating interest expense as the opposite of investment income (interest and dividend income), the subsection is obviously approaching the problem presented in a reasonable manner. Interest expense is the opposite of interest income, and dividend income is sufficiently analogous to interest income that it is reasonable to provide for the offset of interest expense against dividend income. (This is not to say that another treatment of the interest expense would be unreasonable; the only point is that the approach of the Legislature was not unreasonable.)

Id.

(3) The California rule under attack applies only to taxpayers engaging in tax arbitrage. If a taxpayer is not engaged in tax arbitrage, it is not affected adversely by the rule.

(4) The disallowance of a deduction for interest expense is exactly proportionate to the degree to which the taxpayer has engaged in tax arbitrage. Major offenders suffer a major decrease in their deduction, and minor offenders suffer a minor decrease.

(5) The California rule is not targeted at all possible cases of tax arbitrage but only at the most pernicious cases.

(6) The rule satisfies the internal consistency test — the primary test used by the U.S. Supreme Court in determining with a tax is fairly apportioned under the dormant Commerce Clause.

(7) The rule is relatively easy to administer and avoids the complexity and unfairness associated with disallowance rules that depend for their application on a finding of a prescribed motive.

C. *Burden of Proof*

If the taxpayer had proved that California's interest offset-rule was a device for taxing nonbusiness income, then it ought to have won the case. Although substance does not always prevail over form, it ought to prevail when a taxpayer demonstrates that a taxing scheme ostensibly imposing tax on local income is in fact a sham for taxing extra-territorial values. In the absence of proof, however, the Court should not cavalierly treat a Sovereign State as engaging in fabrication.

No evidence was introduced by the taxpayer indicating a legislative intent to engage in sham. On the contrary, the only evidence of legislative intent in the record is contained in the *Pacific Telephone* case,[60] decided by the highest court of California. The California Supreme Court found in that case that the interest-offset rule was adopted to prevent taxpayers from avoiding California taxes on apportionable business income through what is now called tax arbitrage. In its various presentations to the Court, the taxpayer never alleged that the interest-offset rule was a sham.[61] If it had made this allegation, it would have been required to offer proof, and it obviously had no proof.

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[60]Pacific Tel. &. Tel. Co. v. Franchise Tax Bd., 498 P.2d 1030 (Cal. 1972).

[61]The taxpayer did allege that the California rule was "unreasonable," "bizarre," and "off the radar screen." These allegations, however, were not directed at supporting a claim that the rule was a sham. California seems to have treated these allegations as a manifestation of bad manners rather than as a telling legal argument.

What the taxpayer did assert, relying on language in *National Life*,[62] was that California could not do indirectly what it could not do directly. The taxpayer's reading of *National Life* is accurate. The Court recognized, however, that *National Life*, on this point at least, was not good constitutional law and had not been good law for nearly seventy years.[63] As the modern Court made clear in *Atlas Life*,[64] the overly broad prohibition against indirect taxation asserted in *National Life* had been reduced through the interpretive process to a rule prohibiting a government from using deduction-allocation rules as a sham device for taxing income that it otherwise could not tax.[65]

Instead of requiring the taxpayer to prove that California's interest-offset rule was a sham device for taxing extra-territorial values, the Court put the burden on California to prove that the rule was "reasonable." The Court certainly could have required California to offer some rational basis for its rule. Demanding that California reveal the alleged purpose of its rule does not shift the burden of proof away from the taxpayer. In fact, California asserted that the rational basis for its rule was to curtail tax avoidance. As explained in Part III above, the California rule certainly has that effect.

Instead of simply requiring California to offer a rational basis for its rule, the Court, *ex post*, required California to prove to the Court's satisfaction that the interest-offset rule satisfied some unspecified "reasonableness" standard. In so doing, it improperly shifted to California the burden of disproving the Court's implicit allegation that the interest-offset rule was a sham.

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[62]National Life Ins. Co. v. United States, 277 U.S. 508 (1928).

[63]Denman v. Slayton, 282 U.S. 514 (1931). It is routine, of course, for the Court to uphold indirect measures taken by a government when a direct measure would be unconstitutional. For example, a government cannot give direct financial support to a religious organization under the Establishment Clause of the First Amendment. Lemon v. Kurtzman, 403 U.S. 602 (1971). It can indirectly benefit religious organizations, however, by giving them an exemption from property taxes, *Walz v. Tax Commission*, 397 U.S. 664, 668 (1970), or by dispensing educational materials and equipment to church-run schools. Mitchell v. Helms, 530 U.S. 793 (2000). An indirect method that was found to be a sham device for aiding religion, however, would not be upheld.

[64]United States v. Atlas Life Ins. Co., 381 U.S. 233 (1965).

[65]*Id.* at 244 ("Unable to perceive any purpose in reducing one deduction by the full amount of another, save for an intent to impose a tax on exempt receipts, the Court [in *National Life*] ruled that '[o]ne may not be subjected to greater burdens upon his taxable property solely because he owns some that is free. 277 U.S. at 519.'").

V. 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 taxpayer 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 extra-territorial values. Assuming the validity of that contested conclusion, the result reached by the Court is quite limited and unremarkable by due process standards.[66]

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 extra-territorial 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.[67]

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 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.[68]

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[66]One of the many unhappy legacies of the Court's discovery of a due process element in the dormant Commerce Clause is that the Court 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.

[67]The two federal methods given implicit approval are the rule of I.R.C. § 265(a)(2) (1994) (disallowing a deduction for interest on loans used to "purchase or carry" tax-exempt bonds) and the CFC netting rule, contained in Reg. § 1.861-10(e). The Court may not have fully understood that both of these rules provide for direct allocation of interest without tracing in some circumstances.

[68]Many states do have rules that require an allocation of deductions to tax-favored income. *See* Marilyn A. Wethekam & Craig B. Fields, Hunt-Wesson *and Excessive Disallowance Issues*, 19 STATE TAX NOTES 245 (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

Perhaps the publicity surrounding *Hunt-Wesson* will educate other States to the need for legislation to combat tax arbitrage. Indeed, if the corporate 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 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. Part V.A suggests several ways that States might limit the interest deduction in circumstances that present tax-arbitrage risks notwithstanding the Court's decision in *Hunt-Wesson*. Part V.B suggests ways of attacking tax arbitrage by limiting opportunities for taxpayers to deflect nonbusiness income to a tax-haven jurisdiction.

A. *Suggested Limitation on the Interest Deduction*

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. The proposed statutory structure, in principle, has no constitutional significance. A clear, hierarchical 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).[69] The Court has repeatedly

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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.

[69] I.R.C. § 265(a)(2) provides as follows:

(a) General rule.— No deduction shall be allowed for—

upheld that Section against the type of attack brought against California's interest offset rule.[70] 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 extra-territorial values.[71] 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.[72] Tracing of loan proceeds would not be required; it would be enough to deem that a loan was incurred to acquire the tax-favored assets if it was incurred within the statutory period.

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

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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.

[70] *See* Denman v. Slayton, 282 U. S. 514, 519 (1931), *quoted with approval in* Hunt-Wesson, Inc. v. Franchise Tax Bd., 528 U.S. 458, 465-66 (2000). *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.").

[71] 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.

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

portion of the loan would be disallowed in computing TCo's income taxable by the State.

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. Some time 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,[73] 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 million, 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 of interest expense, which is treated as a cost of FCo's deemed 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 arrangement was to minimize taxes paid to the State. This is a standard anti-avoidance rule that elevates economic substance over form.

[73] *See, e.g.*, I.R.C. §§ 482, 267(b) (1994).

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 an amount equal to 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.[74] 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 million 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.

B. *Suggested Limitations on Opportunities to Earn Tax-Favored Income*

In addition to attacking tax arbitrage on the deduction side, States must develop a strategy for dealing with the issue on the income side by limiting opportunities for taxpayers to earn tax-favored income. Actions by the States on the income side of the issue are not constrained by the decision in *Hunt-Wesson*.

[74] *See* I.R.C. §§ 531-537 (1994).

States that have not yet adopted combined reporting have many good reasons for doing so.[75] 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 would 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 the newly-formed company a royalty fee for use of its trademark. The trademark royalty would 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 I, purchases preferred stock from an offshore affiliate. The affiliate does not file a combined report with TCo in State C. TCo receives $75 million in dividends on the preferred stock. In filing its tax return in State C, TCo claims that the dividends constitute nonbusiness income. To minimize its allocable income taxable in its domiciliary State, TCo characterizes the dividends in State I as apportionable business income. To prevent being whipsawed in this fashion, the tax authorities in State C 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.

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[75]For an analysis of the benefits of combined reporting, see Michael J. McIntyre, Paull Mines, and Richard D. Pomp, "Designing a Combined Reporting Regime for a State Corporate Income Tax: A Case Study of Louisiana," __ La. L. Rev. __ (forthcoming). *See* I.R.C. §§ 531-537 (1994).

V. 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.

Constructing rules to prevent tax arbitrage is a little like constructing a levee to hold back a rising river. The levee does not need to be constructed to avoid all leaks; minor seepage is easily tolerated. A major breach, however, destroys the whole purpose of the levee because the river will simply establish a new channel behind the levee and wreck its wrath unfettered. So also with tax arbitrage. The tax system is not jeopardized by isolated cases of tax avoidance. If a loophole expands to become a major breach, however, taxpayers will avoid the bite of the tax system by diverting their capital flows to take advantage of that breach.

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.[76] 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.

[76] *See* FTB Notice 2000-9 (December 19, 2000), *available at* http://www.ftb.ca.gov/legal/notices/2000%5F9a.htm. This pre-Christmas gift provides that nondomiciliary companies generally may allocate all of their interest expense to business income without even pro rata allocation to nonbusiness income. In addition, companies domiciled in California may continue to allocate their interest expense under the interest-offset rule. That is, their interest expense would first reduce their allocable interest income and then would reduce their apportionable income. The Franchise Tax Board made no attempt to limit the obvious tax-arbitrage opportunities that its new rules present.