High Court's Ruling in Hunt-Wesson Lacks Principled Basis

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ABSTRACT: Michael J. McIntyre, professor of law at Wayne State University, comments in a letter to the editor on the U.S. Supreme Court's decision in Hunt-Wesson, regarding California's interest-offset rule, which favored the taxpayer.

SUMMARY: Michael J. McIntyre, professor of law at Wayne State University, comments in a letter to the editor on the U.S. Supreme Court's decision in *Hunt-Wesson*, regarding California's interest-offset rule, which favored the taxpayer. McIntyre wrote a special report on the case that appeared recently in *State Tax Notes*. After writing that report, he was engaged by California as a consultant to its litigating team. He no longer has any affiliation with California.

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To the Editor:

[1] The U.S. Supreme Court has just issued an opinion in *Hunt-Wesson* in favor of the taxpayer. That opinion, written by Justice Breyer, holds that California's attempt to block tax arbitrage through its so-called "interest-offset" rule violates some penumbra of the Commerce Clause and the Due Process Clause. The opinion contains no principled basis for its conclusion, other than the overriding principle that the Supreme Court, if nothing else, is supreme[1] According to the Court, "[t]he legal issue [presented by the case] is less complicated than may first appear, as examples will help to show." The Court goes on to offer the following example, variations of which it repeats throughout the opinion.

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[1]For my discussion of why *Hunt-Wesson* is about tax arbitrage, see Michael J. McIntyre, "Constitutional Limitations on State Power to Combat Tax Arbitrage: An Evaluation of the Hunt-Wesson Case," *State Tax Notes*, Jan 3, 2000, p. 51; 2000 STT 1-2; or Doc 2000-674 (14 original pages).

[2] If, for example, an Illinois tin can manufacturer, doing business in California and elsewhere, earns $10 million from its total nationwide tin can sales, and if California's formula determines that the manufacturer does 10 percent of its business in California, then California will impose its income tax upon 10% of the corporation's tin can income, $1 million. . . . Suppose the Illinois tin can manufacturer has interest expense of $150,000; and suppose it receives $100,000 in dividend income from a nonunitary New Zealand sheep-farming subsidiary. California's rule authorizes an interest deduction, not of $150,000, but of $50,000, for the deduction is allowed only insofar as the interest expense "exceeds" this other unrelated income.

[3] Using this example as its analytical tool, the Court suggests that California, by denying a deduction for interest allocated to dividends from a nonunitary business, has in fact taxed that non-unitary business. The Court quickly retreats, however, from this untenable position. It properly states that it "has consistently upheld deduction denials that represent reasonable efforts properly to allocate a deduction between taxable and tax-exempt income, even though such denials mean that the taxpayer owes more than he would without the denial." Having properly stated the governing principle, the Court falls into difficulty in its application. The following key paragraph demonstrates some wooly thinking by the Court about the nature of tax arbitrage.

[4] The California statute, however, pushes this [anti-tax arbitrage] concept past reasonable bounds. In effect, it assumes that a corporation that borrows any money at all has really borrowed that money to "purchase or carry," cf. 26 U. S. C. section 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*. (My emphasis.)

[5] The first italicized passage in the quotation above is troubling because it suggests that the Court does not recognize what it means to use borrowed money to "carry" an investment. That term, well understood by tax specialists familiar with section 265(a)(2) of the Internal Revenue Code, means that a taxpayer has incurred a debt obligation so as to allow it to hold onto an asset that had been acquired some time in the past, perhaps the distant past. In it interest-offset legislation, California is not pushing the anti-tax arbitrage concept "past reasonable bounds." It is simply applying that concept in a straightforward

manner, similar to how it is applied by the federal government in analogous cases.

[6] The second of the italicized passages in the above quotation is indicative of a confusion that runs throughout the opinion. In several passages, including this one, the Court loses sight of the difference between an investment in the stock of a corporation and an investment in the business assets of that corporation. Contrary to the Court's suggestion, its *Hunt-Wesson* decision does not protect businesses conducted in far-away places from overtaxation by California.[2] California's interest deduction rules provide for a *pro rata* allocation of interest between a business operating partly in the state (the tin can business) and a business conducted entirely outside the state (the sheep farm business) when a corporation is conducting two separate unitary businesses. That is, a taxpayer that operated a tin can business partly in California and a sheep farm business entirely in New Zealand would not be affected by California's interest-offset rule. Indeed, if the interest-offset rule were applicable in such a situation, it would be internally inconsistent and thus unconstitutional under *Complete Auto*.[3]

[7] This confusion between ownership of stock and ownership of the underlying business assets is not some minor foot fault. It leads the Court to make the following statement, a statement that can fairly be characterized as amazing:

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[2]The Court's pastoral example is not representative of the typical case caught under California's interest offset rule. In the typical case, a major corporation, on advice of its tax planners, has inflated its interest deduction by many millions of dollars in order to carry preferred stock, the income from which is not taxable in California or anywhere else. Counsel for *Hunt-Wesson* apparently admitted during oral argument before the Court that the company had reported its dividend income as nonbusiness income to California (thereby avoiding tax in California and other apportionment states) and as business income to Illinois, its state of domicile (thereby avoiding domiciliary taxation).

[3]That is, if every state adopted a mirror image of the Court-imagined California statute, double taxation would be inevitable. The parties to *Hunt-Wesson* agreed, however, that the actual California statute is internally consistent.

[8] 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.

[9] As I have noted above, the California statute does not "unrealistically" make the assumption attributed to it by the Court. On the contrary, California makes the highly realistic assumption that a corporation holding certain nonbusiness financial assets (stock and bonds held for a nonoperational purpose) could liquidate those assets for use in its business. For those stocks and bonds to be classified as nonbusiness assets, the taxpayer must have asserted on its California tax return that they were not being used in its California unitary business *or any other unitary business.*[4] That is, the financial assets, by the taxpayer's own characterization, are reserve assets not needed in its businesses. What is unrealistic about an assumption that the assets that a company has held in reserve, without regard to the needs of any of its operating businesses, could be liquidated to serve the needs of the company's business? The answer is that it is not unrealistic — it is economic reality. The California offset rule reflects this simple reality by requiring companies to net their interest expense and their income from financial assets (stocks and bonds not used in any business).

[10] From the perspective of the states, the Court's decision in *Hunt-Wesson* is a keen disappointment, for it suggests that the Court is prepared to invent new constitutional barriers to efforts of the states to combat tax arbitrage. The opinion does offer, however, some significant opportunities to the states if they are prepared to draft new statutes to take advantage of the new constitutional landscape. For example, the Court apparently endorses the use by states of the various anti-avoidance techniques currently used by the federal government, including the anti-arbitrage rule of Internal Revenue Code section 265(a)(2) and

[4]The Uniform Division of Income for Tax Purposes Act, of course, contemplates this distinction in providing for apportionment of income that is business income (income coming from the regular course of a unitary business or from assets that are integral to a unitary business) and allocation of nonbusiness income (income coming from assets that do not further the unitary business beyond mere financial betterment).

the so-called CFC netting rule of Treasury Regulation 1.861-10.[5] I believe that a state could fashion an effective anti-avoidance rule based on the federal analogies without running afoul of the Court's opinion in *Hunt-Wesson*. Perhaps the attention that *Hunt-Wesson* has given to the problem of tax arbitrage will energize the states to take effective action to combat it. I would hope so, for the problem is enormous and growing, and that's not sheep manure.

Sincerely,

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[5]Unfortunately, the Court seems to misunderstand how the CFC netting rule works, referring to it as a "tracing" rule. Because the CFC netting rule was not cited by any of the parties, I am assuming that the Court addressed it because I had addressed it in my article on *Hunt Wesson*. I am not entirely pleased to make the assumption, however, for it suggests that my explanation of the rule was unclear.