Special Report / Viewpoint

Constitutional Limitations on State Power to Combat Tax Arbitrage: An Evaluation of the *Hunt-Wesson* Case

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I. Introduction

One of the thorniest issues in the design of an income tax is the proper allocation of interest payments. The federal government employs at least five different methods for allocating interest payments, and all of those methods are controversial. Tax theorists have hotly debated the proper treatment of interest payments for decades without reaching any consensus. The U.S. Supreme Court, by granting *certiorari* in *Hunt-Wesson*, has now entered the fray.

Hunt-Wesson is a California case. It deals with the proper allocation of the deduction for interest payments between business income, which is taxable by California on an apportionment basis, and nonbusiness income. Under the U.S. Supreme Court's interpretation of the Due Process Clause, California generally cannot impose its tax on the nonbusiness dividend income of companies that are domiciled outside California.[1] In the absence of antiavoidance rules, this limitation on California's taxing power would create opportunities for taxpayers domiciled outside of California to engage in tax arbitrage. That is, those taxpayers could borrow money and deduct the interest against taxable business income at a time when they are holding nonbusiness assets generating income that is not taxed. It is California's attempt to prevent such tax arbitrage that set the stage for the *Hunt-Wesson* case.

[1]See, e.g., *Allied-Signal Inc. v. Director, Division of Taxation (New Jersey)*, 504 U.S. 768 (1992); *ASARCO Inc. v. Idaho State Tax Commission*, 458 U.S. 307 (1982). California would be permitted under the Due Process Clause to tax a company on dividends that arise from activities conducted in California. *Hunt-Wesson* does not present such a situation. Indeed, California has no provision in its law for taxing such dividends.

California has developed a variety of rules that govern the allocation of deductions[2] when a company is taxable in California on some portion of its income.[3] Special rules apply for the purpose of allocating interest payments between business and nonbusiness income.[4] The interest-allocation rules operate as follows. First, taxpayers net their interest payments against their business (apportionable) interest income. Second, the remaining interest payments must be allocated to nonbusiness dividend and interest income, to the extent thereof.[5] This feature of California law is referred to as the interest-offset rule. Third, any interest payments not allocated under the first two rules are allocated to business (apportionable) income or to nonbusiness income other than dividends and interest.[6] This statutory scheme is illustrated by *Example #1.*

> *Example #1.* T is a company that is domiciled in State A and is engaged in extensive business activities in California. T borrows $1 million from a bank, which it commingles with its other business assets and uses for sundry corporate pur-

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[2]See, e.g., Cal. Rev. and Tax Code, sections 24425, 25123-25127. These rules were not applied in *Hunt-Wesson*, and no challenge to them was presented by the taxpayer in the California courts. I do not address the general rules in this article.

[3]In general, companies are taxable in California with respect to their income under the California franchise tax. California also has a corporate income tax. It applies to certain income, particularly interest on federal securities, that cannot be taxed under a franchise tax.

[4]Cal. Rev. and Tax Code, sections 24344(a)-(b) states as follows:

Sec. 24344. Interest; restrictions

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

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

[5]The interest-offset rule does not apply to dividends paid out of previously taxed income, as specified in Cal. Rev. and Tax Code, section 24402, and certain water's edge dividends, as specified in section 24411. Interest paid to acquire or hold assets producing dividends described in sections 24402 and 24411 do not present the tax arbitrage opportunities that the interest-offset rule is designed to combat. I do not address these special features of the California system in this article because they were not applied in *Hunt-Wesson* and do not appear to me to be relevant to the main issues in that case.

[6]Cal. Code Regs. section 25120(d).

> poses. It pays $100,000 of annual interest on the loan. T 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. Those dividends are not taxable in State A or any other jurisdiction. Under these facts, T would allocate its interest expense deduction of $100,000 as follows:
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> *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.
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> *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. Although the deduction reduces T's gross dividend income to zero, it gives T no direct tax benefit under California law because California does not tax the dividends.
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> *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 T's apportionable sales income to $260,000. The portion of that net income apportioned to California under California's apportionment formula is subject to California's franchise tax.

The first and third of California's allocation rules do not appear to be controversial. It is the direct allocation of interest payments to nonbusiness dividends that is at the heart of the controversy in *Hunt-Wesson*.

The effect of California's interest-offset rule, illustrated in Step 2 of *Example #1*, is that a nondomiciliary company gets no net tax benefit from the interest deduction allocated to nonbusiness dividend and interest income that arose outside of California because the dividend and interest income are already exempt from California tax. A company domiciled in California would get a net benefit, however, because it is taxable on its nonbusiness dividends. A nondomiciliary company earning dividends and interest income taxable by California would get the full benefit of the deduction. On its face, therefore, the California statute is neutral with respect to domiciliary and nondomiciliary companies. For both categories of taxpayer, California allows an interest deduction when the interest expense is linked under the three-step procedure to income taxable by California, and it denies the deduction when the interest expense is linked to tax-exempt income.

In the tax literature dealing with the interest deduction, the California rule under challenge in *Hunt-Wesson* is referred to as a strict-stacking rule.[7] Under strict stacking, interest expense is matched with tax-exempt income without reference to the source of the funds used to acquire the assets producing the exempt income. This is, a taxpayer is caught under a strict-stacking rule if (1) it uses equity capital in its taxable business and uses borrowed capital to acquire assets producing tax-exempt income, or (2) it shuffles its portfolio to use the borrowed capital in its taxable business and uses equity capital to acquire assets generating tax-exempt income. As the tax literature makes clear, strict stacking is the only practical solution to the problems of tax arbitrage that arise in a tax system that generally allows a deduction for interest payments and also allows some categories of income to be exempt from tax.[8]

Hunt-Wesson is a domiciliary of Illinois.[9] It received substantial nonbusiness dividends from sources outside California. It also made even more substantial interest payments during the tax years at issue. In accordance with the Supreme Court's Commerce Clause jurisprudence and its own tax legislation, California did not impose its franchise tax on Hunt-Wesson's nonbusiness dividends. It required Hunt-Wesson, however, to allocate the interest payments to the tax-exempt nonbusiness dividends, to the extent of those dividends, as illustrated in Step 2 of *Example #1.* In the California courts, Hunt-Wesson claimed that this treatment of its interest payments violated the Equal Protection Clause, the Due Process Clause, and the negative Commerce Clause of the U.S. Constitution. Those three arguments were accepted with great enthusiasm at the trial level and rejected on appeal. As discussed below, none of these arguments has substantial merit.

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[7]See Stanley Koppelman, "Tax Arbitrage and the Interest Deduction," 61 SOUTHERN CALIFORNIA LAW REVIEW 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 LAW REVIEW 67 (1992), revised and republished as Chapter 17 of TAXATION TOWARDS 2000, John G. Head and Richard Krever, Eds. (1997) (hereafter "Critique").

[8]Id.

[9]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.

To protect themselves against tax arbitrage by nondomiciliary taxpayers, states need to adopt some measures for limiting the interest deduction.[10] *Example #2* illustrates that point in a simple case.

> *Example #2.* T is a corporation that is domiciled in State A. T earns business income of $1 million in State B. State B has no equivalent to the anti-arbitrage interest rule under attack in *Hunt-Wesson.* On advice of tax counsel, T borrows $20 million from a bank at 5 percent annual interest and uses the funds to purchase $20 million of preferred stock that pays annual dividends of 5 percent. The dividends have no nexus with State B. T now has an interest deduction of $1 million a year and has dividend income of $1 million a year that is exempt from tax in State B. If State B is required by the U.S. Constitution to allow T to deduct its annual interest payments of $1 million from its business income, then it will not collect any tax at all from T.

It is difficult to understand what provision of the U.S. Constitution would prohibit the states from protecting themselves against tax arbitrage under the facts of the above case. Certainly the Commerce Clause, which the Court claims was intended by the framers to provide a level playing field for intrastate and interstate commerce, cannot reasonably be read to provide nondomiciliary taxpayers with a constitutional right to engage in tax arbitrage.

Hunt-Wesson can be distinguished from the above example, in that the California tax authorities did not attempt to show that the taxpayer in *Hunt-Wesson* actually borrowed money for the express purpose of acquiring stock that would generate tax-exempt dividends. The question for the Court is whether the distinction between directly linked debt and debt linked by an anti-arbitrage formula is legally significant under the U.S. Constitution.[11] The distinction certainly is not economically significant because tax arbitrage occurs in either situation. That is, the taxpayer will enjoy the benefits of tax arbitrage whether it uses borrowed money to acquire assets producing tax-exempt income or uses equity capital to acquire those assets and uses its borrowed money to acquire business assets. This point is illustrated in *Example #3.*

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[10]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, Brookings Institution (1985). Steuerle was a high-ranking official in the Reagan Treasury Department at the time this book was written.

[11]Congress has recognized the significance of tax arbitrage in enacting Internal Revenue Code section 148 (Arbitrage). That section is intended to prevent taxpayers from using the proceeds of tax-exempt bonds to acquire higher yielding investments, or to replace funds that were used, directly or indirectly, to acquire higher yielding investments.

> *Example #3.* In year 1, T, a corporation domiciled in State A, borrows $20 million from a bank at 5 percent interest and uses the loan proceeds to purchase equipment for its business located in State B. T has extensive business operations in State B. In year 2, T's gross income in State B is $21 million, against which it takes an interest deduction of $1 million. Instead of using the $20 million to pay off its loan, thereby eliminating its interest deduction, T uses the money to purchase $20 million of preferred stock paying annual tax-exempt dividends of $1 million. If State B is not permitted to treat the interest expense of $1 million as a cost of holding or acquiring the preferred stock, then T will obtain the benefits of tax arbitrage.

As *Example #2* and *Example #3* illustrate, California's interest-offset rule reflects sound tax policy. The effect of that rule is to limit the ability of corporations to deplete a state's tax base by engaging in tax arbitrage. In many cases, the company at issue is domiciled in a state that exempts its domiciliary companies from tax on some or all of the dividend income that would be treated as nonbusiness income in a nondomiciliary state.[12] Some domiciliary states are outright tax havens – Delaware being the obvious example. Other states are serious taxing jurisdictions that have felt compelled by competitive pressures to give an exemption for certain categories of nonbusiness income. New York is a nice example.[13]

The question for the Court is whether the Constitution, properly interpreted, prevents California from pursuing its policy against tax arbitrage. For

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[12]As far as I can ascertain, the record does not disclose whether Hunt-Wesson (Beatrice) paid tax to Illinois on its nonbusiness dividends. If the taxpayer in fact had paid significant taxes to Illinois, it probably would have highlighted that fact in the record. In accordance with Mark Twain's famous advice, Hunt-Wesson may have decided that it was better to remain quiet and have everyone suspect it of tax avoidance than to open its mouth and remove all doubt. Under Illinois law, as I understand it, corporations with a commercial domicile in that state are required to pay Illinois corporate tax on their net nonbusiness dividends. The net dividends would be total nonbusiness dividends minus the dividends-received deduction provided in Internal Revenue Code section 243. For 1980-1983, the years at issue in *Hunt-Wesson*, taxpayers could deduct 80 percent of their portfolio dividends under section 243. Thus *Hunt-Wesson* would have paid state tax on only 20 percent of its nonbusiness income if it had reported them in full to Illinois. If the taxpayer had taken the position with Illinois that the dividends were business dividends, then it would have been taxed on the Illinois apportioned share of that 20 percent. I obviously do not know what the reporting position of Hunt-Wesson was in Illinois. I do know that some state tax officials fear that some taxpayers characterize dividends as nonbusiness income in the nondomiciliary states and as business income in the domiciliary state.

[13]For discussion of the reasons that New York has made itself a tax haven with respect to certain categories of nonbusiness income, see Richard D. Pomp, "Reforming a State Corporate Income Tax," 51 ALBANY LAW REVIEW 375 (1987) at 689-701. These page references are not misprints – this 412-page article by Pomp many be the longest tax article ever printed in a reputable law review.

reasons presented below, I believe that the Court should answer that question in the negative.

In section III, below, I briefly examine five of the interest-allocation rules that taxpayers are required to follow in computing their federal income tax liability. These rules generally have been incorporated by reference into the tax laws of states that use the federal definition of taxable income as their starting point in defining their tax base. I address these rules primarily to make the important point that the proper tax rules for allocating or apportioning interest expense depend critically on the context in which the rules are to apply. If the Court were to give constitutional status to one type of allocation rule and proscribe another, it would undermine the ability of the states to pursue legitimate tax policy objectives through appropriate interest-expense allocation rules.

The various federal interest-expense allocation rules, which have so far escaped challenge under the Foreign Commerce Clause,[14] share some common features with the California rule under challenge in *Hunt-Wesson.* They also have major differences. As the discussion below makes clear, the merits of a particular interest allocation rule depend on the function it is serving. Some of the federal rules are well-suited for their purpose and some are in need of major reform. The California rule is pretty close to an ideal rule given its purpose of curtailing tax arbitrage.

Section IV analyzes California's strict-stacking rule under the negative Commerce Clause. I conclude that the strict-stacking rule under challenge in *Hunt-Wesson* is a wise and constitutional exercise of tax jurisdiction by California. I contend that it is a reasonable method for preventing taxpayers from taking a deduction against their business income for interest payments on a loan that was used, in an economic sense, to hold or acquire assets producing nonbusiness income that is not taxable by California. I go on to argue that the Court should take the opportunity afforded by *Hunt-Wesson* to make clear that it did not intend in *Allied-Signal*[15] to create a legal structure that fostered interstate tax avoidance.

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[14]The federal government regularly denies taxpayers the benefit of an interest deduction to the extent that the deduction has been allocated by formula to foreign-source income. See, e.g. Treasury Regulation section 1.861-8. No direct linkage of the interest expense to the foreign income is required. If California is violating the Interstate Commerce Clause by the use of the formula under attack in *Hunt-Wesson,* then it presumably is also violating the Foreign Commerce Clause by using the federal interest-allocation formula to compute the foreign income of its taxpayers. I understand that all of the nonbusiness dividends in *Hunt-Wesson* are from foreign companies.

[15]*Allied-Signal- Inc. v. Director, Division of Taxation (New Jersey),* 504 U.S. 768 (1992).

This article's primary focus is on the taxpayer's claim that California's strict-stacking rule violates the nondiscrimination prong of the *Complete Auto*[16] tests. The taxpayer also contended before the California courts, however, that the rule violates the taxpayer's rights under the Equal Protection Clause and the Due Process Clause. I view these arguments as makeweights. I address them, nevertheless, in Section II, largely to demonstrate that the California rule meets common notions of fairness.

II. The Taxpayer's Makeweight Arguments Under the Equal Protection Clause And the Due Process Clause

Surely the Supreme Court did not grant *certiorari* in *Hunt-Wesson* simply to shoot down the flawed equal protection and due process arguments sketched below. Indeed, the taxpayer in *Hunt-Wesson* has already abandoned its equal protection argument, although it won on that argument in the California lower court.[17] I assume that the Court took the case to review the implications of the strict-stacking rule under the nondiscrimination prong of the negative Commerce Clause. A discussion of those flawed arguments here is useful, nevertheless, as prologue to the later discussion of the Commerce Clause issue.

A. Equal Protection

The key to a successful equal projection argument is to show that one class of taxpayers is treated less favorably than another class and that the state cannot suggest a legitimate purpose for making the distinction between the two classes. In the tax field, almost all equal protection cases fail. For example, in *Nordlinger*,[18] the Court upheld a challenge to California's Proposition 13 rule, under which individuals with equivalent parcels of real property routinely pay wildly different amounts of property tax. The Court held that California had a rational basis for adopting the Proposition 13 rule because the rule allegedly promoted neighborhood stability and preservation and allegedly preserved the reliance interests of existing owners in paying low taxes. Neither of these alleged goals of Proposition 13 can fairly be characterized as central to the purposes of a broad-based property tax.

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

[17] It is not difficult to surmise why the taxpayer is not pressing its equal protection argument.

[18] *Nordlinger v. Hahn*, 505 U.S. 1 (1992).

The taxpayer in *Hunt-Wesson* claims that California's strict-stacking rule treats nondomiciliary taxpayers less favorably than domiciliary taxpayers in violation of the Equal Protection Clause by giving taxpayers domiciled in the state a deduction for the interest attributed to nonbusiness income while denying the benefit of the deduction to nondomiciliary taxpayers. In fact, however, the strict-stacking rule simply reduces an advantage that nondomiciliary taxpayers otherwise would enjoy over taxpayers domiciled in the state. In evaluating the interest-offset rule, it is necessary to take into account California's treatment of the income that is being "offset." As *Example #4* illustrates, the combination of the interest-offset rule and the exemption of the income being offset never causes nondomiciliary taxpayers to be treated worse than domiciliary taxpayers.

> *Example #4.* X and Y each has business income in State A of $4 million, nonbusiness income of $2 million, and an interest expense of $1 million. X is a domiciliary of State A and Y is not. X is taxable in State A on its gross income of $6 million, reduced by an interest deduction of $1 million. Y is taxable by State A on gross income of $4 million without any reduction for the $1 million of interest, which is allocated to its tax-exempt nonbusiness income. Y may not like the strict-stacking rule, but it cannot fairly complain that State A is treating it less favorably than X. As long as the interest payment is less than the exempt nonbusiness income, Y is treated more favorably than X. If the interest payment equals or exceeds the nonbusiness income, then X and Y are treated exactly the same.

Even if a nondomiciliary taxpayer were able to show that it had received less favorable treatment than similarly situated domiciliary taxpayers, it would not have made out a successful equal protection claim. To succeed with that claim, it must show that the alleged discrimination was not justified by a valid state interest. Under the Court's equal protection jurisprudence, the combating of tax arbitrage surely should be a sufficiently compelling state interest to justify California's strict-stacking rule. In contrast to the flimsy rationales for the Proposition 13 rule, the strict-stacking rule is firmly grounding in tax policy.

B. Due Process

California is alleged to have violated the nexus requirements of the Due Process Clause by taxing, in effect, the portion of Hunt-Wesson's nonbusiness income that is the subject of the interest-offset rule. Both sides agree that California does not have nexus to tax nonbusiness income that arises outside of California within the meaning of the Due Process Clause.

The taxpayer's due-process nexus argument proves too little and too much. It proves too little because California is not taxing Hunt-Wesson's nonbusiness income, in actuality or in effect. It is taxing the portion of Hunt-Wesson's business income that has been apportioned to California under a formula that the Court has specifically endorsed on several occasions, most recently in the *Barclays Bank* case.[19] California clearly has nexus over Hunt-Wesson, which is engaging in business in California, and it equally clearly has nexus over the taxpayer's business income arising in, or attributable to activities occurring in, California. The claim that California lacks nexus to tax is baseless.

That California is not actually taxing Hunt-Wesson on its nonbusiness income is a simple matter of fact. Hunt-Wesson asserts, incorrectly, that California's system for taxing it on its California business income is equivalent to a tax on its nonbusiness income. Even if the taxpayer were correct in its claim, however, it would not have made out a claim for protection under the Due Process Clause. All that is relevant for nexus under that clause is whether the state has sufficient links to the taxpayer and the taxpayer's income to justify exercise of its jurisdiction to tax that income. Substantive complaints about the way the tax is levied are simply not protected by the Due Process Clause.

In any event, California's interest-offset rule is an anti-tax-avoidance rule, not some ruse to tax nonbusiness income. Of course any limitation on a deduction can be analogized to a tax on the income otherwise sheltered from tax by the deduction. The analogy in *Hunt-Wesson* is not strong, however, because the interest-offset rule only operates on taxpayers, such as Hunt-Wesson, that are engaging in tax arbitrage. Nondomiciliary companies are not affected by the interest-offset rule if they do not have business income in the state,[20] if they do not have outstanding debt obligations,[21] or if their business interest income equals or exceeds their interest expense.[22] The uncontested facts of *Hunt-Wesson* demonstrate that the taxpayer is engaged in tax arbitrage. Thus the interest-offset rule appropriately applies. Hunt-Wesson is attempting with its due-process argument to convert a complaint about California's method of computing California taxable business income into a challenge to California's jurisdiction to tax.

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[19]*Barclays Bank PLC v. Franchise Tax Board of California*, 512 U.S. 298 (1994).

[20]If a nondomiciliary company is not engaged in business in California, it will not be taxed by California at all, so the interest-offset rule would not be applicable.

[21]Without an outstanding debt, a company would not have an interest deduction that could be affected by the interest-offset rule. As a result, the interest-offset rule would not affect the way California taxed the company's business income even if the company had nonbusiness dividend income.

[22]As illustrated in step one of *Example #1*, the taxpayer deducts interest expense against interest income in step one, before reaching the interest-offset rule in step two. If no interest expense is left after application of step one, the interest-offset rule does not come into play.

Hunt-Wesson's due process argument also proves too much. If the allocation of a deduction to nonbusiness income is viewed, for constitutional purposes, as a tax on that income, then all possible allocation methods for all types of deductions would run afoul of the Due Process Clause. This point is illustrated by *Example #5*.

> *Example #5*. Q, a nondomiciliary of State A, earns business gross income in that state of $3 million. It also earns nonbusiness gross income of $2 million from rental of an apartment building located in State B. Depreciation on the apartment building amounts to $1 million. The typical depreciation allocation rule is that Q must attribute the deduction for depreciation of the apartment building to the income earned from the apartment building. That allocation rule presumably is beyond constitutional challenge. It has exactly the same effect, however, that the taxpayer claims is prohibited under the Due Process Clause in that it reduces, dollar for dollar, the value of the exemption for nonbusiness income that Q otherwise would enjoy.

The crux of the taxpayer's due-process attack on the interest-offset rule is that the rule actually achieves its intended purpose of eliminating tax arbitrage. The taxpayer apparently would prefer the type of weak anti-arbitrage rule embodied in section 265(a)(2) of the Internal Revenue Code. The federal rule, which depends in part on the taxpayer's manifest intent, is easy for taxpayers to plan around. California's strict-stacking rule, in contrast, is rock solid. I fail to understand, however, how an anti-tax-avoidance rule violates the Due Process Clause simply because it works as the sovereign state intended.

III. Federal Limitations on the Interest Deduction

The federal government uses a variety of measures for limiting the deductibility of interest payments. Each of the rules has some merit, although none of them achieves perfection. The reason the federal government uses so many different limitation rules is that the rules serve quite distinct functions. The merits of these rules cannot be ascertained without reference to the purpose for which they were designed.

In this section, I examine briefly five different methods used by the federal government for limiting the deductibility of interest. The lesson that the Court should draw from the federal experience is that it will face some daunting problems and will create some daunting problems for the states if it should decide in *Hunt-Wesson* to give constitutional status to any particular formula for allocating interest expenses. The states will have problems because they will have less ability to respond creatively to the creative tax-avoidance schemes that taxpayers can be expected to develop to take advantage of the reduction in state sovereign power. The Court will have problems because it is likely to get drawn into the task of developing uniform interest-allocation formulas that meet its constitutional standard.

A. Interest Paid on Loans Used To Acquire or Carry Tax-Exempt Bonds

Section 265(a)(2) of the Internal Revenue Code denies taxpayers a deduction for interest "on indebtedness incurred or continued to purchase or carry" tax-exempt obligations. This language might be interpreted as establishing a strict-stacking rule in that any taxpayer that acquires or holds tax-exempt bonds when it had indebtedness outstanding is plausibly using that indebtedness to "carry" the tax-exempt bonds. The courts and the tax authorities, nevertheless, have consistently viewed section 265(a)(2) as establishing a much more limited restriction on the deduction for interest payments.

Taxpayers always run afoul of section 265(a)(2) whenever they manifest a purpose to "purchase" tax-exempt bonds with borrowed money. Other cases are less clear. In general, however, an interest deduction would be denied to a taxpayer purchasing tax-exempt bonds if the taxpayer has debt outstanding at or near the time of the purchase and is unable to show that the debt had been used to finance the purchase of business or personal assets. That is, if the borrowed money is used to actually purchase tax-exempt bonds or is used to buy investments assets, then section 265(a)(2) is likely to apply. The rule of section 265(a)(2), however, is famously imprecise. The controlling case law and applicable administrative pronouncements[23] give some guidance, but they leave more questions unanswered than answered. The various legal authorities repeatedly assert, for example, that the application of section 265(a)(2) depends on the facts and circumstances of each case.

Section 265 typically would prevent a taxpayer from deducting interest on a loan if the taxpayer used the proceeds of the loan to acquire investment assets and then purchased tax-exempt bonds out of its equity capital. Assume, for example, that a taxpayer borrowed $1 million and used the money to acquire vacant land not used in its business. One year later, it purchased $800,000 of tax-exempt bonds out of its equity capital. The taxpayer probably would lose 80 percent of its interest deduction under these facts, absent some special circumstances that struck the fancy of a particular court. That is, section 265 does not require the type of direct linkage between a loan and

[23]The confused state of the law is nicely presented in *Indian Trial Trading Post v. Com'r*, 60 T.C. 497 (1973), *aff'd per curiam* 503 F. 2d 102 (6th Cir. 1974). *See also* Rev. Proc. 72-18, 1972-1 C.B. 740, modified by Rev. Proc. 87-53 1987-2 C.B. 669.

tax-exempt income that the taxpayer in *Hunt-Wesson* asserts is mandated under the U.S. Constitution.

It is unclear what would happen in the *Hunt-Wesson* case if California were to adopt, as an alternative to its interest-offset rule, an allocation rule based on the approach of section 265(a)(2). The record in that case is wholly inadequate to determine how much interest would be allocated to nonbusiness income under such a system. Indeed, it would take a whole roomful of records to make that determination. The question that the tax authorities and ultimately the courts would need to decide is whether the taxpayer used all of the proceeds of its several loans for direct business needs. If so, then the section 265(a)(2) counterpart probably would not apply. If Hunt-Wesson held some assets for what might be characterized as an investment purpose, however, then the section 265(a)(2) counterpart would come into play.

What would constitute investment assets under section 265(a)(2) is very different from what constitutes nonbusiness assets under the Court's Commerce Clause jurisprudence. For example, a court determining the application of section 265(a)(2) would examine whether a cash reserve used to finance inventory was excessively large, given the particular inventory cycle of the taxpayer. If that reserve was more than could be justified by strict business requirements, then the deductibility of interest on the taxpayer's debt would be subject to challenge.[24]

Section 265(a)(2) is a type of tracing rule. That is, it attempts to establish some link between a particular category of assets and the proceeds of a loan. The linkage so established then determines whether interest on the loan is deductible, either currently or at some time in the future. It is a badly designed tracing rule for a variety of reasons, not the least of which is that it is exceedingly difficult to administer. Well-designed tracing rules need not present serious administrative problems.[25]

In contrast, California's strict-stacking rule is a matching rule. That is, it determines the deductibility of interest by linking it directly with some category of income. The difference in the two approaches is important for purposes of tax theory. In practice, however, the difference is typically more modest. As applied to the facts of *Hunt-Wesson*, a tracing rule would deprive the taxpayer of a deduction for all interest paid with respect to its debt obligations linked to the acquisition of assets producing nonbusiness in-

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[24]See, e.g., *Wisconsin Cheesman Inc. v. United States*, 388 F.2d 420, 423 (7th Cir. 1968).

[25]See section III,E, below (discussing the tracing rules adopted in 1986 to determine whether the interest payments of individuals should be characterized as personal, current, or capital expenditures).

come. The strict-stacking rule actually used by California eliminates the deduction only to the extent of the taxpayer's nonbusiness interest and dividend income. As a result, if the taxpayer in *Hunt-Wesson* arranged to have no dividends paid in a particular year on its nonbusiness preferred shares, it would be entitled to a full interest deduction under strict-stacking. Under a tracing system, it would continue to lose the deduction. Although a properly designed tracing rule has some advantages in combating tax arbitrage, it would be a much more difficult rule for California to implement.[26]

Internal Revenue Code section 265(a)(2) has been subject to well-deserved criticism in the tax literature.[27] The section is generally understood to have as its purpose the discouragement of tax arbitrage. It does not fully achieve that purpose, however, because it allows taxpayers who purchase tax-exempt bonds while owing money to take an interest deduction in many important cases. For example, a taxpayer having a mortgage on a personal residence can deduct interest on the mortgage while receiving tax-free interest income. Similarly, most loans linked to a business use do not run afoul of section 265(a)(2).

There can be no doubt that section 265(a)(2), in operation, is hopelessly complex and cannot be reformed without major restructuring. Most disinterested academic commentators probably would recommend the replacement of section 265(a)(2) with the type of strict-stacking rule under attack in *Hunt-Wesson* if they were asked to redesign that section to prevent tax arbitrage.[28]

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[26]For a fuller discussion of the distinction between matching and tracing and the administrative advantages of each, see McIntyre, "Critique," *supra* note 7. See also Deborah A. Geier, "The Myth of the Matching Principle as a Tax Value," 15 AMERICAN JOURNAL OF TAX POLICY 17 (1998).

[27]For my views on this topic and extensive references to the literature, see McIntyre, "Critique," *supra* note 7; Michael J. McIntyre "An Inquiry Into the Special Status of Interest Payments," 1981 DUKE LAW JOURNAL 765 (1981) (hereafter "An Inquiry"); Michael J. McIntyre, "Comments on 'Indexing for Inflation and the Interest Deduction'" (paper by John Bossons), 30 WAYNE LAW REVIEW 973 (1984). See also Koppelman, "Tax Arbitrage and the Interest Deduction," *supra* note 7; William A. Klein, "Borrowing to Finance Tax-Favored Investments," 1962 WISCONSIN LAW REVIEW 608 (1962); Calvin H. Johnson, "Tax Shelter Gain: The Mismatch of Debt and Supply Side Depreciation," 61 TEXAS LAW REVIEW 1013 (1983); Charlotte Crane, "Matching and the Income Tax Base: The Special Case of Tax Exempt Income," 5 AMERICAN JOURNAL OF TAX POLICY 191 (1986); David Shakow, "Confronting the Problem of Tax Arbitrage," 43 TAX LAW REVIEW 1 (1987).

[28]Some commentators argue that allowing unbridled tax arbitrage might actually improve the efficiency of the tax subsidy granted to state and local governments through the exemption for interest paid with respect to state and local bonds. They would "reform" section 265(a)(2) by repealing it. See, e.g., Shakow, "Confronting the Problem of Tax Arbitrage," *supra* note 12. For an opposing view, see Koppelman, "Tax Arbitrage and the Interest Deduction," *supra* note 3.

B. Interest Payments Linked to Assets Producing Foreign-Source Income

U.S. corporations engaged in foreign operations and paying foreign income taxes must determine the amount of their net foreign-source income in order to compute the limitation on their foreign tax credit. The basic purpose of the limitation on the credit is to protect U.S.-source jurisdiction. If taxpayers are able to take a credit for taxes paid in excess of the U.S. tax imposed on the taxpayer's net foreign income, then those credits will offset U.S. taxes otherwise due with respect to U.S.-source net income.

To compute their net foreign-source income, taxpayers are required to allocate their interest deduction between foreign and domestic sources under the provisions of Treasury Regulation section 1.861-8. The section 1.861-8 regulation is lengthy and complicated, with a variety of special rules. In general, the regulation requires the taxpayer to use what it refers to as the "asset method" for allocating interest deductions. Under the asset method, the actual use that the taxpayer may have made of the proceeds of a loan is irrelevant in allocating interest paid on that loan between foreign and domestic sources.[29] In this important respect, the federal rule is similar to California's interest-offset rule.

In brief outline, the asset method works as follows. First, a taxpayer sorts all of its worldwide assets into two categories – assets producing U.S.-source gross income and assets producing foreign-source gross income. Assets that produce both foreign and domestic income are apportioned between the two categories based on the source of the gross income that they generated in the current taxable year. Second, the taxpayer determines a value for the assets in the two categories, generally its basis in the assets with certain adjustments. Finally, the taxpayer allocates its interest deduction pro rata to the value of the assets in each of the two categories. Thus if the taxpayer uses one half of the assets, by value, to produce foreign-source income, then one half of the interest deduction will be allocated to foreign sources.

Commentators have frequently asserted that the asset method is based on the principle that money is fungible. This characterization of the rule is inaccurate. Very few of the assets of a company engaged in international activities are held in the form of currency. Yet the asset method applies to all corporate assets – money, notes, stock, land, machinery, inventory, and

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[29] For a detailed description and analysis of the interest allocation rules under Reg. section 1.861-8, see Michael J. McIntyre, THE INTERNATIONAL INCOME TAX RULES OF THE UNITED STATES, Lexis Law Publishing (1989, with frequent updates) at Chapter 3/B2ai (hereafter "U.S. Int'l Tax Rules").

anything else on the corporate balance sheet. The real rationale for the asset method is that in a world with efficient capital markets, all of a taxpayer's equity capital, regardless of the form in which it is held, could be used in lieu of borrowed capital to finance whatever expenditures the taxpayer actually made out of the proceeds of its loans.[30]

The observation that a company taking out a loan to make a particular purchase could have made that purchase out of equity capital does not demonstrate that interest payments should be allocated pro rata to all of a company's assets. The asset method is simply one of many plausible methods for allocating interest between foreign and domestic sources. That observation is important, however, in indicating why a direct tracing rule might be inappropriate in determining the "source" of an interest deduction. A proper source rule should result in an appropriate sharing of tax revenue between competing tax jurisdictions.[31] To achieve that proper sharing, the rule must not be subject to easy manipulation by the taxpayer. Otherwise the taxpayer will arrange its affairs to have its deductions allocated in a way that would minimize its tax liability. In large measure, the asset method is a defensible source rule because it takes control over the allocation of the interest deduction out of the hands of the taxpayer and puts it where it belongs – in the hands of the sovereign state.

The section 1.861-8 regulations provide for several exceptions to the asset method. One exception, referred to as the "CFC netting rule" nicely parallels California's interest-offset rule. Under certain circumstances, the CFC netting rule requires a taxpayer to allocate its interest deduction, dollar for dollar, to interest income received from a foreign affiliate.[32] The purpose of the rule is to prevent taxpayers from artificially increasing the percentage of their income allocated to U.S. sources, thereby increasing the limitation on their foreign tax credit, by borrowing money from an unrelated third party and relending it to a foreign affiliate. This dollar-for-dollar allocation is

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[30]In a world of perfect capital markets, all assets are fungible, but only in the limited sense that any asset can be used to support a loan up to the amount of its market value. Fungibility is a relative concept – a category of assets is fungible relative to some particular use. For example, most people are fungible as a source of plasma but generally are not fungible as a source of wisdom. Money is fungible in a very wide variety of contexts, but not always. Money obtained from a purchase-money loan, for example is not fungible with saved money in that the loan proceeds can only be used for the purpose specified in the loan agreement.

[31]For an extended discussion of the criteria for good source of income and source of deduction rules, see McIntyre, "U.S. Int'l Tax Rules," *supra* note 29 at Chapter 3/C. See also Michael J. McIntyre, "The Design of Tax Rules for the North American Free Trade Alliance," 49 TAX LAW REVIEW 769 (1994).

[32]For discussion of the CFC netting rule, see McIntyre, "U.S. Int'l Tax Rules," *supra* note 29 at Chapter 3/B2ai(2)(A).

necessary for the United States to achieve its tax policy goals relating to the foreign tax credit, just as California's dollar-for-dollar allocation under the interest-offset rule is necessary to prevent taxpayers from engaging in tax arbitrage to the detriment of the California tax base.

Another exception to the asset method applies to certain purchase-money nonrecourse loans. The basic idea of the exception is that in some very special cases, taxpayers may make investments with borrowed money that have no economic relationship to their other activities. For the exception to apply, the loan must be a genuine nonrecourse loan, with no guarantees or other mechanisms for linking the loan to the taxpayer's general credit position. In addition, the investment acquired with the loan proceeds must generate sufficient current income to service the debt. The U.S. tax authorities drew on their experience from the tax shelter wars to write antiavoidance rules that prevent recourse debt or debt with guarantees from being disguised as nonrecourse debt. Taxpayers rarely qualify for this exception. The paradigm application would be a real estate transaction that the taxpayer finances with nonrecourse debt and then rents out under a long-term net lease.

C. Denial of Deduction on Excessive Interest Paid To Tax-Exempt Related Persons

Internal Revenue Code section 163(j) is designed to deal with the problem of earnings stripping. In tax parlance, earnings stripping is the use of deductible payments to related companies to deplete the amount of income of a corporate group that is taxable by the source country. In the case of interest payments, earnings stripping would occur when a company distributes its profits to its parent company by making deductible interest payments rather than paying nondeductible dividends.

The earnings-stripping rule applies to interest paid to foreign parent corporations that are exempt from U.S. tax and to certain tax-exempt U.S. entities. Interest must be characterized as "excess interest expense" under the statute to be subject to disallowance. In addition, a safe-harbor rule prevents application of the limitation unless the domestic corporation making the interest payment has a debt/equity ratio in excess of 1.5 to 1.[33]

A primary target of section 163(j) is foreign corporations obtaining interest payments from domestic affiliates that are exempt from tax under a tax treaty (or are subject to a substantially reduced withholding rate) on their

[33]For more details on the operation of the earnings-stripping rule, see McIntyre, "U.S. Int'l Tax Rules," *supra* note 29 at Chapter 2/D5.

interest payments. The United States is unwilling for a corporate group to get the benefit of the interest deduction and also get the benefit of the treaty exemption. The deduction-denial rule can be viewed as a method for indirectly denying foreign taxpayers the rights granted to them under the relevant income tax treaty. Congress and the Treasury Department, however, have concluded that the rule is consistent with U.S. treaty obligations. Most foreign governments appear to agree. Many of them – Canada is an example – have earnings-stripping provisions of their own.

The earnings-stripping rule of section 163(j) resembles California's interest-offset rule in one important respect. The point of similarity is that both rules are designed to prevent taxpayers from obtaining the benefits of an interest deduction and also obtaining the benefits of an exclusion from income. On tax policy grounds, the goal of preventing the dual benefit would appear to be unassailable.

Section 163(j) is an anti-tax-avoidance rule. It applies in addition to the disallowance rule of section 265(a)(2) and the allocation rule of Treasury Regulation section 1.861-8.

D. Limitations on Interest Paid With Respect to Foreign-Currency Loans

Foreign corporations engaged in business in the United States must determine the amount of their interest deduction allocable to their U.S.-source income under Treasury Regulation section 1.882-5. The section 1.882-5 rule is a complex hybrid of a tracing rule, exemplified by the rule of section 265(a)(2), and pro rata apportionment, exemplified by the asset method of Treasury Regulation 1.861-8.[34]

One of the several objectives of the section 1.882-5 rules is to prevent an understatement or overstatement of the U.S. interest deduction when a foreign taxpayer has taken out a loan denominated in a foreign currency and has also made borrowings traceable to its U.S. operations that are denominated in U.S. dollars. The asset method would blend the interest rate on the foreign currency loans with the interest rate on the U.S. loans. That result would be inappropriate, at least in some circumstances, as *Example #6* illustrates.

> *Example #6.* F, a foreign bank, has taken out a loan in its country of residence that is denominated in the currency of that country. That currency is weak relative to the dollar and the interest rate payable on the loan is high relative to the U.S.

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[34]For a slightly dated (soon to be updated) discussion of the section 1.882-5 regulations, see McIntyre, "U.S. Int'l Tax Rules," *supra* note 29 at Chapter 3/B2aii.

prevailing interest rate. F also takes out loans to finance its U.S. branch operations. If the taxpayer used the asset method, the interest paid by the taxpayer would be added up and allocated pro rata among all of F's assets. The result would be that some portion of the high-rate foreign interest would be allocated to U.S. operations, resulting in an understatement of U.S.-source income.

Exactly the opposite problem would arise if F's foreign loans were denominated in a currency that was strong relative to the dollar. In that situation, the foreign interest rate would typically be below the prevailing U.S. rate. The asset method would allocate a portion of the foreign interest to F's U.S. operations and a part of the U.S. interest to foreign operations. As a result, the U.S. interest deduction would an understated, and U.S. income would be overstated.

To deal with the problem illustrated by *Example #6*, section 1.882-5 generally requires foreign taxpayers to determine the amount of their liabilities attributable to the United States, using prescribed formulas. Interest payable with respect to those liabilities is allowable as a deduction against U.S.-source income. The amount of the interest deduction is also determined in part by formulas. The liabilities are divided into two pools – liabilities denominated in U.S. dollars and liabilities denominated in foreign currency. The interest attributable to liabilities in the first pool is determined by using the average of the U.S. interest rate paid by the taxpayer. A comparable rule is applied to determine the interest rate applicable to the other pool.

California presumably incorporates the interest allocation rules of section 1.882-5 by reference when it uses federal taxable income as the starting point in determining the income of foreign corporations engaged in business in California. Despite their enormous complexity, the section 1.882-5 rules are workable and are actually relatively simple in comparison to the complex set of international loan transactions that they are designed to accommodate.

The need for the section 1.882-5 rules illustrates the folly of writing into the Constitution the simple-minded direct tracing rule being promoted by the taxpayer in *Hunt-Wesson.* A tax system cannot accommodate itself to the complex world of international finance unless the policymakers retain the flexibility to design interest-deduction rules that are responsive to that complex environment.

E. Limitations on Interest Linked to the Purchase Of Consumption Goods or Capital Assets

The landmark 1986 Tax Reform Act introduced and rationalized various limitations on the deductibility of interest payments by individuals and certain passthrough entities.[35] Internal Revenue Code section 163(h) provides, with one gargantuan exception, that interest is not deductible with respect to loans used to finance personal consumption. The exception is for loans linked to the individual's personal residence. To facilitate tracing, the statute provides that interest on a loan will be presumed to be nondeductible personal consumption interest unless the taxpayer can demonstrate that the proceeds of the loan were used for some other purpose.

The 1986 tax act also refined the rules governing interest paid on loans linked to the acquisition of certain capital assets. Section 163(d) provides, in effect, that interest paid on loans used to acquire stock, bonds, and similar investment assets are capital costs that must be recovered only when the acquired assets produce taxable gross income. Instead of requiring tracing to each capital asset, however, that section allows for a pooling of investment assets. As a result, if the taxpayer uses borrowed money to acquire a share of stock on which little or no dividends are paid, then the taxpayer will be allowed a deduction for little or no interest. If the taxpayer acquired several investment assets, however, the limitation on the interest deduction becomes a function of the total investment income generated by those assets. As is appropriate for a capitalization rule, section 163(d) provides that the interest it disallows can be carried forward to future years.

A structurally similar set of rules applies to the acquisition of certain passive investment assets. These rules are contained, implicitly, in section 469, which limits the deductibility of losses associated with passive activities. Interest is limited under that section to the extent that it contributes to the creation of a passive activity loss. Section 469 is part of the Internal Revenue Code's general attack on tax shelter abuses – a central feature of the 1986 tax act. In most cases, the problem of tracing the proceeds of a loan to a tax-shelter investment is trivial in that most such loans are purchase-money loans explicitly tied by the loan agreement to the acquisition of a particular asset.[36]

The tracing rules described above have a permissive element to them. That is, the taxpayer can maximize its allowable interest deductions in many cases by using debt-financed capital for business expenditures and equity

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[35]A tracing theory that provides a justification for the general approach adopted by Congress in 1986 is set forth in detail in McIntyre, "An Inquiry," *supra* note 27. For my assessment of the treatment of interest under the 1986 tax act, see McIntyre, "Critique," *supra* note 7.

[36]In the typical tax shelter, the asset was purchased for an inflated price so as to maximize depreciation deductions. The tax-shelter "investor" was willing to overpay for the asset because he paid with a nonrecourse note that he never intended to honor. Without the linkage between the asset and the loan obligation, the "investor" would not be willing to participate in the shelter.

capital for personal consumption expenditures. Given the function of the interest tracing rules, however, the permissive feature seems to me to be appropriate. It certainly is consistent with the tax treatment of expenditures other than interest, as the following example illustrates.

> *Example* #7. P, an individual, has need of two trailers, one for personal camping in the woods and one for use as a business office. He purchases one of the trailers and borrows the other one from his brother-in-law. If he uses the purchased trailer in his business, he will get a deduction for depreciation, whereas if he uses the purchased trailer for camping, he will not get that deduction. The treatment of interest under the 1986 tax act is comparable. If P uses borrowed money to buy the trailer and uses the trailer for business, he will get his interest deduction. If he uses the purchased trailer for camping, however, he loses the interest deduction. The symmetry is complete.[37]

Although the physical tracing rules described above serve a function that is clearly distinct from the function of California's interest-offset rule, they are probably the closest federal analogue for the type of interest-allocation rules that the taxpayer in *Hunt-Wesson* would want the Court to enshrine in the U.S. Constitution. Even these permissive tracing rules, however, would be suspect under the constitutional theory advanced by the taxpayer in that case, for they would operate, in practice, to disadvantage nondomiciliary companies relative to domiciliary companies.

A key to the administration of physical tracing rules is to make the least-favored category of interest the residual category. Under the federal rules, the least-favored category is consumption interest. Interest that the taxpayer cannot directly trace to some other categories is treated as consumption interest. Without that residual rule, the tracing rules are unworkable, for the taxpayer, not the government, is in possession of the information needed to justify a more favorable result. If California were to apply an analogous system for allocating interest deductions between business and nonbusiness income, the residual category would have to be interest paid to acquire nonbusiness assets – that is, assets generating nonbusiness income. Making tax-exempt nonbusiness income the residual category, however, would disadvantage nondomiciliary companies relative to domiciliary companies in exactly the same way as California's interest-offset rule. That is, nondomiciliary companies would be more likely to lose a tax benefit under the residual rule than domiciliary companies because nondomiciliary companies are able to earn tax-free nonbusiness income and domiciliary companies are not.

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[37]I have elaborated in some detail the case for permissive tracing in McIntyre, "An Inquiry," *supra* note 27. That case is made in the context of characterizing interest payments as a capital, current, or personal expense in an ideal income tax that applies to the taxpayer's global income. As discussed in the text, permissive tracing is decidedly inappropriate in the design of source of deduction rules.

The permissive tracing rules adopted for individuals in the 1986 tax act do not provide an appropriate model for the federal government or the states in designing source rules. The interest-allocation rules described above are income-measurement rules. Their function is to specify whether an expenditure for interest is a capital, current, or personal expense. The income-allocation rules at issue in *Hunt-Wesson* are source rules. California is not questioning the legitimacy of the taxpayer's deduction in computing its worldwide income. Its interest-offset rule is intended to determine whether the admittedly-allowable deduction should offset business income or non-business income.

In the design of source rules, a permissive tracing rule is decidedly inappropriate. The proper function of a source rule – whether it is a gross-income rule or a deduction rule – is to link items of net income with particular taxing jurisdictions. The design of those rules may be constrained by certain legal rules, such as the U.S. Constitution or an applicable international agreement, or by prudential concerns for comity with other taxing jurisdictions. Properly designed source rules, however, should not give private parties the power to determine for themselves the reach of the sovereign's tax jurisdiction.[38]

F. Concluding Notes on the Federal Use Of Interest-Allocation Formulas

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.[39] An understanding of the federal rules is helpful, nevertheless, in evaluating the merits of the taxpayer's attack on the California rule in *Hunt-Wesson*, for at least three reasons.

First, the federal experience illustrates that there is no single best method for allocating interest expenses. A particular rule must be evaluated in terms of the purpose it is expected to serve. Section 265(a)(2) of the Internal Revenue Code is a bad rule for stopping tax arbitrage because it allows taxpayers to determine for themselves, in many cases, when the rule will

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[38]A taxpayer faced with a set of source rules can decide whether it wants to allow itself to be captured by a sovereign's tax web. Hunt-Wesson, for example, is free to avoid the reach of California's interest-offset rule by declining to engage in tax arbitrage.

[39]In principle, taxpayers disadvantaged by the federal interest-allocation rules might mount a challenge on equal protection or due process grounds, but that has not happened and is not likely to happen, for such a challenge has little or no chance of success.

apply. California's interest-offset rule is a good anti-arbitrage rule because it takes that control away from the taxpayer and places it in the hand of the sovereign, where it belongs. The allocation rules under Treasury Regulation section 1.861-8 are reasonably good allocation rules for exactly the same reason. The permissive allocation rules under Internal Revenue Code section 163(d) and (h), which give taxpayers some choice about whether interest is characterized as personal, current, or capital, are proper in context because the tax system generally allows taxpayers that choice in analogous circumstances. Except by mistake, however, taxpayers are not given a choice under the federal interest-allocation rules when the purpose of the rules is to prevent tax avoidance or to protect U.S.-source jurisdiction.

Second, a government cannot be limited to a small set of acceptable interest-allocation rules if it is to achieve its tax policy goals. The federal government uses at least five different rules, and there are variations within those rules. For example, the federal government uses a strict-stacking rule as an exception to the pro rata allocation rule of Treasury Regulation section 1.861-8 when such a rule is needed to prevent tax avoidance. A general theory about how allocation should be done – pro rata to assets in the case of the section 1.861-8 rules – must give way when it is found to facilitate tax avoidance. In some cases, it is necessary to apply more than one set of rules. Domestic companies, for example, are subject to the asset method of Treasury Regulation section 1.861-8, the allocation rule of Internal Revenue Code section 265(a)(2), and the income-stripping rules of Internal Revenue Code section 163(j). Foreign companies operating in the United States are subject to the hybrid system of Treasury Regulation section 1.882-5 and the section 265(a)(2) rules.

Third, the government must be able to respond flexibly to taxpayer efforts to avoid the rules. No one sat down one sunny afternoon and wrote Treasury Regulation section 1.861-8 or Treasury Regulation section 1.882-5. Each of those regulations is dozens of pages long, with a multitude of exceptions, special rules, and other filigree. Many of these detailed rules were written piecemeal, in response to taxpayer attacks. Many companies stand to gain many millions of dollars from avoiding the federal government's interest-allocation rules. Consequently, they are willing to pay some very clever people large sums of money to formulate ways to avoid the bite of those rules. In this environment, loopholes in the rules are inevitable. If the government does not respond quickly to plug those loopholes, it will soon find that large numbers of taxpayers are exploiting them.[40] At some point, as happened with the flawed allocation rules under Internal Revenue Code

[40]If an arena with 10 doors is filled with mice, and the cat is allowed to guard doors two through 10, the traffic at door one will be heavy.

section 265(a)(2), the loopholes become so well entrenched that the government loses the political power to close them.

IV. Commerce-Clause Challenge to California's Interest-Offset Rule

In enacting its interest-offset rule to combat tax arbitrage, California has not engaged in conduct that is proscribed by existing constitutional doctrines. The taxpayer in *Hunt-Wesson* cannot deny that it is engaged in tax arbitrage. What is required for tax arbitrage to occur with respect to a particular tax jurisdiction is an outstanding debt obligation on which interest payments are being made and a flow of gross income that is not taxable in the tax jurisdiction. That both elements are present in *Hunt-Wesson* is plain on the record. What the taxpayer in *Hunt-Wesson* is apparently contending is that California should be rendered helpless in combating tax arbitrage whenever the gross income that it is receiving free of tax is protected from taxation by the Court's pronouncements on nonbusiness income. The problem for the taxpayer is that it cannot find any constitutional peg on which to hang this novel doctrine.

I have argued in section II, above, that the arguments advance by the taxpayer in *Hunt-Wesson* under the Due Process Clause and Equal Protection Clause are makeweights.[41] In section IV, A, below, I analyze the claim in *Hunt-Wesson* that California's interest-allocation rules discriminate against interstate commerce in violation of the negative Commerce Clause. I show that this claim is unpersuasive. In section IV,B, below, I suggest how the Court might refine the concept of nonbusiness income to prevent taxpayers from using the exemption for nonbusiness income as a mechanism for avoiding taxation on their business income.

A. California's Interest-Offset Rule as a Permissible Limitation on Tax Arbitrage

In theory, California's interest-offset rule could violate the nondiscrimination prong of the Commerce Clause by discriminating in favor of local taxpayers or by impeding the free-flow of commerce. The taxpayer apparently does not allege a violation of the second type. In any event, California's interest-offset rule, by preventing tax arbitrage, promotes the Commerce Clause ideal of a level economic playing field. Commerce Clause values

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[41]The taxpayer in *Hunt-Wesson* contends that the interest-offset rule also violates the nexus requirements of the Commerce Clause. The taxpayer does not argue that due process nexus and Commerce Clause nexus are different under the facts of this case. I have addressed the due process issue fully in section II.

obviously are not advanced when taxpayers are encouraged by tax rules to chase around after tax-shelter opportunities instead of tending to their core businesses.

The California rule also is free from any discrimination in favor of local players. In the context of *Hunt-Wesson*, the question is whether the California rule discriminates against interstate commerce by favoring domiciliary companies over nondomiciliary companies. On its face, the California statute does not discriminate. All companies, wherever domiciled, are subject to the interest-offset rule. The taxpayer's claim in *Hunt-Wesson* is that the California rule discriminates in effect because it adversely affects nondomiciliary taxpayers and does not adversely affect domiciliary taxpayers. That difference in impact, however, is due entirely to the fact that California taxes domiciliary companies on their nonbusiness income and exempts nondomiciliary companies on that income. The net result of the exemption and the interest-offset rule is that nondomiciliary companies are always treated as well as – or better than – domiciliary companies.

The taxpayer's claim of unequal treatment is a repackaged version of the equal protection argument that it made in the California courts and has now abandoned. As illustrated in *Example #4,* above, nondomiciliary companies receive fair and nondiscriminatory treatment by California. Whatever disadvantage a nondomiciliary company suffers relative to a domiciliary company by having its interest deduction allocated to nonbusiness income is exactly offset by the exemption from tax that California affords to nonbusiness income.

Of course, the taxpayer in *Hunt-Wesson* understands that it is at least as well off being taxed as a nondomiciliary rather than as a domiciliary. Its core complaint is not that it is being treated worse than domiciliary companies but that it is not receiving the *more favorable* treatment it believes it is entitled to receive under the Court's formulation of the nonbusiness concept in *Allied-Signal.* The negative Commerce Clause, however, does not protect taxpayers from the antiavoidance rules of the states as long as those rules do not discriminate against interstate commerce or otherwise violate the Constitution.

Example #1, above, illustrates the three main steps that are involved in determining how interest deductions are allocated under California law. Each of those steps has a strong policy justification, and none of them discriminates against interstate commerce.

In *step one* of the California interest-allocation method, the taxpayer matches its business interest income against an equal amount of interest expense.[42] If the taxpayer's interest income exactly equals its interest expense, then the taxpayer is treated, in effect, as if it has not borrowed any money and had not lent out any money. This reduction of apportionable business interest income by a matching amount of interest expense is more favorable, in its effects, to nondomiciliary companies than to domiciliary companies. Domiciliary companies would prefer to use their interest deduction to offset their nonbusiness income, which is taxable without apportionment.

The matching of business interest income with an equivalent amount of interest expense makes good economic sense because a taxpayer that is both a borrower and lender in form is really neither in substance. That is, a company that borrows $1 million and lends out $1 million is not comparable to an investor or to a debtor. It is more like a company that made no loan and borrowed no money.

California's matching rule is similar in theory and effect to the matching rule applied by the federal government to offsetting option transactions. Assume, for example, that C has an option to buy 10 bushels of corn on October 1 at $5 a bushel and also a commitment to sell corn on or about the same date at around the same price. It is now commonplace for the federal government to treat these two transactions as a wash for tax purposes.[43] From an economic perspective, it is equally appropriate for California to treat a borrowing transaction and an offsetting lending transaction as a wash for purposes of its interest-allocation rules.

In some cases, a taxpayer may obtain some benefit or detriment unrelated to taxation, such as increased or reduced liquidity, from being a lender and a borrower simultaneously. Whatever that benefit or detriment, however, it is quite distinct from the benefits and detriments usually associated with being either a lender or a borrower. California's matching rule is justified, therefore, whether or not the taxpayer can conjure some the business reasons for being both a borrower and a lender.

The *second step* under California's interest-allocation method – the interest-offset rule – is to match the taxpayer's interest expense not allocated under step one with the sum of the taxpayer's nonbusiness interest income and nonbusiness dividend income. The matching of a taxpayer's nonbusiness interest income with an equivalent amount of interest expense is justified

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[42]Of course, if the taxpayer's interest expense is less than its interest income, then step one becomes the final step. In *Hunt-Wesson*, the taxpayer had interest expense substantially in excess of its interest income.

[43]See, e.g., Internal Revenue Code section 1092 (Straddles).

under the rationale offered above for matching business interest income with an offsetting amount of interest expense. The matching of interest expense with nonbusiness dividends is similarly justified because, for most if not all companies, nonbusiness dividends are the functional equivalent of interest income.

Federal tax laws have traditionally treated preferred stock as an equity investment rather than as debt. At some time in the past, that sharp distinction between preferred stock and debt may have made a limited amount of sense. The distinction makes no sense today. Any tax planner worth his or her million-dollar bonus can write an investment document having the label "preferred stock" and an exactly equivalent investment document having the label "debt." Analysts have long recognized the existence of a continuum, with genuine debt at one end and genuine equity at the other. It was once reasonable to assume that a financial instrument labeled "preferred stock" was toward the equity end of that continuum and an instrument labeled "debt" was toward the other end of that continuum. The alchemists in the financial securities business, however, have eliminated the significance of these labels. Preferred stock is now whatever the investor wants it to be.

Many tax jurisdictions have not responded to the labeling practices of the financial securities business. California, with its interest-offset rule, is an exception.

One reason that tax planners are enamored of preferred stock is that it can serve as a hybrid instrument. An example of a hybrid instrument is a financial instrument that is treated as equity by one tax jurisdiction and as debt by another. One of the common advantages of hybrid instruments is illustrated in *Example #8*.

> *Example #8*. P is a company engaged in business in State A. It has a subsidiary, S, domiciled in State B. P transfers a financial instrument to S that obligates it to make periodical payments to S. P convinces the tax authorities in State A to treat the instrument as debt. As a result, the payments from P to S are deductible in computing P's taxable income in State A. S convinces the tax authorities in State B to treat the instrument as preferred stock. The payments it receives from P are then exempt from tax under State B's rules exempting intercompany dividends from tax.

According to the theory of the fungibility of investment capital that the federal government has embraced in designing the interest-allocation rules contained in Treasury Regulation section 1.861-8, California should apply its interest-offset rule not only to nonbusiness interest income and dividends but also to royalty income and other types of nonbusiness income. California has shown restraint, however, by limiting the interest-offset rule to the situations offering the most obvious opportunities for tax arbitrage.

The *third step* under California's interest-allocation method is to allocate interest expense payments between business and nonbusiness income, which were not allocated in the first two steps, using more traditional methods. In *Hunt-Wesson*, all of the interest payments allocated in step three offset business income.

In granting *certiorari* in *Hunt-Wesson*, the Court almost certainly was concerned that California may have violated the negative Commerce Clause by discriminating against interstate commerce. As presented by the lower court in California, the interest-allocation formula applied by California in *Hunt-Wesson* might appear to be an overly aggressive exercise of tax jurisdiction – a reach by California to tax extraterritorial values. In fact, however, the exact opposite is the case. The interest-offset rule is an attempt by California to prevent taxpayers from exploiting the constitutional exemption for nonbusiness income to defeat California's legitimate right to tax business income over which it unquestionably has nexus to tax.

B. Beyond *Hunt-Wesson*

The traditional view of state taxation has been that the source states – the states in which business activities are actually conducted – have primary jurisdiction to tax the income of an enterprise. The domiciliary state has overlapping jurisdiction to tax a company, but that right to tax is a secondary or residual right. This schema corresponds to the way that jurisdiction to tax is allocated by custom and by international tax treaties among national states. The source countries are allowed to tax nonresident companies on whatever income arises within their borders; residence states are allowed to tax their resident companies on their worldwide income, but they have the responsibility for providing appropriate relief from the double-taxation that otherwise would occur from the overlap of source and residence taxation.[44]

Latching on to certain phrases in the Court's decision in *Allied-Signal*, many tax planners have pushed for a more expansive concept of domiciliary taxation. Their position, reflected in the litigating position taken by the taxpayer in *Hunt-Wesson*, is that source taxation and domiciliary taxation are on an equal footing. The upshot is that if source taxation can be seen as intruding on domiciliary taxation, then it must yield.

Tax planners are not seeking to expand the concept of domiciliary taxation because their client companies would rather pay taxes to domiciliary states than to source states. The goal is to minimize the total taxes paid by

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[44]For a general discussion of the international pattern of taxation and the methods of double-taxation relief, see Chapter 2 of Brian J. Arnold & Michael J. McIntyre, INTERNATIONAL TAX PRIMER, Kluwer Law International (1995).

the client companies. Advancing the position of the domiciliary states at the expense of the source states makes tax avoidance easier because most domiciliary states do not tax at least some forms of nonbusiness income. It is quite rare, for example, for a domiciliary state to impose a full tax on dividends paid with respect to nonbusiness preferred stock.

The Court could strike a major blow for sound tax policy by making clear in its decision in *Hunt-Wesson* that it did not intend in *Allied-Signal* to encourage the growth of tax havens that has occurred in response to that decision. Nothing in *Allied-Signal* suggests that the Court was attempting to carve out some category of income – nonbusiness income – that would enjoy a general exemption from taxation. It was simply applying to some stylized facts the well-established principles of nexus. Indeed, the Court was respectful of the concept of nonbusiness income promoted by the Multistate Tax Commission and endorsed by many states, including California, that "nonbusiness income" is a residual, defined, in the terms of the Uniform Division of Income for Tax Purposes Act (UDITPA), as "all income other than business income."[45]

The relative status of source taxation and domiciliary taxation does not matter when those jurisdictional claims do not overlap. For example, if a taxpayer earns business income in State A and derives nonbusiness income in State B, then State A clearly is entitled to tax the business income and State B is clearly entitled to tax the nonbusiness income. The relative status of the jurisdictional claims matters, however, when both the source state and the domiciliary state have jurisdiction to tax. In that case, an equal-status rule would require some apportionment between the source state and the domiciliary state. Apportionment would not be required, however, if the source state has the primary right to tax. This point is illustrated by *Example #9*.

> *Example #9*. T, domiciled in State A, is engaged in a unitary business in State B. T also holds preferred stock in a foreign corporation that has no nexus either with State A or State B. The preferred stock is valued at $2 million and generates $100,000 in annual dividends. T goes to a bank in State B and borrows $2 million, using the preferred stock as collateral for the loan. The proceeds of the loan are used in T's business. The preferred stock has the character of a business asset in that it supports a loan that is used in T's business. It has the character of a nonbusiness asset in that it is not itself used directly in T's business.
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> Under these facts, State A should have the primary right to tax T on its income, with State B having only a residual right to tax. State A might exercise its primary right to tax by characterizing the preferred stock as a business asset, on the ground that the stock was used as collateral to support business activities within the state. Alternatively, State A might exercise its primary right to tax by denying T a deduction for the interest payments on the ground that those pay-

[45]Uniform Division of Income for Tax Purposes Act, section 1(e).

ments were a cost of acquiring or holding a nonbusiness asset. As a practical matter, the approach taken by State A might depend on the filing position taken by T with respect to the character of the preferred stock.

The point of *Example #9* is not that State A should be permitted to avoid or sidestep any limitations to tax imposed by the Due Process Clause or the negative Commerce Clause. It should not be permitted to tax income of a nondomiciliary company unless it has nexus over that income, and any tax it does impose also must satisfy the nondiscrimination prong of the negative Commerce Clause. The point of the example is that source states should not be required to apportion income over which they have nexus between the states where the income arose and the domiciliary state. Apportionment is proper when the taxing states both have a primary right to tax. When one state has the primary right and the other has the secondary right, the latter state should yield to the former.

The Court does not need to address the question of primary and secondary jurisdiction to tax in order to resolve the issues presented in *Hunt-Wesson.* To resolve those issues, it is enough for the Court to hold that states have the right to adopt reasonable rules against tax arbitrage as long as those rules do not discriminate against interstate commerce. Still, it would be nice if the Court would strike a blow against tax-haven abuses by reaffirming the traditional view that a state's jurisdiction to tax based on source takes priority over a state's jurisdiction based on the commercial domicile of the taxpayer.

V. Conclusion

In *Moorman,*[46] the U.S. Supreme Court upheld what was then an odd-ball apportionment formula that Iowa had adopted for determining its share of the unitary income of corporations engaged in business in that state. Under that formula, the income of a unitary business was apportioned solely with respect to the taxpayer's receipts from sales made within and without Iowa. By endorsing this formula, the Court undercut the efforts of many states, including California, to promote for general use the three-factor formula that had previously been endorsed by the Court and was being promoted effectively by the Multistate Tax Commission.

The Court obviously understood that its decision in *Moorman* was undercutting the movement for uniform state laws.[47] It concluded, nevertheless,

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[46]*Moorman Manufacturing Co. v. Bair, Director of Revenue of Iowa,* 437 U.S. 267 (1978).

[47]The states are now under enormous pressure to fashion apportionment rules that favor special interests. Those pressures are orchestrated by the international accounting firms, which have made state tax avoidance a major profit center.

that is simply did not have the constitutional authority to remove all risks of "duplicative taxation." "The prevention of duplicative taxation," the Court stated, "would require national uniform rules for the division of income." The Constitution, however, "is neutral with respect to the content of any uniform rule."

The simple question for the Court in *Hunt-Wesson* is whether California should be free to adopt facially-neutral interest-deduction rules designed to combat tax arbitrage. The simple answer is "yes." The complex answer, which the Court must pursue if it decides for the taxpayer in *Hunt-Wesson*, is that taxpayers have a constitutional right to pursue at least some forms of tax arbitrage. To give that complex answer, the Court must abandon the restraint exhibited in *Moorman* and take on the task of drafting for the states a uniform set of rules governing the allocation of deductions. The very first item on its agenda will be the drafting of rules governing the allocation of interest payments. I would hope the Court will look hard before it leaps into that particular quagmire.

Hunt-Wesson is an important case, conceptually and practically. Tax arbitrage is everywhere, and it is growing. If California cannot employ the only known technique for combating tax arbitrage effectively, then the states are left defenseless against onslaughts from the tax-avoidance industry.