HUNT-WESSON (RUMBLE IN THE JUNGLE)

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I. Summary of Hunt-Wesson, Inc. v. Franchise Tax Board of California

A. What the case was about.

Hunt-Wesson is a corporation incorporated in Delaware and domiciled in Illinois. Hunt-Wesson was a diversified food company producing a wide range of food and food-related products and services for worldwide markets. It is engaged in business both in California and throughout the world.

During fiscal years ended 1980 through 1982, Hunt-Wesson received income in the form of interest from its unitary business operations in the amounts of approximately $10 million, $21 million and $83 million, respectively. During these same years, Hunt-Wesson incurred interest expense from loans in the approximate amounts of $80 million, $55 million and $137 million. Thus, during the three years in question Hunt-Wesson incurred business interest expense in excess of its business interest income in the amounts of $70 million, $34 million and $57 million, respectively.

Hunt-Wesson owned a number of dividend-paying subsidiaries, which were not members of its unitary business. These subsidiaries paid dividends to Hunt-Wesson during the three years in issue in the amounts of approximately $27 million, $29 million and $19 million, respectively. Hunt-Wesson reported all these dividends on its California franchise tax returns as nonbusiness income not subject to California franchise tax. None of the interest expense incurred was reported by Hunt-Wesson as assignable to this $75 million of nonbusiness dividend income. Rather, Hunt-Wesson claimed that the entire amount of the approximately $273 million of interest expense incurred during the years in issue was attributable to, and fully deductible against, its apportionable business income.

On audit, the California Franchise Tax Board allowed Hunt-Wesson to deduct approximately $198 million of the approximately $273 million of interest expense against its apportionable business income, and allocated approximately $75 million of interest expense to the nonbusiness dividend income not subject to tax in California. This allocation was done under the authority of the California interest offset provision.
The computation of Hunt-Wesson’s approximate $198 million allowable interest expense deduction under the interest offset provision was done by taking the sum of the amount of interest expense equal to its business interest income (approximately $114 million), plus the amount by which the remaining interest expense exceeded its nonbusiness dividend income ($84 million - $114 million less $75 million). The balance, $75 million was attributed to and offset by the amount of Hunt-Wesson’s nonbusiness dividend income.

As a result of this audit adjustment, a proposed deficiency assessment was issued to Hunt-Wesson. Hunt-Wesson paid the proposed deficiencies and filed an administrative claim for refund with the California franchise Tax Board. The claim for refund was denied.

Hunt-Wesson filed a refund suit in the California Superior Court. In its complaint, Hunt-Wesson challenged the constitutionality of the interest offset provision (Revenue and Taxation Code section 24344(b)) on the grounds that it violated the Due Process Clause, Commerce Clause and Equal Protection Clause of the Federal Constitution. After trial, judgment was entered in favor of Hunt-Wesson on several grounds. First, although acknowledging that the U.S. Supreme Court has historically paired income and expenses so that a taxpayer should not be permitted to deduct expenses related to generating income exempt from taxation, the superior court found a due process violation because the statute attributed interest expense to non-taxable dividend income without regard to whether such interest was related to the dividend income. Second, because Hunt-Wesson’s nonbusiness dividend income was taxable only by Illinois, its state of domicile, the superior court found the statute operated impermissibly to tax a foreign corporation more than a similarly situated domestic corporation, thus interfering with interstate commerce. Last, the superior court found the statute applied unequally to domestic and foreign corporations, thus violating the equal protection clause. The Franchise Tax Board appealed the trial court decision.

On appeal, and relying in large part on the California Supreme Court decision in Pacific Tel. & Tel. Co. v. Franchise Tax Bd., 7 Cal3d 544, 498 P.2dd 1030 (1972), the California Court of Appeal ruled that the interest offset provision was constitutional and reversed the lower court’s decision. The appellate court first acknowledged the interest offset theory that a corporation should not be able to borrow money to purchase nonbusiness stocks that pay dividends, then get a
deduction for the interest expense related to income not subject to tax in California. Consistent with this theory, the court of appeal observed the Pacific Telephone case had decided that the California Legislature has acted reasonably in treating interest expense as the opposite of dividend income, and by requiring the offset of one against the other. By force of Pacific Telephone, the appellate court found in the favor of the Franchise Tax Board on the basis that a tax loophole would be created to the extent that interest expense deductions could result from money borrowed to generate tax-exempt income.

The appellate court rejected Hunt-Wesson's contention that the interest offset statute operated to tax indirectly income not subject to California franchise taxation, relying on the finding in Pacific Telephone that inclusion of non-taxable dividends in the statutory computation did not constitute taxation of the dividends themselves. Hunt-Wesson's claim that the interest offset statute facially discriminated against interstate commerce was also rejected, looking to the holding in Pacific Telephone that the interest offset statute does not operate to impose a tax on tax exempt income.

The appellate court also distinguished several of the U.S. Supreme Court's decisions dealing with facially discriminatory statutes, including Fulton Corp. v. Faulkner, 516 U.S. 325 (1996), in which that court invalidated North Carolina's intangibles tax.

The appellate court rejected Hunt-Wesson's claim that the interest offset provision discriminated by parenthetically omitting from the interest offset computation dividends declared from income already taxed to the payor by California. As the state had already taxed the dividends once, no constitutional discrimination resulted from California's efforts to refrain from taxing the dividends a second time. In contrast to Fulton, the deductible dividend exclusion in the interest offset provision did not waive an otherwise uniform intangibles tax based entirely on the percentage of the underlying corporate income taxed by the state. Rather, the interest offset provision operated as part of an overall apportionment scheme, matching expenses with income in a manner that the California Supreme Court had determined to be reasonable.

Finally, Hunt-Wesson's equal protection claim was rejected. The court of appeal determined that the interest offset provision did not create an arbitrary classification based on domicile, but rather was rationally related to California's need to address a tax loophole. Hunt-Wesson sought review of the California Court of Appeal's decision.
On March 24, 1999, the California Supreme Court denied Hunt-Wesson's petition for review. Hunt-Wesson proceeded on writ of certiorari to the United States Supreme Court. The United States Supreme Court granted review.

B. What the court did.

The United States Supreme Court decided that the California interest offset provision violated the Federal Constitution's Due Process and Commerce Clauses, thereby reversing the California Court of Appeal.

The Court began its opinion by generally discussing the concepts of unity, formula apportionment and business and nonbusiness income. It then went into a discussion of how net income is determined, including the deduction for interest expense, and focused on the limitation at issue contained in the interest offset provision (i.e., interest deductible shall be the amount by which interest expense exceeds interest and dividend income not subject to allocation by formula).

The Court then focused on the issue before it: Does the Constitution permit California to carve out an exception to its interest expense deduction, which it measures by the amount of nonunitary dividend and interest income that the nondomiciliary corporation has received?

The court began its analysis by stating that the California interest offset provision violates the Due Process and Commerce Clauses of the Federal Constitution based on relevant precedent such as Container Corp. of America v. Franchise Tax Bd., 463 U.S. 159 (1983), Exxon Corp. v. Department of Revenue of Wis., 447 U.S. 207 (1980), Mobil Oil Corp. v. Commissioner of Taxes of Vt., 445 U.S. 425 (1980) and Allied-Signal, Inc. v. Director, Div. Of Taxation, 504 U.S. 786 (1992). The Due Process and Commerce Clauses do not allow a State to tax income arising out of interstate activities – even on a proportional basis – unless there is a “minimal connection” or “nexus” between the interstate activities and the taxing state, and “a rational relationship between the income attributed to the State and the intrastate values of the enterprise.” The parties had conceded the nonbusiness income in question did not bear a “rational relationship” or “nexus” to California. The nonbusiness income could not constitutionally be taxed by a State other than the corporation’s commercial domicile, unless there was some other connection between the taxing state and the income.
The Court continued by concluding the interest deduction limitation contained in the interest offset provision seemed to amount to an impermissible tax. Essentially, the Court reasoned that the provision increases the business income of a taxpayer through the reduction of its interest expense deduction in an amount precisely equal to the amount of nonbusiness interest and dividend income. Although not a direct tax on nonbusiness income, the interest offset provision resulted in an indirect tax of income that did not bear a rational relationship or nexus to California.

The Court went on to examine the justification offered by the State for its position on the propriety of attributing interest expense to nonbusiness income. The state argued that money is fungible and that is difficult to identify the purpose of any particular borrowing, whether it was for a unitary or non-unitary investment purpose. The concern was that a corporation could borrow on the assets of unitary business, use the funds to invest in nonbusiness investments generating nontaxable income, and secure an interest deduction against business income. The state argued this “tax arbitrage” problem is why the U.S. Supreme Court upheld the precursor of 26 U.S.C. section 265(a)(2) which denies an interest deduction insofar as the interest expense was incurred or continued to purchase or carry tax-exempt obligations or securities. The U.S. Supreme Court had consistently upheld deduction denials that represent reasonable efforts to properly attribute a deduction between taxable and tax-exempt income, even though such denials meant that a taxpayer would owe more tax than would be owed without the denial.

The Court commented that if the state could show that its deduction limitation actually reflected the portion of expense properly related to nonbusiness income, the limitation would not be a tax on nonbusiness income – it would instead be a proper allocation of a deduction. The problem was that the deduction limitation pushed this proper allocation concept beyond reasonable bounds. The assumption that borrowings were made and interest expense incurred for nonbusiness purposes, to the extent that nonbusiness interest and dividends were produced, was unrealistic. This lack of practical realism, the court stated, helps explain why the California rule went too far and, citing Container, failed to actually reflect a reasonable sense of how income was generated resulting in taxing constitutionally protected income.

The Court noted that no other taxing jurisdiction has taken so absolute an approach to the tax arbitrage problem that the state presented. Comparatively speaking, the federal rules are much more
reasonable. One set of rules allocates interest expense between domestic and foreign source income by using a ratio of assets and gross income to allocate a corporation's total interest expense. Another set of rules use a kind of modified tracing approach. Other states used one or the other, or a combination of both, to attribute interest expense between business and nonbusiness income. It was reasonable to expect that, over time, these approaches reflected approximately the amount of borrowings that firms have actually devoted to generating each type of income.

Because California's interest offset provision was not a reasonable allocation of expense deductions to the income that the expense generated, it constitutes impermissible taxation of income outside its jurisdictional reach, thus violating both the Due Process and Commerce Clauses of the Federal constitution.

II. Efforts to Address Interest Expense Assignment

A. Outcome of Symposium.

On May 19, 2000, a symposium was held in Sacramento to discuss proposed guidelines for handling interest offset issues following the Hunt-Wesson decision. Discussion points included basic principles such as enforcement of the statute itself, assignment of interest expense to nonbusiness income under the authority of Regulation section 25120 (d), assignment of interest on a group basis, direct tracing, and use of proportional methods such as assets or gross income. Discussion points also included how staff would treat current audit and protest inventory and claims.

Staff prepared a report on the symposium and that report was discussed at the July 5, 2000, three-member Franchise Tax Board meeting. Staff recommended that the interest offset statute – Revenue and Taxation Code, section 24344 (b) - be treated as invalidated in total. Staff further recommended that it rely on Regulation section 25120(d) to allocate interest expense between business and nonbusiness income. The methodology staff proposed to use would be a combination of direct tracing, asset ratio, and gross income ratio. Staff's proposal would give taxpayers an opportunity to present their own allocation, which staff would accept unless the department could show that the taxpayer's method was unreasonable. If it could be accomplished, staff preferred direct tracing; however, either an asset ratio or a gross income ratio could be used. Procedurally,
staff would not conduct re-audits solely on the interest offset issue. At the protest and appeal levels, the interest offset would not be an issue unless that taxpayer raises it, the business/nonbusiness classification of income is at issue, or the taxpayer raises new issues.

Other parties made written proposals to the Board which, generally, would either allow California domiciled corporations to continue to use the interest offset provision, or would allow taxpayers the option to use interest offset, direct tracing and/or ratio allocation.

The Board voted to put the matter over to its next scheduled meeting to allow it more time to reflect on the Hunt-Wesson decision.

B. Three-Member Board Direction

At its September 19, 2000 meeting, the issue of the treatment of interest offset as a result of the Hunt-Wesson decision was again before the Board. Staff and the California Taxpayers’ Association presented proposals for implementation of the Hunt-Wesson decision, including application of that decision to entities domiciled in California and other states. Four individuals testified in support of the Cal-Tax proposal. With one modification, the Board voted favorably towards the Cal-Tax proposal. However, the Board directed staff to draft an FTB Notice reflecting the meaning of its vote on the implementation of the Hunt-Wesson decision. As of the date of this writing, a draft FTB Notice has been prepared and forwarded for the Board’s customary review.