
By Daniel T. Schibley

The justices of the U.S. Supreme Court expressed skepticism about the constitutionality of the California franchise (income) tax interest offset provision during oral arguments on January 12, 2000, in Hunt-Wesson, Inc., Dkt. 98-2043. Many of the justices' questions focused on alternative, and less objectionable, methods available to California for determining the offset and on possible remedies in the event that it is invalidated.

The Background

Under California’s statutory interest offset provision, the deduction from California corporation franchise (income) tax for a corporation's interest expense in excess of its business interest income is reduced by the amount of its nonbusiness income not allocable to California. Hunt-Wesson had sought a refund in California state court on the theory that the interest offset provision violates the Commerce and Due Process Clauses of the U.S. Constitution by arbitrarily limiting Hunt-Wesson's interest expense deduction by the amount of constitutionally exempt dividend income it had received from its nonunitary subsidiaries.

The trial court held for Hunt-Wesson (San Francisco County Superior Court, No. 976628, June 6, 1997), but the California Court of Appeal, First Appellate District, (No. A079969, December 11, 1998) reversed on the basis that it was bound by California Supreme Court precedent holding that inclusion of nontaxable dividends in the statutory offset computation does not constitute prohibited taxation of the dividends themselves. The California Supreme Court denied Hunt-Wesson's request for review, and the U.S. Supreme Court agreed to hear the dispute.

The Argument for Hunt-Wesson

Arguing the case for Hunt-Wesson, Walter Hellerstein, University of Georgia, Athens, Georgia, maintained that with the offset provision, California was sweeping nontaxable income into the tax base, and that only California domiciliary corporations receive the full benefit of the interest expense deduction because domiciliaries can reduce their taxable income by interest expense deductions in the amount of dividends received from nonunitary corporations. He emphasized that there was no evidence that Hunt-Wesson's interest expense bore any relationship to its nonunitary dividends.

In response to a question by Justice David Souter, Hellerstein agreed that California could properly deny the exemption for nonbusiness interest expense that could be directly traced to the generation of nontaxable income; however, he stated that California makes no such attempt but reduces the deduction on a dollar-for-dollar basis. Responding to Justice Anthony Kennedy, Hellerstein said that a state could reasonably say, as California does, that money is fungible and, therefore, it would not be feasible to trace expenses to income. However, even accepting this, he argued that California should then do what the other states do and "spread it around" by reasonably apportioning the offset. Under the guise of saying that money is fungible, Hellerstein argued, California disproportionately assigns all nonbusiness income to California as an offset. He described the precision of California's approach as "like throwing darts at a dart board."

Several of the justices' questions to Hellerstein related to the appropriate remedy should they strike down California's scheme. Hellerstein stated that California has stipulated that Hunt-Wesson will get back the full amount of its disallowed deduction if it prevails, but that, in a letter to General Electric Co., California advised other companies to be prepared for an apportionment. He told Justice Kennedy that if California adopted a scheme involving a reasonable apportionment similar to that of other states, there would not be the windfall to taxpayers predicted by California if its scheme is invalidated. However, Hellerstein told Chief Justice William Rehnquist he was not suggesting that California would have to adopt a scheme identical to that of other states.
Justice Ruth Bader Ginsburg asked if there was a risk of a windfall if, for instance, Illinois, the state of Hunt-Wesson's domicile, gave it a tax break for nonbusiness income. Hellerstein replied that "Illinois is not a tax haven" and that for the years at issue, Illinois had a regulation allowing domestic corporations to apportion their income. Justice Antonin Scalia interjected that even if Illinois chose not to tax the income that would not be a windfall.

The Argument for California

Arguing for the California Franchise Tax Board (FTB), David Lew, Deputy California Attorney General, repeatedly asserted that the offset provision was California's attempt to eliminate the possibility of corporations receiving a double tax benefit by incurring deductible debt expense and using the debt to generate tax exempt income. Several justices, however, suggested that employing a dollar-for-dollar offset was an overly broad remedy for this risk. Justice Sandra Day O'Connor commented that California's allocation of 100% of the income "raises concerns of trying to tax extraterritorial income." Justice Souter said that, instead of adopting a proportional formula, California has adopted an irrebuttable presumption and that due process requires rationality rather than such a presumption. He went on to describe California's scheme as irrational and said that the state must either trace the income or do a rational apportionment. Justice Souter concluded by saying that California could not send a tax bill to everyone just because it could not otherwise be sure some taxpayer was not "getting away."

Justice Stephen Breyer commented that, except for those in the financial business, most companies do not have a great deal of business interest income. Therefore, under California's scheme, most companies will have interest expense in excess of interest income that would be subject to offset.

Lew said that, while no other state currently adopts California's method, he does not know that this is constitutionally relevant under the Court's internal consistency test. In response to Lew's statement that apportionment would not eliminate the possibility of nonbusiness income being generated from deductible expenses, Justice Scalia said that "it is none of California's business" if another state wants to grant a tax benefit to a company doing business in that state.

Justice O'Connor repeated the observation that California was acting as though all interest expense was used to generate nonbusiness income, which was not the case here she said. She also noted that she had yet to hear a convincing reason for California's failure to apportion. Justice Ginsburg stated that the Internal Revenue Code (IRC) provides for a dollar-for-dollar offset in certain circumstances involving the foreign tax credit and that if it was rational for the federal government to do so, it might be rational for California to do so.

Lew characterized California's approach as an assignment rule, rather than a tracing or allocation rule, and he mentioned the difficulties in trying to trace expenses to income. Justice John Paul Stevens asked if California could not have the taxpayer assume the burden of persuading the FTB on the use of the debt generating its interest expense. Lew replied that it would be extremely difficult to administer such a test and that California's existing regime avoids trying to ascertain a company's motive.

In conclusion, responding to a question from Justice Ginsburg, Lew said that if California is ordered to make an effort to apportion it can do so pursuant to existing California regulatory authority without the enactment of a new statute.

Concluding Matters

In a brief reply argument, Hellerstein characterized the IRC provision Justice Ginsburg mentioned as a "finessely tuned netting rule" distinguishable from California's offset provision. He also reemphasized what he described as the disproportionate allocation produced by the California provision, and said that, even if California's method is internally consistent as Lew argued, that does not make it constitutional.

Amicus briefs were filed in support of the FTB by the Multistate Tax Commission and the states of Alaska, Idaho, Montana, and North Dakota, and in support of Hunt-Wesson by the Tax Executives Institute, Inc., the Committee.
on State Taxation (COST), and General Electric Co. An opinion is expected before the June 2000 end of the Court's term. (Hunt-Wesson, Inc., U.S. Supreme Court, Dkt. 98-2043, oral arguments heard January 12, 2000.)