No. 98-2043

In The

Supreme Court of the United States

HUNT-WESSON, INC.,

Petitioner,

v.

FRANCHISE TAX BOARD,

Respondent.

**On Writ Of Certiorari
To The Court Of Appeal Of California
For The First Appellate District**

BRIEF FOR PETITIONER

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QUESTIONS PRESENTED

1. Under the Commerce and Due Process Clauses, a State may not tax the dividends that a nondomiciliary corporation receives from its nonunitary subsidiaries. *Allied-Signal, Inc. v. Director, Div. of Taxation*, 504 U.S. 768 (1992); *ASARCO, Inc. v. Idaho State Tax Comm'n*, 458 U.S. 307 (1982); *F.W. Woolworth Co. v. Taxation & Revenue Dep't*, 458 U.S. 354 (1982). California law nevertheless requires that a nondomiciliary corporation reduce its deductible net interest expense – and thereby increase its apportionable income subject to tax – by the amount of such exempt dividends. Moreover, this requirement applies even when the disallowed interest expense is unrelated to the production of the exempt dividend income. The question presented is:

> Whether a State may tax constitutionally exempt income under the guise of denying a deduction for expenses in an amount equal to such income when there is no evidence that the expenses relate to the production of the exempt income?

2. Whether a State tax discriminates against interstate commerce in violation of the Commerce Clause by disallowing an otherwise deductible expense, thereby increasing California taxable income, solely because the corporation is not domiciled in the State or does not have subsidiaries that engage in taxable in-state activity?

LIST OF PARTIES

The parties are as stated in the caption. In the courts below, the petitioner was referred to as Hunt-Wesson, Inc., Successor in Interest to Beatrice Companies, Inc., and as Hunt-Wesson, Inc., formerly known as Beatrice/Hunt-Wesson, a Successor by Merger with Beatrice Company, formerly known as CagSub, Inc., a Successor in Interest to Beatrice Companies, Inc., formerly known as Beatrice Foods Company.

RULE 29.6 STATEMENT

Hunt-Wesson, Inc. is a wholly owned subsidiary of ConAgra, Inc. Its non-wholly-owned subsidiaries are ConAgra Brands, Inc. and ConAgra Limited.

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OPINIONS BELOW

The Opinion of the Court of Appeal (J.A. 54-66)[1] is not officially reported. The judgment and statement of the Superior Court of California, City and County of San Francisco (J.A. 33-53), is not officially reported. The California Supreme Court's denial of Hunt-Wesson's petition for review (J.A. 67) is not officially reported.

JURISDICTION

The judgment of the Court of Appeal was entered on December 11, 1998. The Supreme Court of California denied Hunt-Wesson's petition for review on March 24, 1999. J.A. 67. The petition for certiorari was filed on June 22, 1999, and was granted on September 28, 1999. The jurisdiction of this Court rests on 28 U.S.C. § 1257(a).

CONSTITUTIONAL AND STATUTORY PROVISIONS INVOLVED

The Commerce Clause of the United States Constitution, U.S. Const. art. I, § 8, cl. 3, provides: "The Congress shall have Power . . . [t]o regulate Commerce with foreign Nations, and among the several States, and with the Indian Tribes."

[1] References to the Joint Appendix are denominated "J.A." followed by a page reference. References to the Appendix to the Petition for Certiorari are denominated "Pet. App." followed by a page reference.

The Due Process Clause of the Fourteenth Amendment to the United States Constitution, U.S. Const. amend. XIV, § 1, provides: "No State shall . . . deprive any person of life, liberty, or property, without due process of law."

Relevant portions of the California statutes are set forth at Pet. App. 35a-38a.

STATEMENT

This case involves a dispute over California's denial of an income tax deduction to nondomiciliary corporations. California's corporate income tax law generally provides that "there shall be allowed as a deduction all interest paid or accrued during the income year on indebtedness of the taxpayer." Cal. Rev. & Tax. Code § 24344(a). However, through its so-called "interest offset" provision, California modifies this general principle for nondomiciliary corporations in a manner that is constitutionally indefensible for three discrete reasons.

First, California denies nondomiciliary corporations an interest expense deduction in an amount equal to constitutionally nontaxable dividends. California denies this deduction even when the disallowed interest expense bears no relationship to the constitutionally nontaxable dividends. As a consequence, California increases a nondomiciliary corporation's taxable income base by an amount equal to the nontaxable income, effectively taxing income that lies beyond California's constitutional reach.

Second, California permits domiciliary corporations, but not nondomiciliary corporations, to reduce their taxable income by interest expense to the extent that the corporation receives dividends from nonunitary corporations. The preferential treatment persists regardless of whether the interest expense bears any relationship to the production of the dividends in question. Because the allowance or disallowance of the deduction turns entirely on the domicile of the dividend-receiving corporation, it violates the cardinal principle of this Court's Commerce Clause jurisprudence barring taxes that facially discriminate in favor of in-state over out-of-state entities.

Third, California provides a selective exception to the rule denying nondomiciliary corporations an interest expense deduction: It permits a nondomiciliary corporation to deduct interest expense without regard to its receipt of constitutionally nontaxable dividends, but *only* if the dividends are received from corporations that engage in taxable activity in California. This limited exception to the rule disallowing nondomiciliary corporations an interest expense deduction, however, runs headlong into the Commerce Clause prohibition against state taxes that condition a tax benefit (the deductibility of interest expense) upon the extent of a corporation's in-state investment.

In short, California's attempt to curtail the availability of its interest expense deduction to nondomiciliary corporations is riddled with constitutional defects, any one of which is sufficient to require its invalidation.

1. Beatrice's Business

The facts of this case, which have been stipulated, are not in dispute.[2] Petitioner Hunt-Wesson, Inc. is the successor in interest to the Beatrice Foods Company ("Beatrice"), the original taxpayer in this case. Beatrice was a Delaware corporation with its commercial domicile in Illinois. During the years at issue (fiscal years 1980 through 1982),[3] Beatrice was a diversified company engaged in business within and without California, primarily in providing food and food-related products and services for worldwide markets. Beatrice also produced other consumer, industrial, and chemical products.

Beatrice owned directly and indirectly certain dividend-paying subsidiaries with which it was not engaged in a unitary business (the "nonunitary subsidiaries"). Stip. ¶ 7 (J.A. 19). Most of the nonunitary subsidiaries were incorporated in foreign countries, and none of them was incorporated in California. Stip. ¶ 7 (J.A. 19). The nonunitary subsidiaries paid to Beatrice dividends which were not taxable by California (the "nonunitary dividends") of $26,718,620 for 1980, $29,482,637 for 1981, and $19,022,617 for 1982. Stip. ¶¶ 7, 8 (J.A. 19).

[2] References to the Joint Stipulation of Facts in this case are denominated "Stip." followed by a paragraph reference. The Joint Stipulation of Facts is reproduced at J.A. 16-24.

[3] The three fiscal years at issue date from March 1, 1979 to February 29, 1980; March 1, 1980 to February 28, 1981; and March 1, 1981 to February 28, 1982. For ease of reference, we will refer to these years in the text simply as "1980," "1981," and "1982," respectively.

In the operation of its business, Beatrice took out loans and incurred interest expense in connection with these loans. Trial Court Statement of Decision ¶ F (J.A. 35). During the years at issue, the outstanding loans amounted to $793,683,348 for 1980, $610,230,945 for 1981, and $1,312,660,515 for 1982. Stip. Exh. 1 (Clerk's Transcript ("CT") pp. 64-66). The interest expense with respect to these loans amounted to $80,490,469 for 1980, $55,101,503 for 1981, and $137,413,162 for 1982. Stip. ¶ 10 (J.A. 19); Stip. Exh. 1 (CT pp. 64-66). It has never been disputed in this case that "no portion of the proceeds of the loans generating the interest expense deductions herein went directly to any non-unitary corporation, each of which was responsible for its own borrowings (J.S. [Stip.] ¶ 9)." Franchise Tax Board's Objection to Proposed Statement of Decision and Request for Hearing on Objection (CT p. 295) (emphasis omitted). Accordingly, Beatrice claimed a deduction for such interest expense on its California franchise tax returns. Stip. ¶¶ 10, 11, 13 (J.A. 19-20).

2. California's Taxing Scheme

California imposes a franchise tax measured by net income on corporations for the privilege of doing business in California. Cal. Rev. & Tax. Code §§ 23151, 23151.1. For a corporation like Beatrice, which is engaged in business within and without the State, California divides the corporation's income into two categories: business income and nonbusiness income. Business income, which is apportioned by formula among all the

States in which the taxpayer does business,[4] means "income arising from transactions and activity in the regular course of the taxpayer's trade or business. . . . " Cal. Rev. & Tax. Code § 25120(a). Nonbusiness income, which generally is allocated to a particular State depending on its situs, "means all income other than business income." Cal. Rev. & Tax. Code §§ 25120(d), 25123-25127.

These definitions are generally "quite compatible with the unitary business principle." *Allied-Signal, Inc. v. Director, Div. of Taxation*, 504 U.S. 768, 786 (1992). Under this principle, a State may tax an apportioned share of a nondomiciliary taxpayer's income arising from its unitary business, but generally may not tax income that is not connected with its unitary business (for example, dividend income received from nonunitary subsidiaries).[5] It is stipulated in this case that "[a]ll of th[e] nonunitary dividends received by Beatrice constituted nonunitary, nonbusiness income not subject to apportionment, or taxation, by the State of California." Stip. ¶ 8 (J.A. 19).

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[4] The formula determines the portion of the corporation's business income that is fairly attributable to California. During the years at issue, the apportionment percentage was the simple average of three fractions – the taxpayer's in-state property over its total property, its in-state payroll over its total payroll, and its in-state sales over its total sales. *See* Cal. Rev. & Tax. Code §§ 25128, 25129, 25132, and 25134.

[5] If the nonbusiness income has its situs in the State, *e.g.*, income from real property located in the State but unrelated to the taxpayer's trade or business, then the State may, of course, tax a nondomiciliary taxpayer's income from such property. *See, e.g.*, Cal. Rev. & Tax. Code § 25124.

California law generally provides that "there shall be allowed as a deduction all interest paid or accrued during the income year on indebtedness of the taxpayer." Cal. Rev. & Tax. Code § 24344(a). Any interest expense attributable to business income must be subtracted from such income, thereby reducing the income subject to apportionment, and any interest expense attributable to nonbusiness income must be subtracted from such income, thereby reducing the income subject to allocation. *See* Stip. ¶ 11 (J.A. 20). This reflects the widely accepted principle of income tax law and practice generally and in California that expenses should be allocated to the category of income to which they are properly attributable. *See* Cal. Rev. & Tax. Code § 24425; *Great W. Fin. Corp. v. Franchise Tax Bd.*, 4 Cal. 3d 1, 6, 479 P.2d 993 (1971), quoting 12 Marshall, Cal. Practice, State and Local Taxation (1969). There is no dispute in this case about the propriety of this principle.

Rather, the dispute in this case centers on California's so-called "interest offset" provision, contained in Cal. Rev. & Tax. Code § 24344(b), which, during the years at issue, provided:

> If income of the taxpayer is determined by the allocation formula contained in Section 25101, the interest deductible shall be an amount equal to interest income subject to allocation by formula, plus the amount, if any, by which the balance of interest expense exceeds interest and dividend income (except dividends deductible under the provisions of Section 24402) not subject to allocation by formula. Interest expense not included in the preceding sentence shall be directly offset against interest and dividend

> income (except dividends deductible under the provisions of Section 24402) not subject to allocation by formula.

Cal. Rev. & Tax. Code § 24344(b).[6]

For a nondomiciliary taxpayer like petitioner, its interest expense deduction is computed in the following manner.[7] First, as a preliminary matter, the taxpayer must attribute its interest expense to business income or nonbusiness income. Only the former – the "business interest expense" – is subject to the interest offset provision.[8] Second, the taxpayer may deduct its business interest expense to the extent that it has business interest income. Third, the taxpayer must "offset" or reduce the remaining net business interest expense on a dollar-for-dollar basis to the extent of its nonbusiness dividend and interest income, none of which is taxable by California.[9] However, the taxpayer retains the right to the interest expense

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[6] The current version of Cal. Rev. & Tax. Code § 24344(b), which is substantially the same as the version in force during the years at issue here, reflects amendments that are not material to this case.

[7] The operation of the interest offset for domiciliary taxpayers is described *infra* at 33.

[8] As the stipulation provides:

> Before the "interest offset" computation was made . . . nonbusiness interest expense . . . was deducted from total interest expense . . . . Thus, the remaining interest expense . . . was business interest expense subject to the "interest offset" computation.

Stip. ¶ 11 (J.A. 20).

[9] *Allied-Signal*, 504 U.S. 768; *ASARCO, Inc. v. Idaho State Tax Comm'n*, 458 U.S. 307 (1982); *F.W. Woolworth Co. v. Taxation & Revenue Dep't*, 458 U.S. 354 (1982); Stip. ¶ 8 (J.A. 19).

deduction, if, but only if, those nonbusiness dividends are received from a corporation deriving taxable income from (and thus doing business in) California.[10] Fourth, if any net business interest expense remains after having been reduced by the amount of the nontaxable, nonbusiness dividends and interest, the taxpayer may deduct such remaining interest expense against its taxable business income.

The operation of this scheme, as described in the preceding paragraph, may be illustrated as follows:

Step 1:		Total Interest Expense
	Less	Nonbusiness Interest Expense
		Business Interest Expense
Step 2:		Business Interest Expense
	Less	Business Interest Income
		Net Business Interest Expense
Step 3:		Net Business Interest Expense
	Less	Nonbusiness Interest Income and Dividends (the "Interest Offset")*
		Remaining Net Business Interest Expense after Interest Offset
Step 4:		Remaining Net Business Interest Expense after Interest Offset

* Interest expense equal to these amounts is disallowed as a deduction (except dividends paid by corporations taxable in California).

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[10] *See* Cal. Rev. & Tax. Code § 24344(b) (providing for interest offset against nonbusiness dividends "except dividends deductible under the provisions of Section 24402"). Dividends deductible under Cal. Rev. & Tax. Code § 24402 are dividends declared from income which has been included in the measure of tax in California.

In substance, then, the interest offset provision sets forth two rules disallowing a deduction for interest expense that is otherwise deductible. The first rule denies a nondomiciliary corporation the benefit of an interest expense deduction by requiring it to allocate its net interest expense to nontaxable income regardless of whether the interest expense bears any relationship to the production of such income. The second rule denies a nondomiciliary corporation receiving nontaxable dividends the benefit of an interest expense deduction unless those dividends are from subsidiaries doing business in California.

3. The Assessment

During an audit of Beatrice's tax returns for the years at issue, the Franchise Tax Board (the "Board") applied the interest offset provision and disallowed a portion of Beatrice's interest expense deduction for each year. Stip. ¶ 12 (J.A. 20). Beatrice's total interest expense for the years at issue was $80,490,469 for 1980, $55,101,503 for 1981, and $137,413,162 for 1982, all of which was business interest expense. Stip. ¶¶ 10, 11, 13 (J.A. 19-20). Under the interest offset provision, the Board first permitted Beatrice to deduct the portion of its business interest expense equal to its business interest income, which amounted to $10,217,578 for 1980, $21,389,332 for 1981, and $83,920,105 for 1982. CT pp. 93, 120. The Board then disallowed Beatrice a deduction for its net business interest expense on a dollar-for-dollar basis to the extent of the constitutionally nontaxable dividends that Beatrice received from its nonunitary subsidiaries. Stip. ¶ 12 (J.A. 20). Those dividends amounted to $26,718,620 for 1980, $29,482,367

for 1981, and $19,022,617 for 1982, Stip. ¶ 7 (J.A. 19), which therefore resulted in the denial of an interest expense deduction in the same amounts, namely $26,718,620 for 1980, $29,482,367 for 1981, and $19,022,617 for 1982. Stip. ¶¶ 7, 12 (J.A. 19, 20); CT pp. 93, 120.[11]

The basis for the Board's denial of Beatrice's interest expense deduction was simply that Beatrice had received nonbusiness dividends from its nonunitary subsidiaries. Stip. ¶ 14 (J.A. 21). The Board made no determination that the interest expense bore any relationship to the constitutionally exempt dividends, Stip. ¶ 14 (J.A. 21), and the statute did not require that it do so. As a consequence of the Board's disallowance of Beatrice's interest expense deduction, it increased Beatrice's California business income subject to apportionment by $26,718,620 for 1980, $29,482,367 for 1981, and $19,022,617 for 1982 – the amount of Beatrice's nontaxable dividend income. Stip. ¶ 12 (J.A. 20). This resulted in tax deficiencies of $139,066 for 1980, $170,486 for 1981, and $109,640 for 1982. Stip. ¶ 20 (J.A. 22).

4. The Proceedings Below

In March 1996, Beatrice commenced this action by filing a suit for refund of taxes and interest in the

[11] The Board allowed a deduction for Beatrice's remaining business interest expense in excess of its nonbusiness dividend income in the amount of $43,554,427 for 1980, $4,229,804 for 1981, and $34,470,440 for 1982. *See*, CT pp. 93, 120.

Superior Court, City and County of San Francisco.[12] Verified Complaint for Refund of Taxes ("Complaint") (J.A. 4). Beatrice alleged, among other things, that the interest offset provision violated the Commerce and Due Process Clauses of the United States Constitution[13] by arbitrarily limiting its interest expense deduction by the amount of its constitutionally nontaxable dividend income. Complaint ¶¶ 21-22 (J.A. 8).

(a) The Superior Court. In June 1997, the Superior Court found that the interest offset provision violated the Commerce and Due Process Clauses. Turning first to the Due Process Clause claim, the court grounded its analysis in two basic, and undisputed, principles: first, "that a State may not tax plaintiff's nonbusiness dividends because plaintiff is a foreign nondomiciliary corporation and such income is only taxable in its state of domicile"; second, "that a state cannot tax indirectly that which it may not tax directly." J.A. 41. These principles, the court reasoned, led inexorably to the conclusion that California's disallowance of Beatrice's interest expense

[12] As stipulated by the parties, Beatrice had exhausted all necessary administrative remedies before the Board and the California State Board of Equalization ("SBE") prior to instituting this challenge in court. Stip. ¶ 24 (J.A. 23). Because the SBE lacked jurisdiction to determine the constitutionality of provisions of the California Revenue and Taxation Code, Beatrice and the Board stipulated in August 1995 that Beatrice's administrative appeal would be dismissed without prejudice. Stip. ¶ 24 (J.A. 23).

[13] Beatrice additionally argued at trial and on appeal that the interest offset provision violated the Equal Protection Clause of the Fourteenth Amendment, but is not pressing that claim here.

deduction violated the Due Process Clause because "[i]t disallows interest deductions on a dollar-for dollar basis with non-taxable dividend income without regard to whether or not such interest is *related* to the dividend income." J.A. 45 (emphasis in original).

The court recognized that California might constitutionally deny an interest expense deduction that was related to income that California could not tax. J.A. 44-45. But "such potential legitimate state purpose" (J.A. 45) simply had no application to this case because

> here the parties have stipulated that no portion of the proceeds of the loans generating the interest expense deductions herein went to any nonunitary corporation, each of which was responsible for its own borrowings. (J.S. ¶ 9). Thus, it appears that no portion of the interest expense deduction can be attributable to the generation of the . . . exempt dividends.

J.A. 45.

The court likewise found that the interest offset provision violated the Commerce Clause. Because only domiciliary corporations received any tax benefit from the offset of interest expense against nonunitary dividends, the court observed that it will always be true that "the amount of tax on a foreign corporation under Rev. & T.C. § 24344(b) will be higher than that of a domestic corporation where both have a) the same taxable business income; b) the same interest expense deductions; and c) the same dividend income." J.A. 48. This discrimination against foreign corporations, the court concluded, could not be squared with this Court's precedents barring discrimination against out-of-state corporations. J.A.

47-49 (citing, among other cases, *Fulton Corp. v. Faulkner*, 516 U.S. 325 (1996); *Camps Newfound/Owatonna, Inc. v. Town of Harrison*, 520 U.S. 564 (1997); and *Armco, Inc. v. Hardesty*, 467 U.S. 638 (1984)). Moreover, the differential treatment of in-state and out-of-state corporations could not be justified by any purported relationship of the interest expense to the nonunitary dividends, since there was no support in the record for the existence of such a relationship. J.A. 45-46.

(b) The Court of Appeal. In December 1998, the Court of Appeal reversed the decision of the Superior Court. The Court of Appeal conceded that, "[i]f we were writing on a clean slate," petitioner's arguments "might appear persuasive." J.A. 61. Nevertheless, the Court of Appeal believed it was bound by a 1972 decision of the California Supreme Court, *Pacific Tel. & Tel. Co. v. Franchise Tax Bd.*, 7 Cal. 3d 544, 498 P.2d 1030 (1972) ("*Pacific Telephone*"), which upheld the Board's statutory interpretation of the interest offset provision (Cal. Rev. & Tax. Code § 24344), even though the Court of Appeal admitted that "the *Pacific Telephone* case did not involve a constitutional challenge to section 24344." J.A. 61.

In rejecting petitioner's contention that the disallowance of an interest deduction based on the receipt of nontaxable dividends effectively taxed such dividends in violation of the Due Process Clause, the Court of Appeal felt constrained by the determination of the California Supreme Court in *Pacific Telephone* that the "inclusion of nontaxable dividends in the statutory offset computation under section 24344 does not constitute taxation of the dividends themselves." J.A. 61. Rather than defending this position, the court below simply declared that "[w]e

defer, as we must, to that decision," even though *Pacific Telephone* was not based on constitutional considerations. J.A. 61.

In dismissing petitioner's Commerce Clause argument, the Court of Appeal again relied principally on "our Supreme Court's holding in *Pacific Telephone* that the interest offset provision does not constitute a tax on the dividends in question." J.A. 62. Hence, Commerce Clause restraints applicable to taxes were not relevant because "our high court has held the interest offset provision is not a tax on the income in question here." J.A. 65. The court found this Court's decision in *Fulton* distinguishable, even though it struck down a statute like California's which conferred a tax benefit based on the extent of a taxpayer's in-state presence, on the ground that here the "alleged favorable effect on local commerce is indirect and incidental." J.A. 62. As for the long line of cases from this Court holding facially discriminatory taxes violative of the Commerce Clause, the Court of Appeal found them "not determinative" because "[i]n the absence of a directly applicable ruling by the federal Supreme Court holding unconstitutional an interest offset provision such as the one in issue here, we remain bound by *Pacific Telephone*." J.A. 63.

(c) The California Supreme Court. On March 24, 1999, the California Supreme Court denied Hunt-Wesson's petition for review. J.A. 67.

SUMMARY OF ARGUMENT

California's attempt through its interest offset provision to limit a nondomiciliary corporation's right to an otherwise available deduction for interest expense suffers from three fundamental constitutional flaws.

First, by denying a nondomiciliary corporation an interest expense deduction merely because it receives income that the Constitution forbids California from taxing, California effectively is taxing that income in violation of the Constitution. A State may not tax indirectly income that it may not tax directly. Yet that is the inescapable effect of the interest offset provision. By reducing an otherwise allowable interest expense deduction on a dollar-for-dollar basis by the amount of the dividend income it may not constitutionally tax, California increases a nondomiciliary corporation's tax base by the exact amount of that nontaxable income. Because the statute does not require – and the facts do not reveal – any relationship between the disallowed interest expense and the nontaxable income, the effect is simply to tax the exempt income, or, what amounts to the same thing, to subject one to greater burdens upon taxable income solely because one receives income that is tax-exempt. *National Life Ins. Co. v. United States*, 277 U.S. 508 (1928).

Second, by denying nondomiciliary (but not domiciliary) corporations the right to reduce their taxable income by interest expense deductions to the extent that the corporation receives dividends from nonunitary corporations, the interest offset provision discriminates against corporations domiciled outside the State. The preferential treatment persists regardless of whether the interest

expense bears any relationship to the production of the dividends in question. Because the allowance or disallowance of the deduction turns entirely on the domicile of the dividend-receiving corporation, it violates the cardinal principle of this Court's Commerce Clause jurisprudence barring taxes that facially discriminate in favor of in-state over out-of-state entities. *See, e.g., South Cent. Bell Tel. Co. v. Alabama*, 526 U.S. 160 (1999) (striking down franchise tax that favored domestic over foreign corporations).

Third, wholly apart from the question whether California may constitutionally deny an interest expense deduction, on a dollar-for-dollar basis, to the extent of a nondomiciliary taxpayer's nonunitary dividends, the interest offset provision is invalid for another, independent reason: It permits taxpayers receiving nonbusiness dividends to deduct their interest expense, but *only* to the extent that the dividends derive from corporations that are taxable in California. By conditioning a tax benefit (the deductibility of interest expense) on the extent of a corporation's in-state activity, the provision discriminates on its face against interstate commerce. In this respect, the interest offset provision is virtually identical to the North Carolina taxing scheme this Court struck down in *Fulton Corp. v. Faulkner*, 516 U.S. 325 (1996), where the State's intangible property tax exemption was measured by the extent of the corporation's in-state activity.

ARGUMENT

I. BY DENYING A DEDUCTION IN THE AMOUNT OF INCOME THAT CALIFORNIA IS PRECLUDED FROM TAXING UNDER THE COMMERCE AND DUE PROCESS CLAUSES, CALIFORNIA IS INDIRECTLY TAXING INCOME BEYOND ITS CONSTITUTIONAL REACH

It is "a just and well-settled doctrine established by this court, that a State cannot do that indirectly which she is forbidden by the constitution to do directly." *Passenger Cases*, 48 U.S. 283, 458 (1848) (plurality opinion). The Court has consistently applied this "great principle" (*id.* at 459) to invalidate state exactions that purport to tax indirectly what the Constitution forbids States from taxing directly. *See, e.g., id.* (striking down an exaction on foreign passengers as a prohibited "duty on tonnage," U.S. Const. art. I, § 10, cl. 3); *Guy v. Baltimore*, 100 U.S. 434, 443 (1880) (striking down wharfage fee on vessels carrying out-of-state products "as a mere expedient or device to accomplish, by indirection, what the State could not accomplish by a direct tax"); *Frick v. Pennsylvania*, 268 U.S. 473, 495 (1925) (striking down state estate tax on the ground that "[i]t would open the way for easily doing indirectly what is forbidden to be done directly, and would render important constitutional limitations of no avail"); *Lee v. Oscèola & Little River Rd. Improvement Dist. No. 1*, 268 U.S. 643 (1925) (striking down state tax scheme that would "accomplish indirectly the collection of a tax against the United States which could not be directly imposed").

The practical effect of California's interest offset provision is to tax indirectly income that California has no

power, under the Commerce and Due Process Clauses, to tax directly. This conclusion follows inexorably from two undisputed propositions.

First, the dividends that petitioner received from its nonunitary subsidiaries are not constitutionally taxable by California. The law is settled that the Commerce and Due Process Clauses bar a State from taxing dividends that a nondomiciliary corporation receives from its nonunitary subsidiaries. *Allied-Signal, Inc. v. Director, Div. of Taxation*, 504 U.S. 768 (1992); *ASARCO, Inc. v. Idaho State Tax Comm'n*, 458 U.S. 307 (1982); *F.W. Woolworth Co. v. Taxation & Revenue Dep't*, 458 U.S. 354 (1982). The parties accordingly have stipulated that the "dividends received by Beatrice constituted nonunitary, nonbusiness income not subject to apportionment, or taxation, by the State of California." Stip. ¶ 8 (J.A. 19).

Second, the only reason why the Board disallowed Beatrice's interest expense is because petitioner received such constitutionally exempt income. Under the interest offset provision, the relationship, if any, of the disallowed interest expense to the production of the constitutionally exempt income is simply irrelevant. Accordingly, the parties again stipulated that "[t]he disallowance of Beatrice's interest expense was due *entirely* to the receipt by Beatrice of dividends from its nonunitary subsidiaries . . . ." Stip. ¶ 14 (J.A. 21) (emphasis supplied).

By denying petitioner a deduction for interest expense equal to the amount of its constitutionally exempt income, California increases petitioner's taxable income base by the precise amount of such income. Because California denies this deduction for no reason other than petitioner's receipt of the exempt income, the conclusion is inescapable that California effectively taxes such income. This is particularly evident when, as in this case, none of that interest expense bore any direct relationship to the production of the exempt income.[14]

In short, it is plain that the increase in petitioner's taxable income is attributable "entirely" (Stip. ¶ 14 (J.A. 21)) to the receipt of income that California has no power to tax under the Commerce and Due Process Clauses. Because petitioner's California tax liability was the same as if its immune income was taxable, the practical effect of the interest offset provision is to tax petitioner's constitutionally exempt income.[15]

The court below did not – and could not – dispute the proposition that the practical effect of the interest offset provision was to tax petitioner's exempt income.[16] Instead, tracking the reasoning of the California Supreme Court opinion in *Pacific Tel. & Tel. Co. v. Franchise Tax Bd.*,

[14] As the trial court observed, "it appears that no portion of the interest expense deduction can be attributable to the generation of the . . . exempt dividends." J.A. 46.

[15] For example, in 1982, because Beatrice received nonbusiness dividends that California could not tax of $19,022,617, California applied the interest offset provision and increased Beatrice's taxable income subject to apportionment by that same amount. Thus, for each dollar of immune dividend income received by Beatrice, the interest offset provision increased Beatrice's taxable income subject to California apportionment by that same dollar.

[16] In fact, the Court of Appeal acknowledged the "persuasive force" (J.A. 61) of petitioner's contention that "the interest offset is overbroad, because it *fails* to apportion interest expense" (J.A. 61 (emphasis supplied)).

7 Cal. 3d 544, 498 P.2d 1020 (1972), the Court of Appeal, in substance, viewed the essential question in this case as whether the *legal* effect of the interest offset provision was the same as its *practical* effect. It held that the answer to this question is no. According to the court, the legal effect of denying a deduction was different from its practical effect on the ground that "the California Supreme Court explicitly held that inclusion of nontaxable dividends in the statutory offset computation under section 24344 does not constitute taxation of the dividends themselves." J.A. 61. Such elevation of form over substance, however, has no place in the analysis of Commerce and Due Process Clause restraints on state taxation.[17]

This Court has condemned, in general, efforts like California's to evade constitutional restrictions on the State's taxing power by circuitous means. It also has condemned specifically, in a related context, the precise mechanism that California seeks to employ here to tax the exempt income. In *National Life Ins. Co. v. United States*, 277 U.S. 508 (1928), this Court struck down a provision of the federal income tax law which permitted insurance

[17] The Court has made it clear in analyzing constitutional restraints on State taxes that its decisions "consider [ ] not the formal language of the tax statute but rather its practical effect," *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274, 279 (1977); that they evaluate "state taxation based upon its actual effect rather than its legal terminology," *American Trucking Ass'ns v. Scheiner*, 483 U.S. 266, 295 (1987); that they are grounded in "economic realities," *id.*; and that they eschew "magic words or labels," *Railway Express Agency, Inc. v. Virginia*, 358 U.S. 434, 441 (1959), "avoid formalism," *Trinova Corp. v. Michigan Dep't of Treasury*, 498 U.S. 358, 373 (1991), and reflect "pragmatism." *Quill Corp. v. North Dakota*, 504 U.S. 298, 310 (1992).

companies to exclude municipal bond interest from their gross income but at the same time required the insurance companies to reduce an unrelated deduction for reserves by the full amount of the exempt interest. In other words, for each dollar of tax-exempt income the taxpayer received, it had to reduce an otherwise allowable deduction by one dollar. Treating the disallowance of the deduction for what it was – a transparent effort to tax exempt income by denying an unrelated deduction in the same amount – the Court ruled that "[o]ne may not be subjected to greater burdens upon his taxable property solely because he owns some that is free." *Id.* at 519.

The statutory provision invalidated in *National Life* is remarkably similar to the California provision at issue here. In each case, a taxpayer ordinarily is entitled to claim a deduction that reduces its income tax base; in each case the taxpayer is required to forgo the deduction, and thereby increase its taxable income, by the amount of its exempt income; and in each case, the deduction need not – and does not – bear any relationship to the exempt income in question. Consequently, the Court of Appeal's decision sustaining California's interest offset provision cannot be squared with the rationale of *National Life* – that one may not be subjected to greater burdens upon taxable income solely because one receives income that is tax-exempt.

In short, California's interest offset provision is a paradigmatic example of a State's effort to tax indirectly what it may not tax directly. By reducing an otherwise allowable interest expense deduction by the amount of dividend income it may not tax under the Commerce and

Due Process Clauses, California increases a nondomiciliary corporation's tax base by the exact amount of the exempt income. Because the statute does not require – and the facts do not reveal – any relationship between the disallowed interest expense and the nontaxable income, the effect is simply to tax the exempt income in violation of the Commerce and Due Process Clauses.

A. The Interest Offset Provision Cannot Be Defended as an Effort to Allocate Interest Expense to Related Income

Throughout this litigation, respondent's principal defense of the interest offset provision has been that it serves to allocate interest expense to related income, *i.e.*, to the income produced by the loans on which the interest was paid. *See, e.g.*, Brief in Opposition to Petition for Writ of Certiorari ("Br. Opp."), *passim*. If respondent's view of the interest offset provision were accurate, petitioner would not be here. Petitioner takes no issue with the widely accepted principle that interest expense should be allocated to the income that it helps produce. But respondent's characterization of the interest offset rule as a method for "correlating" (*id.* at 11) or "matching" (*id.* at i) or reflecting the "economic relationship between" (*id.* at 14) interest expense and related income is demonstrably false. Once the false predicate underlying respondent's argument is removed, the defense collapses.

First, the statute itself unequivocally requires that net business interest expense must be reduced, not just by the interest expense fairly attributable to the taxpayer's non-taxable interest and dividends, but by the full amount of those nontaxable interest and dividends.[18] This reduction of the interest expense deduction by the amount of the nonbusiness interest and dividend income is absolute and unconditional.[19] There is no "matching," no "correlation," no "economic relationship," no anything; just an arbitrary assignment, on a dollar-for-dollar basis, of business interest expense to nontaxable, nonbusiness income.[20]

Second, the premise that the interest offset is merely "matching" nonbusiness income with related interest

[18] As we have noted above (*see supra p. 8*), the statute permits a taxpayer a deduction for its business interest expense in the amount of its "interest income subject to allocation by formula," Cal. Rev. & Tax. Code § 24344(b), *i.e.*, apportionable or business interest income. Hence, it is the "net" business interest expense – the interest expense attributable to business income that remains after subtracting apportionable interest income – that is at issue here.

[19] The statute limits the net business interest expense deduction to the "amount, if any, by which the balance of interest expense exceeds interest and dividend income . . . not subject to allocation by formula." Cal. Rev. & Tax. Code § 24344(b).

[20] As noted above, even the Court of Appeal acknowledged the "persuasive force" (J.A. 61) of petitioner's contention that "the interest offset is overbroad, because it *fails* to apportion interest expense" (J.A. 61 (emphasis supplied)), but felt bound to follow the spurious position of the California Supreme Court in *Pacific Telephone*, which did not even address the federal constitutional issues raised by petitioner here, that the "inclusion of nontaxable dividends in the statutory offset computation . . . does not constitute taxation of the dividends themselves."

expense is further undermined by the fact that, under California law, nonbusiness interest expense has already been disallowed as a deduction, and thereby eliminated from the calculus, prior to the application of the interest offset provision. Stip. ¶ 11 (J.A. 20). It is only the remaining *business* interest expense that is subject to the interest offset rule, as the parties have stipulated. Stip. ¶¶ 11, 13 (J.A. 20). Accordingly, rather than "matching" interest expense to nonbusiness dividends, the interest offset rule *over*allocates such interest expense to such dividends by assigning business interest expense dollar-for-dollar to nonbusiness dividends.

Finally, respondent's attempt to justify the interest offset provision on the ground that "money . . . is fungible" (Br. Opp. at 12) and that "interest costs cannot be readily traced to the specific classification of income which is generated from both business and nonbusiness activities" (*id.*) is a classic nonsequitur. Even if money is fungible, it does not follow that California may adopt any provision – no matter how arbitrary – to allocate interest expense between taxable and nontaxable income. In fact, the interest offset provision does not even rise to the level of an arbitrary allocation provision, because, rather than allocating interest expense between taxable and nontaxable income, it simply assigns it, on a dollar-for-dollar basis, to nontaxable income.

Most tellingly of all, respondent's claim that it is "difficult" as a practical matter to determine "the extent to which interest expense is attributable to business income as opposed to nonbusiness income" (*id.*) is belied by California's own statutes and regulations requiring just such an allocation; by statutes and regulations in other States providing for such an allocation and, in many instances, prescribing methods of fairly attributing interest expense to different classes of income even when the expenses are not traceable to a particular item or items of income; and, by the U.S. Treasury's adoption of similar interest allocation provisions for federal income tax purposes. We briefly describe these interest allocation provisions below.

1. California Itself Has Adopted Statutory and Regulatory Provisions That Seek to Allocate Interest Expense to Related Income in a Fair Manner

Despite the Board's remonstrations about the difficulty of fairly allocating interest expense to related income in light of the fungibility of money, and its invocation of those difficulties as a justification for the interest offset provision's blanket assignment of *all* business interest expense (in excess of business interest income) to nonbusiness income (Br. Opp. 12), California's statutes and regulations in fact provide for precisely the type of reasonable allocation of interest and other expenses to related income that would obviate the constitutional issues raised by this case. For example, section 24425 of the Cal. Rev. & Tax. Code precludes a deduction for "[a]ny amount otherwise allowable as a deduction which is allocable to . . . income not included in the measure of the tax." The California State Board of Equalization ("SBE") has interpreted that provision as incorporating direct tracing. Thus, if the proceeds of a loan can be directly traced to a specific business or non-business purpose, the interest expense is assigned accordingly. *See*

Appeal of Zenith Nat'l Ins. Corp., 1998 Cal. Tax LEXIS 1, 4 Cal. St. Tax Rep. (CCH) ¶ 402-965 (SBE Jan. 8, 1998), *modified*, 1998 Cal. Tax LEXIS 651, 4 Cal. St. Tax Rep. (CCH) ¶ 403-048 (SBE June 25, 1998) (a copy of these decisions are reproduced in the Appendix at App. 23a).

Moreover, even when interest expense cannot be specifically identified with any particular class of income, California has shown itself quite capable of devising reasonable methods for fairly allocating interest expense between various classes of income rather than arbitrarily offsetting such expense on a dollar-for-dollar basis against nontaxable income. Thus, the SBE has upheld the Board's denial of interest expenses allocated to nontaxable income using the ratio of nontaxable income to taxable income. *Appeal of Zenith Nat'l Ins. Corp., supra.*[21]

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[21] Similarly, under subsection (c) of section 24344 (enacted after the years in issue), the California regulations attributing interest expense to foreign investment recognize that, in some circumstances, interest expense may be "related solely to specific property." Cal. Code Regs. tit. 18, § 24344(c)(4)(A). In other circumstances, where "it is difficult if not impossible to specifically assign the cost of funds to specific activities," Cal. Code Regs. tit. 18, § 24344(c)(1), California allocates the otherwise unassigned interest expense according to "the ratio of the value of foreign investment to the total value of all assets . . . ." Cal. Code Regs. tit. 18, § 24344(c)(5)(B)(i). The regulations further provide the following example of the allocation methodology with respect to interest expense that is not related to specific property or activities:

> Corporation A has total interest expense of $1,100. Specifically assigned interest expense is $100. A has foreign investments valued at $500 and total assets valued at $5,500. Specifically assigned interest expense relates to total assets of $500, none of which is foreign investment. . . .

Thus, it is plain that California does not always throw up its institutional hands – as it does in the interest offset provision – and arbitrarily assign the interest expense on a dollar-for-dollar basis to exempt income.

2. Other States Have Adopted Statutory and Regulatory Provisions That Seek to Allocate Interest Expense to Related Income in a Fair Manner

As revealed in more detail in the Appendix to this brief, most States with an income tax have adopted statutes or regulations providing for a fair allocation of interest expense to related income; many have prescribed methods of fairly attributing interest expense to different classes of income when the expenses are not clearly related to a particular item or class of income; and none has embraced a "methodology" like California's, which simply assigns interest expense, on a dollar-for-dollar basis, to nontaxable income.[22] For example:

> The amount of unassigned interest expense attributable to foreign investment is calculated as follows: Total Interest Expense – Assigned Interest Expense = Unassigned Interest Expense ($1,100 – $100 = $1,000). Unassigned Interest Expense x value foreign investment/value total assets (Assets without specifically assigned interest) = interest expense assignable to foreign ($1,000 x $500/$5,000 = $100).

Cal. Code Regs. tit. 18, § 24344(c)(5)(B)(iii).

[22] While there may be interpretations or administrative practices not apparent on the face of the state statutes and regulations that we reviewed, our research disclosed only two States (Idaho and Wisconsin) that ever had an interest offset provision anything like California's, and neither of those States has such a provision in effect today.

- Alabama prorates interest expense deductions between business and nonbusiness income by multiplying total interest expense by the ratio of the average cost of nonbusiness assets to the average cost of total assets;[23]
- the District of Columbia reduces a corporation's deductible interest expense according to the ratio of the average value of the assets producing nontaxable income to the average value of the corporation's total assets;[24]
- Hawaii provides for the proration of deductions among items of business and nonbusiness income in a manner that fairly distributes the deduction among the classes of income to which it is applicable, and, when deductions are not connected with particular classes of income, it provides for an allocation based on the ratio of Hawaii gross income to gross income from all sources;[25]
- Kentucky provides that deductions allowed under the Internal Revenue Code be reduced by expenses allocable to nontaxable income, and it prescribes a number of methods for allocating interest and other expenses to nontaxable income (including asset- and income-based ratios);[26]
- Louisiana, Mississippi, Nebraska, New York, North Carolina, Oklahoma, and Utah have

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[23] Ala. Code § 40-18-35(a)(2). *See* App. 1a.

[24] D.C. Reg. § 123.4. *See* App. 4a.

[25] Hawaii Reg. § 18-235-5-03(b)(4). *See* App. 6a.

[26] Ky. Rev. Stat. Ann. § 141.010(13)(d); Ky. Admin. Release, Revenue Policy 41P150 (June 1, 1983). *See* App. 9a.

adopted similar mechanisms for allocating interest expense between taxable and nontaxable income, when the interest income cannot readily be traced to any particular item or activity;[27] and

- Other States (including Alaska, Arizona, Colorado, Kansas, Missouri, North Dakota, and Oregon) have adopted the Multistate Tax Commission regulations which provide for the proration of deductions among items of business and nonbusiness income in a manner that fairly distributes the deduction among the classes of income to which it is applicable.[28]

The States' widespread adoption of a variety of methods, reasonable on their face, for attributing interest expense to the income it produces, even in circumstances when the expenses cannot be traced directly to particular classes of income, underscores the anomalous character of California's interest offset rule, as well as its indefensibility.

3. The Federal Government Likewise Has Adopted Rules That Seek to Allocate Interest Expense to Related Income in a Fair Manner

The Federal Government's adoption of provisions for allocating interest expense to related income, which are analogous to the provisions adopted by many of the

[27] *See* App. *passim.*

[28] *See* App. *passim.*

States, reinforces the conclusion that California has available to it a wide variety of reasonable alternatives to the interest offset provision for matching interest expense to interest income. For example, Section 265 of the Internal Revenue Code disallows a deduction for interest on indebtedness incurred to "purchase or carry" tax-exempt obligations. I.R.C. § 265. In prescribing the methods for allocating interest expense to the exempt obligations, the Internal Revenue Service will disallow any interest that is "directly traceable" to the holding of tax-exempt obligations and, where interest cannot be so traced:

> [t]he amount of interest on such indebtedness to be disallowed shall be determined by multiplying the total interest on such indebtedness by a fraction, the numerator of which is the average amount during the taxable year of the taxpayer's tax-exempt obligations . . . and the denominator of which is the average amount during the taxable year of the taxpayer's total assets . . . .

Rev. Proc. 72-18, 1972-1 C.B. 740; *see also* Treas. Reg. § 1.265-1(c).[29]

Similarly, in determining the appropriate allocation of interest expense to domestic and foreign source income, the federal income tax regulations provide for the apportionment of interest expense to various income-producing activities by an asset ratio and by a gross income ratio. Treas. Reg. § 1.861-9T. These regulations proceed on the premise that "money is fungible and that

[29] California itself has adopted this methodology under Section 24425. *See, e.g., Appeal of Zenith Nat'l Ins. Co., supra.*

interest expense is attributable to all activities and property regardless of any specific purpose for incurring an obligation on which interest is paid." Treas. Reg. § 1.861-9T(a). Ironically, respondent relied on these regulations in the proceedings below, defending the interest offset provision as reflecting the same "recognition of the fungible nature of money" as underlies the regulations. Defendant's Franchise Tax Board's Trial Brief (CT p. 178). What respondent utterly failed to appreciate, however, is that the very regulations on which it relied provide for a rational asset-based or income-based allocation of interest to various classes of income, Treas. Reg. §§ 1.861-9T(g), (j), not the wholesale assignment of interest expense to exempt income embodied in the interest offset provision.

* * *

In sum, California's interest offset provision is a deeply flawed and virtually unique approach to the problem of allocating interest expense to related income. It offends bedrock constitutional norms – not to mention common sense – by sweeping nonunitary dividends into the tax base under the guise of denying a deduction, on a dollar-for-dollar basis, for interest expense without regard to the relationship of the interest expense to the interest income. The claim that this anomalous provision is somehow justified because "money, by its very nature, is fungible" (Br. Opp. 12) does not survive scrutiny. The widespread adoption by other States, by the Federal Government, and by California itself of methods designed to allocate fairly interest expense to related income, even in circumstances when the expense cannot be traced to particular income-producing activity, demonstrates that

there are reasonable, and presumptively constitutional, alternatives to the interest offset provision.

II. BY PROVIDING LESS FAVORABLE INTEREST EXPENSE DEDUCTIONS FOR NONDOMICILIARY CORPORATIONS THAN FOR DOMICILIARY CORPORATIONS, CALIFORNIA'S INTEREST OFFSET RULE DISCRIMINATES AGAINST INTERSTATE COMMERCE

At the same time that the interest offset provision permits California to tax nonunitary income that lies beyond its constitutional reach, it creates a second constitutional difficulty of equal concern: It discriminates against nondomiciliary corporations in favor of domiciliary corporations.

To appreciate the nature of this discrimination, one must first understand how California taxes nonbusiness dividends earned by domiciliary and nondomiciliary corporations. Under California's rules for allocation of nonbusiness income, "dividends are allocable to this state if the taxpayer's commercial domicile is in this state." Cal. Rev. & Tax. Code § 25126. Consequently, all of a domiciliary's nonbusiness dividends are allocable to – and taxable by – California. By the same token, none of a nondomiciliary's nonbusiness dividends are allocable to – or taxable by – any State in which it is not domiciled. *See* Stip. ¶ 8 (J.A. 19).

As discussed above, the interest offset provision requires taxpayers to offset their net business interest expense by the amount of their nonunitary, nonbusiness dividends. For a nondomiciliary taxpayer like petitioner, this requirement deprives it of the benefit of an interest expense deduction for California tax purposes. It does so by arbitrarily assigning the interest expense to nonbusiness dividends – income that, as we have just explained, California does not tax when earned by nondomiciliaries. *See* Cal. Rev. & Tax. Code §§ 25123, 25126. The provision thereby reduces the nondomiciliary's *nontaxable* income and leaves its California taxable income intact.

But the opposite is true for a domiciliary corporation, which enjoys the full benefit of an interest expense deduction for California tax purposes. By assigning the domiciliary corporation's net business interest expense to nonbusiness income – income that California fully taxes when earned by domiciliaries, *see* Cal. Rev. & Tax. Code §§ 25123, 25126 – the interest offset provision reduces the domiciliary taxpayer's *taxable* California income.

At first blush, one might view this claim of discrimination as nothing more than a description of the natural consequences of allowing an interest expense deduction that corresponds to the State's power to tax nondomiciliary and domiciliary taxpayers' income. Since California has no power to tax any of the nondomiciliary taxpayer's nonbusiness dividends, California's disallowance of the expense deduction corresponds simply to its lack of power to tax the dividends, not to the taxpayer's nondomiciliary status. By the same token, since California has the power to tax all the domiciliary taxpayer's nonbusiness dividends, California's allowance of the interest expense deduction corresponds simply to its power to tax the dividends, not to the taxpayer's domiciliary status.

The critical flaw in this analysis, however, is that it is based on the false premise that there is some relationship between the nonbusiness dividend income and the expenses that are being assigned to it. If there is no relationship between the nonbusiness dividends and the interest expenses, then the denial or grant of a deduction for the interest expenses cannot be justified by reference to the State's power to tax the nonbusiness dividends. Rather, the denial or grant depends solely on the taxpayer's domicile.

Consider, for example, two corporations D and ND, identical in every respect except that D is a domiciliary of California and ND is a nondomiciliary. Assume both corporations manufacture and sell widgets in California and in other States. Each has $1,000 of apportionable business income from its widget operations, $200 of interest expense on a loan whose proceeds were used to purchase widget manufacturing machinery, and $200 of dividends from a nonunitary subsidiary producing Hula Hoops in Outer Mongolia. Under the interest offset provision, D will be able to deduct the full $200 of interest expense from its California tax base, but ND will be able to deduct nothing. Because the interest offset provision in effect transforms business interest expense into nonbusiness interest expense, it permits D to enjoy (albeit under false pretenses) a deduction against its otherwise taxable nonbusiness dividend while providing ND with a meaningless deduction against the nonbusiness dividend that California cannot tax anyway. Because it is irrelevant under the interest offset provision whether the disallowed interest expense bears any relationship to the production of the income against which the expense is offset, it is apparent that the allowance or disallowance of the deduction turns entirely on the domicile of the dividend-receiving corporation.[30]

California's discrimination against nondomiciliary corporations in favor of domiciliary corporations patently violates established Commerce Clause criteria. The rule prohibiting taxes that discriminate against interstate commerce has been a central tenet of this Court's Commerce Clause doctrine from the very beginning. *See, e.g., Welton v. Missouri*, 91 U.S. 275 (1876); *Cook v. Pennsylvania*, 97 U.S. 566 (1878). No aspect of this doctrine is more firmly entrenched than the principle that a State may not favor in-state over out-of-state entities. *See, e.g., Robbins v. Shelby County Taxing Dist.*, 120 U.S. 489 (1887); *Nippert v. City of Richmond*, 327 U.S. 416 (1946). This Court has repeatedly condemned taxes that "favor[ ] domestic corporations over their foreign competitors." *Fulton Corp. v. Faulkner*, 516 U.S. 325, 333 (1996).

Just last Term, the Court applied these principles in striking down Alabama's franchise tax in *South Cent. Bell Tel. Co. v. Alabama*, 119 S. Ct. 1180 (1999). Alabama's

[30] Even the California Supreme Court has acknowledged that the interest offset provision affords a more favorable interest expense deduction to California domiciliaries than to those domiciled elsewhere. Table II and Table IV and the related discussion in the *Pacific Telephone* decision show that two identical corporations, except one is domiciled in California and one is domiciled outside California, are granted different interest expense deductions in California. 7 Cal. 3d at 551, 553. Under the interest offset, the California corporation is allowed a full $2 interest expense deduction, *id.* at 551 (Table II), whereas the non-California corporation is allowed no deduction for any of its interest expense. *Id.* at 553 (Table IV).

taxing scheme favored domestic over foreign corporations by giving domestic – but not foreign – corporations the ability to reduce their franchise tax liability by reducing the par value of their stock. *Id.* at 1185-86. Observing that the tax "facially discriminates against interstate commerce," a unanimous Court invalidated the tax in short order.

California's preference for its own domiciliary corporations is no different in substance from Alabama's domestic preference legislation condemned in *South Central Bell*. As in *South Central Bell*, there can be no dispute that the taxing scheme in question treats local corporations more favorably than their out-of-state competitors:[31] When domiciliary corporations receive dividends from nonunitary corporations, they receive the full benefit of an interest expense deduction against taxable income. Nondomiciliary corporations, by contrast, must forgo the benefit of the interest expense deduction to the extent of their nonunitary dividends. The preferential treatment persists regardless of whether the interest expense bears any relationship to the production of the dividends in question. Since the allowance or disallowance of the deduction turns entirely on the domicile of the dividend-receiving corporation, it violates the "virtually *per se* rule of invalidity" that this Court applies to facially discriminatory taxes. *See, e.g., Camps Newfound/Owatonna Inc. v. Town of Harrison*, 520 U.S. 564, 596 (1997).

[31] Indeed, respondent has acknowledged that the interest offset provision operates to "increase taxes on foreign corporations while reducing those of domestic corporations." *Pacific Telephone*, 7 Cal. 3d at 554.

III. CALIFORNIA'S DENIAL OF A DEDUCTION TO THE EXTENT THAT A TAXPAYER'S SUBSIDIARY "PARTICIPATES IN INTERSTATE COMMERCE" IS INDISTINGUISHABLE FROM THE STATE TAXING SCHEME CONDEMNED IN *FULTON CORP. V. FAULKNER*, 516 U.S. 325, 333 (1996), AND PROVIDES A WHOLLY INDEPENDENT BASIS FOR INVALIDATING THE INTEREST OFFSET PROVISION

Even if this Court were to find that California is constitutionally entitled to deny petitioner an interest expense deduction to the extent of its nonunitary dividends, the interest offset provision still fails to satisfy constitutional strictures for another, wholly independent, reason: It permits nondomiciliary taxpayers receiving nonbusiness dividends to deduct their interest expense, but *only* to the extent that the dividends derive from corporations that are taxable in California. The interest offset provision therefore offends the Commerce Clause principle that state taxing schemes may not favor in-state over out-of-state investment, *see, e.g., Westinghouse Elec. Corp. v. Tully*, 466 U.S. 388 (1984); *Maryland v. Louisiana*, 451 U.S. 725 (1981), and is virtually indistinguishable from the North Carolina tax regime the Court invalidated in *Fulton Corp. v. Faulkner*, 516 U.S. 325 (1996).

Under the interest offset provision, a taxpayer must reduce its otherwise deductible interest expense by dividends received from nonunitary corporations "except dividends deductible under the provisions of Section 24402." Cal. Rev. & Tax. Code § 24344(b). Dividends deductible under Cal. Rev. & Tax. Code § 24402 are dividends "declared from income which has been included in the measure of" California's franchise tax. Accordingly, the exception to the required reduction of deductible interest expense – and the consequent increase in California taxable income – is correlated to the proportion of the taxpayer's dividend-paying subsidiaries' business that is conducted in California. This Court struck down a strikingly similar taxing scheme in *Fulton*.

In *Fulton*, the Court considered a North Carolina intangible property tax as applied to taxpayers who owned corporate stock. The tax was imposed at the rate of 0.25 percent of the fair market value of the stock. The value of the stock assessed under the tax, however, was reduced by a percentage equal to the percentage of the corporation's income subject to tax in North Carolina. Under this regime, if the stock was issued by a corporation doing all of its business in North Carolina, a 100 percent reduction of the value of the stock would be allowed; if the stock was issued by a corporation doing 50 percent of its business in North Carolina, a 50 percent reduction of the value of the stock would be allowed; and if the stock was issued by a corporation doing none of its business in North Carolina, no reduction of the value of the stock would be allowed.

The Court had no hesitation in branding North Carolina's taxing scheme as "facially" discriminatory (*id.* at 333):

> A regime that taxes stock only to the degree that its issuing corporation participates in interstate commerce favors domestic corporations over their foreign competitors in raising capital among North Carolina residents and tends, at

> least, to discourage domestic corporations from plying their trades in interstate commerce.

Id.

California's interest offset scheme suffers from precisely the same constitutional infirmity. It permits a nondomiciliary taxpayer an interest deduction against taxable income (and thus a reduction in California tax) only to the extent that a nonunitary, dividend-paying subsidiary does business in California. Thus, just as in North Carolina, the taxpayer receives a benefit only insofar as the corporation in which it has invested is doing business in the taxing State. If the taxpayer's nonunitary, dividend-paying subsidiary were doing all of its business in California, a 100 percent deduction of the taxpayer's otherwise deductible interest expense would be allowed; if the taxpayer's nonunitary, dividend-paying subsidiary were doing 50 percent of its business in California, 50 percent of the taxpayer's otherwise deductible interest expense would be allowed; and if the taxpayer's nonunitary, dividend-paying subsidiary were doing none of its business in California, none of the taxpayer's otherwise deductible interest expense would be allowed.

The Court's conclusion with regard to the North Carolina regime applies equally to the California regime:

> A regime that [denies an interest deduction] only to the degree that [the dividend-paying subsidiary] participates in interstate commerce favors domestic corporations over their foreign competitors in raising capital among [California] residents and tends, at least, to discourage domestic corporations from plying their trades in interstate commerce.

Fulton, 516 U.S. at 333. Accordingly, Cal. Rev. & Tax. Code § 24344(b) "facially discriminates against interstate commerce." *Id.*

Little more needs to be said after *Fulton* about the unconstitutionality of California's discrimination in favor of taxpayers who invest in corporations that conduct their activity in California rather than in other States. Nevertheless, it is plain that the provision is wholly irreconcilable with the bedrock principle of this Court's Commerce Clause jurisprudence that "a State may not tax a transaction or incident more heavily when it crosses state lines than when it occurs entirely within the State." *Armco, Inc. v. Hardesty*, 467 U.S. 638, 642 (1984). California's interest offset provision fails to satisfy this criterion.

Consider the choice facing a nondomiciliary corporation like petitioner, which is taxable in California and is considering whether to invest in nonunitary Corporation A, which does business only in California, or in nonunitary Corporation B, which does business only in other States. If petitioner invests in Corporation A, it will receive a deduction for its net interest expense to the extent of the dividends paid by Corporation A. If it invests in Corporation B, it will be denied a deduction for its net interest expense to the extent of the dividends paid by Corporation B.

A more blatant violation of the Court's Commerce Clause doctrine is difficult to imagine. A nondomiciliary corporation which invests in a subsidiary engaged in activity in other States is penalized by comparison to its competitor which invests in a subsidiary that plies its trade within the taxing State. The price of investing outside California is the loss of an interest expense deduction. California's taxing scheme therefore "forecloses tax-neutral decisions" (*Boston Stock Exch. v. State Tax Comm'n*, 429 U.S. 318, 331 (1977)) and has a forbidden impact on interstate commerce because "it exerts an inexorable hydraulic pressure on interstate businesses to ply their trade within the State that enacted the measure rather than 'among the several States.'" *American Trucking Ass'ns v. Scheiner*, 483 U.S. 266, 286-87 (1987).[32]

[32] We wish to reiterate that the constitutional difficulties engendered by the limitation of the interest expense deduction to dividends received from corporations doing business in California exist entirely aside from the constitutional infirmities we have addressed in Points I and II above. *See supra 18 and 33.* Even if the general disallowance of interest expense due to the receipt of tax-exempt dividends were sustained, California still would be precluded from selectively allowing an interest expense deduction based on the extent of the in-state presence of the taxpayer's dividend-paying subsidiaries. Indeed, even if there were no interest offset provision at all, and California simply denied any deduction for interest expense, except to the extent that one received dividends from corporations paying tax in California, the limitation would fail to pass constitutional muster for the reasons set forth above. In short, the denial to petitioner of an interest expense deduction to the extent that its dividend-paying subsidiaries did not derive their income from California is fatally defective, wholly apart from the interest offset provision's other constitutional deficiencies.

CONCLUSION

For the foregoing reasons, the judgment of the California Court of Appeal should be reversed.

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