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PROCEEDINGS BEFORE
THE SUPREME COURT
OF THE
UNITED STATES

CAPTION: HUNT-WESSON, INC. Petitioner v. FRANCHISE TAX
BOARD OF CALIFORNIA
CASE NO: 98-2043 c\|
PLACE: Washington, D.C.
DATE: Wednesday, January 12, 2000
PAGES: 1-45

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THE SUPREME COURT

OF THE

UNITED STATES

CAPTION: HUNT/WESSON INC. (Respondent) v. BR/NCI/HSB TAX

BOARD OF CALIFORNIA

CASE NO: 98-2013

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U.S. Supreme Court

1 IN THE SUPREME COURT OF THE UNITED STATES

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3 HUNT-WESSON, INC. :

4 Petitioner :

5 v. : No. 98-2043

6 FRANCHISE TAX BOARD OF :

7 CALIFORNIA :

8 - - - - -X

9 Washington, D.C.

10 Wednesday, January 12, 2000

11 The above-entitled matter came on for oral
12 argument before the Supreme Court of the United States at
13 11:20 a.m.

14 APPEARANCES:

15 WALTER HELLERSTEIN, ESQ., Athens, Georgia; on behalf of
16 the Petitioner.

17 DAVID LEW, ESQ., Deputy Attorney General, Oakland,
18 California; on behalf of the Respondent.

C O N T E N T S

| | | |
|----|-----------------------------|------|
| 1 | | |
| 2 | ORAL ARGUMENT OF | PAGE |
| 3 | WALTER HELLERSTEIN, ESQ. | |
| 4 | On behalf of the Petitioner | 3 |
| 5 | ORAL ARGUMENT OF | |
| 6 | DAVID LEW, ESQ. | |
| 7 | On behalf of the Respondent | 24 |
| 8 | REBUTTAL ARGUMENT OF | |
| 9 | WALTER HELLERSTEIN, ESQ. | |
| 10 | On behalf of the Petitioner | 44 |
| 11 | | |
| 12 | | |
| 13 | | |
| 14 | | |
| 15 | | |
| 16 | | |
| 17 | | |
| 18 | | |
| 19 | | |
| 20 | | |
| 21 | | |
| 22 | | |
| 23 | | |
| 24 | | |
| 25 | | |

1 P R O C E E D I N G S

2 (11:20 a.m.)

3 CHIEF JUSTICE REHNQUIST: We'll hear argument
4 next in Number 98-2043, Hunt-Wesson v. Franchise Tax
5 Board.

6 Spectators are admonished, do not talk so long
7 as you're in the courtroom. The Court remains in session.

8 Mr. Hellerstein.

9 ORAL ARGUMENT OF WALTER HELLERSTEIN

10 ON BEHALF OF THE PETITIONER

11 MR. HELLERSTEIN: Mr. Chief Justice, and may it
12 please the Court:

13 This case involves a constitutional challenge to
14 two mechanisms that California employs to deny
15 nondomiciliary corporations, like petitioner here, an
16 otherwise allowable interest expense deduction. Each of
17 these mechanisms provides an independent basis for
18 invalidating the application of California statute to
19 petitioner.

20 First, as respondent has stipulated, California
21 denied petitioner an interest expense deduction entirely
22 because it received nontaxable dividends from nonunitary
23 subsidiaries.

24 Second, California denied petitioner an interest
25 deduction because those dividends were paid by

1 subsidiaries that did no business in California. It is
2 worth stressing at the outset, Your Honors, that the
3 second mechanism is indistinguishable from the taxing
4 scheme that this Court struck down in *Fulton Corporation*
5 *v. Faulkner*.

6 QUESTION: Well, I suppose we don't have to
7 answer all the questions here if we were to find that the
8 interest offset is unconstitutional because it taxes
9 income over which California lacks jurisdiction to tax.
10 That's the end of it, presumably.

11 MR. HELLERSTEIN: That is correct, Justice
12 O'Connor. Either basis would be -- would invalidate the
13 statute.

14 During the tax years at issue here, 1980 to '82,
15 petitioner Hunt-Wesson, which is the successor in interest
16 to the original taxpayer in this case, the Beatrice Foods
17 Company, earned lawfully \$75 million in dividends from
18 nonunitary subsidiaries. Now, it is undisputed here that
19 California had no power to tax those dividends under this
20 Court's decisions in *ASARCO*, and *Woolworth* --

21 QUESTION: Beatrice was an Illinois domiciliary
22 the same way Hunt-Wesson is?

23 MR. HELLERSTEIN: Yes, Chief Justice Rehnquist,
24 Beatrice was an Illinois domiciliary. Actually, Hunt-
25 Wesson is a California domiciliary, but they -- again,

1 they were the successor in interest. During the years at
2 issue we are dealing with an Illinois domiciliary.

3 Now, during those same years, California denied
4 Beatrice an interest deduction --

5 QUESTION: Beatrice, I think. It's named after
6 a little town in Nebraska, and I think it's pronounced
7 Beatrice.

8 MR. HELLERSTEIN: Beatrice. Mr. Chief Justice,
9 I will pronounce it Beatrice.

10 (Laughter.)

11 QUESTION: Smart move.

12 (Laughter.)

13 MR. HELLERSTEIN: During these years, Beatrice
14 received a -- its interest expense deduction was denied on
15 a dollar-for-dollar basis simply because it received these
16 nontaxable dividends.

17 There is no evidence, no evidence at all in this
18 case that the interest expense bore any relationship to
19 these dividends. Indeed, even if we had proven -- if we
20 had proven that every penny of our interest expense had
21 gone to generate California taxable income, we would have
22 been denied this interest expense deduction simply because
23 we had these nontaxable dividends. Now, this --

24 QUESTION: Let me ask this question. What if
25 the interest expense had been incurred to generate

1 different nonunitary income. Say you borrowed money to
2 buy a lot of securities in Japan, whereas the income here
3 is from income from securities in Germany, would it then
4 be permissible? Do you understand my question?

5 MR. HELLERSTEIN: I'm not sure. I mean, the way
6 that --

7 QUESTION: I want to give you a hypothetical in
8 which the interest expense is incurred to generate
9 nonunitary income but not the nonunitary -- not the same
10 nonunitary income that might be earned elsewhere.

11 MR. HELLERSTEIN: Yes, Justice Stevens, I
12 understand your question, and the answer to your question
13 is that this statute works regardless of any proof of any
14 relationship.

15 QUESTION: I understand.

16 MR. HELLERSTEIN: There could be a relationship,
17 there couldn't be a relationship. It's like throwing
18 darts at a dartboard.

19 QUESTION: Well --

20 MR. HELLERSTEIN: It might work, might not.

21 QUESTION: Well, maybe in Justice Stevens'
22 hypothetical it wouldn't be deductible in the first place.

23 MR. HELLERSTEIN: Well, in Justice Stevens'
24 hypothetical, if we have interest expense, under the
25 California regime we get the deduction first against any

1 interest, business interest income we have, and then we're
2 denied the deduction if we have the nontaxable dividends.

3 QUESTION: But the interest has to be business
4 interest income, does it not, used for a purpose -- the
5 money has to be used for a purpose in connection with the
6 business, or does it not?

7 MR. HELLERSTEIN: The interest expense that we
8 have, the interest expense is defined at the Federal
9 level. We use a Federal taxing scheme, so the Federal
10 Government does not distinguish between whether or not the
11 interest expense is business or nonbusiness.

12 Now, under the California statute and under
13 their own -- or their own schedule, the very first thing
14 we do is, we take any interest expense that is, in fact,
15 attributable to the nonbusiness income, and we take that
16 out of the mechanism. Then the only thing that is left is
17 the interest expense associated with the business. It is
18 that interest expense that in fact is put into this little
19 mechanism that California has that denies us on a dollar-
20 for-dollar basis the deduction against the nonunitary
21 dividends.

22 QUESTION: Is that the subject of that --

23 QUESTION: Go on.

24 QUESTION: Was that the subject of sort of the
25 disagreement as to whether in fact under the California

1 scheme you are supposed to deduct the nonbusiness income
2 from -- interest expense from --

3 MR. HELLERSTEIN: That is correct, Justice
4 Souter. Let me explain that, because there has been a
5 dispute, and both sides say the dispute doesn't matter.

6 QUESTION: Could you tell me, for --

7 MR. HELLERSTEIN: Yes.

8 QUESTION: -- I was about to ask what you mean
9 by nonbusiness interest expense. Is it just interest
10 expense, or nonbusiness income, for that matter? Does
11 that mean just income that California can't tax, or does
12 it have some other meaning?

13 MR. HELLERSTEIN: Yes.

14 QUESTION: Let's get a definition.

15 MR. HELLERSTEIN: Okay. Let's start with
16 nonbusiness income. Nonbusiness income is income that
17 under this uniform statute that many States have is
18 allocated, that is, is sent to one jurisdiction or
19 another, rather than put into this mix that's mixed up and
20 apportioned. Now --

21 QUESTION: It's really business income that just
22 can't be taxed --

23 MR. HELLERSTEIN: Oh --

24 QUESTION: -- in this case by California.

25 MR. HELLERSTEIN: Well, let me -- I must be a

1 bit more -- I've got to polish it a bit, because in our
2 case that's correct. In our case the particular
3 nonbusiness income we're talking about are nonunitary
4 dividends, and there's no dispute that California can't
5 tax that.

6 If, for example, Beatrice had an unrelated
7 beauty parlour in California, California could have taxed
8 that. That might be nonbusiness income, but if it was in
9 California it could have been taxable. But in this case,
10 there's no distinction. There's no dispute that the
11 nonbusiness income is not taxable.

12 Now, to answer your question about what is
13 nonbusiness interest expense, I think we use that term,
14 and I don't think there'd be any disagreement here, we
15 would use that term to describe any interest expense that
16 could be directly traced to the nonbusiness dividends.

17 If, for example -- and there's no evidence in
18 this case that anything like this happened -- if, for
19 example, we had gone out and borrowed money to acquire the
20 nonunitary subsidiaries, and you could trace that
21 borrowing to the nonunitary subsidiaries, then to be sure
22 you would have nonbusiness interest expense, and we
23 would -- our position here is that California could
24 probably deny that.

25 They could probably deny it if they had a

1 tracing mechanism, which they don't, if they said, we've
2 seen that you've gone out and you borrowed money to buy
3 something that's going to generate income that you can't
4 tax, we accept that. Indeed, we even accept their notion,
5 which is that it's impossible to trace. All interest is
6 fungible. All the money is fungible. Who knows where we
7 use this. Again, we can -- we accept that proposition.

8 The problem is that California statute doesn't
9 implement that proposition. When, in fact, you don't know
10 where the interest expense is earned, that is, you can't
11 do the tracing that we're talking about, what do
12 jurisdictions do?

13 QUESTION: I'm not sure what you accept insofar
14 as the fact that all money's fungible and can't be traced.
15 You say you accept that proposition.

16 MR. HELLERSTEIN: No, what I'm saying is --

17 QUESTION: And that's -- it seems to me that you
18 might accept that proposition in some instances, but not
19 in every instance, or then you'd lose your case. Or am I
20 wrong?

21 MR. HELLERSTEIN: I think, Justice Kennedy, I
22 don't believe you're right that we'd lose our case,
23 because we're willing to -- we accept the proposition that
24 a State can reasonably take the position, and California
25 in this case could reasonably have taken the position that

1 all money is fungible, and therefore it is impossible ever
2 to trace on a direct basis a dollar of interest income to
3 a dollar of interest expense.

4 But even accepting that proposition, one thing
5 is clear from -- when you accept that proposition that you
6 are then saying, you don't know where money is coming from
7 or going, but then it cannot be -- it cannot be assigned
8 disproportionately to nontaxable income rather than to
9 taxable income, so even accepting the notion that money is
10 fungible, all we're saying -- and we're not saying --
11 we're not trying to constitutionalize any particular
12 methodology.

13 All we're saying is, do what 48 other State, or
14 45 other States do, do what the Federal Government does.
15 Spread it around on any of a variety of reasonable bases,
16 including, if you'll read the letter that California's
17 already written to General Electric if they lose this
18 case, spread it around based on where your assets are.
19 That is, if you don't know where your money's coming
20 from --

21 QUESTION: Or deny the deduction altogether.

22 MR. HELLERSTEIN: Justice Kennedy, if California
23 wanted to deny all interest deduction to all taxpayers,
24 whether they had taxable or nontaxable income, we wouldn't
25 be here. We think that's quite arbitrary. It might no

1 longer be a net income tax, but that's not the
2 constitutional issue raised by this case.

3 The problem here is that what California has
4 done is, under the guise of saying money is fungible, come
5 up with a mechanism that disproportionately assigns
6 income, at least in our case, to the nontaxable income, so
7 based on the undisputed facts of this case, California's
8 taken the position that somehow we never make a dollar, a
9 penny -- we never make a penny from interest expense
10 invested in nonbusiness income.

11 QUESTION: But if California could deny interest
12 deductions in toto -- your claim here is more of an equal
13 protection claim, that you've been treated differently
14 than other California corporations similarly situated, and
15 I'm not sure that's made out.

16 MR. HELLERSTEIN: No, Chief Justice Rehnquist,
17 our claim is that while we agree that California could
18 have an across-the-board nondiscriminatory treatment of
19 interest expense, what California is doing, and the court
20 below held -- the trial court held they were violating the
21 Equal Protection Clause, but we've not raised that here.

22 We're saying that what this does, what this
23 statute does is two things. First, it sweeps nontaxable
24 income into the tax base. That's a due process violation.
25 That's an extraterritorial component. California in fact

1 says that we're going to measure your tax by these
2 dividends out there that we can't get our hands on under
3 ASARCO, under Woolworth, number 1.

4 Number 2, we're also -- in our view this also
5 has a discriminatory component, because when you look at
6 who gets this interest deduction it's only the domiciliary
7 rather than the nondomiciliary. As arbitrary as the
8 statute is, it helps the domiciliary because these -- this
9 interest expense is always attributed to the nonbusiness
10 income, which in this case would be taxable by California,
11 so the nondom -- so the domiciliary gets the full tax
12 deduction, whereas the nondomiciliary --

13 QUESTION: Oh, I don't see how that helps you.
14 I mean, I'm not saying that you don't have a good case in
15 the other part, but I mean, after all, it's an Illinois
16 corporation. I take it if they allocate all of the
17 interest income to the Illinois Mongolian sheep farm, that
18 Illinois, they'll get the deduction on the Illinois income
19 tax.

20 MR. HELLERSTEIN: No, Justice Breyer, because
21 Illinois does not have this arbitrary system like
22 California does. Illinois would take the position that
23 this -- one of two positions. I'm assuming it could
24 either trace -- it could say, we're going to directly
25 trace --

1 QUESTION: Do you know, does that really happen?
2 So in other words when California insists that the tin can
3 business allocates its interest income to its Mongolian
4 sheep farm, the -- Illinois will not allow them to deduct
5 that interest expense that California shifted over there.

6 MR. HELLERSTEIN: That is correct. In other
7 words -- let me just make sure that I -- I mean --

8 QUESTION: I'm making up -- what I keep --

9 MR. HELLERSTEIN: Yes. No, but -- no --

10 QUESTION: -- is, in my mind I imagine a tin can
11 company selling all over the United States. It owns a
12 Mongolian sheep farm.

13 MR. HELLERSTEIN: Exactly, and --

14 QUESTION: Okay. Now -- go ahead.

15 MR. HELLERSTEIN: And therefore the -- this
16 would -- it would generate nonbusiness dividends.
17 California would say, gee, you have interest equal to
18 those nonbusiness dividends, no deduction, and then in
19 Illinois -- then the question would be whether Illinois
20 would take the same position, and the answer is no,
21 because Illinois, being a State that is not off the radar
22 screen like California, but does what other States do,
23 they'd look at their interest expense, see whether or not
24 this interest was associated first with the Outer
25 Mongolian sheep farm.

1 If it wasn't -- if it was, they get the
2 deduction, because this is a domiciliary State. If it
3 wasn't, it would go into the pool and they might spread it
4 around, so that's how it would work.

5 QUESTION: Mr. Hellerstein, your position is not
6 that California couldn't reject any part of this. It
7 could have an offset, but it as to be according to some
8 apportionment, some reasonable apportionment.

9 MR. HELLERSTEIN: That is precisely right,
10 Justice Ginsburg. Our position is that there are a wide
11 variety of acceptable methodologies for assigning or
12 allocating income to various jurisdictions. They're in
13 place in all of the States, they're in place at the
14 Federal level, and what we're simply saying is that you
15 cannot have allocation by wishful thinking, which is
16 essentially what California has here. It's a simply --

17 QUESTION: What is -- assuming we agree, but
18 what does California do with respect to these back years
19 that have already been treated this way?

20 MR. HELLERSTEIN: Well, I can tell you that
21 our --

22 QUESTION: Can it adopt a, what you would
23 consider a constitutional rule, and apply them to those
24 past years?

25 MR. HELLERSTEIN: Justice Scalia, I can only

1 speak to two specific situations that -- one that I'm
2 aware of because it's our case, another because it's in
3 the amicus brief. Certainly with regard to our case there
4 has been -- we have stipulated to the refund to which
5 we're entitled should we prevail in this case.

6 It was my understanding from -- certainly from
7 the letter that California has written to General --

8 QUESTION: On the basis of what, some kind of
9 apportionment scheme that you're willing to accept?

10 MR. HELLERSTEIN: No. The stipulation -- the
11 stipulation was based on a -- it was an all-or-nothing
12 proposition. We were going -- there might have been
13 settlement negotiations earlier, but at this point we
14 agreed here --

15 QUESTION: You'll get it all back.

16 MR. HELLERSTEIN: If we win.

17 QUESTION: And it's too late for them to say,
18 okay, we'll apportion some of it. They -- none of it
19 would be --

20 MR. HELLERSTEIN: For these particular years,
21 that is correct, Justice Scalia. However, I think it's
22 quite clear, from the letter appended to the General
23 Electric's brief, that California is aware of this
24 litigation, they have written letters to General Electric
25 and presumably to other taxpayers saying, and by the way,

1 if we lose this case, you'd better apportion your interest
2 expense by a reasonable amount, namely an asset allocation
3 method, so I --

4 QUESTION: Well, on that basis maybe you could
5 help me understand what the State says in its red brief at
6 page 21.

7 It says, if a deduction of the entire amount of
8 interest expense is allowed, the corporation stands to
9 gain a tax windfall, and then it goes on. I take it
10 that's only because California does not have an
11 apportionment system in place, is that correct?

12 MR. HELLERSTEIN: I think frankly --

13 QUESTION: I mean, is that the way you would
14 answer that? You'll say, well, sure, but if you have an
15 apportionment scheme in place like other States do, there
16 won't be a windfall. Is that how you answer that?

17 MR. HELLERSTEIN: Actually, Justice Kennedy, the
18 way I would answer that, I think that's because of
19 California's Californiacentric view of the universe. In
20 fact, there is no windfall, because Beatrice pays taxes in
21 45 other States, so that the -- any income -- we're not
22 talking about tax exempt municipal bonds here. I mean,
23 income that California says is not taxable in California
24 because it's not a unitary -- part of the unitary business
25 is presumably taxable somewhere else.

1 The only time there would be a windfall would be
2 if the income that California is not taxing under a proper
3 scheme is somehow not taxed by the other jurisdiction.

4 QUESTION: Well, is the answer there wouldn't be
5 a windfall if there were an apportionment scheme? Would
6 you accept that answer?

7 MR. HELLERSTEIN: I would certainly accept that
8 if California apportioned in the way that other States
9 apportioned, there would be no windfall, that is correct.

10 QUESTION: But you don't intend, do you,
11 Mr. Hellerstein, that California has to have the same
12 method of taxing that -- even if 48 other States have it,
13 the Constitution doesn't require them to have --

14 MR. HELLERSTEIN: Absolutely not, Mr. Chief
15 Justice. Absolutely not. We are saying that there are --
16 we are saying that their method is so far off the radar
17 screen, is so different from any method that even
18 approximates a reasonable method, and there are a large
19 variety of them, whether it's assets or gross receipts or
20 net income, any of those would be appropriate.

21 Indeed, to look at this Court's own opinions,
22 this Court has looked at this problem in a number of
23 instances, generally when the question was whether or not
24 a taxpayer, or how a taxpayer should attribute expense
25 between taxable income and tax exempt income, generally

1 either municipal bond income that wasn't taxable at the
2 Federal level, or alternatively, Federal taxable income
3 that wasn't taxable by the States, and what the Court has
4 said -- when the Court has looked at this, the Court has
5 really rejected both extremes.

6 The Court has rejected the extreme view of the
7 States, which has been to say -- or the taxing authority,
8 when the taxing authority has said, you may not deduct
9 1 penny of this expense -- that is, the expense must be
10 matched dollar-for-dollar against the tax-exempt income,
11 which is what the -- the kind of situation that arises in
12 National LIfe, the Court said, you can't do that, because
13 that really undermines the exemption.

14 On the other hand, when taxpayers have been
15 greedy, when taxpayers have said, we don't want \$1 of our
16 expense assigned to our nontaxable income, because that
17 undermines the exemption, the Court has said no, that's
18 not right, either.

19 What the Court has said is really precisely what
20 most States and the Federal Government have said in this
21 kind of situation, is when you don't know, when you can't
22 trace the amounts, what you do is, you spread it evenly.
23 This Court has said, there's no reason in law, or no sound
24 legal or economic reason for distinguishing between the
25 taxable and the nontaxable dollar. That's the theme. So

1 long as there is some reasonable apportionment between
2 taxable and nontaxable, that, I think, is all the
3 Constitution requires.

4 What the Constitution forbids is a
5 disproportionate assignment of income to values that
6 cannot be taxed.

7 QUESTION: Can you -- because I'm not totally
8 familiar. Which part of the Constitution forbids that?

9 MR. HELLERSTEIN: Forbids --

10 QUESTION: I mean, let's assume you're
11 completely right.

12 MR. HELLERSTEIN: Right.

13 QUESTION: This is totally irrational. I mean,
14 it's completely unfair. They're taxing income that arises
15 in other places. What is -- what -- can you just trace
16 through for 1 second what the argument is that that
17 violates the Constitution?

18 MR. HELLERSTEIN: Yes, Justice Breyer. It will
19 depend on --

20 QUESTION: I know there will be cases that
21 support you, but I mean, what's the reasoning?

22 MR. HELLERSTEIN: Well, I guess, you know, it
23 would depend on the provision. Well, the basic thought is
24 that by arbitrarily denying the deduction you are taxing
25 the income, so --

1 QUESTION: And what prevents California from
2 taxing income from Mongolia, or Illinois or something?

3 MR. HELLERSTEIN: The Due Process and the
4 Commerce Clause, as this Court has held in Allied-Signal
5 and ASARCO and Woolworth. In the intergovernmental
6 immunities cases, that is, when we're dealing with --
7 let's deal with the modern cases. We're dealing with
8 State taxation of Federal obligations such as in the
9 Barker Bank case. There, Georgia would have been
10 forbidden under the -- under McCullough v. Maryland, but
11 as embodied in, know in Federal statutes from taxing the
12 Federal income. Some of the earlier cases are based on
13 the --

14 QUESTION: But the Federal principle that a
15 State can't tax a Federal entity wouldn't necessarily
16 carry over if you weren't dealing with a Federal entity.

17 MR. HELLERSTEIN: Well, Chief Justice Rehnquist,
18 the way the cases have arisen with regard to that issue,
19 that is, it is a given proposition of -- I think of
20 Federal constitutional law and also valid Federal
21 statutory law that States may not tax income from Federal
22 obligations, so a State, for example, could not come along
23 and deny, as California has denied, an interest expense
24 deduction arbitrarily assigned to every dollar of Federal
25 income that it can't tax.

1 QUESTION: Yes, but income from a Federal
2 obligation may be different for constitutional purposes
3 than income from some other kind of obligation.

4 MR. HELLERSTEIN: That is correct. That is
5 correct.

6 QUESTION: And so what is it that -- one day
7 California says, you know, we're taxing people. We don't
8 want to be fair, and what we're going to do is, we are
9 going to tax income that arises in Illinois, and moreover,
10 it's going to be terrible, because companies are going to
11 have to pay more tax than they have income.

12 QUESTION: Well, I thought we'd held in Allied-
13 Signal that it violates the Due Process Clause --

14 QUESTION: That's what I wondered.

15 QUESTION: -- for a State to tax --

16 QUESTION: It's the Due Process Clause that it
17 does that --

18 QUESTION: Extraterritorial --

19 QUESTION: -- because it takes their property
20 without due process.

21 MR. HELLERSTEIN: It is both, indeed, as Justice
22 O'Connor was pointing out, and in Allied-Signal the Court
23 said that the extraterritorial analysis, or the bar on
24 State taxation of extraterritorial values is rooted both
25 in the Due Process and the Commerce Clauses, so you'd have

1 two constitutional bases for that.

2 QUESTION: Well, what about the argument that,
3 indeed, your client is getting a windfall because home
4 States like Illinois give a tax break for this category of
5 investment income?

6 MR. HELLERSTEIN: Well, in fact, Justice
7 Ginsburg, Illinois is not a tax haven, and during the
8 years at issue here, the -- and this -- by the way, these
9 were years during which there was considerable uncertainty
10 as to whether or not income was apportionable. There were
11 the -- this Court -- some members of this Court will
12 recall the ASARCO and Woolworth and container cases in the
13 eighties, where there was uncertainty.

14 Illinois had a regulation at that -- during
15 those years that actually allowed a domiciliary
16 corporation like Beatrice, and the regulation is 300-
17 2(c)(2)(A), that during those years allowed a domiciliary
18 corporation to apportion its income.

19 Now, that was a decision made by Illinois.
20 Illinois had the constitutional power, and indeed our --
21 it is stipulated in the -- it's -- I believe it's
22 stipulation, paragraph 8. It's stipulated that nonunitary
23 dividends were taxable by the State of Illinois, so
24 there's no windfall tax haven issue here. In fact --

25 QUESTION: You don't think that matters, though,

1 do you, anyway?

2 MR. HELLERSTEIN: No.

3 QUESTION: If Illinois decides to be generous
4 and not tax something, California, if it has no
5 jurisdiction to tax, can say, hey, you know, somebody's
6 getting a break. We ought to be able to reap that tax.

7 MR. HELLERSTEIN: That --

8 QUESTION: It would still not be -- not be
9 justified.

10 MR. HELLERSTEIN: That is precisely right,
11 Justice Scalia. California's power to tax does not expand
12 based on Illinois' decision whether or not to tax. We'd
13 have -- I'd like to reserve the next 5 minutes for
14 rebuttal. Thank you.

15 QUESTION: Very well, Mr. Hellerstein.

16 Mr. Lew, we'll hear from you.

17 ORAL ARGUMENT OF DAVID LEW

18 ON BEHALF OF THE RESPONDENT

19 MR. LEW: Mr. Chief Justice, and may it please
20 the Court:

21 I think the issue before this Court can be
22 simply stated, and that is, what interest expense is
23 California constitutionally required to treat as a tax
24 deduction?

25 As this Court has held, a State bears no

1 constitutional obligation to permit a taxpayer to take a
2 deduction for an expense which relates to income which
3 that State is barred from taxing. The petitioner in this
4 case has conceded that States such as California have the
5 constitutional authority to allocate expenses to different
6 streams of income and, more importantly, concedes that
7 States have the authority to do so by applying formulas
8 that assign interest expense to income that is not taxable
9 by the State of California.

10 The petitioner's narrow --

11 QUESTION: Yes, but the problem here is,
12 California has chosen to allocate 100 percent of the
13 taxpayer's interest expense in excess of its business
14 interest income to its generation of nonbusiness income
15 that's not taxable by California.

16 MR. LEW: Well, the --

17 QUESTION: I mean, it's California's choice to
18 have this scheme, and it's enacted one that does raise
19 concerns of trying to tax extraterritorial income, in
20 effect. I mean, California wouldn't have to do it this
21 way. California could have a reasonable allocation
22 method. But what's the rationale for this scheme it does
23 have, which just seems to go beyond what California is
24 authorized to do?

25 MR. LEW: Well, the answer to your question,

1 Justice O'Connor, is that what California is trying to do
2 with this statute is basically eliminate a double tax
3 benefit that arises whenever a corporation, number 1,
4 incurs debt, and there is therefore interest expense
5 generated by that debt, and at the same time has funds
6 invested in nontaxable activities which produce nontaxable
7 income.

8 The problem is that part of the debt either
9 directly or indirectly is used to support the nontaxable
10 activities.

11 QUESTION: But you solved that problem by
12 denying it against all nonunitary income whether or not
13 the interest expense was related to it.

14 MR. LEW: Well, what the statute is attempting
15 to do, Justice Kennedy, is to essentially close that
16 loophole in the most effective way possible.

17 QUESTION: Well, of course, it's always
18 effective if you deny apportionment.

19 MR. LEW: Well, the theory behind doing it on a
20 dollar basis -- and if I may just take one step back. The
21 formula first allocates interest expense to -- against the
22 corporation's business interest income on a dollar-for-
23 dollar basis.

24 QUESTION: And if the business interest is big
25 enough, then there's going to be no problem.

1 MR. LEW: That's correct. All of it is -- all
2 of it is deductible.

3 QUESTION: Of course.

4 MR. LEW: To the extent that any remains, that
5 is allocated also on a dollar-for-dollar basis against the
6 corporation's nonbusiness income, and again it's intended
7 basically to eliminate the possibility that any amount of
8 that interest expense which is related to the generation
9 of income that's not taxable by the State of California is
10 used by the corporation to reduce its California tax base.

11 QUESTION: Yes, but it's not allocable against
12 all its nonbusiness income.

13 MR. LEW: It's -- well, the answer to your
14 question is, it's allocable against its nonbusiness
15 interest and dividend income. That's what the statute
16 calls for.

17 QUESTION: My can company has no business
18 interest income. It's not in the lending business. It
19 sells \$1 million worth of cans in California. It happens
20 to borrow about \$900,000 to get the tin. Now, what
21 conceivable reason does California have to allocate that
22 \$900,000 that they used to buy the tin for the cans to
23 some kind of income it has from the sheep farm in Florida?

24 MR. LEW: Because the money that is borrowed
25 basically is -- can't -- is used to free --

1 QUESTION: Say you don't know. Maybe they're
2 lying. They said they used it for tin, but maybe they're
3 not telling the truth. Okay, other States have dealt with
4 that problem by saying, since we can't trust anybody here,
5 and it's hard to trace, what we'll do is, we will
6 proportionately allocate. If you have a million coming in
7 from the tin business, and you have 100,000 from the sheep
8 farm, do it 10 percent to the sheep farm, 90 percent to
9 the tin.

10 All right. Now, why -- what possible reason is
11 it for not taking some variation on that theme? Of
12 course, if you can show it went to the sheep farm, that's
13 the end of it. You win. But where you just don't know --

14 MR. LEW: There's nothing wrong with a
15 proportional approach, Your Honor, except that it doesn't
16 really close the loophole.

17 QUESTION: How does it not close the loophole?

18 MR. LEW: Because to the extent that less than
19 \$1 of interest expense is used to offset a dollar of
20 nonbusiness income, there's still that differential that
21 exists.

22 QUESTION: Sure there's a differential, but the
23 sheep farm had nothing whatsoever to do with the lending.

24 MR. LEW: Well --

25 QUESTION: I mean, I don't see why you call that

1 a loophole.

2 MR. LEW: The assumption is that it's not
3 related, and --

4 QUESTION: Yes, right. Oh, you mean maybe it is
5 related?

6 MR. LEW: Indirectly, yes.

7 QUESTION: Well, maybe the tin is really
8 related, so why don't you allocate all the deduction for
9 the tin to the sheep, too?

10 MR. LEW: Well, the answer is that you just
11 don't know that, and what -- and what California is trying
12 to do is to prevent any of that interest that might be
13 related to the generation of income that it cannot tax to
14 be used to reduce its California tax base.

15 QUESTION: Well, when you say they just don't
16 know, what you're referring to is the -- a process in
17 which most States know by virtue of a reasonable
18 apportionment formula, and so when you say, well, we just
19 don't know, that seems to be the equivalent of saying,
20 well, we can't apportion, but you clearly can.

21 MR. LEW: Well, there's no problem,
22 constitutional problem with apportionment. I mean, that
23 is one way to deal with the problem for sure, but to the
24 extent that interest in fact does relate to nonbusiness,
25 or nontaxable income, there's still that -- there's still

1 that possibility that a portion of the interest expense
2 that in fact relates to generation of nontaxable income is
3 going to be applied to reduce the corporation's California
4 taxes.

5 QUESTION: Yes, but you don't know either, and
6 instead of adopting an apportionment formula, what you in
7 effect do is adopt an irrebuttable presumption, and as
8 against an apportionment formula, which provides a
9 rational basis, and an irrebuttable presumption which
10 ignores the facts, due process normally requires the
11 rational process.

12 MR. LEW: Well, I can only say that the
13 objective of the State is to attempt to eliminate that
14 possibility of the taxpayer receiving a double tax
15 benefit.

16 QUESTION: Oh, you certainly do that.

17 QUESTION: Yes.

18 (Laughter.)

19 QUESTION: No question.

20 QUESTION: You achieve that objective.

21 (Laughter.)

22 MR. LEW: And toward that objective it seems
23 that the way that California does it is reasonable,
24 because a dollar-for-dollar offset of interest expense and
25 interest or dividend income basically returns the

1 corporation to the same economic position --

2 QUESTION: Well, it does if there's a dollar-
3 dollar relationship between the expense and the income,
4 and you're in effect saying, we don't care. We will
5 simply assume that, and we will assume that by means of
6 this presumption, and due process requires rationality,
7 not irrebuttable presumptions.

8 MR. LEW: Well, you know, we can't say that it
9 does or it doesn't. That is --

10 QUESTION: But you have to say that it does.
11 You don't have a right to send a tax bill to every
12 nondomiciliary of California for all of their income, and
13 you say, well, you know, we can't be sure that we can't
14 tax it.

15 (Laughter.)

16 QUESTION: It's just irrational. You either
17 demonstrate that it comes from this other nontaxable
18 income, or -- or, if you can't demonstrate it, then, you
19 know, do a reasonable apportioning, but you do neither
20 one. You're just saying, here, here's a tax bill, pay it,
21 or we're not sure where this income comes from, but we
22 don't want you to get away with something.

23 MR. LEW: Well, it seems to me that the economic
24 reality -- the dollar-for-dollar allocation is really an
25 attempt to reflect the economic reality that interest

1 income is the economic counterpart to interest expense.

2 If a corporation borrows money --

3 QUESTION: If you treat the interest as paid --
4 say you have a mortgage on a new plant that you're using
5 in California. You treat it as the functional equivalent
6 of interest to buy securities in Mongolia that are going
7 to have nothing to do with the unitary business. You just
8 merge all of your interest income and treat it as
9 fungible.

10 MR. LEW: That's --

11 QUESTION: Your interest expense, I mean,

12 MR. LEW: That's correct.

13 QUESTION: Yes, and notwithstanding the fact
14 that it's very easy to identify that in fact some of the
15 income produced by those borrowings is not part of the
16 unitary business.

17 MR. LEW: Well, I think that if the Court
18 accepts the notion of fungibility, then the problem is
19 being --

20 QUESTION: If it wasn't spent there, it could
21 have been spent elsewhere, so it's hard to say that it
22 necessarily went to this. It's saving you spending other
23 money elsewhere. Of course, that's true.

24 MR. LEW: That's correct.

25 QUESTION: But if you adopt that fungibility

1 principle, which your opponent is quite willing to accept,
2 what it leads to is not the conclusion that you can tax
3 all of it, but the conclusion that you should apportion
4 it.

5 MR. LEW: Well -- well, I disagree with the idea
6 that it is being taxed. After all, the formula itself
7 allows as a first step an allocation of interest expense
8 against a corporation's business interest income, so to
9 the extent that the amount of business interest income
10 is -- swallows up the entire amount of the expense, then
11 all of it is allocated to reduce the corporation's
12 California taxes.

13 QUESTION: I don't see what that -- I mean, most
14 businesses, except if they're in the financial business,
15 don't have a lot of business interest income compared to
16 their other business, so I don't think that helps too
17 much, does it?

18 MR. LEW: Well, I think it -- I think it
19 demonstrates that the statute applies its rules in a fair
20 and even-handed way. I mean, certainly it is possible
21 under California's statute for a corporation to come out
22 better than it would under a proportional approach, and I
23 think that that is one of the things that has to be
24 understood, that the statute does allocate interest
25 expense to interest income and dividend income in a fair

1 and in an even-handed basis. In fact, the first step of
2 the statute allocates it to business interest income.

3 And with regard to the -- what the statute does,
4 it basically shifts those deductions which it considers to
5 be attributable to nontaxable income to the -- it
6 attributes it to the income which is then taxed -- which
7 is then allowed as the deduction by the State of domicile
8 if, in fact, that State utilizes a statutory scheme which
9 is similar to California's.

10 Now, it is true that none of the other States
11 currently adopt such a provision, but under this Court's
12 internal consistency analysis I'm not sure whether or not
13 that's a constitutionally significant point. If in fact
14 it were the case that all of -- that all States utilized
15 this formula, then the taxpayer would be able to have the
16 benefit of all of the deductions which California has
17 essentially shifted over to the State of domicile and
18 enjoy a reduction in its nonbusiness income in that State.

19 It -- the statute simply attempts to assign
20 interest expense to its proper use or application, and it
21 does so on a dollar-for-dollar basis against its business
22 income and against the corporation's nonbusiness income.
23 In that sense, it is applied even-handedly, and again,
24 those deductions would be available to the corporation in
25 the State of domicile under a consistent -- internal

1 consistency analysis.

2 Now, as I said, the proportionality approach is
3 one way of dealing with the problem, but again it doesn't
4 solve the problem of a corporation obtaining a tax benefit
5 completely, because to the extent that less than --

6 QUESTION: Wait, only if Illinois or, you know,
7 some other State decides to give it the tax benefit, and
8 that's none of your business. If some other State wants
9 to give them a tax double benefit, that's none of
10 California's business.

11 MR. LEW: Sure. I agree.

12 QUESTION: So -- but that's the tax benefits
13 you're talking about.

14 MR. LEW: No. I'm talking about the tax benefit
15 that arises when a corporation incurs debt, is able to
16 write off the interest expense from that debt, and at the
17 same time use that debt, either directly or indirectly, to
18 generate income which California is not permitted to tax.
19 That is the double tax benefit that I'm talking about.

20 QUESTION: Yes, but California asserts here the
21 right to treat it as though it was all used, the money, to
22 generate nonbusiness income.

23 MR. LEW: That's right. That is correct.

24 QUESTION: Even though we know on the facts of
25 this case, don't we, that that isn't true, and there's no

1 move made by California to do any allocation.

2 MR. LEW: Well, I don't agree that under the
3 facts of this case that was -- that is, in fact, the case.
4 If the Court is -- if Your Honor is referring to the
5 stipulation, then I don't believe that that is what the
6 parties stipulated. If the parties stipulated --

7 QUESTION: Where are you reading from, Mr. Lew?

8 MR. LEW: I'm reading from joint appendix page
9 21, stipulation number 14. I believe that is what Justice
10 O'Connor was --

11 QUESTION: Well, that doesn't cover that point,
12 but -- and I can find it elsewhere, I assume, but let me
13 ask you this. Let's assume what I said is true. The
14 effect of the California provision would be to not
15 allocate it at all.

16 MR. LEW: It -- well --

17 QUESTION: You treat it as though all of the
18 expense incurred in borrowing money went to the outside
19 nonunitary business.

20 MR. LEW: Well, what -- again, and I know that
21 I've said this before, what California is attempting to do
22 is basically ensure that none of the interest expense was
23 used, in fact, to generate income which California's not
24 permitted to tax.

25 QUESTION: Is it your position, Mr. Lew, that

1 California in the long run, by its system, doesn't -- is
2 not able to tax any more income than it would be by the
3 proportionality just because some people get a break and
4 others don't under it?

5 MR. LEW: I'm not sure if I understand your
6 question completely, Your Honor, but let me try to answer
7 it this way. I think that the argument -- the criticisms
8 that can be leveled against California's statute can also
9 be leveled against a proportionality approach in the sense
10 that a certain portion of interest expense is being
11 allocated to nonbusiness, nontaxable income.

12 Now, we don't know whether or not the amount
13 that was allocated is the correct amount, but it does have
14 the effect of increasing the corporation's tax in the
15 State of California, so to the extent that that can be
16 viewed as an indirect taxation of nontaxable income, that
17 is what is being done there, and that's the same criticism
18 that's being made in our case as well.

19 QUESTION: You can't ask the State to do more
20 than it can do. I mean, if it's hard to do it, hard to
21 allocate it, that's an effort, that's a reasonable effort,
22 so they're not unreasonable when they make a reasonable
23 effort, even if it doesn't all work out perfectly.

24 But given the possibility of that reasonable
25 effort, what justification is there for taking the money

1 that's not apportionable?

2 MR. LEW: Well, again -- same argument, Your
3 Honor, and that I think is -- it's a reasonable objective,
4 and the approach that it takes is the surest way of
5 closing that loophole.

6 QUESTION: Well, it's sure all right. It's 100
7 percent dollar-for-dollar. I mean, it makes no effort to
8 apportion, and you're going to have to persuade me that
9 that's reasonable, because I don't find anything in what
10 you've said that makes me think that's reasonable. No
11 other State does that. There's no effort made to allocate
12 it. I just -- I have yet to hear a reason.

13 QUESTION: I guess --

14 QUESTION: Except I want to be sure, 100 percent
15 sure.

16 QUESTION: I guess the California supreme court
17 case on which the California court of appeal decision here
18 was based was decided a long time ago.

19 MR. LEW: That's correct.

20 QUESTION: Before our decisions in Allied-Signal
21 and ASARCO.

22 MR. LEW: That's correct.

23 QUESTION: Right. And it's sort of hard for you
24 to give up that old 1972 California supreme court opinion.

25 (Laughter.)

1 MR. LEW: Well, I think that -- I think that in
2 that the court, the California supreme court has held that
3 it does not result -- that the allocation of interest
4 expense to nontaxable income on a dollar-for-dollar basis
5 does not constitute a tax, I think it's still applicable
6 here, even in light of Allied-Signal and other cases.

7 QUESTION: The argument has been made that if
8 you look at how the Federal taxation works, income
9 taxation, in the main there is an allocation, but there's
10 also an argument that at least in one respect the Federal
11 income tax -- I forgot whether it's -- it has something to
12 do with foreign investment, or foreign corporations, that
13 the Internal Revenue Code does what California does in
14 that one discrete area.

15 MR. LEW: That is my understanding, yes, Your
16 Honor, that there is a dollar-for-dollar allocation
17 allowed under certain circumstances in the Federal scheme.

18 QUESTION: So you could make the argument that
19 if it's rational for the Internal Revenue Code to do that,
20 so it's rational for California to --

21 MR. LEW: I think there's a basis for doing
22 that, Your Honor. I also believe that in -- that section
23 265 of the Internal Revenue Code as well provides for a
24 dollar-for-dollar offset in certain situations.

25 QUESTION: If I'm right -- I don't know if this

1 is the only place that does that in the code. There's a
2 rule which my law clerk found which is a controlled
3 foreign corporation netting rule, and that has to do with
4 a circumstance where you have to allocate income expense
5 to certain foreign source income earned when you lend the
6 money to a controlled foreign corporation and there's both
7 been an increase in lending and an increase in borrowing.

8 And under those circumstances there is some
9 rationality, where you've loaned more money to your off-
10 shore corporation, and at the same time you've increased
11 the borrowing, so I could at least see a rational there
12 for saying we're going to assume this extra lending is
13 allocated to the extra borrowing, but I don't think you
14 even have anything like that here.

15 MR. LEW: Well, I --

16 QUESTION: In other words, it's a tracing rule,
17 rather than an allocation rule. All that your opponent is
18 asking is that you either allocate or trace, but you've
19 done neither.

20 MR. LEW: Well --

21 QUESTION: The Federal provision seems to try to
22 trace.

23 MR. LEW: Right. The California statute is
24 definitely not a tracing rule. It's actually just an
25 assignment rule, and it's basically based on the idea that

1 it's extremely difficult, if not impossible, to trace
2 interest expense to its ultimate use or application, and
3 again it's just based on the idea that this is what --
4 California's interest in trying to close this loophole.

5 That's what the statute is trying to do, and I
6 think that to the extent that that constitutes a
7 legitimate State objective, I think it certainly
8 accomplishes that goal, and it does so, I think, in a fair
9 way in the sense that it does allow that first step to
10 allocate interest expense to -- on the basis of business
11 interest income, and to the extent that there is any
12 remaining, it does allocate it against its nonbusiness
13 income.

14 QUESTION: Why can't you just ask the taxpayer
15 to assume the burden of persuading you that any
16 interest -- any income, or interest deduction that it
17 seeks to obtain is attributable to the unitary business?

18 MR. LEW: Well, I think that that is -- that is
19 one way to go, but I think that's also subject to
20 manipulation as well, Your Honor.

21 QUESTION: The same is true of payroll and other
22 expenses in this gigantic balance sheet and income
23 statement they have to prepare in these things. There's
24 always room for --

25 MR. LEW: And that's -- I think the problem, if

1 you're trying to determine, you know, a corporation's
2 motive, I think that's just, as a matter of tax
3 administration, extremely difficult to do, and it's
4 essentially a facts and circumstances kind of test, and I
5 just think that it's extremely difficult to administer
6 that kind of test, you know, especially for a State like
7 California.

8 That, I think, is what the problem is, and that
9 is why there is this statute, which essentially eliminates
10 any type of concept of motive or, you know, purpose, and
11 just says, look, if you have interest expense, and you are
12 using some of your capital to generate income that is not
13 taxable in the State of California, that there is the --

14 QUESTION: It does seem to me it's not entirely
15 unlike taking the president of the corporation's salary.
16 You do some allocating there. You've got to -- you know,
17 there's room for -- I don't know why interest is any
18 harder to allocate than something like that.

19 MR. LEW: Oh, it's -- well, interest is harder
20 to allocate than other -- the thing about interest is that
21 it is extremely fungible, I guess is the best way to put
22 it, and you can't --

23 QUESTION: The dollars paid to the president of
24 the corporation is pretty fungible, too.

25 QUESTION: Is there any --

1 QUESTION: For salary, I mean.

2 QUESTION: Is there any requirement that the
3 interest deduction be based on loans that were made in
4 California, or can they be made anywhere?

5 MR. LEW: I believe they can be made anywhere,
6 Your Honor.

7 QUESTION: Do you think that California, if we
8 were not to accept your position, and were to say that you
9 have to make some effort to allocate, California could do
10 that --

11 MR. LEW: Yes. I think it --

12 QUESTION: -- without having a new statute that
13 does it? That is, the example -- which company was it
14 that we have in these cases? Is it General Motors, or
15 General Electric? I don't remember. Could the tax
16 commissioner say, well, what we did is no good, here's
17 something else that is good, so we're going to do that
18 even though we don't have a statute that so provides?

19 MR. LEW: Yes. It is my belief that that could
20 probably be done pursuant to other California regulatory
21 authority which allows for a spreading of interest expense
22 similar to the method that has been endorsed by the
23 petitioner. I don't think that it would necessarily
24 require a -- the enactment of a new statute.

25 I don't really have anything else. If the Court

1 has any further questions I'll be happy to answer them.
2 Other than that, I'm done.

3 QUESTION: Thank you, Mr. Lew.

4 Mr. Hellerstein, you have 5 minutes remaining.

5 REBUTTAL ARGUMENT OF WALTER HELLERSTEIN

6 ON BEHALF OF THE PETITIONER

7 MR. HELLERSTEIN: I have three very brief
8 points. First, with regard to the CFC netting rule that
9 both Justice Breyer and Justice Ginsburg referred to,
10 you're quite right, Justice Breyer, the CFC netting rule
11 is, in fact, a very finely tuned tracing rule, as Justice
12 Scalia said. It only arises in a situation when
13 there's -- you go to some unrelated lender, you borrow
14 money, you then relend that money to your controlled
15 foreign corporation, the controlled foreign corporation
16 then pays you interest.

17 That's the situation we're talking about. If
18 California had anything like that, we certainly wouldn't
19 be here. Again, a finely tuned mechanism addressed to a
20 specific tax evasion problem which actually doesn't
21 even -- it just reduces the foreign tax credit, is what
22 we're talking about. It's not even a -- it's not a
23 jurisdictional problem.

24 Point two, Mr. Lew suggested, gee, these -- all
25 these other formulas that we're suggesting are reasonable

1 are vulnerable to the same sort of criticism that we're
2 making, and that's not true. The criticism that we're
3 making is that the California formula disproportionately
4 assigns interest expense to nontaxable income. All of
5 those other formulas do it on an even-handed,
6 nondiscriminatory basis.

7 And finally, his suggestion that, because the
8 statute is internally consistent it is therefore
9 constitutional, is a non sequitur. It would be -- if
10 California had a statute that assigned income based on the
11 number of square miles in a State, that would be
12 internally consistent, but I think would plainly be
13 unconstitutional and, indeed, in cases involving
14 retaliatory taxes, which are entirely consistent, this
15 Court has also held they are unconstitutional.

16 If the Court has no further questions --

17 CHIEF JUSTICE REHNQUIST: Thank you, Mr.
18 Hellerstein. The case is submitted.

19 (Whereupon, at 12:16 p.m., the case in the
20 above-entitled matter was submitted.)

CERTIFICATION

Alderson Reporting Company, Inc., hereby certifies that the attached pages represents an accurate transcription of electronic sound recording of the oral argument before the Supreme Court of The United States in the Matter of:

HUNT-WESSON, INC. Petitioner v. FRANCHISE TAX BOARD OF CALIFORNIA
CASE NO: 98-2043

and that these attached pages constitutes the original transcript of the proceedings for the records of the court.

BY Donn Marie Federico
(REPORTER)