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NOTE: Where it is feasible, a syllabus (headnote) will be released, as is being done in connection with this case, at the time the opinion is issued. The syllabus constitutes no part of the opinion of the Court but has been prepared by the Reporter of Decisions for the convenience of the reader. See *United States* v. *Detroit Timber & Lumber Co.*, 200 U. S. 321, 337.

SUPREME COURT OF THE UNITED STATES

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HUNT-WESSON, INC. *v.* FRANCHISE TAX BOARD OF CALIFORNIA

CERTIORARI TO THE COURT OF APPEAL OF CALIFORNIA, FIRST APPELLATE DISTRICT

No. 98–2043. Argued January 12, 2000– Decided February 22, 2000

A State may tax a proportionate share of the "unitary" income of a nondomiciliary corporation that carries out a particular business both inside and outside that State, *Allied-Signal, Inc.* v. *Director, Div. of Taxation*, 504 U. S. 768, 772, but may not tax "nonunitary" income received by a nondomiciliary corporation from an "unrelated business activity" which constitutes a "discrete business enterprise," *e.g.*, *id.*, at 773. California's "unitary business" income-calculation system for determining that State's taxable share of a multistate corporation's business income authorizes a deduction for interest expense, but permits (with one adjustment) use of that deduction *only to the extent* that the amount exceeds certain out-of-state income arising from the unrelated business activity of a discrete business enterprise, *i.e.*, nonunitary income that the State could not otherwise tax under this Court's decisions. Petitioner Hunt-Wesson, Inc., is a successor in interest to a nondomiciliary of California that incurred interest expense during the years at issue. California disallowed the deduction for that expense insofar as the nondomiciliary corporation had received relevant nonunitary dividend and interest income. Hunt-Wesson challenged the disallowance's constitutional validity. The State Court of Appeal found it constitutional, and the State Supreme Court denied review.

Held: Because California's interest deduction offset provision is not a reasonable allocation of expense deductions to the income that the expense generates, it constitutes impermissible taxation of income outside the State's jurisdictional reach in violation of the Federal Constitution's Due Process and Commerce Clauses. States may not tax income arising out of interstate activities– even on a proportional basis– unless there is a "minimal connection" or "nexus" between

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such activities and the taxing State, and a "rational relationship between the income attributed to the State and the intrastate values of the enterprise." *Container Corp. of America* v. *Franchise Tax Bd.*, 463 U. S. 159, 165–166. Although California's statute does not directly impose a tax on nonunitary income, it measures the amount of additional unitary income that becomes subject to its taxation (through reducing the deduction) by precisely the amount of nonunitary income that the taxpayer has received. Thus, that which California calls a deduction limitation would seem, in fact, to be an impermissible tax. *National Life Ins. Co.* v. *United States,* 277 U. S. 508. If California could show that its deduction limit actually reflected the portion of the expense properly related to nonunitary income, however, the limit would not, in fact, be a tax on that income, but merely a proper allocation of the deduction. See *Denman* v. *Slayton,* 282 U. S. 514. The state statute, however, pushes this proportional allocation concept past reasonable bounds. In effect, it assumes that a corporation that borrows any money at all has really borrowed that money to "purchase or carry," cf. 26 U. S. C. §265(a)(2), its nonunitary investments (as long as the corporation has such investments), even if the corporation has put no money at all into nonunitary business that year. No other taxing jurisdiction has taken so absolute an approach. Rules used by the Federal Government and many States that utilize a ratio of assets and gross income to allocate a corporation's total interest expense between domestic and foreign source income recognize that borrowing, even if supposedly undertaken for the unitary business, may also support nonunitary income generation. However, unlike the California rule, ratio-based rules do not assume that *all* borrowing first supports nonunitary investment. Rather, they allocate each borrowing between the two types of income. Over time, it is reasonable to expect that the ratios used will reflect approximately the amount of borrowing that firms have actually devoted to generating each type of income. Conversely, it is simply not reasonable to expect that a rule that attributes all borrowing first to nonunitary investment will accurately reflect the amount of borrowing that has actually been devoted to generating each type of income. Pp. 5–9.

Reversed and remanded.

BREYER, J., delivered the opinion for a unanimous Court.