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## Constitutional Considerations of State Taxation of Multinational Corporate Income: Before and After *Container Corporation of America v. Franchise Tax Board*

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### I. INTRODUCTION

Domestic law has been applied to the multinational corporation through operation of the federal securities laws, the federal antitrust laws, and the federal tax laws.<sup>1</sup> Over the last two decades much critical commentary has been directed to identifying the extent to which the national tax laws apply to multinational corporations.<sup>2</sup> More recently consideration has been given to whether state governments can include foreign-source income in determining taxable corporate income.<sup>3</sup> The crux of the question is whether the states should be limited in taxing such income, which primarily consists of dividends, interest, and capital gains derived from foreign subsidiaries and affiliates.<sup>4</sup>

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<sup>1</sup>See generally, C. BERGSTEN, T. HORST & T. MORAN, AMERICAN MULTINATIONALS AND AMERICAN INTERESTS (1978); R. TINDALL, MULTINATIONAL ENTERPRISES: LEGAL AND MANAGEMENT STRUCTURES AND INTERRELATIONSHIP WITH OWNERSHIP, CONTROL, ANTITRUST, LABOR, TAXATION AND DISCLOSURE (1975).

<sup>2</sup>See generally, L. KRAUSE & K. DAM, FEDERAL TAX TREATMENT OF FOREIGN INCOME (1964).

<sup>3</sup>See GENERAL ACCOUNTING OFFICE, REPORT TO THE CHAIRMAN, HOUSE COMMITTEE ON WAYS AND MEANS: KEY ISSUES AFFECTING STATE TAXATION OF MULTIJURISDICTIONAL CORPORATE INCOME NEED RESOLVING (1982) (GA1.13 GGD-82-38) [hereinafter cited as G.A.O. REPORT-1982]. The General Accounting Office, in a long-anticipated report, concluded that congressional action is required to resolve controversies and complexities in the State taxation of multijurisdictional corporations. For purposes of this article, a multijurisdictional corporation may be defined as a corporation or a group of related corporations operating in several states or of diverse nationality joined together by common ownership and management. The taxation of international investments has become important in recent years because of the growth in the international economy.

<sup>4</sup>For purposes of this article, a foreign subsidiary or affiliate is a non-United States corporation in which a corporation based in the United States has a substantial

In *ASARCO Inc. v. Idaho State Tax Commission*<sup>5</sup> and *F. W. Woolworth Co. v. Taxation & Revenue Department*,<sup>6</sup> the United States Supreme Court severely restricted the ability of the states to tax a domestic parent corporation on foreign-source income on the grounds that due process considerations prevented state taxation of subsidiaries which did not have a unitary business relationship with the parent corporation. Although consistent with the reasoning of *ASARCO* and *Woolworth*, the Supreme Court recently endorsed the state taxation of the worldwide combined income generated by a domestic parent corporation and its foreign subsidiaries which were found to constitute a unitary business in *Container Corp. of America v. Franchise Tax Board*.<sup>7</sup>

The purpose of this article is to examine the due process considerations with regard to the state taxation of corporate foreign-source income as developed by the Supreme Court, and to analyze the Court's commitment to the unitary business concept. First, the constitutional and statutory principles underlying current methods of state taxation of multijurisdictional corporations need to be identified. Secondly, the historical development of the unitary business principle will be discussed along with an overview of recent legislative activity and judicial decisions in this area. Finally, an examination will be made of recent United States Supreme Court decisions recognizing constitutional considerations regarding the state taxation of the income of multinational corporations based in the United States.

Attention will be directed at *Mobil Oil Corp. v. Commissioner of Taxes*,<sup>8</sup> in which the Supreme Court held that it is permissible for a state to include foreign-source dividends in taxable income, assuming there is a unitary relationship between the payor foreign corporation and the recipient domestic corporation. The analysis developed in the *Mobil* decision provides the foundation for the Court's subsequent decisions placing limits on state taxation of foreign-source income. An examination of the factual situations and constitutional principles contained in *ASARCO* and *Woolworth* reveals that there continues to be a number of unresolved issues related to the power of the states to tax foreign-source income. *Container* seems to be the

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ownership interest. Unlike a multistate corporation which conducts business within a domestic context, a multinational corporation has the capacity to create markets for its products and services on a global scale in an international context. For a report on the growth of multinational corporations, see GENERAL ACCOUNTING OFFICE, REPORT TO THE CHAIRMAN, HOUSE COMMITTEE ON WAYS AND MEANS: IRS COULD BETTER PROTECT U.S. TAX INTERESTS IN DETERMINING THE INCOME OF MULTINATIONAL CORPORATIONS 4 (1981) (GA1.13 GGD-81-81) [hereinafter cited as G.A.O. REPORT-IRS].

<sup>5</sup>102 S. Ct. 3103 (1982).

<sup>6</sup>102 S. Ct. 3128 (1982).

<sup>7</sup>103 S. Ct. 2933 (1983).

<sup>8</sup>445 U.S. 425 (1980).

Court's valedictory opinion on these due process matters for the decision serves to defer the further resolution of these issues to the judgment of the state courts.

## II. THE SOURCES OF THE CONSTITUTIONAL LIMITATIONS

The states have the general power to tax the income of corporations.<sup>9</sup> The United States Constitution, however, imposes several restrictions on the states' taxing power.<sup>10</sup> Among these,<sup>11</sup> the most significant restrictions are imposed by the commerce clause<sup>12</sup> and the due process clause.<sup>13</sup>

### A. Commerce Clause Limitations

The commerce clause restrains a state from promoting taxation which discriminates against interstate commerce<sup>14</sup> by providing a direct commercial advantage to local business,<sup>15</sup> or which places an undue burden of multiple taxation<sup>16</sup> on interstate commerce.<sup>17</sup> Under the four-pronged standard announced by the Supreme Court in *Complete Auto Transit, Inc. v. Brady*,<sup>18</sup> a tax will pass review under the

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<sup>9</sup>As of December 31, 1981, 44 states and the District of Columbia had some type of corporate income tax. See 1 [All States Unit] ST. & LOC. TAX SERV. (P-H) ¶ 101; see also *Moorman Mfg. Co. v. Bair*, 437 U.S. 267, 278-80 (1978); Corrigan & Dexter, *States' Latitude in Taxing Multistate Businesses*, 11 URB. LAW. 505 (1979).

<sup>10</sup>See P. HARTMAN, FEDERAL LIMITATIONS ON STATE AND LOCAL TAXATION 6 (1981).

<sup>11</sup>The equal protection clause of the fourteenth amendment is such a restriction which provides, in pertinent part, that no state shall "deny to any person within its jurisdiction the equal protection of the Laws." U.S. CONST. amend. XIV, § 1. See *Western & S. Life Ins. Co. v. State Bd. of Equalization*, 451 U.S. 648 (1981) (upholding the constitutionality of retaliatory state tax imposed upon foreign insurance companies); Note, *Taxing Out-of-State Corporations After Western & Southern: An Equal Protection Analysis*, 34 STAN. L. REV. 877 (1982).

<sup>12</sup>U.S. CONST. art. I, § 8: "The Congress shall have Power . . . To regulate Commerce with foreign Nations, and among the several States, and with the Indian Tribes."

<sup>13</sup>U.S. CONST. amend. XIV, § 1: "[N]or shall any State deprive any person of life, liberty, or property, without due process of law."

<sup>14</sup>State taxes that "discriminate against interstate commerce" are strictly scrutinized under the commerce clause. *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274, 279, 288-89 n.15 (1977); see also *Memphis Steam Laundry Cleaner, Inc. v. Stone*, 342 U.S. 389, 394-95 (1952); *Nippert v. City of Richmond*, 327 U.S. 416 (1946).

<sup>15</sup>See *Maryland v. Louisiana*, 451 U.S. 725 (1981); *Boston Stock Exch. v. State Tax Comm'n*, 429 U.S. 318 (1977).

<sup>16</sup>Multiple taxation is the taxation of the same income by more than one taxing jurisdiction. See *Mobil Oil Corp. v. Comm'r of Taxes*, 445 U.S. 425, 442-46 (1980).

<sup>17</sup>For general discussions with regard to commerce clause restrictions on the power of states to tax, see Hellerstein, *State Taxation Under the Commerce Clause: An Historical Perspective*, 29 VAND. L. REV. 335 (1976); Hellerstein, *State Taxation and the Supreme Court: Toward a More Unified Approach to Constitutional Adjudication?*, 75 MICH. L. REV. 1426 (1977); Tushnet, *Rethinking the Dormant Commerce Clause*, 1979 WIS. L. REV. 125.

<sup>18</sup>430 U.S. 274 (1977).

commerce clause so long as the tax "[1] is applied to an [interstate] activity with a substantial nexus with the taxing State, [2] is fairly apportioned, [3] does not discriminate against interstate commerce, and [4] is fairly related to services provided by the State."<sup>19</sup> When the instrumentalities of foreign commerce are involved, however, the state tax may be unconstitutional under the commerce clause if it violates either of two standards articulated in *Japan Line, Ltd. v. County of Los Angeles*,<sup>20</sup> namely, if the tax (1) creates a substantial risk of multiple taxation at the international level, or (2) interferes with the federal regulation of foreign commercial relations.<sup>21</sup>

### B. Due Process Clause Limitations

It is a well established principle of constitutional law that the due process clause precludes a state from taxing value earned outside of its borders.<sup>22</sup> When imposing a tax which is geared to income, the

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<sup>19</sup>*Id.* at 279. See also *Commonwealth Edison Co. v. Montana*, 453 U.S. 609 (1981) (focusing on the "fair relation" prong of the *Complete Auto Transit* test which is satisfied if the measure of the tax is reasonably related to the extent of the taxpayer's contact with the taxing state).

<sup>20</sup>441 U.S. 434 (1979).

<sup>21</sup>*Id.* at 450-51. But see *Mobil Oil Corp. v. Comm'r of Taxes*, 445 U.S. 425, 446 (1980).

In *Japan Line*, the Court considered whether a property tax was unconstitutional if the tax was assessed against shipping containers owned and registered in another nation and used exclusively in foreign commerce. The Court explained why some multiple taxation may be acceptable with respect to the state taxation of interstate commerce, but not acceptable with respect to the state taxation of foreign commerce.

Due to the absence of an authoritative tribunal capable of ensuring that the aggregation of taxes is computed on no more than one full value, a state tax, even though "fairly apportioned" to reflect an instrumentality's presence within the State, may subject foreign commerce "to the risk of a double tax burden to which [domestic] commerce is not exposed, and which the commerce clause forbids."

441 U.S. at 447-48 (quoting *Evco v. Jones*, 409 U.S. 91, 94 (1972) (quoting *J.D. Adams Mfg. Co. v. Storen*, 304 U.S. 307, 311 (1938))). The Court analyzed the potentially harmful effect that such a state tax may have on foreign commerce:

A state tax on instrumentalities of foreign commerce may frustrate the achievement of federal uniformity in several ways. If the State imposes an apportioned tax, international disputes over reconciling apportionment formulae may arise. If a novel state tax creates an asymmetry in the international tax structure, foreign nations disadvantaged by the levy may retaliate against American-owned instrumentalities present in their jurisdictions. Such retaliation of necessity would be directed at American transportation equipment in general, not just that of the taxing State, so that the Nation as a whole would suffer. If other States followed the taxing State's example, various instrumentalities of commerce could be subjected to varying degrees of multiple taxation, a result that would plainly prevent this Nation from "speaking with one voice" in regulating foreign commerce.

441 U.S. at 450-51.

<sup>22</sup>See *ASARCO, Inc. v. Idaho State Tax Comm'n*, 102 S. Ct. 3103, 3109 (1982).

taxing power asserted by a state must bear a fair and substantial financial relationship to the protections, opportunities, and benefits conferred by that state. In these instances the controlling question is whether the taxing state has given anything to the corporation for which it can ask a return.<sup>23</sup> In *Moorman Manufacturing Co. v. Bair*,<sup>24</sup> the Court refined this question by combining prior decisions into the following test:<sup>25</sup> (1) a minimal connection must exist between the corporation's activities and the taxing state,<sup>26</sup> and (2) there must be a rational relationship between the income attributed to the state for taxing purposes and the values connected with the state.<sup>27</sup>

### III. PRINCIPLES AND METHODS OF STATE TAXATION OF INCOME OF MULTINATIONAL CORPORATIONS

In complying with the constitutional limitations, the states have developed certain methods and adopted certain principles with regard to the taxation of corporate net income. These principles and methods are related to the composition of taxable income, a state's jurisdiction to tax, and the division of such net income among the taxing jurisdictions. Because most of these concepts may be applicable to multinational corporations as well as to multistate corporations, it is appropriate to briefly review them.

#### A. *Composition of the Tax Base: Determining Taxable Income*

The majority of the states make reference to the federal taxable income of a multinational corporation for the initial determination of the composition of the income taxable by the state.<sup>28</sup> Those states, however, make certain adjustments to federal taxable income in order to later determine what portion of a multinational corporation's income they can tax. With respect to such adjustments, an important issue is whether and to what extent intercorporate dividends are to

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<sup>23</sup>*Wisconsin v. J.C. Penney Co.*, 311 U.S. 435, 444 (1940).

<sup>24</sup>437 U.S. 267 (1978).

<sup>25</sup>*Id.* at 272-73.

<sup>26</sup>The Court has stated that this is the "time-honored concept: that due process requires some definite link, some minimum connection, between a state and the person, property, or transaction it seeks to tax." *Miller Bros. Co. v. Maryland*, 347 U.S. 340, 344-45 (1954). The nexus is established if a corporation avails itself of the "substantial privilege of carrying on business" within the taxing state. *Wisconsin v. J.C. Penney*, 311 U.S. 435, 444-45 (1940).

<sup>27</sup>*Butler Bros. v. McColgan*, 315 U.S. 501, 506 (1942).

<sup>28</sup>For a discussion of this method and a listing of the states using it, see G.A.O. REPORT-1982, *supra* note 3, at 13, 60-61. The remaining states which tax corporate net income generally start with the gross income of the multijurisdictional corporation and deduct certain items. L. HALE & R. KRAMER, STATE TAX LIABILITY AND COMPLIANCE MANUAL 28-29 (1981) [hereinafter cited as HALE & KRAMER].

be included in the taxable income.<sup>29</sup> Similar issues arise with respect to other types and forms of income, such as interest and royalties<sup>30</sup> or capital gains from the sale of assets in a state other than the taxing state.<sup>31</sup> These issues are often resolved by focusing on an even more fundamental analysis—whether the taxing state has the appropriate jurisdiction to tax the income.

### B. Jurisdiction to Tax

The states use various criteria to establish jurisdiction to tax,<sup>32</sup> however, the appropriate criteria will vary depending on the type of tax.<sup>33</sup> With respect to net income taxes, two of the most significant concepts are commercial domicile<sup>34</sup> and nexus.<sup>35</sup> States have the power to tax their domiciliaries on income earned in other states.<sup>36</sup> In *Memphis Natural Gas Co. v. Beeler*,<sup>37</sup> the Court upheld a tax on the net

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<sup>29</sup>The federal tax system permits corporations within a controlled group to deduct 85% to 100% of the dividends received from other corporations to the extent that the dividends received represent income that has already been subject to federal income taxation in order to avoid multiple taxation of the income prior to the distribution of the income to shareholders. See I.R.C. §§ 243-247 (West 1978 & West Supp. 1983), § 882 (West 1982 & West Supp. 1983); B. BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS ¶ 5.06 (4th ed. 1979). In the case of an affiliated group of corporations which files a consolidated return under I.R.C. sections 1501-1505, dividends paid by one member of the affiliated group to another member of the affiliated group are eliminated from taxable income. See Treas. Reg. § 1.1502-14(a)(1) (1972). Dividend income, however, is generally subject to state tax even though it may be deductible for federal income tax purposes. The majority of the states do not acknowledge these deductions. See HALE & KRAMER, *supra* note 28, at 45.

<sup>30</sup>See, e.g., *Qualls v. Montgomery Ward & Co.*, 266 Ark. 207, 585 S.W.2d 18 (1979) (interest).

<sup>31</sup>See, e.g., *Atlantic Richfield Co. v. State*, 198 Colo. 413, 601 P.2d 628 (1979).

<sup>32</sup>For a general listing of the various jurisdiction to tax criteria which are used by the states which tax multijurisdictional corporations, see G.A.O. REPORT-1982, *supra* note 3, at 59-60. States tax corporations: (1) doing business in the state; (2) deriving income from sources or activities in the state; (3) owning, leasing, or deriving income from property in the state; (4) or maintaining an office in the state. *Id.*

<sup>33</sup>See, e.g., *Standard Pressed Steel Co. v. Washington*, 419 U.S. 560 (1975) (presence of agents in the state is sufficient contact to justify imposition of sales or gross receipts taxes); *National Geographic Soc'y v. Franchise Tax Bd.*, 430 U.S. 551 (1977) (any type of permanent office or employees imposes duty to collect use taxes on sales).

<sup>34</sup>"Commercial domicile" is the state in which the operations and activities of a corporation are managed. *Wheeling Steel Corp. v. Fox*, 298 U.S. 193, 211-12 (1936); see also *Developments in the Law—Federal Limitations on State Taxation of Interstate Business*, 75 HARV. L. REV. 953, 1005 (1962) (courts have relied on *Wheeling Steel* to sustain net income taxes on the basis of commercial domicile).

<sup>35</sup>See *supra* note 26 and accompanying text.

<sup>36</sup>*New York ex rel. Cohn v. Graves*, 300 U.S. 308 (1937) (rent from out-of-state land); *Lawrence v. State Tax Comm'r*, 286 U.S. 276 (1932) (compensation for personal services rendered outside taxing state).

<sup>37</sup>315 U.S. 649 (1942).

income of a foreign corporation over commerce clause objections on the ground that the corporation's establishment of a commercial domicile in the state provided the necessary jurisdiction to tax.<sup>38</sup>

The due process clause requires sufficient activities or connections between the corporation and the taxing state to provide the state with the jurisdiction to tax.<sup>39</sup> In the past, the Supreme Court has not imposed a very demanding test for determining what minimum connections are necessary to satisfy the due process requirement. In *Northwestern States Portland Cement Co. v. Minnesota*,<sup>40</sup> the Court sustained the power of a state to levy a net income tax on an out-of-state corporation doing an exclusively interstate business in the state.<sup>41</sup> The Court concluded that the states could tax the entire net income of a multijurisdictional corporation generated by interstate as well as intrastate activities provided that the income was fairly divided among the taxing states and that the tax was not discriminatory.<sup>42</sup> Shortly thereafter, Congress enacted legislation on the states' jurisdiction to tax.<sup>43</sup>

### C. Division of Income Among Jurisdictions

In general, the due process clause provides that a state may only tax net income arising from sources within the state.<sup>44</sup> Because a state may not tax value earned outside of its borders, the states have devised three methods to determine the portion of a multijurisdictional corporation's income which is deemed to be earned within their borders: separate accounting, specific allocation, and formulary apportionment.<sup>45</sup>

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<sup>38</sup>*Id.* at 652, 656-67.

<sup>39</sup>See *supra* notes 22-27 and accompanying text.

<sup>40</sup>358 U.S. 450 (1959).

<sup>41</sup>The systematic sales solicitation activities in the state subjected the corporation to the state net income tax even though all orders taken were subject to the final approval of out-of-state offices. *Id.* at 454.

<sup>42</sup>*Id.* at 452.

<sup>43</sup>Act of Sept. 14, 1959, Pub. L. No. 86-272, tit. I, §§ 101-104, 73 Stat. 555-56 (codified at 15 U.S.C. §§ 381-384 (1976)). Even though this law placed restrictions on a state's jurisdiction to tax, it is of little importance to the multijurisdictional corporation because its scope includes only small merchandising businesses. See Hellerstein, *State Taxation Under the Commerce Clause: An Historical Perspective*, 29 VAND. L. REV. 335, 339 (1976). For an analysis of Pub. L. No. 86-272 and a treatment of the case law thereunder, see Hartman, "Solicitation" and "Delivery" Under Public Law 86-272: An Uncharted Course, 29 VAND. L. REV. 353 (1976); *Developments in the Law—Federal Limitations on State Taxation of Interstate Business*, 75 HARV. L. REV. 953 (1962).

<sup>44</sup>See Rudolph, *State Taxation of Interstate Business: The Unitary Business Concept and Affiliated Corporate Groups*, 25 TAX L. REV. 171, 181 (1970) (cited in *ASARCO*, 102 S. Ct. at 3109 n.11); see also *Northwestern States Portland Cement Co.*, 358 U.S. at 464.

<sup>45</sup>See Dexter, *The Unitary Concept in State Income Taxation of Multistate-Multinational Businesses*, 10 URB. LAW. 181, 181 (1978); H.R. REP. NO. 1480, 88th Cong.,

Separate accounting is used when a corporation can separate with accuracy the net income, if any, generated or derived within a particular state from income generated or derived within other states or geographic areas. Specific allocation involves determining the source of particular items of income, such as interest, dividends, and capital gains, which the states may allocate to the commercial domicile of the corporation. Specific allocation is sometimes used in conjunction with formulary apportionment.

In contrast to this formal geographical or transactional accounting, formulary apportionment does not trace the source of the income or assign income-generating activities to certain states; rather, the formulary apportionment method divides the income of a corporation in accordance with a mathematical formula which quantifies income-generating factors and roughly approximates the income connected with the taxing state.<sup>46</sup> The Court has given the states wide latitude in selecting apportionment formulas and has said that it will not invalidate an assessment resulting from such a formula unless a corporation proves "by clear and cogent evidence" that the income attributed to the State is in fact "out of all appropriate proportions" to the income-generating activities in that state or is a gross distortion.<sup>47</sup>

#### D. Legislative Development and Statutory Application

All states which have a corporate income tax use formulary apportionment.<sup>48</sup> The mathematical formula attributes the total income of a multijurisdictional corporation to the states on the basis of certain income-generating factors. The three factors most generally used in the apportionment formula are property, payroll, and sales.<sup>49</sup> Most of the taxing states have statutes which apportion income by comparing the average of the three factors of the formula within the taxing state to the total of such factors both within and without the

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2d Sess. 160-217 (1964) [hereinafter cited as Special Subcommittee Report]; G. ALTMAN & F. KEESLING, ALLOCATION OF INCOME IN STATE TAXATION 67-168 (1950); HALE & KRAMER, *supra* note 28, at 30-36; J. HELLERSTEIN & W. HELLERSTEIN, STATE AND LOCAL TAXATION 432-37 (4th ed. 1978) (separate accounting) [hereinafter cited as STATE AND LOCAL TAXATION]; Boren, *Specific Allocation of Corporate Income in California: Some Problems in the Uniform Division of Income for Tax Purposes*, 30 TAX. L. REV. 607 (1975) (specific allocation); Hartman, *State Taxation of Corporate Income from a Multistate Business*, 13 VAND. L. REV. 21, 64-74 (1959) (formula apportionment).

<sup>46</sup>See *Moorman Mfg. Co. v. W. Bair*, 437 U.S. 267, 273 (1978).

<sup>47</sup>*Id.* at 274 (quoting *Hans Rees' Sons, Inc. v. North Carolina ex rel. Maxwell*, 283 U.S. 123, 135 (1931)). The burden of proving that a state tax is unconstitutional traditionally has been on the taxpayer. Dexter, *supra* note 45, at 187.

<sup>48</sup>See Dexter, *supra* note 45, at 182 & n.1.

<sup>49</sup>See *General Motors Corp. v. District of Columbia*, 380 U.S. 553, 559 (1965); Special Subcommittee Report, *supra* note 45, at 168-70 (providing a description of formula apportionment and illustrations of the mechanics of the use of different formulas).

state.<sup>50</sup> There have been two significant state statutory developments addressing the problem of dividing the income of a multijurisdictional corporation among those states having the jurisdiction to tax some portion of that income: (1) the Uniform Division of Income for Tax Purposes Act (UDITPA)<sup>51</sup> and (2) the Multistate Tax Compact (Compact).<sup>52</sup>

The UDITPA sets forth principles of allocation and apportionment of the income of a multijurisdictional corporation which are designed to ensure that the states avoid both multiple taxation and under taxation.<sup>53</sup> These principles split corporate income into business income and non-business income.<sup>54</sup> Business income arises from transactions and activities in the regular course of business.<sup>55</sup> Non-business income is all income other than business income.<sup>56</sup> Items of non-business income, such as dividends, interest, and capital gains, are allocated to the particular state according to the principles set out in the UDITPA,<sup>57</sup> which usually permit a tax to be imposed where the corporation is commercially domiciled.<sup>58</sup> Business income is apportioned on the basis of an equally weighted three-factor formula<sup>59</sup> which includes property, payroll, and sales.<sup>60</sup>

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<sup>50</sup>The three-factor formula is:

$$\frac{\text{In-State property} + \text{In-State payroll} + \text{In-State sales}}{\text{Total property} \quad \text{Total payroll} \quad \text{Total sales}} \times \frac{\text{Total Income}}{\text{corporate income}} = \frac{\text{taxable by}}{\text{the State}}$$

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See 1 [All States Unit] ST. & LOC. TAX SERV. (P-H) ¶ 1046; Special Subcommittee Report, *supra* note 45, at 170.

<sup>51</sup>UNIFORM DIVISION OF INCOME FOR TAX PURPOSES ACT, 7A U.L.A. 91 (1957) [hereinafter cited as UDITPA]. The UDITPA is also reproduced as Article IV of the Multistate Tax Compact [hereinafter cited as Compact] in 1 [All States Unit] ST. & LOC. TAX SERV. (P-H) ¶¶ 6315-6332. For a list of the states which have adopted substantially all of the UDITPA to date, see 7A U.L.A. 11 (Supp. 1983).

<sup>52</sup>For the text of the Compact, see 1 [All States Unit] ST. & LOC. TAX SERV. (P-H) ¶ 6310. For a list of the Compact members and associate members, see *id.* ¶ 5150.

<sup>53</sup>See generally Lynn, *Formula Apportionment of Corporate Income for State Tax Purposes: Natura Non Facit Saltum*, 18 OHIO ST. L.J. 84 (1957); Lynn, *The Uniform Division of Income for Tax Purposes Act*, 19 OHIO ST. L.J. 41 (1958); Pierce, *The Uniform Division of Income for State Tax Purposes*, 35 TAXES 747 (1957) (a discussion of the basic components by the drafter of the UDITPA).

<sup>54</sup>This "income-splitting" is not a simple process. See STATE AND LOCAL TAXATION, *supra* note 45, at 490-504.

<sup>55</sup>UDITPA, *supra* note 51, § 1(a).

<sup>56</sup>*Id.* at § 1(e).

<sup>57</sup>*Id.* at §§ 4-8; see Dexter, *Taxation of Income from Intangibles of Multistate Multinational Corporations*, 29 VAND. L. REV. 401, 406-07 (1976) (a detailed description of the specific allocation of non-business income as well as criticism of the income-splitting as lacking a reasonable basis).

<sup>58</sup>UDITPA, *supra* note 51, § 7.

<sup>59</sup>*Id.* at §§ 9-17. See *supra* note 50.

<sup>60</sup>If this formula does not result in a fair reflection of the taxpayer's state ac-

The Compact<sup>61</sup> is an interstate taxation agreement with regard to the taxation of multijurisdictional corporations which has adopted the UDITPA provisions.<sup>62</sup> The Compact established the Multistate Tax Commission (Commission)<sup>63</sup> and, pursuant to the Compact, any member state may request that the Commission perform an audit on its behalf.<sup>64</sup> The Compact was sustained in *United States Steel Corp. v. Multistate Tax Commission*<sup>65</sup> against a facial attack on the ground that it violated the compact clause of the United States Constitution.<sup>66</sup>

There is a third state development of importance with regard to the division of a multijurisdictional corporation—combined reporting.<sup>67</sup> Under combined reporting, a state determines its proportionate share of the combined income which, with respect to the members of an affiliated group of corporations, is taxable by the state. It then applies its apportionment formula to the combined income.<sup>68</sup> A combined

tivities, relief may be sought under UDITPA § 18.

<sup>61</sup>For a succinct summary of the origins and the nature of the Compact, see Hellerstein, *State Taxation Under the Commerce Clause: An Historical Perspective*, 29 VAND. L. REV. 335, 341 (1976).

<sup>62</sup>See *supra* note 51.

<sup>63</sup>Composed of one member from each member state, the Commission is the governing and administrative body of the Compact. The Commission is empowered to formulate regulations which address allocation and apportionment of income for income tax purposes. The regulations are merely advisory and not binding on any state unless it adopts them. See STATE AND LOCAL TAXATION, *supra* note 45, at 544.

<sup>64</sup>See article VI of the Compact in 1 [All States Unit] ST. & LOC. TAX SERV. (P-H) ¶ 6310.

<sup>65</sup>434 U.S. 452 (1978). See Dexter, *An Analysis of the Supreme Court's U.S. Steel Decision Upholding Multistate Tax Compact*, 48 J. TAX'N 368 (1978).

<sup>66</sup>434 U.S. at 472-78. The Court concluded that the existence of the Commission did not enhance the political power of the member states so as to encroach upon the supremacy of the United States. *Id.* at 472. The Court also upheld the Compact over challenges based on commerce clause and fourteenth amendment grounds. *Id.* at 478-79. For the text of the compact clause, see U.S. CONST. art. I, § 10, cl. 3.

<sup>67</sup>Peters, *Use of Combined Reporting Required by Increasing Number of States*, 41 J. TAX'N 375 (1974). The Commission has been advocating the use of combined reporting. See Corrigan, *Interstate Corporate Income Taxation—Recent Revolutions and a Modern Response*, 29 VAND. L. REV. 423, 439-41 (1976). For a general introduction to combined apportionment and allocation with regard to multicorporate enterprises, see STATE AND LOCAL TAXATION, *supra* note 45, at 438-43, 520-26. For the background with respect to the development of combined reporting and its relationship to separate accounting and formulary apportionment, see HALE & KRAMER, *supra* note 28, at 60-79.

<sup>68</sup>Rudolph, *supra* note 44, at 197-201. In this sense, a prerequisite to combined reporting is that the affiliated group be a unitary business. The income of separate but related corporations determined to be engaged in a unitary business is combined to calculate the tax liability of the members of the related corporate group. After the elimination of certain intercorporate transactions, such as dividends, the net income is that of the combined group and the apportionment formula includes the factors of the members of the combined group. For a discussion of combined reporting, see Keesling, *A Current Look at the Combined Report and Uniformity in Allocation Practices*, 42 J. TAX'N 106 (1975). The combined report usually includes only related corporations in which the parent corporation owns, directly or indirectly, more than 50%

report is not a consolidated tax return; rather, it has the qualities of an information return.<sup>69</sup> Combined reporting is applied by some states to multijurisdictional corporations which are operating within the United States, outside of the United States, or both.<sup>70</sup> When formula apportionment is applied to the combined income of an affiliated group of corporations consisting of both foreign corporations operating outside of the United States and one or more corporations doing business within the taxing state, the method is commonly referred to as worldwide combined reporting.<sup>71</sup>

Congress has not fully exercised its power to legislate in the area of state taxation.<sup>72</sup> The application of any legislation which has been enacted has, in every instance, been very narrow in scope.<sup>73</sup> The Supreme Court has acknowledged both the limitations of any judicial resolution of state taxation controversies<sup>74</sup> and the appropriateness of congressional action.<sup>75</sup> Proposed legislation placing limitations on the states' power to tax the income of multijurisdictional corporations has been considered in recent years.<sup>76</sup> For example, bills have been proposed to limit the taxation of foreign-source income of multinational corporations.<sup>77</sup> The most recent legislative efforts with regard to the taxation of foreign-source income have been concerned with prohibiting the states from using worldwide combined reporting and restricting the states in the taxation of foreign-source dividends.<sup>78</sup> The

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of the stock. See Buresh & Weinstein, *Combined Reporting: The Approach and Its Problems*, 1 J. STATE TAX'N 5, 8 (1982).

<sup>69</sup>See Buresh & Weinstein, *supra* note 68, at 6-7.

<sup>70</sup>The application of combined reporting is based either on statutory provisions relating to such reports or on judicial or administrative decisions construing combined reporting statutory provisions. See, e.g., *F. W. Woolworth Co. v. Director of Div. of Taxation*, 45 N.J. 466, 213 A.2d 1 (1965).

<sup>71</sup>See Hellerstein, *State Income Taxation of Multijurisdictional Corporations: Reflections on Mobil, Exxon, and H.R. 5076*, 79 MICH. L. REV. 113, 156 (1980); G.A.O. REPORT-1982, *supra* note 3, at 31.

<sup>72</sup>Pub. L. No. 86-272, see *supra* note 43, was the first time that Congress passed legislation concerning the power of the states to tax the income of corporations engaged in interstate commerce. Except for this legislation, the power of Congress to regulate state taxation of the income of interstate corporations has been virtually unexercised.

<sup>73</sup>Since the enactment of Pub. L. No. 86-272, Congress has passed other legislation limiting the power of the state to tax in certain well-defined areas. See, e.g., 15 U.S.C. § 78bb(d) (1976) (stock transfer taxes); 49 U.S.C. § 11503 (Supp. V 1981) (railroad property); 49 U.S.C.A. § 11503a (West 1983) (motor carrier property).

<sup>74</sup>*Northwestern States Portland Cement Co. v. Minnesota*, 358 U.S. 450, 457 (1959).

<sup>75</sup>*Moorman Mfg. Co. v. Bair*, 437 U.S. 267, 280 (1978).

<sup>76</sup>See Madere, *State Taxation After Mobil and Exxon*, 33 TAX EXEC. 103, 127-31 (1981).

<sup>77</sup>For a thorough summary and analysis of this legislation, see Hellerstein, *supra* note 71, at 154.

<sup>78</sup>S. 655, 97th Cong., 1st Sess. (1981); H.R. 1983, 97th Cong., 1st Sess. (1981). No final action was taken on these bills. For a discussion of their constitutional

issue of whether and how to include the income from foreign corporations in a taxpayer's apportionable income has not only been treated extensively in congressional hearings, but has also been of central importance in recent tax treaty negotiations.<sup>79</sup>

#### IV. THE UNITARY BUSINESS PRINCIPLE

A significant area in which substantial uniformity exists among all of the states which tax multijurisdictional corporations, then, is the use of formulary apportionment.<sup>80</sup> The application of formulas to apportion the income of a multijurisdictional corporation, however, is permitted only in the case of a unitary business.<sup>81</sup> The Supreme Court has recently reaffirmed that an essential prerequisite of apportionability for state taxation of a multijurisdictional enterprise is adherence to the unitary business principle.<sup>82</sup> The unitary business principle is a historical concept which has been developed throughout this century by the Supreme Court. While this principle has been the subject of much commentary,<sup>83</sup> the determination of whether a business satisfies the unitary business principle is no easy task. The difficulty stems from the definitional criteria for determining whether a corporate enterprise should be characterized as a single unitary enterprise for tax purposes.<sup>84</sup>

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ity, see Dexter, *State Taxation of Multinationals: Are the Mathias and Conable Bills Constitutional?*, 14 TAX NOTES 715 (1982).

<sup>79</sup>For example, the United States-United Kingdom Income Tax Treaty originally contained a provision which substantially restricted the ability of the states to use combined reporting and formulary apportionment with regard to United States corporations which are subsidiaries of United Kingdom corporations. The provision was eventually deleted from the treaty. See Hellerstein, *supra* note 71, at 161.

<sup>80</sup>See *supra* notes 46-50 and accompanying text.

<sup>81</sup>"Formulary apportionment, which takes into account the entire business income of a multistate business in determining the income taxable by a particular state, is constitutionally permissible only in the case of a unitary business." ASARCO Inc. v. Idaho State Tax Comm'n, 102 S. Ct. 3103, 3111 n.14 (1982) (quoting Rudolph, *supra* note 44, at 183-84).

<sup>82</sup>ASARCO Inc. v. Idaho State Tax Comm'n, 102 S. Ct. 3103, 3110 (1982).

<sup>83</sup>See Hellerstein, *Recent Developments in State Tax Apportionment and the Circumscription of Unitary Business*, 21 NAT. TAX J. 487 (1968); Rudolph, *supra* note 44; Dexter, *supra* note 45. For other scholarly discussions of the unitary business concept, see ALTMAN & KEESLING, *supra* note 45, at 97-102; STATE AND LOCAL TAXATION, *supra* note 45, at 504-56; Dexter, *Taxation of Income from Intangibles of Multistate-Multinational Corporations*, 29 VAND. L. REV. 401 (1976); Keesling, *A Current Look at the Combined Report and Uniformity in Allocation Practices*, 42 J. TAX'N 106 (1975); Keesling & Warren, *The Unitary Concept in the Allocation of Income*, 12 HASTINGS L.J. 42 (1960).

<sup>84</sup>For a discussion of the Supreme Court's unwillingness to settle upon a single definition of the scope of a unitary business, see Hellerstein, *supra* note 71, at 148-51.

### A. Origins

The origin of the unitary business principle lies in state ad valorem property tax cases.<sup>85</sup> At the turn of the century, a so-called unit rule was designed to apply ad valorem taxes to interstate utility systems<sup>86</sup> and was also applied in early railroad cases.<sup>87</sup> This tax concept assumed that the value of a railroad was a function of the rail system as a whole; therefore, a formula was developed to divide the value of the rail system as a unit among all of the jurisdictions within which it operated.<sup>88</sup> These cases provide the basis for the contemporary proposition that all of the properties of a unitary business utilized in the operations of the business, whether it conducts the business in a single or multiple corporate form, are subject to a reasonable apportionment formula.<sup>89</sup> Subsequently, the unit rule was incorporated into the field of income taxation.

### B. Developments: Corporate Income Tax Cases

The seminal case on formulary apportionment is *Underwood Typewriter Co. v. Chamberlain*<sup>90</sup> decided by the United States Supreme Court in 1920. This case involved the imposition of a net income tax on a manufacturing and sales corporation operating in different states. The corporation had its manufacturing plants and substantial property located within the taxing state while a greater portion of its sales were made in other states.<sup>91</sup> The taxing state apportioned income on the basis of a single-factor property formula.<sup>92</sup> The corporation argued that the formula taxed "income arising from business conducted beyond the boundaries of the State" in violation of the due process clause.<sup>93</sup> The Court rejected the due process objection and concluded that the formula resulted in a fair apportionment reaching only profits generated in the state.<sup>94</sup> *Underwood*, then, sanctioned formulary ap-

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<sup>85</sup>Dexter, *supra* note 45, at 184.

<sup>86</sup>*Id.* See Isaacs, *The Unit Rule*, 34 YALE L.J. 838 (1926).

<sup>87</sup>See, e.g., *Union Pacific Ry. v. Cheyenne*, 113 U.S. 516 (1884).

<sup>88</sup>The Supreme Court summarized its holdings in this regard and considered what constituted a unitary business in *Adams Express Co. v. Ohio State Auditor*, 165 U.S. 194, 220-23 (1897).

<sup>89</sup>Dexter, *supra* note 45, at 191.

<sup>90</sup>254 U.S. 113 (1920).

<sup>91</sup>*Id.* at 117-19. The corporation earned income through a "series of transactions" beginning with manufacturing in the state and ending with sales outside of the state. *Id.* at 120-21.

<sup>92</sup>The single-factor formula using property as a basis computes the ratio of real and tangible personal property values within the state to the value of that same property owned in total by the corporation so as to determine the state's proportionate share of income. *Id.* at 118.

<sup>93</sup>*Id.* at 120.

<sup>94</sup>*Id.* at 121. The Court acknowledged the difficulty of determining the state's fair proportionate share of taxable income by accounting only for the manufacturing

portionment as a proper method of dividing the net income of a corporation derived from the interstate operations of a vertically integrated business among nondomiciliary states.

In 1924, the Court extended the *Underwood* reasoning to permit a taxing state to impose taxes based on apportionment of net income earned by a foreign corporation in *Bass, Ratcliff & Gretton, Ltd. v. State Tax Commission*.<sup>95</sup> This case involved a vertically integrated operation across national boundaries. The unitary business was a British corporation which manufactured its product in England and sold it in the United States as well as in England.<sup>96</sup> The taxing state used a single-factor property formula similar to that used in the *Underwood* case and included the foreign income in the total taxable income to be apportioned.<sup>97</sup> Even though the corporation had showed a loss from United States operations on its federal income tax return, the use of the formula resulted in income taxable by the state.<sup>98</sup> The Supreme Court sustained the tax over due process objections basing its holding on a finding that the corporation was carried on as a unitary business.<sup>99</sup>

In 1931, in *Hans Rees' Sons, Inc. v. North Carolina ex rel. Maxwell*,<sup>100</sup> a case involving facts strikingly similar to those at issue in *Underwood* and *Bass*, the Supreme Court upheld the corporation's challenge to a state tax based on apportionment.<sup>101</sup> The corporation manufactured its product in the taxing state, but its principal offices

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within the state. *Id.* at 120-21. See also *Moorman Mfg. Co. v. Bair*, 437 U.S. 267, 278-80 (1978) (formulary apportionment is used as a rough approximation of the net income of a corporation attributable to the taxing jurisdiction).

<sup>95</sup>266 U.S. 271 (1924). The *Bass* case involved a franchise tax measured by net income attributable to the taxing state. *Id.* at 277. A franchise tax is an assessment for the privilege of doing business in the taxing jurisdiction. The significance of this case lies in the inclusion of foreign-source income into preapportionment taxable income. *Id.* at 282. In this regard, foreign-source income refers to income generated outside of the United States.

<sup>96</sup>*Id.* at 278-79.

<sup>97</sup>The single-factor formula using property in this case is different from that used in *Underwood*. In the instant case the state determined that the property owned in total by the corporation contributed to generating dividend income. *Id.* at 277-80.

<sup>98</sup>*Id.* at 279-80.

<sup>99</sup>*Id.* at 282. Although the term "unitary business" is not used in *Underwood*, the Court upheld the tax in *Bass* by citing *Underwood*. *Id.* at 280-82. One may infer that the corporation described in *Underwood* was a unitary business.

<sup>100</sup>283 U.S. 123 (1931).

<sup>101</sup>*Id.* at 136. It is interesting to note that a taxpayer has not often successfully prevailed in challenging the results of a taxing state's formulary apportionment of net income. Some of the successful taxpayer cases have been the following: *Colonial Pipeline Co. v. Traigle*, 421 U.S. 100 (1975); *Standard Pressed Steel Co. v. Dep't of Revenue*, 419 U.S. 560 (1975); *Norfolk & W. Ry. Co. v. Missouri State Tax Comm'n*, 390 U.S. 317 (1968); *Memphis Natural Gas Co. v. Stone*, 335 U.S. 80 (1948).

and storage facilities were in another state.<sup>102</sup> Its worldwide net income resulted from sales in the United States, Canada, and Europe.<sup>103</sup> The taxing state utilized a single-factor property formula and attempted to tax from sixty-six to eighty-five per cent of the corporation's net income, while the corporation offered strong evidence derived from a separate accounting procedure which showed that at most twenty-three per cent of its profit was attributable to its manufacturing in the taxing state.<sup>104</sup> The Court characterized a manufacturing and marketing enterprise in several jurisdictions as unitary<sup>105</sup> and did not question whether the corporation was in fact a unitary business. The Court simply held that the formula based on a single-factor analysis was invalid because the result in this case was unreasonable.<sup>106</sup> The precedential value of this opinion is of limited significance because the majority of the states presently have a three-factor apportionment formula which has survived judicial scrutiny.<sup>107</sup>

In the 1942 decision of *Butler Brothers v. McColgan*,<sup>108</sup> the Court approved the use of the three-factor apportionment formula and extended the application of the unitary business concept from manufacturing enterprises to a wholly mercantile operation. In this case, a single corporation used a central office in one state to purchase all of the goods and inventory for branch wholesale distribution centers in several states, including the taxing state.<sup>109</sup> The central office also provided resources such as advertising, accounting, and management for the branches. The central office allocated the costs of its operations among the branch offices and, by means of separate accounting, accurately determined a loss for the taxing state.<sup>110</sup> The state applied the three-factor formula which resulted in a tax liability.<sup>111</sup> The corporation, however, maintained that the application of the formula in this case resulted in the taxation of extraterritorial values in violation of the due process clause.<sup>112</sup>

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<sup>102</sup>283 U.S. at 126-27.

<sup>103</sup>*Id.* at 127.

<sup>104</sup>*Id.* at 128-34.

<sup>105</sup>*Id.* at 133.

<sup>106</sup>The statute was applied unreasonably and arbitrarily by attributing to the taxing state a percentage of income "out of all appropriate proportion to the business transacted by the [corporation] in that state." *Id.* at 135-36. The Court distinguished *Underwood* and *Bass* on the ground that the corporations in those cases failed to establish that the amount of net income with which the corporations were charged in the taxing states under the apportionment method was not reasonably attributable to the processes conducted within the borders of those states. *Id.* at 133.

<sup>107</sup>See *supra* notes 48-50 and accompanying text.

<sup>108</sup>315 U.S. 501 (1942).

<sup>109</sup>*Id.* at 504.

<sup>110</sup>*Id.* at 504-05.

<sup>111</sup>*Id.*

<sup>112</sup>*Id.* at 506-07.

The Court determined that the state properly characterized the corporation as a unitary business, focusing on the centralized management and functional integration of the interstate operations.<sup>113</sup> In so doing, the Court relied on a test developed by the state court,<sup>114</sup> the so-called three-unities test, which consists of (1) unity of ownership, (2) unity of use, and (3) unity of operation and management.<sup>115</sup> The Court held that the reasonableness of a particular apportionment formula may not be contested by the corporation by means of a separate accounting once the corporate enterprise has been properly characterized as a unitary business.<sup>116</sup>

#### V. STATE TAXATION OF MULTINATIONAL CORPORATE FOREIGN-SOURCE DIVIDENDS: *Mobil*

The key precedent regarding state taxation of foreign-source income is the United States Supreme Court decision in *Mobil Oil Corp. v. Commissioner of Taxes*.<sup>117</sup> In this 1980 decision, the Supreme Court addressed the constitutional limitations on a nondomiciliary state's taxation of a domestic corporation's dividend income received from foreign subsidiaries and affiliates.<sup>118</sup> The Court rejected both due process and commerce clause objections and held that it is permissible for a state to include foreign-source dividends in a multinational corporation's apportionable tax base so long as there is a unitary relationship between the payor foreign corporation and the recipient domestic corporation.<sup>119</sup> The reasoning of the Court in arriving at its holding has generated considerable commentary.<sup>120</sup>

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<sup>113</sup>*Id.* at 508.

<sup>114</sup>*Butler Bros. v. McColgan*, 17 Cal.2d 664, 111 P.2d 334 (1941), *aff'd*, 315 U.S. 501 (1942).

<sup>115</sup>315 U.S. at 508-09. See Boren, *Separate Accounting in California and Uniformity in Apportioning Corporate Income*, 18 U.C.L.A. L. REV. 478, 490-94 (1971) (discussing the development of the three-unities test together with modifications made by the California courts). Commentators have been critical of the many ambiguities of the three-unities test and its modifications. See Dexter, *supra* note 45, at 192-98. For example, the test gives no significance to the distinction between in-state business and out-of-state business.

<sup>116</sup>315 U.S. at 508-09. Even though it was not decided on constitutional grounds, *General Motors v. District of Columbia*, 380 U.S. 553 (1965), stands as the Supreme Court's endorsement of the three-factor formula noting its prevalence among the taxing states and its justification as a rough practical approximation of the distribution of a corporation's sources of income and the social cost for which the corporation is responsible.

<sup>117</sup>445 U.S. 425 (1980).

<sup>118</sup>*Id.* at 427.

<sup>119</sup>For an excellent analysis of the *Mobil* decision together with an analysis of proposed federal legislation for the restriction on state taxation of foreign-source income, see Hellerstein, *supra* note 71.

<sup>120</sup>Many articles have been written which are mostly critical of the *Mobil* decision. See, e.g., Chisum, *State Taxation of Interstate Corporate Income from Intangible Prop-*

Mobil, a New York corporation authorized to do business in Vermont, was engaged in an integrated, worldwide business which involved the production, refinement, distribution, and sale of petroleum products.<sup>121</sup> Mobil's foreign business was conducted through wholly and partly owned subsidiaries and affiliates, none of which was incorporated in or conducted business in Vermont.<sup>122</sup> Mobil's activities in Vermont were limited to the marketing of petroleum products and formed only a small part of its worldwide business.<sup>123</sup>

This dispute involved Mobil's tax liability to Vermont for the years 1970, 1971, and 1972. Vermont imposed a net income tax on every corporation doing business in the state.<sup>124</sup> Net income was composed of taxable income as defined by the Internal Revenue Code.<sup>125</sup> Because Mobil was engaged in business both within and without the state, Vermont used the three-factor apportionment formula to determine a fair and equitable portion of the net income attributable to Mobil's commercial activities in Vermont.<sup>126</sup> On its federal income tax returns, Mobil's net income included substantial dividends received from its

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*erty: Due Process and Commerce Clause Limitations*, 13 TEX. TECH. L. REV. 1 (1982); Corrigan, *How Multistate Tax Commission Conducts Joint Audits and Controls Income Allocations*, 25 TAX'N FOR ACCT. 108 (1980); Corrigan, *Toward Uniformity in Interstate Taxation*, 11 TAX NOTES 507 (1980); Corrigan, *Mobil-izing Interstate Taxation*, 13 TAX NOTES 803 (1981); Dexter, *Tax Apportionment of the Income of a Unitary Business: An Examination of Mobil Oil Corp. v. Commissioner of Taxes of Vermont*, 1981 B.Y.U. L. REV. 107; Feinschreiber, *State Taxation of Foreign Dividends After Mobil v. Vermont: Adjusting the Apportionment Formula*, 6 INT'L TAX J. 267 (1980); Hellerstein, *Allocation and Apportionment of Dividends and the Delineation of the Unitary Business*, 14 TAX NOTES 155 (1982); Keesling, *The Impact of the Mobil Case on Apportionment of Income*, 1981 B.Y.U. L. REV. 87; Killefer, *State Taxation of Commerce: Mobil Oil Corporation v. Commissioner of Taxes of Vermont*, 8 J. CORP. TAX'N 3 (1981); Nackenson, *The Impact of Mobil v. Vermont on Interstate Taxation*, 6 INT'L TAX J. 323 (1980); Peters, *Supreme Court's Mobil Decision on Multistate Income Apportionment Raises New Questions*, 53 J. TAX'N 36 (1980); Comment, *State Taxation of Foreign Source Corporate Dividends: Another Conquest of the Expanded Unitary Business Doctrine*, 22 URB. L. ANN. 229 (1981).

<sup>121</sup>445 U.S. at 427-28.

<sup>122</sup>*Id.* at 428.

<sup>123</sup>*Id.*

<sup>124</sup>*Id.* at 429. VT. STAT. ANN. tit. 32, §§ 5811(15), 5832 (1981).

<sup>125</sup>445 U.S. at 429. Under the Vermont state taxation system, net income is defined as the taxable income of the taxpayer "under the laws of the United States." VT. STAT. ANN. tit. 32, § 5811(19) (1981).

<sup>126</sup>445 U.S. at 429. Vermont's formula multiplied the corporation's net income "by a fraction representing the arithmetic average of the ratios of sales, payroll, and property values within Vermont to those of the corporation as a whole." *Id.* See VT. STAT. ANN. tit. 32, § 5833(a) (1981). For the taxable year 1972, the ratios of Mobil's Vermont sales, payroll, and property to those factors "everywhere" were approximately .24%, .06%, and .25%, respectively. 445 U.S. at 429 n.2. Vermont applied the fraction produced by the formula to the corporation's federal taxable income with minor modifications which, for example, excluded income exempt from state taxation under federal law. *Id.* at 429. VT. STAT. ANN. tit. 32, § 5811(18) (1981).

foreign subsidiaries and affiliates.<sup>127</sup> On its Vermont returns, Mobil subtracted from federal taxable income its foreign-source dividend income, which resulted in losses for 1971 and 1972.<sup>128</sup> The Vermont Department of Taxes restored the items to the preapportionment tax base and assessed accordingly.<sup>129</sup>

Mobil argued that the restoration of the foreign-source income to its preapportionment tax base violated the due process clause as well as the commerce clause.<sup>130</sup> In addition, Mobil petitioned for modification of the apportionment.<sup>131</sup> The Supreme Court of Vermont sustained the tax on the foreign-source dividends,<sup>132</sup> and on appeal, the United States Supreme Court affirmed the judgment.<sup>133</sup>

Mobil proposed three principal arguments for exclusion of its foreign-source dividends from income subject to formulary apportionment.<sup>134</sup> First, the corporation argued that the lack of a nexus between the taxing State and either the parent corporation's management of its investments in the subsidiaries or the business activities of the subsidiaries precluded taxation of its dividend income.<sup>135</sup> Thus, the state tax on this foreign income violated due process. In considering this due process clause argument, the Court determined that a sufficient nexus existed between the parent corporation's activities and the taxing state to permit the assessment of the tax. The Court found that there was nothing unique about foreign-source dividends so as to prohibit their taxation.<sup>136</sup> To the extent that a multinational corporation operates as a functionally integrated enterprise and earns dividends from subsidiaries or affiliates which reflect profits derived from such an enterprise, those dividends are treated as income which is to be appropriately included in the parent corporation's apportionable tax base pursuant to the unitary business principle.<sup>137</sup> The Court reasoned that it would be misleading to characterize the

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<sup>127</sup>Mobil's federal income tax returns for 1970-72 showed taxable income of approximately \$220 million, \$308 million, and \$233 million, respectively. 445 U.S. at 430. Of that, net dividend income accounted for approximately \$174 million, \$283 million, and \$280 million. *Id.*

<sup>128</sup>*Id.* Mobil subtracted amounts representing interest and foreign taxes as well as dividends. *Id.* at 430 n.6.

<sup>129</sup>*Id.* at 431-32. Mobil's aggregate tax liability for the three years was calculated by Vermont at over \$76,000. *Id.* at 432.

<sup>130</sup>*Id.* at 432.

<sup>131</sup>*Id.* Vermont allows a corporation to petition for relief where the three-factor formula results in an unfair apportionment.

<sup>132</sup>*Mobil Oil Corp. v. Comm'r of Taxes*, 136 Vt. 545, 394 A.2d 1147 (1978).

<sup>133</sup>445 U.S. at 449.

<sup>134</sup>*Id.* at 436.

<sup>135</sup>*Id.*

<sup>136</sup>*Id.* at 438-39. Mobil had claimed that foreign-source dividends by their very nature are not apportionable income. *Id.* at 434.

<sup>137</sup>*Id.* at 440.

dividends received in a unitary business as proceeding from a separate identifiable source because separate accounting may fail to account for contributions to profitability, such as integrated functions, centralized management, and economies of scale which arise from the operation of the business as a whole.<sup>138</sup>

Therefore, the nondomiciliary corporation must show that foreign-source income was earned in the course of activities unrelated to its activities in the taxing state in order to establish that the income is not subject to formulary apportionment.<sup>139</sup> The Court found that Mobil failed to demonstrate that the activities of its foreign subsidiaries were distinct from its marketing activities in the taxing state.<sup>140</sup> The unitary business principle remains the linchpin of the Court's decision with regard to the due process analysis of state taxation of foreign-source income.<sup>141</sup> A multinational corporation must prove that there is not an underlying unitary business involving the operations producing the foreign-source income in order to exclude such income from a state's apportionable tax base.<sup>142</sup>

Second, Mobil argued that it was subject to an unconstitutional burden of multiple taxation because the foreign-source dividends would be potentially taxable in full in the state of its commercial domicile by means of specific allocation.<sup>143</sup> On this commerce clause issue, the Court decided that where the foreign-source income bears relation to benefits conferred by several states, formulary apportionment, rather than specific allocation, is ordinarily the acceptable means of

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<sup>138</sup>*Id.* at 438.

<sup>139</sup>*Id.* at 439. Because Mobil failed to sustain its burden of proving any unrelated business activity on the part of its subsidiaries and affiliates, the Court did not have to decide whether the foreign-source dividends would be apportionable in the absence of a unitary business relationship. The Court added a critical qualification to its holding that the foreign-source dividends were not shown to be exempt, as a matter of due process, from apportionment in this instance:

We do not mean to suggest that all dividend income received by corporations operating in interstate commerce is necessarily taxable in each State where that corporation does business. Where the business activities of the dividend payor have nothing to do with the activities of the recipient in the taxing State, due process considerations might well preclude apportionability, because there would be no underlying unitary business.

*Id.* at 441-42.

<sup>140</sup>*Id.* at 439.

<sup>141</sup>*Id.*

<sup>142</sup>The corporate form of a business may have nothing to do with the underlying economic realities of the business enterprise and transforming operating income into dividends ought not impair the apportionability of income. *Id.* at 440-41. It is interesting to note how the Court framed the issue and confined its opinion to the issue of "whether there is something about the character of income earned from investments in affiliates and subsidiaries operating abroad that precludes, as a constitutional matter, state taxation of that income by the apportionment method." *Id.* at 435.

<sup>143</sup>*Id.* at 436.

taxation.<sup>144</sup> The Court acknowledged that the state of commercial domicile may have the authority to impose some tax on the dividend income;<sup>145</sup> however, the Court concluded that there is no reason to find the taxing authority of the domiciliary state exclusive in cases in which the dividend income proceeds from a unitary enterprise where some part of that business operates in states other than the state of the corporation's commercial domicile.<sup>146</sup> The Court ruled the domicile analysis based on property tax principles carries little force in the context of income taxation.<sup>147</sup> The Court determined that a non-domiciliary state's interest in taxing its proportionate share of a multinational corporation's dividend income was not preempted by any interest of the state of commercial domicile.<sup>148</sup>

Third, Mobil argued that the foreign-source of the dividends subjected the corporation to a risk of multiple taxation at the international level.<sup>149</sup> The corporation did not broadly propose that foreign-source income is totally sheltered from state taxation; rather, Mobil maintained that federal tax policies against double taxation of foreign-source income required that the income must be specifically allocated to the state of commercial domicile for imposition of state taxation.<sup>150</sup> Mobil asserted that the Court's decision in *Japan Line, Ltd. v. County of Los Angeles*<sup>151</sup> required the allocation of the tax to the state of the corporation's domicile, because apportionment's inherent inaccuracy would create a risk of multiple taxation which the Court would be unable to correct.<sup>152</sup> The Supreme Court found that the tax did not impose an undue burden on foreign commerce.<sup>153</sup> The Court distin-

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<sup>144</sup>*Id.* at 446.

<sup>145</sup>*Id.* at 445.

<sup>146</sup>*Id.* at 445-46.

<sup>147</sup>*Id.* at 445. The Court noted that cases upholding allocation to a single situs for property tax purposes have distinguished income tax situations involving formulary apportionment. *See* *Wheeling Steel Corp. v. Fox*, 298 U.S. 193, 212 (1936).

<sup>148</sup>445 U.S. at 445-46. The constitutionality of a state tax assessed pursuant to formulary apportionment should not depend on the vagaries of the tax policies of the state of commercial domicile of a corporation. *Id.* at 444. The commercial domicile in this case did not tax the dividend income in question and the Court noted that "actual multiple taxation is not demonstrated on this record." *Id.*

<sup>149</sup>*Id.* at 436.

<sup>150</sup>*Id.* at 446.

<sup>151</sup>441 U.S. 434 (1979). *See supra* notes 20-21 and accompanying text.

<sup>152</sup>445 U.S. at 446.

<sup>153</sup>*Id.* at 449. The Court rejected Mobil's argument on several grounds. First, the argument focused on the effect of foreign taxation when the important issue was the effect of domestic taxation. *Id.* at 447. Second, the argument extended to any income arguably earned in foreign commerce which would force the states to determine whether the income has a foreign source. *Id.* Third, the argument underestimated the Court's ability to correct discriminatory taxation of foreign commerce resulting from multiple

guished the *Japan Line* decision on the ground that it involved a state property tax and that the analysis of that opinion did not apply to an income tax.<sup>154</sup> The Court did not provide any analysis supporting this distinction. In addition, the Court noted that both federal and state taxation of income is the norm and that federal and state treatment of foreign-source income for tax purposes need not be similar, absent some congressional directive.<sup>155</sup>

In summary, the Court held that neither the due process clause nor the commerce clause requires a preference for specific allocation, rather than formulary apportionment, of foreign-source dividend income.<sup>156</sup> The decision affirms formulary apportionment of foreign-source dividends where there is a unitary business relationship among the payor foreign subsidiaries or affiliates and the recipient parent corporation; however, it does not require that the states employ this method. Even though the holding in *Mobil* is limited as such, the analysis of this decision remains at the center of the issues concerning the state taxation of foreign-source income.

The most important issue unanswered by the *Mobil* opinion is the criteria for a fair apportionment formula to be used in the context of foreign-source income. The Court did not address a second due process clause requirement which necessitates a rational relationship between the income taxed and the activities of the corporation within the state.<sup>157</sup> Arguably Vermont's apportionment formula violated this second requirement because it failed to reflect the foreign sales, property, and payroll values of the subsidiary corporations.<sup>158</sup>

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taxation. *Id.* Fourth, specific allocation would not necessarily entail less of a tax on foreign-source income. *Id.* at 447-48.

<sup>154</sup>The Court properly rejected the corporation's reliance upon *Japan Line*, which was concerned with property taxation of instrumentalities of foreign commerce. *Japan Line* dealt with multiple taxation on a purely international level, not on an interstate level as in *Mobil*. Federal interests necessitate that any state taxation of foreign commerce must meet stricter standards of review than like taxation imposed solely on interstate commerce.

<sup>155</sup>445 U.S. at 448.

<sup>156</sup>*Id.* at 449.

<sup>157</sup>The Court avoided this issue when it explained that Mobil's "election to attack the tax base rather than the formula substantially narrows the issues before us. In deciding this appeal, we do not consider whether application of Vermont's formula produced a fair attribution of [Mobil's] dividend income to that State." *Id.* at 434.

<sup>158</sup>In his dissenting opinion, Justice Stevens expressed the view that Vermont's formula was indefensible because, "Unless the sales, payroll, and property values connected with the production of income by the payor corporations are added to the denominator of the apportionment formula, the inclusion of earnings attributable to those corporations in the apportionable tax base will inevitably cause Mobil's Vermont income to be overstated." *Id.* at 461 (Stevens, J., dissenting). For the position that apportionment formula factors should be adjusted by taking into account the prop-

## VI. ASARCO AND *Woolworth*: DUE PROCESS LIMITATIONS ON THE STATE TAXATION OF FOREIGN-SOURCE INCOME

The concept of a unitary business has expanded from single corporations or an affiliated group of corporations doing business in several states to include the income of a nondomiciliary corporation derived from subsidiaries and affiliates operating outside of the United States. *Mobil* endorsed the application of formulary apportionment to such foreign-source income.<sup>159</sup> The principal basis for finding any limitation on the power of a state to impose formulary apportionment on multinational enterprises is a successful demonstration that members of a group of affiliated corporations are in fact engaged in discrete business enterprises unrelated to their activities in the state.<sup>160</sup> For the first time since the 1931 decision in *Hans Rees' Sons, Inc. v. North Carolina ex rel. Maxwell*,<sup>161</sup> the corporate taxpayers in the companion cases of *ASARCO Inc. v. Idaho State Tax Commission*<sup>162</sup> and *F. W. Woolworth Co. v. Taxation and Revenue Department*<sup>163</sup> succeeded in obtaining a ruling from the Supreme Court that a state tax on foreign-source income was unconstitutional by showing that certain income had been derived from discrete business enterprises.<sup>164</sup>

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erty, payroll, and sales of the payor subsidiaries, when dividend income is included in a corporation's tax base, see Feinschreiber, *State Taxation of Foreign Dividends After Mobil v. Vermont: Adjusting the Apportionment Formula*, 6 INT'L TAX J. 267 (1980); Nackenson, *The Impact of Mobil v. Vermont on Interstate Taxation*, 6 INT'L TAX J. 323 (1980). For a more thorough discussion of the unitary business principle in a purely interstate context, see *Exxon Corp. v. Dep't of Revenue*, 447 U.S. 207 (1980).

The analysis developed in *Mobil* was subsequently applied by the Supreme Court in *Exxon* to income earned from the domestic operations of a vertically integrated petroleum products corporation. The Court reviewed the record analyzing the actual business operations of the corporation which disclosed a centralized management providing the means to operate an optimum short-term operational program. 447 U.S. at 224. The marketing activities in the taxing state were found to be interdependent with the integrated operations of the corporation as a whole. Centralized purchasing contributed to overall profits, centralized coordination achieved operating efficiencies, and overall product distribution was enhanced by administration from the national headquarters. *Id.* The Court concluded that the corporation was a "highly integrated business which benefits from an umbrella of centralized management and controlled interaction." *Id.*

<sup>159</sup>445 U.S. at 449.

<sup>160</sup>*Id.* at 439.

<sup>161</sup>283 U.S. 123 (1931). See *supra* notes 100-07 and accompanying text.

<sup>162</sup>102 S. Ct. 3103 (1982).

<sup>163</sup>102 S. Ct. 3128 (1982).

<sup>164</sup>For a discussion of *ASARCO* and *Woodworth*, see Floyd, *The "Unitary" Business in State Taxation: Confusion at the Supreme Court?* 1982 B.Y.U. L. REV. 465; Peters, *Supreme Court Requires Unitary Relationship Before States Can Tax Investment Income*, 57 J. TAX'N 314 (1982); Seago, *The Revitalization of the Unitary Business Principle—ASARCO and Woolworth*, 1 J. STATE TAX'N 101 (1982).

### A. Reaffirmation of the Unitary Business Limitation: ASARCO

In *ASARCO*,<sup>165</sup> a domestic corporation challenged a nondomiciliary state's taxation of income received in the form of dividends, interest, and capital gains from subsidiaries on both due process and commerce clause grounds. The Supreme Court decided the case under due process clause considerations only<sup>166</sup> and found that the nondomiciliary state exceeded its jurisdiction to tax this income where the business activities of the payor subsidiaries had nothing to do with the recipient parent corporation's activities in the taxing state.<sup>167</sup> The Court also found the due process requirement of a rational relationship between the income attributed to the taxing state and the values attributable to the state was not met.<sup>168</sup>

1. *Facts and Lower Court Developments.*—ASARCO, the parent corporation, mined, smelted, and refined nonferrous metals in several states. Its commercial domicile was in New York.<sup>169</sup> ASARCO's primary activity in Idaho was the operation of a silver mine, but it mined and marketed other nonferrous metals and maintained a managerial office for the operations of its regional mining division in Idaho.<sup>170</sup> The Court examined the taxability of income ASARCO received from dividends, interest, and capital gains<sup>171</sup> from five corporations in which it held substantial ownership interests.<sup>172</sup>

Idaho had adopted a version of the UDITPA.<sup>173</sup> Consequently, Idaho split corporate net income into either business income or non-business income.<sup>174</sup> Under the Idaho statute, business income included income from intangible property, such as interest, dividends, and

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<sup>165</sup>102 S. Ct. 3103.

<sup>166</sup>*Id.* at 3115 n.23.

<sup>167</sup>*Id.* at 3115. For an explanation of the two requirements to be satisfied under the due process clause, see *supra* notes 24-27 and accompanying text.

<sup>168</sup>102 S. Ct. at 3115.

<sup>169</sup>*Id.* at 3105.

<sup>170</sup>*Id.* Idaho calculated that approximately 2.5% of ASARCO's total business activities took place within the state. *Id.*

<sup>171</sup>ASARCO had received other forms of intangible income during the applicable period, but the appropriate treatment of that income for tax purposes was not at issue before the Supreme Court. *Id.* at 3105 n.1. The issue was before the Idaho Supreme Court, however, and it ruled that ASARCO's receipt of certain rents and royalties, as well as its receipt of other dividends from another subsidiary, constituted apportionable income. See *American Smelting & Ref. Co. v. Idaho State Tax Comm'n*, 99 Idaho 924, 935-37, 592 P.2d 39, 50-52 (1979).

<sup>172</sup>102 S. Ct. at 3106. During the applicable period, ASARCO owned approximately 34% to 53% of the stock in the corporations. *Id.* at 3106 n.2.

<sup>173</sup>*Id.* at 3106. For a discussion of the UDITPA, see *supra* notes 51, 55-60 and accompanying text.

<sup>174</sup>102 S. Ct. at 3106.

capital gains, when the acquisition, management, or disposition of that property was an integral or necessary component of the corporation's business operations.<sup>175</sup> Idaho apportioned business income by means of an equally weighted three-factor formula and included its proportionate share of the corporation's business income in the state's taxable income.<sup>176</sup> Nonbusiness income was allocated to the corporation's commercial domicile.<sup>177</sup>

Idaho, a member of the Multistate Tax Compact, requested the Multistate Tax Commission to audit ASARCO.<sup>178</sup> The Commission determined that the dividends, interest, and capital gains received by ASARCO from its five subsidiaries constituted business income and consequently added the amounts to ASARCO's income to be apportioned, even though it also determined that the relationships of these subsidiaries with the parent corporation were insufficient to justify unitary treatment under a combined report.<sup>179</sup> The state tax commission adopted the Commission's adjustments and upheld its conclusions with respect to the characterization of the dividends, interest, and capital gains of the five subsidiaries as business income.<sup>180</sup>

After an adverse lower court decision,<sup>181</sup> the state tax commission appealed to the Idaho Supreme Court.<sup>182</sup> In rejecting due process and commerce clause challenges, the court reaffirmed the characterization of the dividends, interest, and capital gains from the five subsidiaries as apportionable business income of the parent corporation.<sup>183</sup> The United States Supreme Court subsequently reversed this decision.<sup>184</sup>

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<sup>175</sup>*Id.*

<sup>176</sup>*Id.*

<sup>177</sup>*Id.* "Nonbusiness" income was defined as "all income other than business income." *Id.*

<sup>178</sup>*Id.* at 3107. For a discussion of the Multistate Tax Compact and the Commission, see *supra* notes 61-66 and accompanying text.

<sup>179</sup>102 S. Ct. at 3108. For a discussion of the principles and uses of combined reporting, see *supra* notes 67-71 and accompanying text. The Commission recommended that ASARCO and six other of its subsidiaries which it wholly owned be characterized as a single corporation. The Commission combined ASARCO's income with the income of the six subsidiaries and disregarded the six subsidiaries' dividend payments to the parent corporation as intracompany accounting transfers. 102 S. Ct. at 3107. The propriety of this treatment of the six subsidiaries was not an issue before the Supreme Court. *Id.* at 3108.

<sup>180</sup>*Id.* 102 S. Ct. at 3108.

<sup>181</sup>ASARCO petitioned for review, and the state district court, in an unpublished opinion, overruled the state tax commission's determination that the dividends, interest, and capital gains of the five subsidiaries constituted business income. *Id.*

<sup>182</sup>*American Smelting & Ref. Co. v. Idaho State Tax Comm'n*, 99 Idaho 924, 592 P.2d 39 (1979).

<sup>183</sup>*Id.* at 935-37, 592 P.2d at 50-52.

<sup>184</sup>The Supreme Court first vacated and remanded the case for reconsideration in light of its decision in *Mobil. ASARCO Inc. v. Idaho State Tax Comm'n*, 445 U.S. 939

2. *The Majority Opinion.*—After reaffirming the unitary business criteria developed in *Mobil*,<sup>185</sup> the Court examined “the way in which the corporate enterprise is structured and operates, and . . . the relationship with the taxing state.”<sup>186</sup> The most likely foreign subsidiary to be found part of a unitary business was the one in which ASARCO owned about fifty-two per cent of the stock and which sold about thirty-five per cent of its smelted but unrefined copper to ASARCO.<sup>187</sup> Idaho did not dispute, however, that a management agreement with the other shareholders assured that ASARCO was unable to control the subsidiary.<sup>188</sup>

The Court concluded that the business of the subsidiary and ASARCO’s silver mining in Idaho were inadequately connected to permit unitary characterization.<sup>189</sup> Further, the Court found that the remaining four subsidiaries fell far short of meeting the criteria necessary for unitary treatment.<sup>190</sup> In summary, all of those subsidiaries were engaged in similar or related lines of business, but they were unconnected with the taxing state. The parent corporation held substantial minority or borderline majority capital stock interests in the subsidiaries. The parent corporation provided some corporate services for some of the subsidiaries and engaged in minimal business transactions with all of them.

The state did not dispute any of the facts, but merely proposed an expansion of the unitary business concept by arguing that corporate purpose should be the controlling criterion for the unitary business relationship. Thus, intangible income would be deemed a part of a unitary business when that income related to or furthered the corporation’s trade or business.<sup>191</sup> The Court considered this definition of a unitary business too broad and unacceptable because it would transform the unitary business principle into no limitation at all.<sup>192</sup> The Court found that the five subsidiaries were distinct business enter-

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(1980). On remand, the Idaho Supreme Court reinstated its previous opinion. *American Smelting & Ref. Co. v. Idaho State Tax Comm’n*, 102 Idaho 38, 624 P.2d 946 (1981). The Supreme Court reversed that decision. 102 S. Ct. 3103 (1982).

<sup>185</sup>102 S. Ct. at 3109-11.

<sup>186</sup>*Id.* at 3115 n.22.

<sup>187</sup>*Id.* at 3111-12. Another 20-30% of the subsidiary’s output was sold to a similarly owned corporation. *Id.* at 3111-12, 3112 n.16.

<sup>188</sup>*Id.* at 3112.

<sup>189</sup>*Id.*

<sup>190</sup>*Id.*

<sup>191</sup>*Id.* at 3114. The state relied upon the definition of business income in the UDITPA, *supra* note 51, at § 1(a). The argument was that a relationship exists between investments and the business of the owner of the investments which, without more, is sufficient to justify the apportionment of any income derived from the investments. See Dexter, *Tax Apportionment of the Income of a Unitary Business: An Examination of Mobil Oil Corp. v. Commissioner of Taxes*, 1981 B.Y.U. L. REV. 107, 119.

<sup>192</sup>102 S. Ct. at 3114.

prises which had nothing to do with ASARCO's activities in Idaho.<sup>193</sup> Because there was no rational relationship between the dividends, interest, and capital gains which had been attributed to the state and the intrastate values of the business enterprise, the Court held that Idaho violated the due process clause by taxing that income.<sup>194</sup>

3. *The Dissenting Opinion.*—In a strong dissent, Justice O'Connor<sup>195</sup> argued that business and economic sense dictated a contrary result. Justice O'Connor asserted that the Court erred in its finding that ASARCO's investments were not part of a unitary business because ASARCO failed to carry its burden of proof in at least three ways.<sup>196</sup> First, ASARCO did not demonstrate that its investment decision making was separate and apart from its expertise in the nonferrous metals business.<sup>197</sup> Second, ASARCO failed to show that its holdings in the subsidiaries were separate and apart from its management of the financial requirements of its nonferrous metals business since ASARCO presumptively used the foreign-source income as part of its working capital.<sup>198</sup> Third, the dissent argued that ASARCO's capital interest in the subsidiaries contributed to its nonferrous metals business advantages, maintaining that ASARCO had effective operational control of at least three of the five subsidiaries. The multinational corporate format provided greater stability to profits and the vertically integrated relationship provided assured supplies of materials and stable outlets for products.<sup>199</sup>

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<sup>193</sup>*Id.* at 3115.

<sup>194</sup>*Id.* at 3115-16.

<sup>195</sup>Both *ASARCO* and *Woolworth* were 6-3 decisions in which Justice Blackmun and Justice Rehnquist twice joined Justice O'Connor in the dissenting opinions. The dissenting opinion in *Woolworth*, however, is quite brief in that it incorporates by reference the rationale set forth in the dissenting opinion in *ASARCO*, Chief Justice Burger filed a concurring opinion in both cases, 102 S. Ct. 3140 (1982), joining the majority opinion written in both cases by Justice Powell in reliance on the majority's express statement that the Court's holdings do not preclude congressional action in this area. *See* 102 S. Ct. 3103, 3114 n.23.

<sup>196</sup>102 S. Ct. at 3119 (O'Connor, J., dissenting).

<sup>197</sup>*Id.* at 3119-20. The flaw in this argument is the explanation of how the parent corporation's expertise with respect to the investments in the subsidiaries had anything to do with the activities of the parent corporation in the taxing state.

<sup>198</sup>*Id.* at 3120-21. The dissent's perception of the facts differed from the undisputed facts in the record. ASARCO's stock investments were not an integral part of its business operations in Idaho. 102 S. Ct. at 3113-14 n.21.

<sup>199</sup>102 S. Ct. at 3121-23 (O'Connor, J., dissenting). The description of the five subsidiaries as providing assured supplies and outlets is at variance with the undisputed facts. *Id.* at 3114 n.21. As to the dissent's "business advantage" argument, the Court responded in *Woolworth*:

Income, from whatever source, always is a "business advantage" to a corporation. Our cases demand more. In particular, they specify that the proper inquiry looks to "the underlying unity or diversity of business enterprise,"

After challenging the reasoning of the majority opinion, the dissent discussed what it judged to be the adverse consequences of the majority decision. First, the dissent suggested that perhaps no state would be able to meet due process requirements in order to include ASARCO's investment income as such in its apportionable tax base.<sup>200</sup> Second, the dissent detected a suggestion in the majority opinion that only a domiciliary state might enjoy a constitutional preference to tax such income.<sup>201</sup> Third, the dissent argued that it was possible that only those states in which the investment activities were conducted could tax the income resulting from those activities.<sup>202</sup> As a result, the dissent concluded that the majority opinion had "straightjacketed" the ability of the states to develop fair systems of apportionment and had curtailed the state statutory developments pursuant to the UDITPA.<sup>203</sup> Finally, the dissent argued that the majority's reliance on the due process clause, as opposed to the commerce clause, may preempt possible congressional action.<sup>204</sup>

The majority opinion acknowledged the dissenting opinion's criticism of the unitary business principle but asserted that the analysis of the dissent relies on considerations different from those identified as controlling in *Mobil*. According to the majority, *Mobil* held that the income was determined to be apportionable by the states because it was apparent that those corporations were engaged in

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*Mobil*, 445 U.S. at 440, not to whether the nondomiciliary parent derives some economic benefit—as it virtually always will—from its ownership of stock in another corporation.

102 S. Ct. 3128, 3135 (citing *ASARCO*, 102 S. Ct. at 3113-15).

<sup>200</sup>102 S. Ct. at 3124 (O'Connor, J., dissenting). See Dexter, *Taxation of Income From Intangibles of Multistate-Multinational Corporations*, 29 VAND. L. REV. 401, 403 (1976); McClure, *Toward Uniformity in Interstate Taxation: A Further Analysis*, 13 TAX NOTES 51, 53 (1981). This conclusion does not necessarily follow. The business of managing investments in the state of commercial domicile may be separate and apart from the activities in a nondomiciliary state. The domiciliary state may have contributed to the investment activities while the nondomiciliary state may have contributed nothing to the investment activities. See Seago, *supra* note 164, at 113-14.

<sup>201</sup>102 S. Ct. at 3124-25 (O'Connor, J., dissenting).

<sup>202</sup>*Id.* at 3125-26.

<sup>203</sup>*Id.* A review of the UDITPA and the Commission's interpretation of the Act may bear out this declaration, but it does not lend support to the implication that the interpretation of the UDITPA which was advocated in *ASARCO* and *Woolworth* by the states was either desirable or logical. See Peters, *supra* note 164, at 316.

<sup>204</sup>102 S. Ct. at 3126-28 (O'Connor, J., dissenting). The majority opinion did not address this concern: "The question of federal authority to legislate in this area—whether to lay taxes or to delegate such power—is not presented in this case, and we imply to view as to it." *Id.* at 3115 n.23. "In any event, it is difficult to understand how the limitations placed on state taxation of income having no connection with the taxing state could impede the Congress in the exercise of its power to regulate interstate commerce." Peters, *supra* note 164, at 316. This can be done provided that legislation is consistent with the *ASARCO-Woolworth* due process considerations.

unitary businesses with a continuous flow and interchange of common products. These essential factors were demonstrated to be wholly absent in this case.<sup>205</sup> The majority concluded that it properly applied the principles of *Mobil* but reached a wholly different result because the facts differed in these critical ways.<sup>206</sup>

*B. Limitations on the State Taxation of Foreign-Source  
Income: Woolworth*

*F. W. Woolworth Co. v. Taxation and Revenue Department*<sup>207</sup> reapplied the principles developed in *ASARCO*, but elaborated on the parameters of the unitary business relationship and therefore provides needed additional guidance for subsequent cases. The issues raised in *Woolworth* were resolved solely by reference to due process clause considerations. The Court held that a nondomiciliary state's taxation of a portion of the dividend income received by a domestic corporation from foreign subsidiaries which constitute discrete business enterprises and which do no business in the taxing state fails to meet established due process standards.<sup>208</sup>

1. *Facts and Lower Court Developments.*—Woolworth is engaged in the retail merchandising business. It has chain stores located throughout the United States and has its commercial domicile in New York.<sup>209</sup> Of relevance to this case, Woolworth received dividends from four foreign subsidiaries, all of which are similarly engaged in chain store retail merchandising.<sup>210</sup> Three of the payors are wholly-owned and the fourth is a publicly held British corporation in which Woolworth has a 52.7% interest.<sup>211</sup> Woolworth elected all of the directors of the wholly owned subsidiaries.<sup>212</sup>

The taxing state, New Mexico, adopted the UDITPA<sup>213</sup> and is a member of the Compact.<sup>214</sup> Pursuant to its statute, the state divided corporate income between business income,<sup>215</sup> to which it applied its

<sup>205</sup>102 S. Ct. at 3116 n.24.

<sup>206</sup>*Id.* at 3114 n.22.

<sup>207</sup>102 S. Ct. 3128 (1982).

<sup>208</sup>*Id.* at 3139.

<sup>209</sup>*Id.* at 3131.

<sup>210</sup>*Id.* Together, the four foreign subsidiaries paid Woolworth approximately \$39.9 million in dividends.

<sup>211</sup>*Id.*

<sup>212</sup>*Id.* at 3134.

<sup>213</sup>For a discussion of the UDITPA, see *supra* notes 51, 55-60 and accompanying text.

<sup>214</sup>102 S. Ct. at 3134. For a discussion of the Multistate Tax Compact, see *supra* notes 61-66 and accompanying text.

<sup>215</sup>“[B]usiness income’ means income arising from transactions and activity in the regular course of the taxpayer’s trade or business and includes income from tangible and intangible property if the acquisition, management and disposition of the property constitute integral parts of the taxpayer’s regular trade or business operations.” N.M. STAT. ANN. § 7-4-2(A) (1981).

apportionment formula, and nonbusiness income,<sup>216</sup> which was generally allocated on the basis of commercial domicile to a single state.<sup>217</sup> Woolworth reported its foreign-source dividend income as nonbusiness income, none of which was allocated to New Mexico.<sup>218</sup>

On audit, the state determined that Woolworth should have included its foreign-source dividend income as apportionable business income.<sup>219</sup> The New Mexico Supreme Court found that the dividend income from the subsidiaries met the statutory test for inclusion as apportionable income<sup>220</sup> and held that the dividends were income earned in a unitary business.<sup>221</sup> The United States Supreme Court reversed.<sup>222</sup>

2. *The Unitary Business Limitation on the State Taxation of Foreign-Source Dividend Income.*—The United States Supreme Court acknowledged that Woolworth had the potential to operate its subsidiaries as a single, unitary business; however, the Court found that the New Mexico Supreme Court wrongfully resolved the constitutional issue before it by relying too heavily on the potential ability to operate the foreign subsidiaries as part of a unitary relationship, rather than making its determination with reference to the actual operation of the corporation. The Court made it clear that the potential ability to operate a corporation as part of a unitary business is not the controlling criterion when the dividend income is in fact derived from a discrete business enterprise.<sup>223</sup> For a state properly to impose a tax on the foreign income, the Supreme Court held that the corporation must be operated as an integrated enterprise in fact.<sup>224</sup> The Court then emphasized the factors which produce substantial mutual interdependence, enumerated in *Mobil*, as relevant to the state taxation of foreign-source dividend income, namely: whether the activities in the taxing state contributed to the income of the subsidiaries as a result of functional integration, centralization of management, and the achievement of other economies of scale arising from the operation of the business as a whole. If these factors do exist, then this evidence of a unitary business may provide the state with the jurisdiction of foreign-source dividend income, namely: whether the activities other connections with that state.<sup>225</sup>

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<sup>216</sup>“[N]onbusiness income’ means all income other than business income.” *Id.* at § 7-4-2(D).

<sup>217</sup>102 S. Ct. at 3131-32.

<sup>218</sup>*Id.* at 3132.

<sup>219</sup>*Id.*

<sup>220</sup>*Id.* at 3133. See *Taxation & Revenue Dep’t v. F. W. Woolworth Co.*, 95 N.M. 519, 624 P.2d 28 (1981).

<sup>221</sup>102 S. Ct. at 3133.

<sup>222</sup>*Id.* at 3140.

<sup>223</sup>*Id.* at 3134.

<sup>224</sup>*Id.*

<sup>225</sup>*Id.* at 3135.

The Court turned to a consideration of the extent to which these factors were present in the case and made the threshold determination that there existed little in the way of functional integration.<sup>226</sup> The Court distinguished the business of retail merchandising from the integrated multinational business of producing, processing, and marketing a resource on a worldwide basis which involves a flow of international trade, exchanges of personnel, and substantial mutual interdependence.<sup>227</sup> The Court referred to this as a "critical distinction"<sup>228</sup> and consistent with this distinction the evidence in the case was found to show that no phase of any subsidiary's business was an integrated operation together with the parent corporation.<sup>229</sup> Each subsidiary performed independently of the parent corporation in its ordinary course of business.<sup>230</sup> The parent corporation neither provided essential corporate services for the subsidiaries nor engaged in any centralized purchasing, manufacturing, or warehousing of merchandise.<sup>231</sup> Each subsidiary obtained financing from sources other than the parent. The record persuaded the Court that, in fact, there existed no functional integration.<sup>232</sup>

Next, the Court considered the extent to which there was centralized management or economies of scale. Management decentralization was reflected in the fact that there was no interchange of personnel, no central training program, and each subsidiary was independent and autonomous in operations and policies with regard to retailing.<sup>233</sup> The management of the foreign subsidiaries had complete control over the business decisions affecting their operations. The Court deemed it important that none of the parent corporation's departments was devoted to overseeing the operations of the

<sup>226</sup>*Id.*

<sup>227</sup>*Id.* at 3135, 3139.

<sup>228</sup>The Court explained:

There is a critical distinction between a retail merchandising business as conducted by Woolworth and the type of multinational business—now so familiar—in which refined, processed, or manufactured products (or parts thereof) may be produced in one or more countries and marketed in various countries, often worldwide. In operations of this character there is a flow of international trade, often an interchange of personnel, and substantial mutual interdependence. The uncontradicted evidence demonstrates that Woolworth's international retail business is not comparable. There is no flow of international business. Nor is there any integration or unitary operation in the sense in which our cases consistently have used these terms.

*Id.* at 3138-39 (footnote omitted).

<sup>229</sup>*Id.* at 3135.

<sup>230</sup>*Id.*

<sup>231</sup>*Id.* at 3135-36.

<sup>232</sup>*Id.* at 3136.

<sup>233</sup>*Id.* at 3136-37.

subsidiaries.<sup>234</sup> The personnel departments of Woolworth's foreign subsidiaries were fully independent operations, dedicated to recruiting and training nationals to fill positions at every level of the business. In sum, it appeared to the Court that each subsidiary operated as a distinct business enterprise at the level of full-time management.<sup>235</sup>

The Court did find that there was some centralization of management. The parent corporation maintained common directors with some of the subsidiaries.<sup>236</sup> There were frequent contacts in upper management.<sup>237</sup> Major financial decisions, such as the distribution of dividends and the creation of substantial indebtedness, were subject to the parent corporation's approval.<sup>238</sup> Woolworth published consolidated financial statements other than for tax purposes.<sup>239</sup> However, the operations of the parent company were so unrelated to the operations of its subsidiaries that the stable operation of one corporation was not important to another's full utilization of capacity.<sup>240</sup>

The Court, therefore, emphasized that the overriding finding of fact was that "[e]xcept for the type of occasional oversight—with respect to capital structure, major debt, and dividends—that any parent gives to an investment in a subsidiary, there [was] little or no integration of the business activities or centralization of the management of [the subsidiaries]."<sup>241</sup> On the basis of these facts, the Court concluded that the corporations involved in *Woolworth* were not part of a unitary business.<sup>242</sup> Moreover, the apportionment of the foreign-source dividend income did not bear the necessary relationship to benefits afforded by the taxing state because New Mexico attempted to reach extraterritorial values wholly unrelated to the business of the parent corporation's retailing activities within that state.<sup>243</sup>

3. *Federal Tax Policy and the State Taxation of Foreign-Source Dividends Deemed Received: Gross-Up.*—The rationale and analysis used by the Court in the resolution of the first issue carried over to determine a similar result with respect to a second issue in *Woolworth* by which the state had attempted to broaden the income base subject to state taxation. The Court's decision on the second issue

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<sup>234</sup>*Id.* at 3137.

<sup>235</sup>*Id.* at 3139.

<sup>236</sup>*Id.* at 3137.

<sup>237</sup>*Id.*

<sup>238</sup>*Id.*

<sup>239</sup>*Id.* at 3137-38. Neither the parent corporation nor any of the foreign subsidiaries consolidated its federal tax return with any of the other corporations. *Id.* at 3137.

<sup>240</sup>*Id.* at 3138.

<sup>241</sup>*Id.*

<sup>242</sup>*Id.*

<sup>243</sup>*Id.* at 3139.

spanned a mere paragraph of the opinion, but the approach taken is illustrative of the importance to be attached to the unitary business limitation as the primary hurdle which any state must surpass in order to include vast amounts of other forms of foreign-source income within apportionable income. New Mexico had reached out to include within Woolworth's apportionable income an amount known as "gross-up," which attempt, for the reasons already expressed, the Court summarily held to contravene the due process clause.<sup>244</sup> In order to better appreciate this result, it is helpful to briefly and generally describe the federal tax concept of "gross-up" and its characterization for state tax purposes by both the corporation and the state.

In the allocation of income of a multinational group of corporations, the posture of the federal tax system is unlike that of the states in its recognition of the separate source of income earned in the United States as distinguished from income earned in foreign nations.<sup>245</sup> A member of a multinational group of related corporations is treated as if it were an independent corporation, the income of which is subject to taxation in the nations in which it has its operations. The taxable income of a domestic corporation, which is a member of such an affiliated group, is determined on the basis of elaborate separate geographical and transactional accounting rules, that is, by means of separately determining the income realized and the expenses incurred on the books of that corporation.<sup>246</sup>

Pursuant to this method, if the parent corporation of such a related group of multinational corporations is a domestic corporation, the taxable income of the parent corporation is for most purposes determined without regard to the income of its foreign affiliates and subsidiaries.<sup>247</sup>

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<sup>244</sup>*Id.*

<sup>245</sup>B. BITTKER, FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS ¶ 70.1 (1981); P. POSTLEWAITE, INTERNATIONAL CORPORATE TAXATION §§ 1.01, 1.03 (1980).

<sup>246</sup>B. BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATION AND SHAREHOLDERS ¶ 15.06 (4th ed. 1979). The United States Internal Revenue Service is authorized to monitor transactions and to reallocate any income, deduction, or other item which affects taxable income among domestic corporations and their foreign subsidiaries and affiliates and, if reallocation is required, to determine the taxable income of each corporation. See I.R.C. § 482 (1976). Thus, the federal tax system is based on a separate accounting approach. See generally, G.A.O. REPORT-IRS, *supra* note 4; Note, *Multinational Corporations and Income Allocation Under Section 482 of the Internal Revenue Code*, 89 HARV. L. REV. 1202 (1976).

<sup>247</sup>In conjunction with the separate accounting rules are the source rules for the determination of the extent to which items of income are to be characterized as derived from domestic sources or from foreign sources. P. POSTLEWAITE, *supra* note 245, at §§ 2.01-2.27. Another mechanism exists for calculating the amount of foreign-source income. I.R.C. §§ 861-864 (1976 & West Supp. V 1981). The qualified separate accounting approach is incorporated in the model convention proposed by the Organization for Economic Cooperation and Development (OECD) of which there are 24 members, including the United States. See OECD Model Convention, 1 TAX TREATIES (CCH) ¶ 151. The United States Treasury Department's Model Income Tax Treaty also adopts the

Federal taxation of the income of the foreign subsidiaries is deferred until the parent corporation receives a dividend or is deemed to receive a dividend from the subsidiaries.<sup>248</sup> Double taxation is avoided by granting to domestic corporations credits against income taxes paid to foreign governments on the earnings which constitute the dividends from the subsidiaries to the parent corporations.<sup>249</sup> The qualified separate accounting approach, domestic income tax deferral, and credits against other income taxes may be the three basic principles of the federal system with respect to the taxation of the income of related corporations.<sup>250</sup>

The allowance of a tax credit for inter-corporate dividends among such related corporations is an important mechanism in the federal tax system. In some cases, foreign tax credits may be the combination of foreign income taxes actually paid by the domestic corporation and those taxes which are deemed paid by statutory formula as well.<sup>251</sup> Under the statutory scheme of the Internal Revenue Code, section 901 authorizes the election to take a credit for foreign income

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qualified separate accounting approach and resembles the OECD Model Convention. See Model Income Tax Treaty, 1 TAX TREATIES (CCH) ¶ 158 (June 16, 1981).

<sup>248</sup>G. HUFBAUER & D. FOSTER, U.S. TAXATION OF THE UNDISTRIBUTED INCOME OF CONTROLLED FOREIGN CORPORATIONS 1-63 (Tax Policy Research Study No. 3, Essays in International Taxation: 1976, 1976). Exceptions to deferral are found in I.R.C. §§ 951-964 (West 1982 & West Supp. 1983) (shareholders currently taxed on income of a controlled foreign corporation in certain situations), and in I.R.C. §§ 551-558 (1976) (foreign personal holding companies).

<sup>249</sup>I.R.C. §§ 901-904 (West 1982 & West Supp. 1983). For a lengthy analysis of the foreign tax credit, see E. OWENS, THE FOREIGN TAX CREDIT (1961). For a more concise explanation, see Dale, *The Reformed Foreign Tax Credit: A Path Through the Maze*, 33 TAX L. REV. 175 (1978). See also *Ad Hoc Committee on Foreign Tax Credit, ABA Tax Section, Comments Regarding Proposed Foreign Tax Credit Regulations*, 33 TAX LAW. 35 (1979). The rationale of the foreign tax credit was explained as follows:

[The] foreign tax credit system embodies the principle that the country in which a business activity is conducted (or in which any income is earned) has the first right to tax the income arising from activities in that country, even though the activities are conducted by corporations or individuals resident in other countries. Under this principle, the home country of the individual or corporation has a residual right to tax income arising from these activities, but recognizes the obligation to insure that double taxation does not result. Some countries avoid double taxation by exempting foreign source income from tax altogether. For U.S. taxpayers, however, the foreign tax-credit system, providing a dollar-for-dollar credit against U.S. tax liability for income taxes paid to a foreign country, is the mechanism by which double taxation is avoided.

Joint Committee on Taxation 234, 1976-3 C.B. 246; see Surrey, *Current Issues in the Taxation of Corporate Foreign Investment*, 56 COLUM. L. REV. 815 (1956).

<sup>250</sup>Surrey, *Reflections on the Allocation of Income and Expenses Among National Tax Jurisdictions*, 10 LAW & POLY IN INT'L BUS. 409, 415-16 (1978); see also G.A.O. REPORT-1982, *supra* note 3, at 32; Hellerstein, *supra* note 71, at 162-63.

<sup>251</sup>B. BITTKER, FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS ¶ 69.2.1 (1981).

taxes.<sup>252</sup> Section 901(a) provides for a credit for taxes deemed to have been paid pursuant to section 902. Under section 902(a), a domestic corporation which has received a dividend from a foreign subsidiary will be deemed to have paid any foreign taxes paid by the foreign subsidiary with respect to the earnings from which the dividend is distributed.<sup>253</sup> This credit may be computed by multiplying the foreign taxes of the subsidiary by a fraction which consists of dividends received over the after-tax profits of the foreign subsidiary.<sup>254</sup>

If a domestic corporation elects to take advantage of this foreign tax credit, then Internal Revenue Code section 78 requires that the domestic corporation include in gross income an amount equal to the deemed-paid tax credit computed pursuant to section 902(a), which amount is to be treated as a dividend received by the domestic corporation in addition to the amount of the dividend actually received from the foreign subsidiary.<sup>255</sup> This procedure with respect to the augmentation of foreign-source dividend income is commonly referred to as "gross-up".<sup>256</sup> Although the amount of gross-up is never ac-

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<sup>252</sup>Geen & Schreyer, *Foreign Tax Credit-Qualification and Computation*, 5-4th TAX MGMT. A-3 (1979).

<sup>253</sup>See generally, R. RHOADES, *INCOME TAXATION OF FOREIGN RELATED TRANSACTIONS* § 5.06[2] (1982); E. OWENS & G. BALL, *THE INDIRECT CREDIT* (1976). The amount of taxes deemed paid by the domestic corporation is the proportion of the foreign taxes on accumulated profits which the amount of the dividend bears to the accumulated profits in excess of the foreign taxes. Geen & Schreyer, *supra* note 252, at A-31 to A-32. The "accumulated profits" of the foreign subsidiary are the pre-tax profits without reduction for the foreign taxes. I.R.C. § 902(c)(1) (1976); Treas. Regs. §§ 1.902-1(e), 1.902-1(f) (1980). See Schoenfeld, *Some Definitional Problems in the Deemed Paid Foreign Tax Credit of Section 902: "Dividends" and "Accumulated Profits"*, 18 TAX L. REV. 401 (1963); see also Rev. Rul. 71-65, 1971-1 C.B. 212 (treatment of dividends in kind for purposes of the § 902 credit computations).

<sup>254</sup>B. BITTKER & J. EUSTICE, *supra* note 246, at ¶ 17.11. See Geen & Schreyer, *supra* note 252, at A-32. In *American Chicle Co. v. United States*, 316 U.S. 450 (1942), the Court held that for purposes of computing the credit, "accumulated profits" of the foreign subsidiary were to be defined as the foreign subsidiary's total pre-tax profits less the foreign income taxes. For a description of this outdated approach, see R. RHOADES, *supra* note 253, at §§ 5.06[4]-[5]. The *American Chicle* rule was criticized because it did not avoid the allowance of what would otherwise amount to both a deduction and a credit for the foreign taxes. This led to the enactment of the gross-up provision. See I.R.C. § 78 (1976); Geen & Schreyer, *supra* note 252, at A-31 to A-32.

<sup>255</sup>The tax base for the domestic corporation is the actual dividend plus the dividend deemed received under I.R.C. § 78 (1976). See R. RHOADES, *supra* note 253, § 5.06[7], at 5-142 & n.86. Under Proposed Regulations § 1.902-3(d)(1)(ii), the dividend deemed received is treated as being received by the parent corporation from the same foreign subsidiary as was the actual dividend. *Id.* The § 78 dividend is treated as a dividend for practically all purposes of the Internal Revenue Code. *Id.* § 5.06[7].

<sup>256</sup>For a thorough description of the concept of "gross-up," see R. RHOADES, *supra* note 53, at § 5.06[7], together with other related sections contained in the text in connection therewith; see also B. BITTKER, *supra* note 251, at ¶ 69.2. *Woolworth* provided

tually received, it is deemed as having been received by the domestic corporation from the foreign subsidiaries for purposes of claiming the foreign tax credit.<sup>257</sup>

The second issue raised in *Woolworth* concerned the apportionment of the gross-up dividend income deemed received by the parent corporation from its foreign subsidiaries.<sup>258</sup> *Woolworth* did not report the federal gross-up amount as New Mexico business income.<sup>259</sup> On audit, the state took the position that gross-up is business income subject to apportionment.<sup>260</sup> The state court of appeals disagreed with the characterization of gross-up as business income and excluded the amount from apportionable income.<sup>261</sup> The New Mexico Supreme Court rejected the corporation's constitutional challenges to the inclusion of the gross-up amount in apportionable income<sup>262</sup> and also rejected the corporation's contention that the apportionment formula should be adjusted if the dividend income were found to be apportionable.<sup>263</sup>

The United States Supreme Court determined that the foreign tax credit of *Woolworth* related to the taxation by foreign countries

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the following example illustrating the foregoing methods:

"If a foreign subsidiary of a United States parent earns \$100, pays foreign tax of \$40, and pays a dividend of \$30 out of its after-tax profits of \$60 the deemed paid foreign tax credit of the parent under section 902(a) is 30/60 X \$40, or \$20. The parent includes \$50 in dividend income (*i.e.*, the actual dividend of \$30 plus \$20 of "gross-up") and claims a foreign tax credit of \$20 against the federal income tax on this income."

*Woolworth*, 102 S. Ct. at 3132 n.6. Another good example may be found at Geen & Schreyer, *supra* note 252, at A-32.

<sup>257</sup>*Woolworth*, 102 S. Ct. at 3132. The Court reasoned that the "gross-up computation is a figure that the Federal Government 'deems' *Woolworth* to have received for purposes of part of *Woolworth's* federal foreign tax credit calculation." *Id.* at 3139. The Court looked to the legislative intent in its analysis. *Id.* A possible inference from this reasoning is that gross-up may not be construed to be a dividend for state tax purposes in any event.

<sup>258</sup>This issue had been raised earlier in Vermont by *Woolworth*. *F. W. Woolworth Co. v. Comm'r of Taxes*, 133 Vt. 93, 328 A.2d 402 (1974); *F. W. Woolworth Co. v. Comm'r of Taxes*, 130 Vt. 544, 298 A.2d 839 (1972); *see also, Mobil*, 445 U.S. at 433 n.9 (the gross-up issue was not considered by the Court).

<sup>259</sup>The magnitude of the item of gross-up and the substantial effect of its inclusion in apportionable income is illustrated by this case. *Woolworth* calculated \$25.5 million of gross-up. This figure, together with the \$39.9 million in actual dividends from *Woolworth's* four subsidiaries and a \$1.6 million foreign exchange gain, increased the parent corporation's apportionable income from \$86,622 to \$401,518. 102 S. Ct. at 3132.

<sup>260</sup>*Id.* The State of New Mexico does not permit a deemed-paid tax credit or other credit similar to the federal tax credit. In fact, no states grant a credit similar to the federal tax credit and most states do not allow a deduction so as to avoid any resultant double taxation. *See G.A.O. REPORT-1982, supra* note 3, at 41.

<sup>261</sup>*F. W. Woolworth Co. v. Bureau of Revenue*, 95 N.M. 542, 543-44, 624 P.2d 51, 52-53 (N.M. Ct. App. 1979), *rev'd*, 95 N.M. 519, 624 P.2d 28 (N.M. 1981).

<sup>262</sup>102 S. Ct. at 3133-34.

<sup>263</sup>*Id.* at 3134 n.9.

of the parent corporation's foreign subsidiaries, each of which operated a discrete business enterprise. Therefore, the attempt by the state to tax this gross-up was unconstitutional, especially since New Mexico contributed nothing to the activities of the foreign subsidiaries.<sup>264</sup> Nevertheless, it remains somewhat uncertain whether gross-up income deemed received for federal foreign tax credit purposes may be apportionable income for state tax purposes in the case of a unitary business relationship where a state has a deemed-paid foreign tax credit similar to the federal rules. Further, a question may still remain as to whether the parent corporation's state of commercial domicile may treat the entire gross-up figure as dividends deemed received for its state tax purposes.

### C. *Summary Comment on ASARCO and Woolworth*

The contribution of *Woolworth* and *ASARCO* is the recognition of the extent to which the existence of a substantial mutual interdependence between the parent corporation and its foreign subsidiaries plays in determining whether due process considerations prohibit the state taxation of foreign-source income. The Supreme Court, in *ASARCO* and *Woolworth*, examined the way in which the corporate enterprises were structured and operated, employed sound economic analysis in discerning the relationship of the enterprise with the taxing state, and adopted identifiable criteria for the determination of whether an enterprise is unitary. The Court has established the rule that a nondomiciliary taxing state cannot subject foreign-source income to an apportionment formula unless the parent corporation and its foreign subsidiaries foster such substantial mutual interdependence that they constitute a unitary business under the criteria reiterated by the Court. It would not be fair to render the application of formula apportionment to the receipt of income arising out of mere passive investments, such as those in *ASARCO*, or in connection with distinct business operations, such as those in *Woolworth*. Nevertheless, there remain questions as to the relative importance of each of the constituent criteria used to define the unitary business relationship and as to the importance of the matrix of facts and assumptions which may relate to these criteria.

*ASARCO* had argued that functional integration between a payor subsidiary and a recipient parent corporation should be the "bright line" criteria for a nondomiciliary state's application of formula apportionment to the income received by that parent corporation from the subsidiary.<sup>265</sup> In the past, however, the Court had upheld the applica-

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<sup>264</sup>*Id.* at 3139.

<sup>265</sup>*See* Brief for Appellant at 13, *ASARCO*, 102 S. Ct. 3103.

tion of the unitary business/formula apportionment method not only to vertically integrated enterprises but also to a series of vertically integrated enterprises which operated separately in several different jurisdictions and which were linked by managerial or operational resources that resulted in a sharing or exchange of value and other economies of scale among the enterprises.<sup>266</sup> Substantial mutual interdependence, then, may exist among related corporations in the absence of a vertically integrated enterprise and, as such, render the related corporate group a unitary business. In *ASARCO* and *Woolworth*, the Court determined that a unitary business relationship did not exist where there was neither functional integration nor substantial mutual interdependence among related corporations. Although the *ASARCO* and *Woolworth* decisions set forth and reaffirm some important taxation principles, their holdings are necessarily limited to the Court's rigorous examination of the facts presented in each case. The decisions seemed to be decided primarily upon the factual record rather than upon innovations in the legal principles of state corporate income taxation.

A description of the relationship between Woolworth and its foreign subsidiaries provides a useful factual paradigm with respect to which a corporate taxpayer may look for guidance to determine whether dividend income or other types or forms of income from its subsidiaries are derived from unrelated business activities. The fact that the foreign subsidiaries engaged in essentially the same business as the parent corporation, that major financial decisions of the subsidiaries were subject to the approval of the parent corporation, that there existed interlocking directorates, and that there were exchanges of information and the potential for control in which all of these factors may result did not by themselves warrant characterization as a unitary business. The operations of the foreign subsidiaries were decentralized to such an extent that the activities of each within each particular country were so integrated and self-sustaining as to be separate and apart from the operations of the parent corporation.<sup>267</sup> There was seemingly no transfer of products between the parent corporation and its subsidiaries, and the personnel departments of the foreign subsidiaries were independent operations.<sup>268</sup> Thus, "no phase of any subsidiary's business was integrated with the parent's."<sup>269</sup>

*Woolworth* and *ASARCO* could have been read to stand for the

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<sup>266</sup>*Butler Bros. v. McColgan*, 315 U.S. 501 (1942). See *supra* notes 108-16 and accompanying text, See *Container Corp. of America v. Franchise Tax Board*, 103 S. Ct. 2933, 2941 (1983).

<sup>267</sup>*Woolworth*, 102 S. Ct. at 3135-36.

<sup>268</sup>*Id.*

<sup>269</sup>*Id.* at 3135.

proposition that, in the case of a group of related domestic and foreign corporations which is not vertically integrated, a finding of a unitary business would be impermissible without a flow of international trade among the related corporations. As we have seen, prior decisions of the Court which involved unitary apportionment within the domestic context had been cases in which there had been a substantial flow of goods and services among vertically integrated entities.<sup>270</sup> In the most recent decision of the Supreme Court, however, this point was further clarified by stating that the degree of substantial mutual interdependence necessary to justify taxation can arise in a number of different ways. The important criteria is that there be a sharing or exchange of value, not simply a flow of trade.

#### VII. STATE TAXATION OF THE WORLDWIDE COMBINED INCOME OF A MULTINATIONAL ENTERPRISE: *Container*

*Container Corp. of America v. Franchise Tax Board*<sup>271</sup> is the first decision of the United States Supreme Court to address the constitutional considerations arising out of the application of worldwide combined reporting to the income of a domestic corporation and its foreign subsidiaries. As we have already noted,<sup>272</sup> however, the concepts of "unitary business" and "formulary apportionment" play a central role in the combined reporting scenario. So in this fundamental sense the application of combined apportionment to a worldwide enterprise does not differ radically from the approach taken by the states in previous cases before the Court; rather, it is logically consistent with the unitary business/formula apportionment approach.<sup>273</sup> One of the distinguishing features of this form of apportionment is the composition of taxable income. Generally speaking, instead of including foreign-source income such as dividends from the subsidiaries in the parent corporation's apportionable tax base, combined reporting includes the income realized from the operations of the foreign subsidiaries themselves, and excludes intercorporate dividends so as to avoid double inclusion of that income in the corporation's tax base.<sup>274</sup> Another distinguishing characteristic of combined reporting, which necessarily parallels the composition of taxable income, is in the taxing state's calculation of its apportionable share of the net income of the related

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<sup>270</sup>*See, e.g., Exxon Corp. v. Dep't of Revenue*, 447 U.S. 207 (1980) (continuous product flow in domestic context constituted unitary enterprise where it was a highly integrated business); *Moorman Mfg. Co. v. Bair*, 437 U.S. 267 (1978) (integrated manufacturing and distribution of feeds).

<sup>271</sup>103 S. Ct. 2933 (1983).

<sup>272</sup>*See supra* notes 67-71 and accompanying text.

<sup>273</sup>103 S. Ct. at 2941.

<sup>274</sup>*Id.* at 2942 n.5.

domestic and foreign corporations. The standard three-factor apportionment formula includes the property, payroll, and sales of the foreign subsidiaries. Irrespective of these formal variations, one might easily infer that the due process and foreign commerce clauses were once again invoked and applied to the facts of this case.

#### A. Background of the Case

Container was engaged in the production and distribution of paper-board packaging. The operation of the corporation was vertically integrated and largely domestic.<sup>275</sup> Container controlled several wholly-owned and partially-owned overseas subsidiaries.<sup>276</sup> In most instances, the subsidiaries were fully integrated and were engaged in essentially the same line of business as the domestic corporation in their local markets. The subsidiaries purchased only small amounts of materials from the domestic corporation.<sup>277</sup> Although day-to-day management and personnel matters were handled by the subsidiaries, the domestic corporation had five persons assigned to overseeing the subsidiaries' operations.<sup>278</sup> Those officers addressed long-term decisions and prescribed profitability and ethical standards.<sup>279</sup> Container held or guaranteed much of the long-term debt of the subsidiaries, provided advice in several areas, and occasionally aided in the acquisition of equipment.<sup>280</sup>

Container was doing business in California which had a corporate franchise tax geared to income.<sup>281</sup> The corporation initially calculated its tax liability to the state based on an apportioned share of its net income without regard to any income attributable to the foreign subsidiaries.<sup>282</sup> The state insisted that the corporation should have characterized its foreign subsidiaries as part of a unitary enterprise

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<sup>275</sup>*Id.* at 2943.

<sup>276</sup>Container's ownership interest in the subsidiaries ranged between 66.7% and 100%. *Id.*

<sup>277</sup>Such transactions amounted to approximately one percent of the subsidiaries' total purchases. *Id.*

<sup>278</sup>*Id.* at 2943-44.

<sup>279</sup>*Id.* at 2944.

<sup>280</sup>*Id.*

<sup>281</sup>The California tax statute at issue was in large measure similar to most of the statutes discussed earlier in this article. The statute derived most of its relevant provisions from the UDITPA. *See supra* notes 51-60 and accompanying text. The apportionment formula which California adopted was the standard three-factor formula. *See supra* note 50. California's corporate franchise tax was measured by net income. The California method of apportionment is explained in Keesling & Warren, *The Unitary Concept in the Allocation of Income*, 12 HASTINGS L.J. 42, 43 (1960).

<sup>282</sup>103 S. Ct. at 2944. Container also deducted all dividends and other non-business income as authorized by state law. *Id.* at 2945.

and not merely as passive investments.<sup>283</sup> The state's calculations increased the corporation's tax liability.<sup>284</sup> Container commenced a refund action, the parties submitted the case to the trial court on stipulated facts, and the court upheld the additional assessment. The state court of appeals affirmed, finding that Container and its overseas subsidiaries constituted a unitary enterprise, and the California Supreme Court declined review.<sup>285</sup>

In the United States Supreme Court, Container challenged the taxation of the worldwide combined income of the multinational corporate group on three major grounds.<sup>286</sup> First, the nondomiciliary state was precluded from the application of combined apportionment because the domestic corporation and its subsidiaries and affiliates operating abroad do not constitute a unitary enterprise for tax purposes. Second, the three-factor combined apportionment formula used by the state misapportions income to the domestic corporation thereby resulting in extraterritorial taxation in contravention of the due process requirement of fair apportionment. Third, worldwide combined reporting is inconsistent with the qualified separate accounting approach used by the federal government and other foreign governments and results in multiple taxation which impairs federal uniformity thereby violating the foreign commerce clause.

### B. Due Process Considerations

1. *The Propriety of the Unitary Business Determination.*—On the threshold issue, the Court concluded that the state properly applied the unitary business principle to the multinational corporate group. In reaching this conclusion, the Court stated that it would, "if reasonably possible, defer to the judgment of the state courts in deciding whether a particular set of activities constitutes a 'unitary business.'"<sup>287</sup> The Court declared that since the constitutional limitations on the unitary business principle are well-established and the factual records in the cases tend to be long and complex, the role of the Court is not to engage in de novo adjudications, but rather "to determine whether the state court applied the correct standards to the case; and if it did, whether its judgment 'was within the realm of permissible judgment.'"<sup>288</sup>

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<sup>283</sup>*Id.* at 2945. California's unitary treatment of multi-corporate enterprises is discussed in Keesling & Warren, *supra* note 281, at 57.

<sup>284</sup>See 103 S. Ct. at 2945 n.11 for a detailed accounting and explanation of the net effect of the adjustments on the corporation's tax liability.

<sup>285</sup>*Id.* at 2945.

<sup>286</sup>*Id.* at 2939.

<sup>287</sup>*Id.* at 2945.

<sup>288</sup>*Id.* at 2946 (quoting *Norton Co. v. Dep't of Revenue*, 340 U.S. 534, 538 (1951)). The Court noted that the approach which it previously used in *ASARCO* and *Woolworth* is consistent with this standard of review. 103 S. Ct. at 2946 n.15. In *ASARCO* the

Container made three claims that the state court was incorrect in its particular application of the legal principles. First, Container claimed that the state court, like the state court in *Woolworth*, erred in its reliance upon the corporation's potential ability to control the operations of the foreign subsidiaries.<sup>289</sup> The Supreme Court disagreed, finding that the state court had relied principally on the fact that certain officers of the parent corporation established standards of compliance for the subsidiaries.<sup>290</sup> The Court noted that even though the potential ability to control a subsidiary is not a dispositive factor in finding a unitary business, it is a relevant factor.<sup>291</sup> Second, Container argued that the state court incorrectly relied on a presumption that related corporations engaged in the same business are unitary. Because this presumption was only one factor among many considered by the state court, the Supreme Court found its limited use reasonable. The Court reasoned that when related corporations are engaged in essentially the same line of business, these activities increase the probability of better utilization of existing business resources through operational integration or economies of scale.<sup>292</sup> Third, Container argued that a substantial flow of goods between the parent corporation and its subsidiaries should be a prerequisite to a determination of a unitary business. While such a test may be sensible as an administrative policy matter, the Court could perceive of no reason to impose the test on the states as a constitutional requirement.<sup>293</sup> The Court stated that the constitutional requirement for finding a unitary business is not a substantial flow of goods, but a more wide-ranging flow of value which results from "functional integration, centralization of management, and economies of scale."<sup>294</sup> Although a substantial flow of goods is one of the means in which substantial mutual interdependence among related corporations can result, it is not the sole means.<sup>295</sup>

The state court's judgment that the multinational corporate group constituted a worldwide unitary enterprise was guided by several factors.<sup>296</sup> Two of those factors were given special attention by the Court.<sup>297</sup> First, there existed a flow of capital resources through substantial loans and guarantees from the parent corporation to the

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Court relied on factual findings made by the state courts that a unitary business finding was impermissible. *Id.* The Court in *Woolworth* examined the evidence and concluded that the state court made critical errors in both the conclusions it drew and the legal principles it applied. *Id.*

<sup>289</sup>See *supra* text accompanying note 223.

<sup>290</sup>103 S. Ct. at 2946.

<sup>291</sup>*Id.* at 2946 n.16.

<sup>292</sup>*Id.* at 2947.

<sup>293</sup>*Id.* at 2947 n.17.

<sup>294</sup>*Id.* at 2947 (quoting *Woolworth*, 102 S. Ct. at 3135 (quoting *Mobil*, 445 U.S. at 438)).

<sup>295</sup>103 S. Ct. at 2947.

<sup>296</sup>*Id.* at 2947-48.

<sup>297</sup>*Id.* at 2948 n.19.

subsidiaries which resulted in a flow of value.<sup>298</sup> The Court pointed out that those capital transactions served an operational function and not merely an investment function.<sup>299</sup> Second, the parent corporation played a managerial role in the affairs of its subsidiaries which was "grounded in its own operational expertise and its overall operational strategy."<sup>300</sup> Even though day-to-day management of the subsidiaries was handled by local executives,<sup>301</sup> the Court noted that merely decentralizing the everyday management responsibilities would not prevent the finding of unitary business.<sup>302</sup> Based on these factors, the Court found that *Container* came closer to presenting a functionally integrated enterprise than either *ASARCO* or *Woolworth*.<sup>303</sup> These factors, taken in combination, convinced the Supreme Court that the state court reached a conclusion within the realm of permissible judgment, and, therefore, the state was entitled to tax the multinational corporate group as a single unitary entity.<sup>304</sup>

2. *The Fairness of the Apportionment Formula.*—The Constitution requires that the state apply a fair formula which apportions the income of the business, if the state determines that a particular set of activities produces a unitary enterprise.<sup>305</sup> *Container* challenged the application of the standard three-factor apportionment formula to the foreign operations of its subsidiaries, claiming that a disproportionate result occurred because the foreign operations were significantly more profitable than the domestic operations of the parent corporation.<sup>306</sup> This, claimed *Container*, resulted in the allocation of an inflated amount of income to its apportionable tax base.<sup>307</sup> *Container* maintained that this result was compounded by the fact that wage rates, one of the three factors of the formula, were substantially lower in their foreign

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<sup>298</sup>Approximately half of the long term debt of the subsidiaries was either held directly or guaranteed by the parent corporation. *Id.* at 2944. There was no indication that the loans and guarantees were conducted at arm's length and it is likely that they were part of an effort to ensure multinational corporate expansion and integration. *Id.* at 2948 n.19. Also, capital expenditures of the subsidiaries were subject to the approval of the parent corporation. *Id.* at 2944.

<sup>299</sup>*Id.* at 2948 n.19. Cf. Hellerstein, *State Income Taxation of Multijurisdictional Corporations, Part II: Reflections on ASARCO and Woolworth*, 81 MICH. L. REV. 157, 180-83 (1982) (income from transactions in capital investments which are integrally related to the taxpayer's business activities in the taxing state should be appropriate for inclusion in the recipient's apportionable tax base).

<sup>300</sup>103 S. Ct. at 2948 n.19.

<sup>301</sup>*Id.* at 2943-44.

<sup>302</sup>*Id.* at 2948 n.19 (citing *Exxon Corp. v. Dep't of Revenue*, 447 U.S. 207, 224 (1980)).

<sup>303</sup>103 S. Ct. at 2947-48.

<sup>304</sup>*Id.* at 2948.

<sup>305</sup>*Id.* at 2942. See *supra* text accompanying notes 24-27, 44, 47.

<sup>306</sup>103 S. Ct. at 2948.

<sup>307</sup>*Id.* at 2949.

operations.<sup>308</sup> As a result, the income earned on the books of foreign subsidiaries which have lower production costs and greater profitability is apportioned to the taxable income of domestic corporations which have higher production costs or lesser profitability.<sup>309</sup> As evidence in support of this argument, Container presented various statistical data comparing wage rates, productivity, and profitability in domestic operations with foreign operations in the multinational corporate group.<sup>310</sup>

The Supreme Court held that the application of the standard three-factor apportionment formula to the combined income of the multinational corporate group was fair because Container had failed to demonstrate that the income attributed to the taxing state was "out of all appropriate proportion to the business transacted in that State."<sup>311</sup> Container's argument and its supporting evidence were predicated on a variation of separate geographical accounting. The Court restated that separate geographical accounting suffers from weaknesses that justify the use of formula apportionment, including the potential failure to "account for contributions to income resulting from functional integration, centralization of management, and economies of scale."<sup>312</sup>

Although the three-factor formula is necessarily imperfect, the Court found it consistent in the sense that the payroll, property, and sales factors taken in combination appear to reflect a large share of income-generating activities.<sup>313</sup> There is a substantial margin of error inherent in any method which attributes income among the components of a unitary enterprise. The Court concluded that Container had failed to demonstrate that the margin of error inherent in the three-factor apportionment formula was significantly greater than the margin of error inherent in the formal geographical or transactional accounting method.<sup>314</sup>

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<sup>308</sup>*Id.*

<sup>309</sup>This effect of combined reporting is illustrated by the following simplified example. *P* corporation has a domestic operation solely within the taxing state. Its foreign subsidiary, *S* corporation, operates solely in another country. Assuming that both corporations have equal payroll, property, and sales, combined apportionment would combine the total income of both corporations and apportion 50% of the combined income to each corporation. The same analysis would apply where *S* corporation realized earnings of \$10 million and *P* corporation incurred an operating loss of \$5 million. In this situation the taxing state would apportion \$2,500,000 of income to *P* corporation and impose a tax on that income.

<sup>310</sup>103 S. Ct. at 2949.

<sup>311</sup>*Id.* at 2948 (quoting *Hans Rees' Sons, Inc. v. North Carolina ex rel. Maxwell*, 283 U.S. 123, 135 (1931)).

<sup>312</sup>103 S. Ct. at 2948-49 (quoting *Mobil*, 445 U.S. at 438).

<sup>313</sup>103 S. Ct. at 2949.

<sup>314</sup>*Id.* at 2949-50. The statistical evidence presented by Container demonstrated that the income taxable under the separate accounting method was 14% less than the combined apportionment method, a "far cry" from the 250% difference present in *Hans Rees' Sons, Inc. v. North Carolina ex rel. Maxwell*, 283 U.S. 123 (1931). 103 S. Ct. at 2950.

### C. Foreign Commerce Considerations

The separate accounting method for taxing domestic owned enterprises operating abroad is the method used by the federal government and is the internationally accepted standard.<sup>315</sup> Under this method, related foreign and domestic corporations are treated as if they are separate and independent entities dealing with each other at arm's length.<sup>316</sup> *Container* argued that the commerce clause compelled California to utilize that separate accounting, arm's-length method in determining the corporation's tax obligations.<sup>317</sup> Because the domestic corporation and its subsidiaries formed an international unitary business, the Court analyzed the state tax under the two additional commerce clause considerations announced in *Japan Line, Ltd. v. County of Los Angeles*.<sup>318</sup> The Court examined, first, whether the tax increases the risk of multiple taxation and, second, whether the tax interferes with needed federal uniformity.

The Court acknowledged that actual double taxation resulted under the facts in *Container*, but found that double taxation is not inevitable in all cases involving the simultaneous use of worldwide unitary apportionment and arm's-length allocation.<sup>319</sup> Furthermore, because there are substantial differences among the allocation rules applied by the various taxing jurisdictions which have adopted the arm's-length approach, compelling the state to adopt that approach would not necessarily avoid double taxation.<sup>320</sup> The Court was unwilling to require the state to adopt one allocation method over another where double taxation was a possibility under both.<sup>321</sup>

On the second commerce clause consideration, the Court found that the state tax did not impair federal uniformity for it neither implicated foreign policy issues nor violated a clear federal directive. Although a finding that the state tax might lead to foreign retaliation would raise foreign policy issues,<sup>322</sup> the Court identified three factors that weighed strongly against such an implication.<sup>323</sup> First, the

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<sup>315</sup>103 S. Ct. at 2950.

<sup>316</sup>*Id.* at 2952.

<sup>317</sup>*Id.* at 2939.

<sup>318</sup>441 U.S. 439 (1979). *See supra* notes 20-21 and accompanying text.

<sup>319</sup>103 S. Ct. at 2954.

<sup>320</sup>*Id.* at 2953-55.

<sup>321</sup>*Id.* at 2954-55. The Court distinguished *Japan Line* on several grounds. First, it involved a property tax instead of an income tax. *Id.* at 2952. Second, the state tax at issue in that case inevitably resulted in double taxation. *Id.* Finally, the incidence of the property tax fell on foreign rather than domestic corporations. *Id.* The Court recognized the difficulty of avoiding double taxation when allocating income among various taxing jurisdictions and called the task similar "to slicing a shadow." *Id.* at 2954.

<sup>322</sup>*Id.* at 2955.

<sup>323</sup>*Id.* at 2955-56.

tax did not automatically result in international double taxation. Second, the legal incidence of the tax fell on a domestic corporation and not a foreign corporation.<sup>324</sup> Third, the amount of tax paid by the corporation was more a function of the state's rate of taxation than it was of its allocation method. Finally, the Court refused to find that the state tax was preempted by federal statutes, or inconsistent with federal policy.<sup>325</sup>

#### D. Summary Comment on Container

One might argue that there are some endeavors in which a careful disorderliness is the best method. One such endeavor is the application of formula apportionment to purported unitary enterprises. The endeavor is careful not to step upon the limits of a constitutionally acceptable application. There is also a certain disorderliness to this endeavor because the states have adopted various apportionment formulas which strive to reach as much of the corporate income as possible. *Container* will cause apprehension among some corporate taxpayers in regard to both their compliance with a variety of state tax statutes and the possible multiple taxation of the same income. After *Container*, a state may elect two ways to tax the foreign-source in-

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<sup>324</sup>The Court acknowledged that the imposition of a tax on a corporation with a domestic domicile may lead to less significant foreign retaliation than in the case of a domestic corporation owned by foreign interests. The Court did not decide whether such a case would require it to alter its analysis. *Id.* at 2956 n.32.

<sup>325</sup>*Id.* at 2957. The dissent in this 5-3 decision did not consider whether in *Container* the taxpayer and its subsidiaries constituted a unitary business or whether the apportionment formula was fair because they found the California tax unconstitutional on foreign commerce clause grounds. Justice Powell was joined by Chief Justice Burger and Justice O'Connor in a dissenting opinion which viewed the state tax as clearly violating the foreign commerce clause. The principles which were enunciated in *Japan Line*, the dissent argued, should be controlling in this case because the facts in *Japan Line* were identical on the issues of double taxation and federal uniformity. *Id.* See *supra* notes 20-21 and accompanying text. The dissent maintained that double taxation is inherently inevitable because California had rejected the international norm in favor of a system which was fundamentally different in its basic assumptions. The risk of double taxation under the separate accounting, arm's length approach was said to be the result of disagreements in application only and not of structural differences as with unitary apportionment. 103 S. Ct. at 2958-59. On the issue of federal uniformity, the dissent maintained that the California tax is flatly inconsistent with federal policy. *Id.* at 2961. Therefore, the dissent concluded that the California tax violated the foreign commerce clause on both requirements under *Japan Line* and should be declared unconstitutional. *Id.* The dissent pointed out that the majority opinion did concede that the California tax had resulted in double taxation and that its decision ran contrary to the federal government's preference for the arm's length method adopted by the international community. *Id.* at 2957. As such, the dissent claimed that the majority failed to meet the requirements which a standard of review of close scrutiny demands in such a case under the foreign commerce clause. *Id.*

come of a domestic corporation. First, it may tax the dividends, interest, or capital gains received by a corporation doing business in the taxing state from its overseas affiliates. Second, it may tax the income of the overseas affiliates as a portion of the total combined income of a multinational corporate group, provided that the state properly determines the scope of the unitary enterprise and fairly apportions the income. With either approach, the income of the foreign corporation is indistinguishable from any other income of the domestic corporation when subjected to formula apportionment.

The equally weighted three-factor formula widely used by the states was not only approved by the Court in *Container*, but has become "something of a benchmark against which other apportionment formulas are judged."<sup>326</sup> Because an apportionment formula must bear a reasonable relation to all of the activities generating the income of a multinational enterprise, foreign property, payroll, and sales should be included in the equally weighted three-factor formula when calculating the state's share of the income of a multinational enterprise. The formula used in *Container* included property, payroll, and sales of the foreign subsidiaries, but the absence of those factors may lead to the inherent unfairness and difficulties which were the subject of the strong dissent in *Mobil*.<sup>327</sup>

Despite endorsing the application of the standard three-factor formula to the worldwide combined income of a multinational group of corporations, the Court in *Container* acknowledged the imperfections which are necessarily inherent in the formula.<sup>328</sup> The equal weight given to each of the three factors is arbitrary, and the formula does not reflect all of the factors which are material to the generation of income. The formula is based on the economic assumption that rates of return on property and payroll are roughly equal in various taxing jurisdictions. This assumption has clear weaknesses when made in the context of worldwide operations. Although variations in the cost of payroll and property in an interstate or a domestic context result in a margin of error in the apportionment of income, this margin of error is constitutionally acceptable because it is reasonable to assume that the rate of return on an investment in one state will roughly approximate the rate of return on an investment in another state. In an international context, however, the cost of payroll and property and the rates of return with respect to those factors vary so significantly from those in a domestic context that the economic assumption may no longer be valid. The application of the equally weighted three-factor formula to foreign operations, therefore, may

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<sup>326</sup>103 S. Ct. at 2943.

<sup>327</sup>See *supra* notes 157-58 and accompanying text.

<sup>328</sup>103 S. Ct. at 2949-50 & n.20.

be inherently arbitrary and entail unreasonable distortions in apportionment.

The result of the Court's opinion in *Container* is an endorsement of a substantial margin of error resulting from the application of the three-factor formula to the combined income of a global enterprise.<sup>329</sup> Formula apportionment divides the income of a multinational enterprise on the basis of a mathematical generalization.<sup>330</sup> If this approach was applied by all taxing jurisdictions, it should result in no double taxation of the income of a multinational unitary enterprise.<sup>331</sup> In order to eliminate double taxation, the Court would have to establish a single method of taxation among the taxing jurisdictions, a task which it considers to be a federal legislative responsibility.<sup>332</sup> Therefore, it is likely that multinational corporations will continue to be subjected to inconsistent formulas in the apportionment of income by many states. This marked lack of consistency among the formulas adopted by the states, compounded by the fundamental differences between formula apportionment and the international norm of a qualified separate accounting approach, will likely result in the taxation of more than all of the income of the multinational unitary enterprise.

Aside from the apportionment formulas themselves, many of the most significant issues in the state taxation of multinational corporations have arisen in relation to the determination of the existence of a unitary business and in the definition of the scope of the components which constitute the unitary enterprise. In the resolution of these issues, the Court has expressed a willingness to defer to the judgment of the state courts.<sup>333</sup> Given this fact, one can expect the state courts to continue to make crucial errors in determining the existence and scope of the unitary enterprise. Because of the Court's decision in *Container*, confusion and misunderstanding may also continue to exist with respect to the criteria used in establishing the extent of a unitary business.

Before the *Container* decision, it could have been argued that the Supreme Court had implicitly adopted a standard for finding a horizontally integrated business to be unitary: Was there a substantial flow of goods within the enterprise? The express adoption of a substantial flow of goods requirement as the predominant criterion for a unitary business relationship may have appropriately reflected the economic logic behind the development of formulary apportionment.<sup>334</sup> Coupled

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<sup>329</sup>*Id.* at 2950.

<sup>330</sup>*Id.* at 2952.

<sup>331</sup>*Id.* at 2942.

<sup>332</sup>*Id.* at 2943.

<sup>333</sup>*Id.* at 2945.

<sup>334</sup>The use of formulary apportionment has its origins in cases evidencing such complete functional integration through the interchange of products and services, that

with the other unitary business criteria adopted by the Court, that standard would have provided additional certainty for the state tax administrators, state courts, and multinational corporations.<sup>335</sup> In *Container*, however, the Supreme Court specifically rejected the narrow "flow of goods" test, finding it an inappropriate constitutional requirement to impose upon the states.<sup>336</sup> Although finding that the test for a unitary enterprise may be satisfied by a substantial flow of goods between a parent corporation and its subsidiaries, the Court stated that "[t]he prerequisite to a constitutionally acceptable finding of unitary business is a flow of *value*, not a flow of goods."<sup>337</sup> The Court rightfully adopted a flow of value standard in lieu of the taxpayer's proposed flow of goods test in *Container*.<sup>338</sup> What is problematic with the Court's pronounced prerequisite is that the concept of "value" is difficult to define. One may assume that a flow of value means a substantial interchange of products, markets, management services, technologies, capital resources, or other contributions to income which, in combination or degree, are relevant to substantial mutual interdependence among related corporations. In this context, the substantial flow of value requirement has the advantage of providing a controlling factor in an otherwise largely complex determination as to whether a business is unitary. The other essential factors such as functional integration, centralized management and operations, or other economies of scale gain greater meaning and become more determinative as useful criteria when used in conjunction with the fundamental requirement of a flow of value. Although reasonable minds may differ as to what constitutes a flow of value, the *Container* opinion has added much to our understanding of the delineation of a unitary business.

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"[t]he legislature in attempting to put upon this business its fair share of the burden of taxation was faced with the impossibility of allocating specifically the profits earned by the processes conducted within its borders." *Bass, Ratcliff & Gretton, Ltd. v. State Tax Comm'n*, 266 U.S. 271, 281 (1924). See *supra* notes 95-99 and accompanying text. For enterprises that manufactured products in one taxing jurisdiction and distributed them in others, formulary apportionment became a logically consistent and meaningful method for the division of the net income of a multijurisdictional corporation. In the absence of substantial mutual interdependence, as evidenced by such a substantial flow of trade, a coherent justification for apportionment may be lacking. See Hellerstein, *supra* note 83, at 501-02.

<sup>335</sup>This approach has been advocated by a leading commentator. See Hellerstein, *supra* note 83, at 501-02.

<sup>336</sup>103 S. Ct. at 2947 n.17.

<sup>337</sup>*Id.* at 2947.

<sup>338</sup>From an economic point of view, it is easy to demonstrate the existence of a unitary business where there is no significant flow of goods. See McClure, *Operational Interdependence is not the Appropriate 'Bright Line Test' of a Unitary Business—at Least Not Now*, 18 TAX NOTES 107 (1983).

## VIII. CONCLUSION

This article has considered only the principal features of the unitary business/formula apportionment concepts. The important constitutional problems which are presented when a taxing state applies its particular version of formula apportionment to the income of related domestic and foreign corporations which are purportedly engaged in a multinational unitary enterprise have been described. The challenges to the application of the unitary business/formula apportionment concepts have been advanced by corporate taxpayers primarily under the due process and commerce clauses. Although commerce clause considerations bear directly upon the issues associated with fair apportionment, especially in the international context, due process considerations have been more important, or at least more fundamental, as a means for resolving the problems.

The first step toward resolution of the problems raised by the unitary business/formula apportionment concepts can be understood only by reference to actual business practices. The unitary business/formula apportionment approach is not to be perceived as a counter-movement by any level of government against the formal geographical or transactional accounting approach for determining a state's appropriate share of the income of an integrated corporate group; rather, it is the logical consequence of both revenue objectives of government and accounting techniques used by corporations. Some corporations prefer unitary apportionment over separate accounting because it may result in undertaxations or a more reasonable tax liability. Originally, the separate accounting approach was preferred by the states for the determination of the income tax of a corporation doing business largely within the state. As the activities of corporations spread across interstate boundaries, however, the application of some variation of formula apportionment became a practical necessity for the purpose of the fair division of the corporation's income among several taxing jurisdictions. The interstate businesses of corporations have become so functionally integrated that separate accounting is no longer practical. The next logical development of the unitary apportionment approach was its application to the interstate operations of affiliated corporations deemed to be a single unitary enterprise. Finally, whether a state is taxing an affiliated group of domestic corporations engaged in activities generating income in an interstate context, or an affiliated group of domestic and foreign corporations engaged in activities generating income both in an interstate and an international context does not appear to amount to a logically or constitutionally significant difference. The application of formula apportionment seems proper when a particular set of activities of a related group of corporations as a practical necessity renders the application of separate accounting improper. Worldwide combined reporting of

multinational corporate income, then, is the logical conclusion of an apportionment technique applied to regional railroad property a century ago.

In four recent cases, the United States Supreme Court has considered the constitutional implications of the state taxation of the income of a multinational group of corporations. In these decisions, a searching inquiry has been made into the understanding of the unitary business principle. Much guidance is made available through the study of these opinions. They establish that related domestic and foreign corporations may be treated as a unitary business to the extent that there is a sharing or an exchange of value throughout the multinational corporate group as evidenced by substantial mutual interdependence. As a necessary corollary to determining the scope of the unitary enterprise, the cases also establish that the apportionment of the income of the unitary business between the taxing state and the rest of the world must take into account a reasonable measure of the income generating activities of the unitary business, conducted as a whole, and its concrete relationship to activities within the state. In *Mobil*, the Court approved the state taxation of foreign-source dividends as part of the domestic recipient's apportionable income, but only because the Court assumed that the payor subsidiaries were engaged in a unitary business relationship with the parent corporations. In *ASARCO* and *Woolworth*, the court confined its analyses to due process considerations, and, as in *Mobil*, the unitary business principle formed the linchpin of its decision. The Court determined that a state cannot include foreign-source income in the apportionable income of a nondomiciliary corporation doing business in a taxing state when it can be demonstrated that the payor subsidiaries are discrete business enterprises apart from the parent corporation and have no other connection with the taxing state. In *Container*, the Court held that the worldwide combined income of a domestic corporation and its foreign subsidiaries is subject to unitary apportionment without contravention of the due process clause as long as the unitary business test has been properly applied and the apportionment formula is fair. In so holding, the Court declined to endorse the proposition that it was necessary to a finding of a unitary business that there be a continuous and significant product flow between the domestic parent corporation and its foreign subsidiaries in the absence of vertical integration among the corporations. Instead, the Court chose to establish the unitary business relationship in the totality of the circumstances which necessitates a case by case determination of whether there exists substantial mutual interdependence sufficient to justify the finding of a unitary business.

The attitude taken by the Court to the taxing power of the states in these four cases is quite consistent with that which the Court has

followed in previous state tax cases—an attitude of judicial restraint or nonintervention. The constitution places limited restrictions on the taxing power of the states and the Court is unlikely to alter its traditionally limited function with respect to the adjudication of these matters. The Court declines to intervene into the complexities of state finance and impose general legal formulations upon the taxing power of the states where those principles are not constitutionally required. In the absence of congressional action, the Court has developed objective standards which are not intended to extend beyond the concrete circumstances to which they are applied. These standards reflect the Court's generalizations with respect to the practical operation of state corporate income taxes. In these cases, the Court has affirmed the latitude which the states have in taxing the income of multinational corporations.

