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STATE TAXATION OF UNITARY BUSINESSES

I. Introduction

Modern business arrangements are often dictated by geographical considerations. In the textiles industry, for example, the warmth and moisture of the southeast create an optimum environment for the processing of cotton. The manufacturing phase of spinning and weaving is customarily located in a state such as South Carolina. Once the dyed and finished cloth is ready for manufacture into garments, it is transported to a heavily populated state such as New York, where the supply of a skilled work force makes garment manufacture feasible. In addition, because the textiles marketplace is historically centered in places like New York and Chicago, executive and sales offices of the textile company are located in those cities. Thus, the transformation of raw material into a marketable product stretches across South Carolina, New York and Illinois. This textiles business is an example of what is known as a multistate¹ business. Assuming a jurisdictional nexus is present, all three states may tax the income derived from sources within each state.²

The income taxation of multistate businesses has created vexing problems for tax administrators and businesses. A problem most resilient to solution is how to divide the income of a multistate business among the states which claim tax jurisdiction. The concepts of unitary business and formula apportionment were developed by the states to serve as an expedient and rational means by which to divide the income of a multistate business for tax purposes.³ A uni-

1. A multistate business is one which engages in operations in more than one state, and, as a result of these operations, may conceivably be subject to taxation in each state. For a description and survey of multistate businesses, see HOUSE COMM. ON THE JUDICIARY, STATE TAXATION OF INTERSTATE COMMERCE, H.R. REP. NO. 1480, 88th Cong., 2d Sess. 69-90 (1964) [hereinafter cited as 1964 HOUSE REPORT].

2. The chief limitations on a state's taxing power are imposed by the due process clause and the commerce clause. U.S. CONST. amend. XIV; *id.* art. 1, § 8. See pt. II *infra*.

3. The best analyses of these concepts include G. ALTMAN & F. KEESLING, ALLOCATION OF INCOME IN STATE TAXATION (1950) [hereinafter cited as ALTMAN & KEESLING]; HOUSE COMM. ON THE JUDICIARY, STATE TAXATION OF INTERSTATE COMMERCE, H.R. REP. NO. 1480, 88th Cong., 2d. Sess. (1964). Other helpful discussions include: W. BEAMAN, PAYING TAXES TO OTHER STATES (1963) [hereinafter cited as BEAMAN]; Dane, *A Solution to the Problems of State Taxation of Interstate Commerce*, 12 VILL. L. REV. 507 (1967); Hartman, *State Taxation of Corporate Income From a Multistate Business*, 13 VAND. L. REV. 21 (1959); Heller-

tary business is one in which the operations conducted both within and without the taxing state cannot be separated for the purpose of measuring the income earned in each state. Formula apportionment will allocate the income of the unitary multistate business between the taxing jurisdiction and other states by means of a mathematical ratio.⁴ Thus, the unitary business concept is the first step in identifying the tax base; the second step is to apply a mathematical ratio to calculate how much of the income of the business entity is to be allocated to the taxing state. The income so allocated by the formula apportionment procedure forms the basis upon which a net income or franchise tax can be imposed.⁵

In dividing the income of a multistate business for tax purposes, little difficulty is presented if the laws of the states are uniform. However, if any pattern exists in state taxation practices, it is that of diversity.⁶ Differences exist in the definition of a "unitary" business, which part of the income of such a business should be apportioned, the tax situs of income, and the proper application of the apportionment formula. The list of problems above is far from exhaustive.⁷ Because of this wide diversity in state practices, there are dangers of under or over taxation.

Congress has recognized that the area of division of income for state taxation of multistate business is in critical need of uniformity. However, the numerous attempts made to standardize the

stein, *Recent Developments in State Tax Apportionment and the Circumscription of a Unitary Business*, 21 NAT'L TAX J. 487 (1968); Lynn, *Formula Apportionment of Corporate Income for State Tax Purposes: Natura Non Facit Saltum*, 18 OHIO ST. L.J. 84 (1957); Rudolph, *State Taxation of Interstate Business, The Unitary Business Concept and Affiliated Corporate Groups*, 25 TAX L. REV. 171 (1970).

4. See pt. IV *infra*.

5. A net income tax is a direct levy on income earned within the tax jurisdiction. A franchise tax is an imposition for the privilege of engaging in business in the tax jurisdiction; the net income earned in the jurisdiction serves as a measure of the tax. See 1964 HOUSE REPORT, *supra* note 1, at 99-129. The primary purpose of state income and franchise taxes is to raise revenue to meet the costs of government. Because multistate businesses obtain protection and benefits from the taxing jurisdictions, it is only fair that they share in the costs of such services. See Hartman, *State Taxation of Corporate Income From a Multistate Business*, 13 VAND. L. REV. 21, 21-23 (1959). See also note 166 *infra*.

6. See generally [1967] STATE & LOC. TAXES, ALL STATES UNIT (P-H) ¶¶ 101-1051.

7. See, e.g., Braden, *Cutting the Gordian Knot of Interstate Taxation*, 18 OHIO ST. L.J. 57 (1957); P. HARTMAN, STATE TAXATION OF INTERSTATE COMMERCE (1953); Drazen, *Recent Trends in State Taxation of Interstate Commerce*, 34 TAXES 286 (1956); Hartman, *State Taxation in Interstate Commerce*, 7 VAND. L. REV. 138 (1956); Hellerstein, *State Franchise Taxation of Interstate Businesses*, 4 TAX L. REV. 95 (1948); Note, *State Taxation and Interstate Commerce*, 54 COL. L. REV. 261 (1954).

state jurisdiction and apportionment rules have hitherto been unsuccessful.⁸ Additionally, some state tax administrators have adopted the Multistate Tax Compact.⁹ Although the Compact represents a significant step towards standardizing the technical rules of the apportionment formulae, there remains a divergence of views as to what constitutes a unitary business. Only when this concept is clearly defined can income apportionment be validly applied. The Supreme Court now has an opportunity to clarify this area, as two cases dealing with this issue are pending before the Court.¹⁰

Part II of this comment will discuss the objectives and constitutional issues to be considered in developing a definition of the unitary business concept. An in-depth analysis of this concept is presented in part III. The origin of the unitary business concept will be traced to the early property tax and income tax cases, and the current state definitions of unitary business will be examined and compared. Part IV will briefly describe the methods used for dividing the income of a multistate business. The methods will be contrasted and their relationship to the unitary business concept explained. The conclusion will summarize the discussion in part III and propose a definition of a unitary business.

8. These efforts have been reflected in numerous bills introduced in almost every session of Congress throughout the last fourteen years. Bills now before the Congress include H.R. 5, 96th Cong., 1st Sess. (1979)(Rodino Bill), reprinted in [1977] ALL STATES TAX GUIDE (P-H) §§ 901, 945-2; S. 983, 96th Cong., 1st Sess. (1979)(Mathias Bill).

Except for the Act of Sept. 14, 1959, Pub. L. No. 86-272, 73 Stat. 555 (1959)(current version at 15 U.S.C. §§ 381-84 (1976)), the power of the Congress to regulate state taxation of interstate commerce has been unexercised. Pub. L. No. 86-272 prohibits the states from imposing income taxes on foreign corporations if interstate operations within the taxing state constitute minimal activities. *Id.* See Hartman, "Solicitation" and "Delivery" Under Public Law 86-272: An Uncharted Course, 29 VAND. L. REV. 353 (1976); Hellerstein, *State Taxation Under the Commerce Clause: An Historical Perspective*, 29 VAND. L. REV. 335 (1976) [hereinafter cited as *State Taxation*].

9. The Multi-State Tax Compact, reprinted in [1967] STATE & LOC. TAXES, ALL STATES UNIT (P-H) ¶¶ 6310-68 [hereinafter cited as MTC], adopts the UNIFORM DIVISION OF INCOME FOR TAX PURPOSES ACT reprinted in [1967] STATE & LOC. TAXES, ALL STATES UNIT (P-H) ¶¶ 6100-6286 [hereinafter cited as UDITPA]. The UDITPA provides a set of uniform rules of apportionment and allocation of income. See also Note, *The Constitutionality of the Multistate Tax Compact*, 29 VAND. L. REV. 453 (1976). As of 1979, twenty states are parties to the Multi-State Tax Compact. They are: Alabama (subject to legislative consent), Alaska, Arkansas; California, Colorado, Hawaii, Idaho, Kansas, Michigan, Missouri, Montana, Nebraska, Nevada, New Mexico, North Dakota, Oregon, South Dakota, Texas, Utah, and Washington. See [1977] ALL STATES TAX GUIDE (P-H) ¶ 564.

10. *Exxon Corp. v. Wisconsin Dep't of Revenue*, 90 Wis.2d 700, 281 N.W.2d 94, *prob. juris. noted*, 100 S. Ct. 446 (1979); *Exxon Corp. v. South Carolina Tax Comm'n*, 258 S.E.2d 93 (S.C.), *prob. juris. noted*, 48 U.S.L.W. 3458 (U.S. Nov. 30, 1979) (No. 79-843).

II. The Unitary Business Concept and the Constitution

A definition of a unitary business should accommodate two objectives in state taxation of multistate businesses. The first objective is to ascertain whether the practical effects of the definition are acceptable on constitutional grounds; the second is to minimize the risk of multiple taxation while providing for the revenue needs of the state.

A. The Due Process Clause

The due process clause states that no state may take property without due process of law.¹¹ Under this stricture, a state may tax those persons or entities over which its protection and control extend,¹² including foreign corporations.¹³ In general, a state may tax net income derived from sources within the state.¹⁴ Income from business activities is deemed to have its source in the state where the activities are conducted. Sufficient activity must exist within the state in order to form the jurisdictional nexus¹⁵ required for income taxation of operations conducted outside the state.¹⁶ For a unitary business, this jurisdictional nexus is satisfied by that portion of its activities which are located within the taxing state. Because a unitary business' operations are so interrelated as to constitute a single business, that portion of unitary income reasonably attributable to the taxing state is regarded as having its source within the state.¹⁷ If this attribution of income is accomplished by a reasonable formula¹⁸ designed to reach income derived from within the state, it will satisfy the due process clause.¹⁹ Such a formula should account for the reciprocal earnings effect of the in-

11. U.S. CONST. amend. XIV.

12. *Hans Rees' Sons, Inc. v. North Carolina*, 283 U.S. 123 (1931); *Shaffer v. Carter*, 252 U.S. 37 (1920).

13. *Northwestern Cement Co. v. Minnesota*, 358 U.S. 450, 464 (1959); *West Publishing Co. v. McColgan*, 27 Cal. 2d 705, 711-13, 166 P.2d 861, 864-65, *aff'd per curiam*, 328 U.S. 823 (1946). A foreign corporation is one which is incorporated outside the taxing state.

14. See cases cited in notes 12-13 *supra*.

15. *International Shoe Co. v. Washington*, 326 U.S. 310 (1945).

16. *Id.* See also BEAMAN, *supra* note 3, ch. 7, at 7-6.

17. See, e.g., *Butler Bros. v. McColgan*, 315 U.S. 501 (1942); *Underwood Typewriter Co. v. Chamberlain*, 254 U.S. 103 (1920); *John Deere Plow Co. v. Franchise Tax Bd.*, 38 Cal. 2d 214, 238 P.2d 659, *appeal dismissed*, 343 U.S. 939 (1951).

18. See pt. IV *infra*.

19. See, e.g., *Northwestern Cement Co. v. Minnesota*, 358 U.S. 450 (1959); *Underwood Typewriter Co. v. Chamberlain*, 254 U.S. 113 (1920).

state and out-of-state operations so that the income reached by the taxing state arises "out of or [is] connected with the activities within the taxing state."²⁰ This will permit the state to tax only those income items attributable to the "local activities within the taxing state."²¹ In meeting his burden of proof²² when challenging the apportionment, the taxpayer has traditionally used separate accounting to demonstrate the unfairness of the apportionment. This method of attack has been rendered ineffective by the Supreme Court.²³

B. The Commerce Clause

The Supreme Court has stated that the purpose of the commerce clause is to "resolve a conflict between the Constitution's mandate that trade between the states be permitted to flow freely without unnecessary obstruction from any source, and the state's rightful desire to require that interstate business bear its proper share of the costs of local government in return for benefits received."²⁴ While the current trend of commerce clause cases is far from stable,²⁵ there are some "firm peaks of decision which remain unquestioned."²⁶

It is established that a state may not levy a tax on the privilege of engaging in interstate commerce.²⁷ In addition, the states are not allowed "one single-tax-worth of direct interference with the free flow of commerce."²⁸ State taxation of unitary businesses, due either to inconsistent definitions or inconsistent treatment of a unitary business, may result in multiple taxation of such businesses.²⁹ This is illustrated by the experience of Kennecott Copper Corporation in two recent cases.

20. *International Shoe Co. v. Washington*, 325 U.S. 310, 319 (1945).

21. *Northwestern States Portland Cement Co. v. Minnesota*, 358 U.S. 450, 452 (1959).

22. See *ASARCO, Inc. v. Idaho State Tax Comm'n*, 99 Idaho 924, 592 P.2d 39, *appeal docketed*, 48 U.S.L.W. 3031 (U.S. June 8, 1979) (No. 78-1839); *Hans Rees' Sons, Inc. v. North Carolina*, 283 U.S. 123 (1931). See also note 44 *infra* for a discussion of burdens of proof in property tax cases.

23. *ASARCO, Inc. v. Idaho State Tax Comm'n*, 99 Idaho 924, 592 P.2d 39, *appeal docketed*, 48 U.S.L.W. 3031 (U.S. June 8, 1979) (No. 78-1839).

24. *Michigan-Wisconsin Pipe Line Co. v. Calvert*, 347 U.S. 157, 166 (1954).

25. See *State Taxation*, *supra* note 8, at 346-48.

26. 358 U.S. at 458.

27. *Id.*

28. *Id.*; *Freeman v. Hewit*, 329 U.S. 249, 256 (1946).

29. *State Taxation*, *supra* note 8, at 346-48.

In *Chase Brass & Copper Co. v. Franchise Tax Board*,³⁰ the plaintiff, a Connecticut corporation and a subsidiary of Kennecott Copper Corporation, was engaged in the manufacture of brass, bronze and copper products. While manufacturing was done entirely outside of California, Chase Brass warehoused and sold its manufactured products within the state.³¹ The parent corporation, Kennecott Copper, has three other subsidiaries: Kennecott Sales, Braden Copper and Bear Creek Mining. Kennecott Sales, a New York corporation, markets the copper extracted by Kennecott Copper. Kennecott Sales and Kennecott Copper supplied the copper needed by Chase Brass. However, the products which entered California were manufactured elsewhere. No sales were made by Kennecott Copper and Kennecott Sales in California.³² Braden Copper and Kennecott Wire and Cable were engaged in mining or manufacture. All their products were sold by Kennecott Sales. None of them did business in California. Bear Creek Mining was a Delaware corporation which explored for metals in California, but made no significant discoveries.³³

California taxed the plaintiff and its affiliates as a unitary business. Chase Brass, the plaintiff, attacked this treatment on due process grounds. It argued that it gained no particular advantage by reason of the parentage of Kennecott. The court examined the business by using the three unities concept³⁴ and found unity of operations in purchasing, advertising, accounting, legal, financing and retirement plans. Unity of use was found in the executive forces. The court concluded that Kennecott Copper, Kennecott Sales, and Chase Brass constituted a unitary business doing business in the state of California.

Two years later, the same parent company was the plaintiff in *Kennecott Copper Corp. v. State Tax Commission*.³⁵ Utah taxed Kennecott on a separate accounting basis, in effect treating one division of Kennecott as a separate business. Kennecott vigorously argued that it was being whipsawed by the inconsistent treatment accorded it by Utah and California. The Utah Supreme Court up-

30. 10 Cal. App. 3d 496, 95 Cal. Rptr. 805, *appeal dismissed*, 400 U.S. 961 (1970).

31. *Id.* at 501, 95 Cal. Rptr. at 807.

32. *Id.* at 500, 95 Cal. Rptr. at 806.

33. *Id.*

34. *Id.* at 502, 95 Cal. Rptr. at 807. See notes 72-82 *infra* and accompanying text.

35. 27 Utah 2d 119, 493 P.2d 632 (1972).

held the tax commission. The taxpayer appealed to the Supreme Court. The State of California joined and filed an amicus brief, urging reversal of the Utah decision. The Supreme Court denied certiorari.³⁶

Such conflicting methods of division of tax bases which result in taxation of more than one hundred percent of the base are inequitable to multistate businesses. Given this diversity in definitions and treatments of unitary businesses, such businesses are open to the risk of multiple taxation. Because no definitive guidelines have been offered by the Supreme Court or Congress on the treatment of a unitary business, the Kennecott experience may well happen again. This is precisely the type of burden on interstate commerce that the commerce clause is designed to prevent.

III. The Unitary Business Concept

A. Origin of the Unitary Business Concept

1. Property Tax Cases

The origin of the unitary business concept in tax cases can be traced to early property tax cases.³⁷ In *Pullman's Palace Car Co. v. Pennsylvania*,³⁸ the taxpayer was a railroad car company. Its tangible property consisted mainly of train cars located in various states. The cars were moved by railroad carriers under contract. The property was termed "rolling stock" because the cars constantly moved around. Pennsylvania devised the "unit rule" to impose a property tax on the company's property, including rolling stock, within the state. The property value was obtained by multiplying the company's capital stock by the ratio of local mileage to total car mileage. The unit rule was so named because the entire rolling stock, franchise and capital of the company was regarded as the unit of taxation. The taxpayer attacked the assessment on due process grounds. The Supreme Court upheld the assessment on the theory that "the whole property of the company might be regarded

36. 409 U.S. 973 (1972). Presumably, California's action was taken to buttress that state's unitary apportionment approach.

37. See, e.g., *Cleveland, Cin., Chi. & St. L. Ry. v. Backus*, 154 U.S. 439 (1894); *Pittsburgh, Cin., Chi. & St. L. Ry. v. Backus*, 154 U.S. 421 (1894); *Maine v. Grand Truck Ry.*, 142 U.S. 217 (1891); *Pullman's Palace Car. Co. v. Pennsylvania*, 141 U.S. 18 (1890); *Western Union Tel. Co. v. Massachusetts*, 125 U.S. 530 (1887); *Kentucky R.R. Tax Cases*, 115 U.S. 321 (1885); *State R.R. Tax Cases*, 92 U.S. 575 (1875).

38. 141 U.S. 18 (1890).

as a unit plant, with a unit value, a proportionate part of which value might be reached by the state authorities on the basis indicated."³⁹ The controversial aspect of this rule is its premise that local value embodies not only the physical worth of a company's property, but also a portion of its intangible value.⁴⁰

The unitary concept was more clearly enunciated in *Adams Express Co. v. Ohio*.⁴¹ The taxpayer was an express company which operated its transportation business in several states. Its property included horses, wagons and furniture distributed in the different states. The express company challenged Ohio's unit rule of assessment on constitutional grounds. The Court considered what constituted a unitary business. It stated:

Doubtless there is a distinction between the property of railroad and telegraph companies and that of express companies. The physical unity existing in the former is lacking in the latter; but there is the same unity in the use of the entire property for the specific purpose, and there are the same elements of value arising from such use The unit is a unit of use and management, and the horses, wagons, safes, pouches and furniture; the contracts for transportation facilities; the capital necessary to carry on the business, whether represented in tangible or intangible property, in Ohio, possessed a value in combination and from use in connection with the property and capital elsewhere, which could as rightfully be recognized in the assessment for taxation in the instance of these companies as the others.

We repeat that while unity which exists may not be a physical unity, it is something more than a mere unity of ownership. It is a unity of use, not simply for the convenience or pecuniary profit of the owner, but existing in the very necessities of the case — resulting from the very nature of the business.⁴²

Therefore, the single specific use of the properties united together gave rise to the classification of the company as a unitary business. Notably, the Court recognized that under special circumstances⁴³ some property of the company may not be used in connection with the unitary business. However, the "unit rule" of assessment was

39. *Adams Express Co. v. Ohio*, 165 U.S. 194, 221-23, *rehearing denied*, 166 U.S. 185 (1897).

40. For further application of the unit rule to transportation companies, see *Schwab v. Richardson*, 263 U.S. 88 (1923); *American Refrig. Transit Co. v. Hall*, 174 U.S. 70 (1899).

41. 165 U.S. 194 (1897); see also *Adams Express Co. v. Indiana*, 165 U.S. 255 (1897).

42. 165 U.S. at 221-22.

43. See *Pittsburgh, Cin. Chi. & St. L. Ry. v. Backus*, 154 U.S. 421 (1894) (property separate and distinct in character located outside the taxing state).

upheld in this case because no such special circumstances were present.⁴⁴

2. *Income Tax and Franchise Tax Cases*

The "unit rule" of assessment developed in the property tax cases was later extended to the area of income and franchise taxation of integrated manufacturing and selling enterprises.⁴⁵ In *Underwood Typewriter Co. v. Chamberlain*,⁴⁶ the corporation, incorporated in Delaware, had its principal office in New York, all its manufacturing facilities in Connecticut and branch offices and warehouses in other states. Under the Connecticut statute, Underwood's taxable income was allocated to the state based on a single factor property formula. Because forty-seven percent of Underwood's property was located in the state, the formula resulted in an allocation of forty-seven percent of the corporate income to Connecticut. Most of Underwood's sales were made outside Connecticut. Based on the low volume of sales consummated in the state, the taxpayer contended that only 3.3 percent of its net income was received in Connecticut. Plaintiff, in the lower court, challenged the statute on the grounds that it imposed an undue burden upon interstate business, and attempted to tax income arising from business conducted outside the taxing state.⁴⁷ Renewing this argument in the Supreme Court, the Court nonetheless rejected the com-

44. 165 U.S. at 227. In the *Adams* case, the Court presumed that "all the property of the corporation or company is held and used for the purposes of its business . . ." *Id.* The taxpayer had the burden of proof to show such special circumstances to rebut the presumption. *Id.* In later cases, the burden seems to have shifted. In *Norfolk & West. Ry. v. Missouri State Tax Comm'n*, 390 U.S. 317 (1968), the taxpayer showed evidence that the equalized value of its rolling stock in Missouri was much less than that computed by formula. The Court stated that Missouri had to counter such evidence by disproving the disproportionate result of its formula. *Id.* at 317. Later, the Court was alert to strike down the property tax statutes when it found that apportionment resulted in the taxation of out-of-state values. *Cf. Britton, State Taxation of Extraterritorial Value: Allocation of Sales to Destination*, 46 VA. L. REV. 1160 (1960).

45. See, e.g., *Western Cartridge Co. v. Emmerson*, 281 U.S. 511 (1930); *Hump Hairpin v. Emmerson*, 258 U.S. 290 (1922); *Atlantic & Pac. Tea Co. v. Grosjean*, 301 U.S. 412 (1937). See Issacs, *The Unit Rule*, 35 YALE L.J. 838 (1926). For a more detailed discussion of these cases, see Goldstein, *Allocation of Income for Purpose of Corporate Taxation*, 1 TAX L. REV. 149 (1946); Brooks, *Allocation of Income for Purposes of Corporate Taxation - Another View*, 2 TAX L. REV. 72 (1946); Goldstein, *Allocation of Income for Purpose of Corporate Taxation - A Reply*, 2 TAX L. REV. 80 (1946); Hellerstein, *Recent Developments in State Tax Apportionment and the Circumscription of Unitary Business*, 21 NAT'L TAX J. 487 (1968).

46. 254 U.S. 113 (1920).

47. *Underwood Typewriter Co. v. Chamberlain*, 92 Conn. 199, 102 A. 600 (1917).

merce clause argument by noting the clearly established rule that income taxation of interstate commerce is permissible.⁴⁸ Addressing the due process objection, the Court analyzed the nature of the business.⁴⁹ The Court discussed the unit rule of valuation used in property taxation on property employed as an integral part of an interstate transportation system. It observed that "the profits of the corporation were largely earned by a series of transactions beginning with manufacture in Connecticut and ending with sale in other states."⁵⁰ This was noted as typical of manufacturing businesses. Because of the manner in which income was earned, the Court stated that the legislature was "faced with the impossibility of allocating specifically the profits earned by the processes conducted within its borders."⁵¹ The Court concluded that Connecticut's formula was designed to reach only profits earned within the state. Therefore, the state's statute was upheld.⁵² In *Underwood*, the critical fact supporting the finding of a unitary business was that the income of the multistate business was earned by a single, continuous "series of transactions."⁵³

This same rationale led to the finding of a unitary business in *Bass, Ratliff and Gretton v. State Tax Commission*,⁵⁴ decided in 1924. The taxpayer, a British corporation, manufactured ale in England. The ale was then sold in both England and the United States. Sales in the United States were made through branches in Chicago and New York. The combined worldwide operations showed a substantial profit, but its United States operations showed a loss. Presumably, this result was reached by computing income under the separate accounting method.⁵⁵ New York's apportionment statute employed a single factor formula like that in *Underwood*.⁵⁶ The taxpayer's worldwide net income was used as the tax base for the formula apportionment. As a consequence, profits were attributed to New York although the United States operations reported a loss under separate accounting. In sustaining the appor-

48. 254 U.S. at 119-20.

49. *Id.* at 120-21.

50. *Id.* at 120.

51. *Id.* at 121.

52. *Id.* at 121-22.

53. *Id.* at 120.

54. 266 U.S. 271 (1924).

55. *See* pt. IV *infra*.

56. *See* note 46 *supra* and accompanying text.

tionment, the Court stressed the fact that Bass, Ratliff & Gretton was engaged in a unitary business, and found the fact that some income was from a foreign source irrelevant. In finding a unitary business, the Court seized the language used in *Underwood*. It stated that Bass's profits were earned by "a series of transactions beginning with manufacture in England and ending in sales in New York and other places — the process of manufacturing resulting in no profits until it ends in sales"⁵⁷

The *Bass, Ratliff* case is significant because the Court specifically refers to the unit rule concept employed in property taxation as "directly applicable to the carrying on of a unitary business of manufacture and sale partly within and partly without the State."⁵⁸ Thus, the stage was set for the subsequent articulation of the unitary business concept in the area of state taxation of multi-state businesses.

In *Hans Rees' Sons v. North Carolina*,⁵⁹ a New York corporation was engaged in the business of tanning, manufacturing, and selling belting and other heavy leathers. Its manufacturing operations were conducted exclusively in North Carolina. The company maintained its sales office and a warehouse in New York. Its products were sold at the wholesale and retail level throughout the United States, Canada, and Western Europe. Approximately forty percent of the output of its manufacturing plant in North Carolina was shipped to the New York warehouse; the balance was shipped directly to customers upon order from the New York sales office. North Carolina treated the taxpayer's multistate operations as a unitary business for tax purposes. Using a single factor property formula, the state apportioned approximately eighty percent of the corporate income to North Carolina. Asserting the invalidity of the formula, the taxpayer offered evidence to show that its net income was comprised of buying, manufacturing, and selling profit and that only seventeen percent of its income was derived from the manufacturing and tanning operations within North Carolina.⁶⁰ This evidence was stricken by the trial court. The state supreme

57. 266 U.S. at 282.

58. *Id.* The *Bass* case involved a franchise tax rather than an income tax. While the opinion seems to attach some importance to the nature of the tax, it is doubtful that the distinction is of significance.

59. 283 U.S. 123 (1931).

60. *Id.* at 127.

court sustained the ruling of the trial court, but held that even if the evidence were deemed to be competent it would not change the result.

On appeal, the United States Supreme Court viewed the case as if the evidence had been received by the state court as true and accurate but as having no bearing on the validity of the apportionment in question.⁶¹ The taxpayer's objection was premised upon both the due process and commerce clauses. The Court noted that in state tax-apportionment cases evidence can always be received to show a state had applied a method reaching profits which are in no just sense attributable to transactions within its jurisdiction. The Court held that the taxpayer had carried his burden of proof and found the North Carolina apportionment unreasonable.⁶²

Under the standards established in the *Underwood* and *Bass, Ratliff* cases, the taxpayer in *Hans Rees' Sons* clearly conducted a unitary business. Its worldwide net income was earned through a series of transactions beginning from manufacturing in North Carolina and ending in sales throughout the United States, Canada and Western Europe. However, in setting aside the North Carolina apportionment and allowing separate accounting, the Court never reached the question whether Hans Rees' Sons was engaged in a unitary business. Rather, the formula apportionment was overruled because its result was unreasonable, owing to the peculiar procedural twist in the case.⁶³

In *Butler Brothers v. McColgan*,⁶⁴ the Supreme Court gave fuller expression to the role of the unitary concept and the contrasts between separate accounting and formula apportionment. Here, the taxpayer, an Illinois corporation, engaged in the wholesale dry goods and merchandising business. It operated seven wholesale stores in seven states, including one in California. Each of the seven locations served a separate territory with its own sales persons, handled its own collections and credit arrangements, and kept its own accounts. All of the sales in California were handled by its

61. *Id.* at 135.

62. *Id.*

63. For further analyses and comments on later developments, see Palestin, *Interstate Taxation: Non-Unitary Corporation — Should Statutory Apportionment Yield to Separate Accounting?*, reprinted in NAT'L TAX ASS'N, PROCEEDINGS OF THE FIFTY-EIGHTH ANNUAL CONFERENCE 531 (1965); Beaman, *supra* note 3, ch. 3; Cohen, *State Tax Allocations and Formulas Which Affect Management Operating Decisions*, 1 J. TAX. 2 (1954).

64. 315 U.S. 501 (1942), *aff'g* 17 Cal. 2d 664, 111 P.2d 334 (1941).

San Francisco office. All purchases made by the San Francisco office came from the company's home office in Chicago. Charges for the goods were made to each location at cost plus transportation expenses. Operating and advertising costs for the central purchasing division were allocated among the seven wholesale stores. Although the business as a whole realized a profit, the California operations showed a loss. This loss was computed by the taxpayer using a separate accounting method. California treated Butler Brothers as a unitary business and used a formula to allocate a portion of the taxpayer's overall profit to the state. The taxpayer contended that the California formula resulted in an allocation of out-of-state income to the taxing state in violation of the due process clause.

The Supreme Court's decision relied upon the unit rule developed earlier in the property tax cases. The Court articulated the analogy to which it had alluded in *Underwood Typewriter Co.* and *Bass, Ratliff & Gretton*.⁶⁵ The Court held that Butler Brothers was a unitary business and upheld the California apportionment formula.

A critical factor in the Court's holding was Butler Brothers' use of a central purchasing division. This system enabled it to obtain lower prices than would be possible for the individual branches. The Court noted that this mode of operation alone would indicate that the branches' functions were "closely integrated."⁶⁶ The savings afforded by the lower purchasing prices were reflected in the lower costs to each branch, and undoubtedly contributed to the net profit of the business.⁶⁷

In sustaining the application of the unitary business concept the Court emphasized the unity of ownership and management which characterized the taxpayer's interstate business operations. The

65. See notes 46 & 54 *supra* and accompanying text.

66. 315 U.S. at 508.

67. The predominant advantage of centralized management in this case was of course the discounts afforded by central purchasing. The Court however did not enumerate what "other advantages" there may be. *Id.* at 509. To attack the apportionment, the taxpayer had to prove that the California branch did not contribute to the overall profit. A fatal defect in the taxpayer's case was the failure to show how much of the volume purchase savings was contributed by the California branch. Apparently an attempt to carry this proof could be made by determining the purchase prices available to small purchasers. The difference between these higher prices and Hans Rees' discounted prices represented the total savings. The California store's contribution to this savings can be based on the ratio of its purchases (or inventory) to total purchases.

Supreme Court concluded that California was justified in assuming that the branch contributed its share to the "advantages of centralized management of this unitary enterprise and to the net income earned."⁶⁸

Butler Brothers is significant because it was the first Supreme Court case to apply the unitary business concept to a non-integrated business. The Supreme Court has not comprehensively discussed the unitary business concept since the *Butler Brothers* case. The subsequent application of the concept has been made by the state courts.

B. State Definitions of a Unitary Business

The burden of refining and developing the unitary business concept has fallen largely on the state courts. The Supreme Court has, up the present, provided only broad guidelines.⁶⁹ The task is made more complex because the states must deal not only with federal constitutional issues,⁷⁰ but also with state constitutional and statutory law. Because of the wide latitude states have in applying divi-

68. *Id.*

69. See *Bass, Ratcliff & Gretton, Ltd. v. State Tax Comm'n*, 266 U.S. 271 (1924); *Underwood Typewriter Co. v. Chamberlain*, 254 U.S. 133 (1920); *John Deere Plow Co. v. Franchise Tax Bd.*, 38 Cal. 2d 214, 238 P.2d 569 (1951), *appeal dismissed*, 343 U.S. 939 (1952); *Butler Bros. v. McColgan*, 17 Cal. 2d 664, 111 P.2d 334 (1941), *aff'd*, 315 U.S. 501 (1942). In a recently decided case, *Mobil Oil Corp. v. Commissioner of Taxes of Vermont*, 48 U.S.L.W. 4306 (Mar. 19, 1980), the Supreme Court considered the unitary business concept. In this case, Vermont included Mobil's dividend income from overseas subsidiaries in its preapportionment tax base. This treatment assumes that the dividend was derived from a unitary business, part of which was conducted within Vermont. The Court stated that appellant's procedural position before it made unnecessary a discussion of the unitary business concept. Mobil, the Court stated, "confined [itself] to the question 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 4308. On that issue the Court upheld the Supreme Court of Vermont's holding that such income may be included in the corporation's tax base. J. Stevens, dissenting, argued that the procedural and substantive issues were "inherent[ly] interdependent." "The question whether Vermont may include investment income in the apportionable tax base should not be answered in the abstract without consideration of the other factors in the allocation formula. The apportionable tax base is but one multiplicand in the formula. Appellant's challenge to the inclusion of investment income in the component necessarily carries with it a challenge to the product." *Id.* at 4316. J. Stevens argued that the dividend income should not be included in the tax base because the corporations from which Mobil derived the income were neither engaged in the petroleum business nor had any connection with Mobil's marketing business in Vermont. *Id.* at 4315.

70. See pt. II *supra*.

sion of income rules,⁷¹ there are conflicting views as to the definition of a unitary business.

The tests employed by the states follow two general approaches. The first approach focuses on the operational relationships between the activities in the tax jurisdiction and the activities outside the jurisdiction. The second approach stresses the economic relationships between the in-state and the out-of-state activities.

1. Operational Tests

a. The Three Unities of Ownership, Operation and Use

A popular definition of a unitary business was first enunciated by the California Supreme Court in the *Butler Brothers* case⁷² and has been applied in a variety of cases.⁷³ A unitary business was defined in *Butler Brothers* as one in which there is unity of ownership, operation, and use.⁷⁴ Unity of ownership means that the activities outside the tax jurisdiction, combined with the in-state operations, are owned by the same taxpayer.⁷⁵ Unity of operation may be evidenced by central purchasing, advertising, accounting, and management divisions.⁷⁶ Unity of use is found in a centralized executive force and a general system of operation.⁷⁷ *Butler Brothers* did not discuss what combination of these requirements is necessary to comprise a unitary business.

The three unities rule was applied in *Edison California Stores, Inc. v. McColgan*.⁷⁸ In that case, a multistate retail shoe business was operated through a Delaware parent corporation with its headquarters in St. Louis. The corporation was comprised of fifteen wholly-owned subsidiary corporations, each operating in its state of incorporation. The parent provided centralized management, purchasing, advertising, and other centralized administrative func-

71. See *International Harvester Co. v. Evatt*, 329 U.S. 416, 422-23 (1947).

72. *Butler Bros. v. McColgan*, 17 Cal. 2d 664, 678, 111 P.2d 334, 341 (1941). See notes 64-68 *supra* and accompanying text.

73. See, e.g., *Wurlitzer Co. v. State Tax Comm'n*, 35 N.Y.2d 100, 315 N.E.2d 805, 358 N.Y.S.2d 762 (1974); *Honolulu Oil Corp. v. Franchise Tax Bd.*, 60 Cal. 2d 417, 386 P.2d 40, 34 Cal. Rptr. 552 (1963); *W.S. Dickey Clay Mfg. Co. v. Dickinson*, 200 Tenn. 25, 289 S.W.2d 533 (1956).

74. *Butler Bros. v. McColgan*, 17 Cal.2d 664, 111 P.2d 334 (1941). See *John Deere Plow Co. v. Franchise Tax Bd.*, 38 Cal. 2d 214, 228, 229, 238 P.2d 569, 577 (1951).

75. *Butler Bros. v. McColgan*, 17 Cal. 2d 664, 111 P.2d 334, 341 (1941).

76. *Id.*

77. *Id.*

78. 30 Cal. 2d 472, 183 P.2d 16 (1947).

tions. The home office determined operating policies for the entire affiliated group and maintained the principal accounting records for all subsidiaries. Goods purchased by the central purchasing division were shipped to the various stores operated by the subsidiaries, which were charged with the cost and a portion of general overhead expenses. Each subsidiary operated solely within the geographical confines of its particular state. The California tax commissioner regarded the entire business, comprising the parent and all of its subsidiaries, as a unitary business. The taxpayer objected on the grounds that the unit rule did not apply to separate corporate entities.⁷⁹ The court rejected this argument and held that the corporate veil of each corporation could not cloak the existence of an integrated multistate unitary business enterprise. In finding a unitary business, the California Supreme Court stated that:

In the present case all of the elements of a unitary business are present — unity of ownership, unity of operation by centralized purchasing, management, advertising and accounting, and unity of use in the centralized executive force and general system of operation. The business of the parent and all of its subsidiaries is owned and managed under one centralized system, to the same extent as in the Butler Brothers case and other cases considered therein. Thus the business is unitary regardless of the fact that in the Butler Brothers case there was but one corporation involved . . . and that in the present case there is a parent corporation owning and controlling as units of one system fifteen different branches organized as corporations⁸⁰

Significantly, the court in *Edison California Stores* added that the business is unitary where the business done within the state is dependent upon or contributes to the operations of the business without the state. Where no such dependency exists, the business within the state must be considered as separate.⁸¹ As applied by the California Supreme Court in *Butler Brothers*, the three unities rule is overly formalistic and fails to account for the relationship of the business to the taxing jurisdiction. The rule is applicable not only to a business carried on wholly within a state, but also to a business operated partially within the state. The California court's approach fails in the ultimate objective of providing an appropriate

79. *Id.* at 479-80, 183 P.2d at 17, 21-22.

80. *Id.* at 479-80, 183 P.2d at 21.

81. *Id.* at 481, 183 P.2d at 16. For a comprehensive discussion of the unitary concept as applied to affiliated corporations, see Rudolph, *State Taxation of Interstate Business: The Unitary Business Concept and Affiliated Corporate Groups*, 25 TAX L. REV. 171 (1970).

method of income division. In contrast, the United States Supreme Court's decision in the same case stressed the significant savings generated by the fact of operating a store in the taxing state.⁸² This approach focuses more clearly on the out-of-state's contribution to the in-state operation.

b. The "Dependent Upon or Contributory" Test

In defining unitary business, Professors Altman and Keesling, authors of a leading treatise in this field, declared that "[t]he essential test is whether or not the operation of the business within the state is dependent upon or contributory to the operation of the business outside the state."⁸³ As noted earlier,⁸⁴ the court in *Edison California Stores* used this test in conjunction with the three unities test. This test has been widely used in many states. Its application can be illustrated by the case of *Coca Cola Co. v. Department of Revenue*.⁸⁵ The taxpayer was a Delaware corporation engaged in the manufacture of soft drink syrups for fountain and bottled use. The syrups were sold to wholesale dealers and to approximately 900 bottling plants throughout the United States. Coca Cola owned all the shares of forty of the 900 bottling plants, including Pacific Coca Cola Bottling Company, located in Portland, Oregon. Approximately ten percent of the syrup manufactured by the taxpayer was sold to its subsidiaries' bottling plants. Coca Cola owned and operated a Portland syrup plant which supplied Pacific with its syrup. It was one of twelve plants in the United States preparing Coca Cola syrup using a secret formula. Sales of the syrup to "independent bottlers" and wholly owned bottling companies were made at the same prices. Pacific's contract with Coca Cola prohibited it from buying syrup and bottling beverages from any other manufacturer. Coca Cola retained control over the nature and quality of the product, advertising, marketing methods, research and development, maintenance and audit of books and records, and the geographical area to be served.

The Oregon Supreme Court, using the dependent upon or con-

82. See 315 U.S. 501, 508-09 (1942). The California Supreme Court did not stress this factor. 17 Cal. 2d 664, 678, 111 P.2d 334, 341 (1941).

83. ALTMAN & KEESLING, *supra* note 3, at 101; see Goldstein, *Allocation of Income for Purposes of Corporate Taxation*, 1 TAX L. REV. 149 (1946).

84. See notes 78-82 *supra* and accompanying text.

85. 271 Or. App. 517, 533 P.2d 788 (1975).

tributory test,⁸⁶ held that the Oregon operations were part of a unitary business. The court found that Pacific was dependent upon Coca Cola for all of its supplies and for the management guidance described above. Pacific's contribution to the overall operation of Coca Cola was its purchase of syrup and bottling beverages. The court noted that but for the fact that common ownership was missing between Coca Cola and the "independent bottlers," the independent companies would also be included in the unitary business.

This "dependent upon or contributory" test has been criticized as inadequate by Messrs. Keesling and Warren⁸⁷ because the test does not clearly indicate that the relationship between the business and the taxing jurisdiction is the sole criterion for distinguishing between separate and unitary business; that is, the business must be conducted partly within and without the taxing jurisdiction. They suggest the word "dependent" is confusing and misleading.⁸⁸ If the operations within a state are only dependent upon the operations out of the state and do not contribute to the earnings of income, it is argued that they should not be credited with any portion of the income derived from productive activities outside the state.⁸⁹ This position is sound. Application of the dependent upon test would capture income from a company's out-of-state operations which derived no benefit, or more precisely income, from the in-state operations. In addition, this test fails to achieve the objective of formula apportionment because it only considers the mode of operations, and does not take into account the earnings effect of the in- and out-of-state operations. Where the only connection between the operations is that the in-state business is dependent upon the out-of-state business only, the corporation should not be considered a unitary business.

c. Interdependence of Operating Units

Some courts look to the relationship between the operating units in the determination of a unitary business. Operating units are those divisions of a business engaged in direct income activities, such as producing and selling. Non-operating units are those en-

86. *Id.* at 524, 533 P.2d at 792.

87. Keesling & Warren, *The Unitary Concept in the Allocation of Income*, 12 HASTINGS L.J. 42, 48 (1960).

88. *Id.*

89. *Id.*

gaged in support and management functions, such as accounting, research, and development. Pennsylvania, for example, follows the "interdependence of operating units" test closely.⁹⁰

In *Commonwealth v. ACF Industries, Inc.*,⁹¹ the taxpayer was a New Jersey corporation with its headquarters in New York. In Pennsylvania, ACF Industries manufactured railroad and tank cars, pressed steel and pressure vessels, repaired freight and tank cars, and sold other products. These activities, as well as certain aerospace and nuclear engineering operations, were also conducted outside Pennsylvania. Before 1960, ACF Industries engaged in several joint business activities with Republic Aviation Corporation. Such joint ventures included the submission of a joint bid to NASA involving flight testing of nuclear rocket propulsion systems, the manufacture and sale of F-105 fighter planes to the federal government by Republic, and the construction of flight simulators to train pilots on the F-105 planes by ACF Industries. In 1960, ACF Industries purchased some shares of stock of Republic in the hope of acquiring the latter. In 1961, ACF Industries abandoned the plan of acquisition and sold the stock at a five million dollar gain. The issue presented to the Pennsylvania Supreme Court was whether the sale of the Republic stock related to the conduct of a unitary business in Pennsylvania.

The court found that the purchase of the Republic stock was an isolated investment designed to motivate a study of possible corporate combination, that the F-105 contracts were unrelated events entered into two years before the stock purchase, and that the stock, when held, did not contribute to, nor was related to, ACF's business in Pennsylvania. The court held that because of the lack of interdependence between the holding of the stock and the operations in Pennsylvania, the purchase, holding, and sale of the Republic stock was not part of the unitary business in Pennsylvania. In dictum, the court stated:

[I]t is virtually impossible to envision a successful multiform claim based upon a separation of vertical functions of a corporation where the selling

90. See, e.g., *Commonwealth v. Advance-Wilson Indus., Inc.*, 456 Pa. 200, 317 A.2d 642 (1974); *Commonwealth v. ACF Indus., Inc.*, 441 Pa. 129, 271 A.2d 273 (1970); *Commonwealth v. Ford Motor Co.*, 350 Pa. 236, 38 A.2d 329 (1944); *Commonwealth v. Quaker Oats Co.*, 350 Pa. 253, 38 A.2d 325 (1944); *Commonwealth v. Minnesota Mining and Mfg. Co.*, 11 Pa. Commw. Ct. 629, 315 A.2d 346 (1974); *Morewood Realty Corp. v. Commonwealth*, 6 Pa. Commw. Ct. 244, 294 A.2d 219 (1972), *aff'd*, 458 Pa. 204, 327 A.2d 328 (1974).

91. 441 Pa. 129, 271 A.2d 273 (1970).

function deals in the products of the manufacturing and/or wholesaling functions. . . . [P]erformance by the corporate whole of policy, administrative, research and similar functions for otherwise independently operated units does not vitiate multiformity any more than does their common but independent contributions of benefits to the corporate whole.⁹²

This view recognizes that a company which is completely integrated is typically a unitary business.⁹³ This follows from the fact that net income is a result of various activities and transactions culminating in sales. It is therefore not possible to determine what part of that net income is attributable to the integrated activities of manufacture, sale, and distribution.

d. Interdependence at a Management or Supporting Function Level

Where interdependence is lacking at the operating units level some courts hold that an interdependence at the management or supporting functions level will support the finding of a unitary business. Management functions are those typically performed at the executive level. Such functions include policy formulation, fiscal control, and financing. Supporting functions are those which are not typically part of the production or marketing process. For example, in a manufacturing and selling concern, the supporting functions would include the providing of legal counsel, accounting services, technical, and laboratory assistance. These functions are similar to the unity of operation and use requirements in *Butler Brothers v. McColgan*⁹⁴ where the supporting function was the central purchasing of goods to be sold at the operating level.

In *Superior Oil Co. v. Franchise Tax Board*,⁹⁵ an expansive view of a unitary business was taken by finding interdependence at the management and supporting services level. Superior was not an in-

92. *Id.* at 141-42, 271 A.2d at 279.

93. *Cf. Underwood Typewriter Co. v. Chamberlain*, 254 U.S. 113 (1920); *Bass, Ratcliff & Bretton, Ltd. v. State Tax Comm'n*, 266 U.S. 271 (1924), where the Court mentioned integration.

94. 315 U.S. 501 (1942), *aff'g* 17 Cal. 2d 664, 111 P.2d 334 (1941). See notes 64-68 *supra* and accompanying text.

95. 60 Cal. 2d 406, 386 P.2d 33, 34 Cal. Rptr. 545 (1963). California is a stronghold of the unitary concept. For other California cases, see *Appeal of F.W. Woolworth Co.*, [1972] CAL. TAX REP. (CCH) ¶¶ 204-806; *Chase Brass & Copper Co. v. Franchise Tax Bd.*, 10 Cal. App. 3d 496, 95 Cal. Rptr. 305, *cert. denied*, 400 U.S. 961 (1970); *Honolulu Oil Corp. v. Franchise Tax Bd.*, 60 Cal. 2d 417, 386 P.2d 40, 34 Cal. Rptr. 552 (1963).

tegrated oil company, as it did not engage in refining and processing. It engaged only in producing and selling petroleum and petroleum products in California and seven other states. Typically, Superior sold its crude petroleum at the well site to other oil companies. All of its California crude oil mined was sold within the state and all of its crude oil mined outside the state was sold outside California. Its executive office was in Los Angeles, which handled accounting, insurance, and the purchasing of equipment for the entire enterprise. Superior sought unitary business treatment in order to apply losses incurred in Arkansas and Louisiana to offset its California income. The state, on the other hand, wanted to tax Superior as a separate business. The court rejected the state's position and found that Superior was a unitary business. The decision was based on the centralized performance of certain supporting functions by Superior's executive office, and its contribution to out-of-state business. The court declared:

It is only through a multitude of individual operations which precede and make possible the outflow of petroleum at a producing well that Superior is able to obtain possession of a product which it can market. While the actual recovery and sale of the crude oil are, perhaps, local activities, nevertheless very extensive interstate transactions are theretofore involved in the other individual operations which make such production possible. The evidence here reveals that such essential factors as land acquisition, exploration, technology, testing, availability of equipment and personnel, financing and many others are definitely interstate in character. It must also be considered that each producing well in a particular state is the end product of interstate activities which may involve many other unproductive wells in many other states. Superior's products are thus acquired for the local market only as the result of interstate transactions. . . .⁹⁶

The court concluded that Superior's operations were substantially dependent upon the following out-of-state operations: transfers of funds from out-of-state assets to finance California operations, legal counselling provided by company counsel outside the state, the transfer of equipment and materials from out-of-state branches, fiscal control, technical and laboratory assistance, and the transfer of employees from other branches.⁹⁷

That Superior was dependent on the out-of-state supportive functions enumerated above proves that it is the out-of-state func-

96. 60 Cal.2d at 415-16, 386 P.2d at 39, 34 Cal. Rptr. at 550-51.

97. *Id.* at 414, 386 P.2d at 39, 34 Cal. Rptr. at 550-51.

tions which contributed to the savings inside the state. Also, whatever savings were obtained by centralized management in Los Angeles were not sufficiently material to allow the California operations to make any significant contribution to overall earnings.⁹⁸ A separate business existed in California because the contribution by management services in California to earnings was immaterial and there was a lack of interdependence at the basic operations level. The critical factor for finding a unitary business was absent because there was no contribution to earnings derived from the other state's operations. To subject the operations in the other states to apportionment as a unitary business would cause income earned in other states to be taxed in this taxing jurisdiction. In sum, *Superior Oil* pushes the unitary business concept to an extreme that is inconsistent with the objective of formula apportionment and violates the due process clause by exceeding the jurisdictional power of a state to tax income.⁹⁹

e. The "Interdependent and of Mutual Benefit" Test

Some states define a unitary business as one in which the operations in the taxing state and the operations outside the state are interdependent and of mutual benefit to each other. An illustration of the application of this test is provided by *Western Auto Supply Co. v. Commissioner of Taxation*.¹⁰⁰ In this case, the taxpayer was a Missouri corporation engaged in the retail and wholesale merchandising of automotive parts on a nationwide basis. The corporation sought to divorce its wholesaling activity from its retail operations by separately accounting for the retail operations in Minnesota.¹⁰¹ The Minnesota Supreme Court found a unitary business on the basis of the reciprocal relationship of the centralized activity with retail operations. The court stressed the contribution which the retail operations made to the total profit.¹⁰² The court stated: "[t]he test . . . is whether its various parts are interdependent and of mutual benefit so as to form one unit rather than separate business entities, and not whether the operating experience of the parts is the

98. *Id.* at 412-13, 386 P.2d at 38, 34 Cal. Rptr. at 549-50.

99. *See* pt. II *supra*.

100. 245 Minn. 346, 71 N.W.2d 797 (1955).

101. *Id.*

102. *Id.* at 353, 71 N.W.2d at 805; *see also* *Fleming v. Oklahoma Tax Comm'n*, 157 F.2d 888 (10th Cir. 1946).

same in all places.”¹⁰³

This language of mutual benefit in the above definition signifies that the operations in the taxing jurisdiction and the operations outside that jurisdiction must contribute to each other. In contrast, the “dependent upon or contribute to” definition discussed earlier¹⁰⁴ has no such mutuality requirement. The “mutual benefit” definition is therefore more restrictive. Those businesses that contribute to outside operations, but do not receive any benefit from such outside operations, may not be classified as a unitary business under this definition. For example, if in the taxing state a business is engaged in engineering services and consulting, and in a neighboring state the same taxpayer engages in mining operations, the mining operations receive substantial assistance from the engineers employed in the neighboring state. However, in furnishing such technical advice, the engineering consulting business does not receive a fee. Under the “mutual benefit” definition, the mining operations would not be classified as a unitary business with the engineering consultancy because the former did not benefit the latter. However, the mutual benefit test ignores the fact that the engineering business substantially contributed to the earnings of the mining operations. Therefore, the mining operations should be combined with the engineering consultancy as a single unitary business.

f. “Essential to Operation” Test

An even more restrictive test of a unitary business was adopted by the Minnesota court in *Skelly Oil Co. v. Commissioner of Taxation*.¹⁰⁵ In that case, the taxpayer was an integrated oil company. It produced, manufactured, and marketed crude oil products and accessories. It also maintained its own pipelines.¹⁰⁶ However, Skelly sold the bulk of the oil it produced to other oil companies; less than ten percent of the crude oil Skelly produced was manufactured by it into gasoline, lubrication oil, and other products. In Minnesota, Skelly marketed products manufactured from its crude oil resources outside the state. Minnesota applied a three-factor formula to Skelly’s entire net income. The court sustained Skelly’s contention that its Minnesota marketing operations were separate and

103. 245 Minn. at 353, 71 N.W.2d at 805.

104. See pt. III(B)(1)(b) *supra*.

105. 269 Minn. 351, 131 N.W.2d 632 (1964).

106. *Id.* at 352, 131 N.W.2d at 634.

distinct from the manufacturing operations.

In finding a separate business, the court relied on two critical facts. The first was that Skelly's refining and marketing operations did not serve to increase the amount of the company's production income outside the state; the second was that "the business of producing was not dependent upon the business of marketing. Each business could be operated entirely independent of each other."¹⁰⁷ The court noted that some companies are engaged only in the producing business, others only in marketing and refining. Because there was no "connection or interdependence" between the two businesses of production and marketing, no income could be allocated to Minnesota.¹⁰⁸

The *Skelly* case represents one extreme of defining the contours of a unitary business.¹⁰⁹ The production of crude oil out-of-state and the marketing of these same products in Minnesota were interdependent operations. Concerted activities were carried out to bring a product from production to sale, resulting in a profit. Despite the fact that some market prices are available for crude oil, the segregation of manufacturing and selling profit still involved a great degree of estimation. The interdependence at this basic operations level suggests that the activity in the taxing state is a portion of the "series of transactions" contributing to the profits of the company. The *Skelly* case disregards the underlying rationale for the development of formula apportionment. Separate accounting is inadequate to compute the profits of a business where interdependent operations are carried on in more than one state.¹¹⁰

Operational interdependence occurs when property or the services of individuals contribute directly to the earning of income which is the inseparable end-product of these elements. In the textiles example offered above,¹¹¹ operational interdependence is present. All of the property and services involved in the manufacturing and selling operations contribute to the earning of consolidated income. Therefore, the definition used by the court in *Skelly* is too restrictive.¹¹² By holding that the operations have to be essential to

107. *Id.* at 367, 131 N.W.2d at 643.

108. *Id.* at 367-68, 131 N.W.2d at 643.

109. See Hellerstein, *supra* note 3.

110. See pt. IV *infra*.

111. See example used in pt. I *supra*.

112. See Hellerstein, *supra* note 3, at 490-91.

one another, it allows some truly unitary businesses to escape taxation. The fact remains that while there may be operational independence among the separate business units, there is interdependence among these companies in an economic sense; namely, a single flow of goods and services in a single "series of transaction" culminating in the earning of income of the entire group. As was recognized in the *Underwood Typewriter* and *Bass, Ratliff*¹¹³ cases, it is the inseparable nature of this continuous earning process that renders a business unitary.

2. Economic Effect Tests

Economic unity is shown where two or more series of activities, although independent from an operational standpoint, create a positive effect on the earnings of the business.¹¹⁴ Operational unity occurs when property or the services of individuals directly contribute to the earnings of income by the corporation.¹¹⁵ Under these tests, a unitary business should be found where the combined positive effects of the separate operations on the company's earnings are significant. The merit of the economic and operational unity test is its emphasis on the economic effect of the operations of the multistate business within and without the taxing jurisdiction. Typically, economic advantages accrue at a management or supporting services level. An example of this is *Butler Brothers v. McColgan*.¹¹⁶ As discussed earlier,¹¹⁷ the taxpayer in this case operated seven wholesale stores in seven states. Each store had its separate operations. However, because of the large volume of wholesale goods needed to supply seven stores, the company was able to buy at large quantities and obtain favorable prices. The purchasing profit was a substantial element of success in the company.¹¹⁸ Because each of the separate stores contributed to the income advan-

113. See notes 46-58 *supra* and accompanying text.

114. Oregon follows this definition of operational and economic unity. See *Hamilton Management Corp. v. State Tax Comm'n*, 253 Or. 602, 457 P.2d 486 (1969). The unitary business concept is the subject of considerable litigation in Oregon. See *John I. Hass, Inc.*, 277 Or. 170, 361 P.2d 820 (1961); *Zale-Salem, Inc. v. State Tax Comm'n*, 237 Or. 261, 391 P.2d 601 (1964); *Humble Oil & Refining Co. v. Department of Revenue*, 4 Or. T.R. 284 (1971).

115. See *Hamilton Management Corp. v. State Tax Comm'n*, 253 Or. 602, 457 P.2d 486 (1969).

116. 17 Cal. 2d 664, 111 P.2d 334 (1941), *aff'd*, 315 U.S. 501 (1942).

117. See notes 64-68 *supra* and accompanying text.

118. 17 Cal. 2d at 669, 111 P.2d at 337.

tage obtained, the separate operations welded into a single business.

Another example of economic unity is a small loan business.¹¹⁹ Small loan companies have offices in a large number of states. Because of the volume of loan demand generated by operating a large number of offices, the company is in a better position to obtain bank financing at lower rates. This lower interest rate is an important element in the company's financial success.

Although savings can be achieved by the central performance of a wide variety of supporting functions, not all such savings should be considered significant enough to find a unitary business. Some standard of materiality should be used.¹²⁰ Only when the savings are substantially related to the income involved should the operations be classified as a unitary business. For example, performance of central accounting, purchase of supplies and handling insurance may produce an insignificant amount of savings to the individual separate operations. Therefore, the operations which share such supporting services should not be regarded as a unitary business on the basis of these services alone.

The Oregon Supreme Court applied the economic and operational unity test in *Hamilton Management Corp. v. State Tax Commission*.¹²¹ There, the taxpayer was a Delaware corporation with its principal office in Colorado. In Oregon, it engaged in business as an investment advisor and sales agent for a mutual fund owned by Hamilton. In addition, all investment advisory services were rendered in Colorado and the personnel and business activities of the taxpayer's sales division were entirely separate. Both divisions, however, made use of the same legal, accounting, and supply departments.¹²²

The issue presented to the court was whether the income received by Hamilton Management from Hamilton Mutual Funds for advisory services should be considered as part of the unitary business. In applying the operational and economic unity test, the court noted that:

119. See *Household Fin. Corp. v. Franchise Tax Bd.*, 230 Cal. App. 2d 926, 41 Cal. Rptr. 565 (1965).

120. See E. Hendriksen, ACCOUNTING THEORY 106-08, 562-64 (1970).

121. 253 Or. 602, 457 P.2d 486 (1969).

122. *Id.* at 605, 457 P.2d at 488.

Income, no matter where received, ordinarily is the product of economic influences operating from many sources, some far back in the chain of economic cause and effect. To establish nexus it is necessary to show that the taxpayer has, in the conduct of his business, taken advantage of the economy of the taxing state to produce the income which is subjected to tax.¹²³

In this connection, the Oregon court noted that Hamilton Management did not take advantage of the economy of the State of Oregon or receive any other benefits provided by the state in rendering investment advice in Colorado.¹²⁴ The business of selling mutual funds in Oregon did not depend upon or contribute to the investment advisory business in Colorado. There was neither operational nor economic unity because the two activities were unrelated.¹²⁵

3. Exxon Corp. v. Wisconsin Department of Revenue

In *Exxon Corp. v. Wisconsin Department of Revenue*,¹²⁶ the taxpayer is a Delaware corporation with general offices in Texas. For the tax years of 1965 through 1968, Exxon's corporate organization consisted of three parts: corporate management, coordination and services management, and operations management. Corporation management was the highest level of management in the company. The operations management was responsible for directing the operating activities of the individual functional segments of the company. Each functional segment was organized into a separate department which operated independently of the other operating segments. The individual functional segments under operations management consisted of exploration and production; refining; marketing; marine; coal and shale oil; minerals and land management. The three major departments were exploration and production, refining, and marketing.¹²⁷

Exxon's management philosophy was to have each department independently responsible for its performance. Each functional department was to compete with other departments for investment funds and with other members of the industry. There was no requirement that crude oil produced by the production department flow through the marketing department outlets in the form of

123. *Id.* at 609-10, 457 P.2d at 489.

124. *Id.* at 610, 457 P.2d at 490.

125. *Id.*

126. 90 Wis.2d 700, 281 N.W.2d 94, *prob. juris. noted*, 100 S.Ct. 446 (1979).

127. *Id.* at 706, 281 N.W.2d at 98.

Humble refined products. Transfer of products and raw materials between departments were based on competitive wholesale prices.¹²⁸

Exxon has a uniform credit card system used nationwide which serves as a marketing tool. It is administered centrally in Houston, Texas, Promotion of Exxon products is also performed there.¹²⁹

Exxon's activities in Wisconsin consisted of the marketing of gasoline and fuel oil, and to a much lesser extent motor oils, greases, and other automobile accessories. The gasoline and fuel oil sold in Wisconsin by Exxon did not originate in Exxon's oil wells; rather, they came into the state as a result of an exchange agreement between Exxon and an unrelated company. The purpose of the exchange agreement was to save transportation costs. Because the unrelated company's refining facilities in the Midwest were in excess of marketing demands, Exxon obtained its supply of gasoline in Wisconsin with reduced transportation costs. The motor oils and greases sold in Wisconsin were manufactured by Exxon outside of the state. Although the opinion of the Wisconsin Supreme Court did not indicate the amount of such sales, these products apparently made up an insignificant percentage of the total sales in Wisconsin. The other automobile accessories were purchased by Exxon's Houston purchasing office from outside suppliers.¹³⁰

For the tax years in question, Exxon filed its tax returns on a separate accounting basis. The Wisconsin Department of Revenue sought to tax Exxon on a unitary business basis, combining Exxon's entire three functional departments, exploration and production, marketing, and refining, as one unitary business. The Wisconsin Tax Appeals Commission modified the Revenue Department's action by finding that Exxon's three functional departments, exploration and production, marketing, and refining, were each a unitary business. The Commission also found that, although Exxon's Wisconsin marketing operations were an integral part of its entire marketing business, they were not an integral part of Exxon's exploration and production function or refining function. The basis of this finding was that there was "no economic dependence between Exxon's Wisconsin marketing operations and the exploration and

128. *Id.* at 715-16, 281 N.W.2d at 102.

129. *Id.* at 716-17, 281 N.W.2d at 103.

130. *Id.* at 717-18, 281 N.W.2d at 103-04.

production and refining functions."¹³¹ On review, the Circuit Court for Dane County reversed the Commission on this issue. It found that Exxon's total business, including the three functional departments, within and without Wisconsin constituted a unitary business.¹³² Exxon appealed to the Wisconsin Supreme Court. The Wisconsin Supreme Court rejected the use of the "economic dependence" test employed by the Commission. The court announced that the "full test" for a unitary business requires "a determination of whether the operation of the portion of the business is 'dependent upon or contributory to the operation of the business outside the state.'"¹³³ However, the court did not distinguish the difference in application of the two tests. In applying the test, the court gave significant weight to the testimony offered by a company official, who stated that:

The profitability of the petroleum industry is very sensitive and directly related to the full utilization of the capacity of the facilities. . . . Where you have high capital investments in refineries, the existence of an assured supply of raw materials and crude is important and the assured and stable outlet for products is important, and therefore when there are — when these segments are under a single corporate entity, it provides for some assurance that the risk of disruptions in refining operations are minimized due to supply and demand imbalances that may occur from time to time.¹³⁴

Based on such testimony and the organization of Exxon, the court found that Exxon's production and refining functions depended upon the marketing operation to provide an outlet for its products. The court therefore, concluded that Exxon's production and exploration, refining, and marketing constituted a unitary business.¹³⁵ This result was reached despite a lack of operational interdependence; that is, a lack of the flow of goods and services at the operating unit level. Exxon appealed to the United States Supreme Court on this issue, contending that Wisconsin's classification of it as a unitary business violated the due process and commerce clauses.

The Wisconsin Supreme Court held that Exxon's entire production, exploration, and marketing functions were a unitary business,

131. *Id.* at 706-07, 281 N.W.2d at 98.

132. *Id.* at 707, 281 N.W.2d at 98.

133. *Id.* at 715-16, 281 N.W.2d at 102.

134. *Id.* at 716, 281 N.W.2d at 103.

135. *Id.* at 721-22, 281 N.W.2d at 105-06.

despite the fact that there was no interdependence at the operating level.¹³⁶ Wisconsin's contribution to the out-of-state production, exploration, and refining operations was premised upon the marketing function's effect on the supply and demand forces of the market. To the extent that Wisconsin activity increased the nationwide demand of petroleum, Exxon's production and refining facilities located out-of-state does increase production. The increase of production would increase the earnings of the production, exploration, and refining department. Based on this reasoning, the earnings effect test¹³⁷ would seem to be satisfied.

A question arises as to whether the nexus relied on by the Wisconsin Supreme Court is too tenuous; that is, whether the link between cause and effect in the market place can be relied on as satisfying the test suggested above. Under the economic effects test, a business is unitary if its in-state operations contribute to the out-of-state and overall company earnings.¹³⁸ This contribution to earnings is found in the way the operations are related to each other. In the case of Exxon, although the marketing department extensively sells the products of outside suppliers, sales of Exxon-produced oil are deemed to be enhanced because of the exchange contracts made possible by the marketing facilities located throughout the United States. The size of Exxon is significant; it is the largest producer and marketer of gasoline. The effect of the marketing operations on the production operations is not determinable. The supply and demand of petroleum and oil in the market is the result of many different forces. Without the extensive marketing network of Exxon, its production and refinery sales would not be as efficient and even somewhat impaired. However, any effect felt by its production and refinery department is that produced by the market forces, a resultant of various factors. Similarly, based on the Wisconsin court's opinion, any contribution by the marketing function to the production department is effected through an autonomous marketplace. This is not the type of earnings that can, or should, satisfy the economic effects test. Therefore, only that portion of the taxpayer's business which received a more direct benefit from the Wisconsin operation should be combined with such Wisconsin operations and thereby be classified as a unitary business. In this

136. *Id.* at 721-22, 281 N.W.2d at 105-06.

137. *See also* Humble Oil Refining Co. v. Dep't of Rev., 4 Or. T.R. 284, 292-93 (1971).

138. *See* pt. III *supra*.

case, Exxon's marketing department should be classified as a unitary business by itself.

IV. Division of Income Methods

Application of the test of whether a taxpayer's operations within the taxing state are a unitary business is the preliminary step in determining the tax base. Once the operations within the state are classified as unitary or separate, three methods are available to allocate that portion of the taxpayer's income to sources within the state.

A. Specific Allocation

Specific allocation¹³⁹ singles out certain items of income which by their nature are assignable to precise geographic locations. Examples of such types of income are rents from real property and dividends.¹⁴⁰ Under this method, the income of a unitary business will not include such items of income as are attributed entirely to a single jurisdiction.¹⁴¹ However, in those states where the unitary concept is strictly adhered to the receipt of income closely related to the regular business activity conducted in the taxing state will be taxed by that state regardless of its allocability to a specific jurisdiction.¹⁴² There has been disagreement with this practice based on the theory that gains or losses from the sale or other dispositions of such property is attributable to fluctuations in market values.¹⁴³

The specific allocation of income to a particular state must be examined in the context of the state's taxing power. Under the due

139. For comprehensive treatment of this subject, see ALTMAN & KEESLING, *supra* note 3, at 67-87; 1964 HOUSE REPORT, *supra* note 1, at 197-217; 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).

140. For example, Iowa requires specific allocation of interest dividends, rents, and royalties. *Iowa Code* tit. XVI, ch. 422, § 422.33-1a, Reg. 22.33(1)4 to -7 (1971 & Cum. Supp. 1979). In California, the pertinent statute is CAL. REVENUE & TAX. CODE §§ 25123-27 (West 1970). Specific allocation is utilized in the UDITPA. See MTC, *supra* note 9, at 6318-22.

141. ALTMAN & KEESLING, *supra* note 3, at 67; Hartman, *State Taxation of Corporate Income from A Multistate Business*, 13 VAND. L. REV. 21, 57 (1959)[hereinafter cited as Hartman].

142. 1964 HOUSE REPORT, *supra* note 1, at 198-200. This section describes the various standards for determining relationships with other income used at the time to decide whether receipts were specifically allocated. Some jurisdictions have adopted the UDITPA, see note 9 *supra*, and may therefore be applying different tests.

143. See Keesling & Warren, *Unitary Concept in the Allocation of Income*, 12 HASTINGS L.J. 42 (1960).

process and commerce clauses, a state has power to tax residents upon their entire net income, wherever earned.¹⁴⁴ Similarly, a state is the creator of a domestic corporation and for that privilege is able to tax its net income wherever earned.¹⁴⁵ Obviously, this opens the business to the risk of double taxation if the income from property is also taxed by the state where such property is located.¹⁴⁶ In addition, a foreign corporation can acquire a "commercial domicile" other than in the state of its incorporation.¹⁴⁷ Multiple taxation can occur if both the "commercial domicile" state and the incorporation state can constitutionally reach the same income. Moreover, the owner of intangibles may neither be domiciled in nor be a resident of the taxing state. It is therefore possible that its income may be treated as having its source in such state.¹⁴⁸

This possibility of multiple taxation has caused much concern. Different concepts of what is a unitary business and what is unitary business income cause severe problems of double taxation through specific allocation. One state may regard a business as unitary and therefore subject all its income to apportionment. The "commercial domicile" state may consider the same business as non-unitary and therefore allocate its dividend income from wholly owned subsidiary corporations to the domicile state.¹⁴⁹ Therefore, the same income from the subsidiary is taxed twice; first, through formula apportionment as unitary income; second, through specific allocation as dividend.

144. *New York ex rel. Cohn v. Graves*, 300 U.S. 308 (1937)(rent from out-of-state land); *Lawrence v. State Tax Comm'n of Mississippi*, 286 U.S. 276 (1932)(compensation for personal services rendered outside taxing state); *Maguire v. Trefry*, 253 U.S. 12 (1920) (net income from bonds held in trust and administered in another state).

145. *See Matson Navigation Co. v. State Board*, 297 U.S. 441 (1936) (tax measured by net income); *cf. Cornell Steamboat Co. v. Sohmer*, 235 U.S. 549 (1915) (gross receipts from business transacted within the state). There has been considerable commerce clause interference when the state tries to tax the gross income of a domestic corporation engaged in interstate commerce. *Adams Mfg. Co. v. Storen*, 304 U.S. 307 (1938). However, the due process clause is said not to forbid a tax by the state where the income is earned, because the taxing state affords the protection and security which enables the taxpayer to earn its profit. *Shaffer v. Carter*, 252 U.S. 37 (1920).

146. *Guaranty Trust Co. of New York v. Virginia*, 305 U.S. 19 (1938).

147. *Wheeling Steel Co. v. Fox*, 298 U.S. 193 (1936) (property tax on intangibles).

148. *See, e.g., New York ex rel. Whitney v. Graves*, 299 U.S. 366 (1937) (income from sale of right to seat on stock exchange located in taxing state).

149. *ASARCO, Inc. v. Idaho State Tax Comm'n*, 99 Idaho 924, 592 P.2d 39, *appeal docketed*, 48 U.S.L.W. 3031 (U.S. June 8, 1979) (No. 78-1839); *Mobil Oil Corp. v. Vermont*, 136 Vt. 545, 394 A.2d 1147, *prob. juris. noted*, 99 S.Ct. 2157 (1979).

B. Separate Accounting

Under separate accounting, a multistate corporation will keep separate books of the income and expenses for its operations within each state.¹⁵⁰ Under this method, a business within the state is treated as separate and distinct from a business conducted outside the state.¹⁵¹ The basic assumption of separate accounting is that net income derived from each state can be accurately measured. The taxable income in each state is computed as if the taxpayer's activities were confined solely to the taxing state. The gross income from all business operations is first determined; the allowable deductions are then subtracted. The resulting net income is attributed to the taxing state.

If a business is truly separate from the business conducted outside the state,¹⁵² division of income by separate accounting can be accurately and easily accomplished. However, where in-state business activity comprises only a portion of a single unitary business, separate accounting is imbued with difficulties. The use of a separate accounting method for a unitary business would involve arbitrary determinations based on conjecture. Piecemeal determinations must be made to attribute total gross income to each of the various functions or activities in the different states. This requires the use of a hypothetical basis upon which values are assigned to the product as it passes each business stage.¹⁵³ Similar difficulties

150. Discussion of separate accounting is treated more fully in ALTMAN & KEESLING, *supra* note 3, at 89-102; 1964 HOUSE REP., *supra* note 1, at 160-67.

151. Some writers suggested a refinement in labelling separate accounting: (1) transactional separate accounting, where the business activities in the several states are in fact related, but by constructing hypothetical analogies, they are separated in the accounting measurement process; and (2) entity separate accounting, where the business activities in the state and out of the state are truly separate. Boren, *Separate Accounting in California and Uniformity in Apportioning Corporate Income*, 18 U.C.L.A. L. REV. 478, 486-90 (1971).

152. A clear example is a conglomerate with divisions in the aerospace, tobacco, and motion picture industry; each division conducts business entirely within one state. See MTC, *supra* note 9, ¶ 6125.

153. To allocate profits to the various stages from production to sale has been the subject of extensive study. Transfer pricing (the assigning of a price to the product in its movement from one division to another) and intra-company transactions pricing can be made on some consistent and rational basis. See generally C. HORNGREN, *COST ACCOUNTING* (1972). However, while a transfer price may serve a useful purpose for internal management reports, it may not work well for state tax purposes. In the latter, there is present the motive to manipulate prices to the taxpayer's advantage. The lack of state resources to audit such pricing techniques render it nonpreferable. The situation is analogous to the federal income taxation of companies under common control. I.R.C. § 482. There, the Internal Revenue Service encountered enormous difficulties. See H.R. REP. No. 1447, 87th Cong., 2d Sess. 28 (1962).

are met in the determination of expenses.¹⁵⁴ The fact that certain expenses are incurred in a state may not justify assigning them to that state. For a unitary business, the expenses are incurred to benefit the entire enterprise, not simply that portion within the state.¹⁵⁵ For example, it is generally recognized that the overhead expenses should be allocated by a formula,¹⁵⁶ even if separate accounting is used for all the other transactions. These defects are present due to the lack of any rational basis by which to make an apportionment and the fact that the divisions of a business do not deal at arms-length.

These difficulties and the lack of effective audit procedures has led to the rejection of separate accounting for a unitary business and to the adoption of formula apportionment.¹⁵⁷ The general approach of the majority of states is that separate accounting should be restricted to truly separate businesses, while apportionment should be used for a unitary business.¹⁵⁸

C. Formula Apportionment

Formula apportionment¹⁵⁹ is considered a preferable alternative

154. ALTMAN & KEESLING, *supra* note 3, at 93.

155. "With regard to a unitary business, the place where expenses affecting the entire business are incurred has little or no bearing on the question of how such expenses should be allocated [S]elling expenses in one state may logically affect the amount of income realized from sales in other states" *John Deere Plow Co. v. Franchise Tax Board*, 38 Cal. 2d 214, 226, 238 P.2d 569, 576 (1951), *appeal dismissed*, 343 U.S. 939 (1952).

156. Assume in our textiles business example, *see* pt. I *supra*, that the business has a gross income of \$2,000,000. Total operating expenses amount to \$1,500,000. It thus has a total operating income of \$500,000. Under separate accounting, this \$500,000 would have to be divided among (1) the cotton processing function in South Carolina, (2) garment manufacturing in New York, and (3) sales functions in Chicago. One way would be to decide on a (A) "reasonable manufacturing profit" basis: *e.g.*, 10% of gross income, or \$200,000, or (B) use market prices, if available: *i.e.*, the prices at which the garment division would need to pay to outside suppliers for the cloth it gets from the cotton processing division. *See* ALTMAN & KEESLING, *supra* note 3, at 90-91.

157. *See* pt. 4(c) *infra*.

158. A few states show preference for separate accounting in their statutes: Alabama, Alaska, Mississippi, New Mexico and South Carolina. In other states there are generalized provisions authorizing separate accounting where the prescribed method of apportionment or allocation produces an inequitable result. For representative cases where the use of separate accounting was upheld, *see* *Standard Oil Co. v. Thoresen*, 29 F.2d 708 (8th Cir. 1928); *Fisher v. Standard Oil Co.*, 12 F.2d 744 (8th Cir. 1926); *Skelly Oil Co. v. Comm'r of Tax.*, 269 Minn. 351, 131 N.W. 2d 632 (1964); *Magnolia Petrol. Co. v. Oklahoma Tax Comm'n*, 190 Okla. 172, 121 P.2d 1008 (1941); *Standard Oil Co. of Ind. v. Wisconsin Tax Comm'n*, 197 Wis. 630, 223 N.W. 85 (1929).

159. For a comprehensive discussion, *see* ALTMAN & KEESLING, *supra* note 3, at 107-68;

to the ineffective treatment of unitary businesses by the separate accounting method. This method recognizes that income and deductions are so closely related in a unitary business that they cannot be precisely sited in individual geographical locations.¹⁶⁰ Income producing activities are said to be a unit. The theory of formula apportionment is that the net income of a business is more dependent on some factors than others.¹⁶¹ At present, the factors generally accepted are sales, property, and payroll.¹⁶² Each factor can be seen as either a source of the taxpayer's income or a source of costs to the taxing jurisdiction.¹⁶³ The formula measures the weight of each factor¹⁶⁴ present in a particular state and compares it with all factors present in the entire business.¹⁶⁵ The resulting ratio is used to allocate the net profits of the business to the state.¹⁶⁶ Though apportionment by formula may be considered ap-

BEAMAN, *supra* note 3, at 3.6 to -16, 7.10 to -19; 1964 HOUSE REPORT, *supra* note 1, at 168-94; Hartman, *supra* note 141, at 64-74.

160. Hartman, *supra* note 141, at 64-65.

161. For an economic analysis of this theory, see Wilkie, *A Theoretical Basis For the Allocation of Multistate Income by Unitary Business Under State Corporate Net Income Taxes*, 13 THE TAX EXECUTIVE 157-74 (1961).

162. This is the formula under UDITPA, *supra* note 9, §§ 6168-6286. A list of states with apportionment formulae and a description of the factors used can be found in [1967] STATE & LOCAL TAXES, ALL STATES UNIT (P-H) ¶ 1046. The three factor formula was introduced by Massachusetts in 1919. For a history of the development of factor formulae, see BEAMAN, *supra*, note 3, chs. 7, 10, 19. Persuasive arguments have been made concerning elimination of the sales factor. See, e.g., Hariss, *Interstate Apportionment of Business Income*, 49 ECON. REV. 398, 400 (1959).

163. See also Studenski, *Toward a Theory of Business Taxation*, 48 J. POL. ECON. 621 (1940). For the proposition that income is from a source within the state, see Cohen, *State Tax Allocations and Formulae which Affect Management Operating Decisions*, 1 J. TAX. 2, 3 (1954).

164. Each factor is expressed as a fraction. The numerator is the dollar amount of the item found or occurring in the tax jurisdiction. The denominator is the dollar amount of the item found or occurring in all relevant jurisdictions.

165. Whether to include foreign income and, consequently foreign items, in the denominators of each factor is a major question debated by proponents of uniform legislation. New York State Bar Ass'n Tax Section Comm. on Interstate Taxation, *Proposals for Improvement of Interstate Taxation Bills*, (H.R. 1538 and S. 317), 25 TAX LAW. 433, 463 (1972).

166. The procedure is to multiply the tax base subject to apportionment (generally the net income of the taxpayer determined by state procedures, with adjustment for any income subject to specific allocation or separate accounting) by this resulting fraction (ratio); the result is income taxed in that jurisdiction. The ultimate fraction combines the factors in note 164 *supra*, and divides these by the total number of factors:

$$\text{Tax Base} \times \frac{\text{Property in Taxing Jurisdiction}}{\text{Property everywhere}} + \frac{\text{Payroll in Taxing Jurisdiction}}{\text{Payroll everywhere}} + \frac{\text{Sales in Taxing Jurisdiction}}{\text{Sales everywhere}}$$

propriate to a particular business, some writers believe that not all of a unitary business' income may be connected to the business in the taxing state.¹⁶⁷ These writers maintain that income items with a specific situs in a foreign state be excluded from total income in the taxing state. Others would require that all income of a unitary business be subject to apportionment in all states.¹⁶⁸

In some jurisdictions, formula apportionment can be applied independently of the unitary theory, as an option for taxpayers who do not wish to use separate accounting.¹⁶⁹ In most jurisdictions, however, apportionment may only be applied to unitary businesses. Obviously, the result of formula apportionment is an estimation. The profits of a business can hardly be limited to the three enumerated factors.¹⁷⁰ The virtue of this formula, however, is its ease of application¹⁷¹ and the simplicity of audit procedures.¹⁷² To the extent that the formulae are uniform from state to state, the apportionment method is an attractive alternative. While most states adopt the three-factor formula, differences exist in their definition of each factor.¹⁷³ This exposes businesses to the risk of overtaxation and the states to the risk of undertaxation.¹⁷⁴

Specific allocation and separate accounting are closely related in theory.¹⁷⁵ Both presume certain income items can be completely

The factors need not be weighted equally, however. *E.g.*, Florida weighs its sales factor 50% and its property and payroll factors 25% each. FLA. STAT. ANN. § 220.15(4) (West Supp. 1979).

167. This is mandated by the UDITPA, *supra* note 10, ¶ 91,409-A. See also Silverstein, *Problems of Apportionment in Taxation of Multistate Business*, 4 TAX. L. REV. 207, 210-11 (1949). See discussion on specific allocation in pt. IV(A) *supra*.

168. See *Mobil Oil Corp. v. Commissioner of Taxes*, 48 U.S.L.W. 4306 (Mar. 19, 1980); Dexter, *Taxation of Income from Intangibles of Multistate-Multinational Corporations*, 29 VAND. L. REV. 401 (1976); 1964 HOUSE REPORT, *supra* note 1, at 161-63.

169. See, *e.g.*, Boren, *Separate Accounting in California and Uniformity in Apportioning Corporate Income*, 18 U.C.L.A. L. REV. 478, 487-89 (1971).

170. See notes 162 & 166 *supra*.

171. The data upon which the formula apportionment is made can easily be derived from a company's internal financial statements, which in most cases are routinely prepared. See Hartman, *supra* note 141, at 66.

172. Audit procedures would be limited to accuracy of the totals derived from internal accounting information. This eliminates the need to verify estimation techniques used in separate accounting.

173. [1967] STATE & LOCAL TAXES, ALL STATES UNIT (P-H), ¶ 1046; 1964 HOUSE REPORT, *supra* note 1, at 170.

174. Studenski, *The Need for Federal Curbs on State Taxes on Interstate Commerce: An Economist's Viewpoint*, 46 VA. L. REV. 1121, 1123-24 (1960).

175. Beaman considers specific allocation to be a form of separate accounting. BEAMAN, *supra* note 3, at 6 n.18.

isolated from the remaining portions of a business. The two concepts, however, are different in practical effect. Specific allocation emphasizes both the nature of the income items and their connection with a geographical situs. Separate accounting is premised on the severance of a business along state boundaries. The justification for the severance is that the operations inside and outside the state are indeed separate and not unitary. Formula apportionment focuses on the unitary nature of the business. The income produced within the unitary parameters of the business is apportioned by formula. It is the distinction between a "unitary" business and a "separate" business which determines when each of the income division methods should be used.

For an individual taxpayer, it is quite possible that only one method or a combination of the three is used. The same taxpayer may engage in several lines of business, some partially unitary, some wholly separate from the taxing state. Therefore, formula apportionment will be applied to the unitary portion and separate accounting to the rest. Also, some income may be classified as inherently derived from the situs, and is not unitary.¹⁷⁶ This income is carved out of the entire profits before any part of it is divided by formula apportionment.

V. Conclusion

The objective of income apportionment rules is to devise a method by which to calculate fairly the amount of income attributable to sources within the taxing state. The unitary business concept advances this objective by indentifying those businesses where the operations in the taxing state are inseparable from those outside the state. Because of the significant contribution of in-state operations to overall company earnings, and the inadequacy of separate accounting to compute the contribution by the in-state operations, formula apportionment is an appropriate alternative in calculating income within the taxing state.

176. There are three possible avenues a state may take:

- (i) provide for specific allocation of some items absolutely, with no inquiry as to whether such income is derived from unitary business or from "business income;"
- (ii) allow for specific allocation only for "non-business" income. See, e.g., CAL. REV. & TAX CODE § 25120(a)(d) (West 1970);
- (iii) specifically allocate only income *not* derived from a "unitary business." This practice is followed by at least four states: Arizona, California, Hawaii and Oregon. See 1964 HOUSE REPORT, *supra* note 1, at 199.

The ultimate criterion should be whether the in-state operations materially contribute to the company's entire earnings which are derived partly outside the taxing jurisdiction. Whether this criterion is met can be inferred from the mode of operations. Where there is great interdependence in a company's basic operations, such as selling the products which the company itself manufactured, there is usually strong evidence of material contribution to earnings by in-state operations. By contrast, if there is only interdependence at a management or support services level, such as accounting, legal advice, and central insurance coverage in a manufacturing concern, the impact on earnings generated by such interdependence may be of a limited nature and should not automatically render the business unitary in nature. In such cases, the effect on earnings due to such interdependence at the management and support services level must be closely examined.

Use of the above criterion will allow a state to tax a proportionate share of the amount which in-state operations contribute to out-of-state earnings. This result is economically sound and is consistent with the objective of income apportionment. In fact, such an approach is mandated by the Constitution.

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