

1983

## Dividends - Foreign Commerce Clause - Parent and Subsidiary Corporations - State Taxes

Michael W. Gleba

Follow this and additional works at: <https://dsc.duq.edu/dlr>



Part of the [Law Commons](#)

---

### Recommended Citation

Michael W. Gleba, *Dividends - Foreign Commerce Clause - Parent and Subsidiary Corporations - State Taxes*, 31 Duq. L. Rev. 859 (1983).

Available at: <https://dsc.duq.edu/dlr/vol31/iss4/10>

This Recent Decision is brought to you for free and open access by Duquesne Scholarship Collection. It has been accepted for inclusion in Duquesne Law Review by an authorized editor of Duquesne Scholarship Collection.

# Recent Decisions

**DIVIDENDS—FOREIGN COMMERCE CLAUSE—PARENT AND SUBSIDIARY CORPORATIONS—STATE TAXES—**The United States Supreme Court has held that a state taxing scheme, which treated corporate dividends received from foreign subsidiaries less favorably than those received from domestic subsidiaries, facially discriminated against foreign commerce in violation of the Foreign Commerce Clause.

*Kraft General Foods, Inc. v Iowa Department of Revenue and Finance*, US , 112 S Ct 2365 (1992).

Kraft General Foods, Inc. (“Kraft”) operated a unitary business throughout the United States and in several foreign countries.<sup>1</sup> Because part of its business was conducted in Iowa, Kraft was subject to the Iowa Business Tax on Corporations.<sup>2</sup>

The Iowa Business Tax on Corporations adopts the federal tax definition of net income with certain adjustments.<sup>3</sup> The Internal Revenue Code allows corporations to deduct from their net income dividends<sup>4</sup> received from domestic subsidiaries.<sup>5</sup> Since the earnings of domestic subsidiaries are themselves taxed by the federal government, this deduction avoids a second federal tax on those earn-

---

1. *Kraft General Foods, Inc. v Iowa Department of Revenue and Finance*, US , 112 S Ct 2365, 2367 (1992).

2. *Kraft*, 112 S Ct at 2367. The Iowa Business Tax on Corporations is found at Iowa Code §§ 422.32 et seq (1981). *Kraft*, 112 S Ct at 2367.

3. *Id.* Iowa Code § 422.35 defines “net income” as “the taxable income before the net operating loss deduction, as properly computed for federal income tax purposes under the Internal Revenue Code of 1954 . . . .” Iowa Code § 422.35 (1981).

4. Dividends are the “distribution of current or accumulated earnings to the shareholders of a corporation . . . .” *Black’s Law Dictionary* 478 (West, 6th ed 1991).

5. *Kraft*, 112 S Ct at 2367. Subsidiaries are corporations “in which another corporation (*i.e.* parent corporation) owns at least a majority of the shares, and thus has control.” *Black’s Law Dictionary* 1428 (West, 6th ed 1991).

ings.<sup>6</sup> Since the federal government does not tax the earnings of foreign subsidiaries, the parent corporation is not given a deduction for the dividends paid to it by foreign subsidiaries.<sup>7</sup> However, the parent corporation can receive a tax credit for the foreign taxes paid on the dividends from its foreign subsidiary and on the foreign subsidiary's earnings.<sup>8</sup> The intended effect of this tax credit is to avoid the double taxation of corporate earnings, just like the deduction for domestic subsidiary dividends.<sup>9</sup>

Like the federal government, Iowa also allows a deduction from net income for domestic subsidiary dividends.<sup>10</sup> Also, Iowa does not allow a deduction for the dividends received from a foreign subsidiary.<sup>11</sup> But, unlike the federal government, Iowa does not allow a tax credit for the taxes paid to foreign countries.<sup>12</sup>

Iowa only directly taxes the earnings of a subsidiary if the subsidiary conducts business in Iowa.<sup>13</sup> Therefore, if an Iowa parent corporation has two subsidiaries that do business in Iowa, one domestic and one foreign, both subsidiaries' income is taxed by Iowa; but, any dividends paid by the domestic subsidiary to the parent are not taxed by Iowa while any dividends paid by the foreign subsidiary to the parent are taxed by Iowa.<sup>14</sup> Likewise, if an Iowa parent corporation had a domestic subsidiary and a foreign subsidiary, neither of which conducted business in Iowa, Iowa would not tax either subsidiaries' income; but, if both subsidiaries paid the parent a dividend, Iowa would tax the foreign subsidiary dividend and would not tax the domestic subsidiary dividend.<sup>15</sup>

---

6. *Kraft, Inc. v Iowa Department of Revenue and Finance*, 465 NW2d 664, 665 (Iowa 1991).

7. *Kraft*, 112 S Ct at 2367.

8. *Id.* A taxpayer can also choose to deduct the foreign tax withheld on foreign dividends, but it cannot take both the credit and the deduction. *Id.* The credit is almost always more valuable to the taxpayer. *Id.*

9. *Id.*

10. *Id.*

11. *Id.*

12. *Id.* at 2368. If a taxpayer deducts from its federal taxable income foreign tax withheld on foreign subsidiary dividends it may also deduct these tax payments from its Iowa taxable income. *Id.* at 2368 n 11. Taking this deduction would reduce, but not eliminate, the Iowa tax on the foreign dividends. *Id.* at 2368. In 1981, Kraft chose to take the tax credit and therefore could not deduct foreign taxes paid from either its federal or Iowa taxable income. *Id.*

13. *Id.* at 2367.

14. *Id.* at 2368.

15. *Id.* At oral argument, counsel for Kraft offered the following illustration: "If an Iowa parent company had a Kentucky subsidiary, [that] did all of its business in Kentucky, and another subsidiary that did all its business in Germany, Iowa would not tax the income

In 1981, Kraft received considerable dividends from its foreign subsidiaries.<sup>16</sup> These dividends had already been taxed by the foreign countries where the subsidiaries were located.<sup>17</sup> Also, the underlying earnings of the foreign subsidiaries, out of which the dividends to Kraft had been paid, were taxed by the foreign countries.<sup>18</sup>

In computing its 1981 federal taxable income, Kraft included the foreign dividends and claimed a foreign tax credit against its federal income tax.<sup>19</sup> However, in computing its taxable income on its 1981 Iowa tax return, Kraft deducted the foreign subsidiary dividends from its Iowa net income.<sup>20</sup> The Iowa Department of Revenue and Finance ("Iowa") assessed a deficiency.<sup>21</sup> After its administrative protest was denied, Kraft challenged the assessment in Iowa courts claiming that the unequal treatment of domestic and foreign subsidiary dividends violated the Foreign Commerce Clause of the Federal Constitution.<sup>22</sup> The Iowa Supreme Court rejected the Foreign Commerce Clause claim because Kraft failed to show "that Iowa businesses receive a commercial advantage over foreign commerce due to Iowa's taxing scheme."<sup>23</sup> The United States Supreme Court granted certiorari.<sup>24</sup> The United States, as

---

of either of those subsidiaries. If each paid a dividend to the Iowa parent, Iowa would tax the German dividends and would not tax the Kentucky dividends." *Id.* at 2368 n 10.

16. *Kraft*, 465 NW2d at 664. Kraft owned capital stock representing more than 80% of the voting power and of the total value of the subsidiaries. *Kraft*, 112 S Ct at 2367 n 2.

17. *Kraft*, 465 NW2d at 664.

18. *Id.*

19. *Id.* at 666.

20. *Id.* Kraft conceded that this deduction was a violation of the Iowa tax statute. *Id.*

21. *Kraft*, 112 S Ct at 2367.

22. *Id.* The Foreign Commerce Clause is found in Article I, Section 8 of the Constitution, which states in pertinent part: "The Congress shall have Power . . . to regulate Commerce with foreign Nations . . ." US Const, Art I, § 8. Kraft also challenged the Iowa statute under the Equal Protection Clause of the Federal Constitution. *Kraft*, 112 S Ct at 2367. The Equal Protection Clause is found in the Fourteenth Amendment, which reads in pertinent part: "No state shall . . . deny to any person within its jurisdiction the equal protection of the laws." US Const, Amend XIV, § 1. However, the United States Supreme Court's decision turns only on the Commerce Clause. *Kraft*, 112 S Ct at 2372.

23. *Id.* at 2367. In considering Kraft's challenge under the Equal Protection Clause, the Iowa Supreme Court found that Iowa's use of the federal formula for the calculation of income was convenient both for the taxpayer and the state and therefore was rationally related to the goal of administrative efficiency and did not deny equal protection. *Id.*

24. *Id.* at 2368. *Kraft General Foods, Inc. v Iowa Department of Revenue and Finance*, 112 S Ct 931 (1992). Certiorari is defined as a "writ of common law origin issued by a superior to an inferior court requiring the latter to produce a certified record of a particular case tried therein. The writ is issued in order that the court issuing the writ may inspect the proceedings and determine whether there have been any irregularities. It is most commonly used to refer to the Supreme Court of the United States, which uses the writ of certiorari as

amicus curiae by special leave of the Court, filed a brief urging that the Iowa tax be sustained against the Foreign Commerce Clause challenge.<sup>25</sup>

The Supreme Court considered the principal issue in this case to be whether, on its face, the Iowa statute discriminated against foreign commerce.<sup>26</sup> By including dividends received from foreign subsidiaries in taxable income, and while not including dividends received from domestic subsidiaries in taxable income, the Court concluded that the Iowa statute did treat foreign dividends less favorably than domestic dividends.<sup>27</sup> While Iowa admitted to this disparate treatment, the state and its amici put forth five arguments to support the conclusion that the disparate treatment was not prohibited discrimination against foreign commerce.<sup>28</sup>

The first argument advanced by Iowa was that the disparate treatment was not discrimination based on the business activity's location or nature because a corporation's domicile does not necessarily establish that it was engaged in either foreign or domestic commerce.<sup>29</sup> Iowa pointed out that a foreign corporation might do business in the United States, and that its dividend payments then would reflect domestic business operations.<sup>30</sup>

While the Court admitted that it cannot be determined from a corporation's domicile whether a corporation is engaged in domestic or foreign commerce, it concluded that Kraft's foreign subsidiaries did in fact operate in foreign commerce.<sup>31</sup> The Court, therefore, held that the flow of value between Kraft and its foreign subsidiaries, including the payment of dividends, constituted foreign commerce.<sup>32</sup>

The Court then pointed out that the Iowa statute's applicability

---

a discretionary device to choose the cases it wishes to hear." *Black's Law Dictionary* 228 (West, 6th ed 1991).

25. *Kraft*, 112 S Ct at 2372. Amicus curiae literally means "friend of the court." It is used to describe a "person with a strong interest in or views on the subject matter of an action, but not a party to the action, [who] may petition the court for permission to file a brief, ostensibly on behalf of a party but actually to suggest a rationale consistent with its own views." *Black's Law Dictionary* 82 (West, 6th ed 1991).

26. *Kraft*, 112 S Ct at 2368.

27. *Id.*

28. *Id.* at 2368-71.

29. *Id.* at 2368.

30. *Id.*

31. *Id.* The parties stipulated to the fact that Kraft's foreign subsidiaries did in fact operate in foreign commerce and that the decision to do business abroad through foreign subsidiaries was based on legitimate business reasons. *Id.* at 2369 n 15.

32. *Id.* at 2369.

depends on the location of the subsidiary's business activities and not only on the subsidiary's domicile.<sup>33</sup> The Court observed that Iowa allowed deductions for both domestic and foreign subsidiary dividends that reflect business activity in the United States.<sup>34</sup> However, the Court then noted that domestic subsidiary dividends that reflect foreign business activity were deductible, but foreign subsidiary dividends that reflect foreign business activity were not deductible.<sup>35</sup> From this the Court concluded that the only dividends taxed by Iowa are foreign subsidiary dividends that reflect foreign earnings, and that this discriminatory treatment of foreign dividends could not be justified by the fact that some of the untaxed dividends of domestic subsidiaries also reflect foreign earnings.<sup>36</sup>

The second argument put forward by Iowa was that the statute did not violate the Commerce Clause because Kraft could have avoided the discrimination by changing a subsidiary's domicile from a foreign to a domestic location.<sup>37</sup>

The Court called this argument unpersuasive and said that it did not think that a state could force a taxpayer to conduct its foreign business through a domestic subsidiary.<sup>38</sup> The Court noted that it had previously held that differential tax treatment based on the nature of a taxpayer's business, and not from the location of its business activities, did not violate the Commerce Clause.<sup>39</sup> The Court went on to state that it found no precedent for the idea that a tax that discriminates against foreign commerce may be upheld,

---

33. *Id.*

34. *Id.*

35. *Id.*

36. *Id.*

37. *Id.* An Iowa parent corporation could also set up a domestic subsidiary in a state which does not tax foreign subsidiary dividends. Then this domestic subsidiary could hold the stock of the foreign subsidiaries and receive the foreign dividend payments. Therefore, when this domestic holding company transferred the earnings to the Iowa parent corporation, the parent would not be receiving dividends from foreign subsidiaries and therefore would not be paying Iowa tax on income attributable to foreign operations. *Id.*

38. *Id.* at 2369-70.

The Court cited *Metropolitan Life Ins. Co. v Ward*, 470 US 869, 878-79 (1985) in support of the conclusion that a state may not force a taxpayer to conduct foreign business through a domestic subsidiary. *Kraft*, 112 S Ct at 2369-70.

In *Metropolitan Life*, the Court found an Alabama statute that imposed significantly lower premium tax rates on Alabama insurance companies than on out-of-state insurance companies to be unconstitutional even though the out-of-state insurance companies could reduce or eliminate the differential by investing in Alabama assets or securities or by starting an insurance company in Alabama. *Metropolitan Life*, 470 US at 882-83.

39. *Kraft*, 112 S Ct at 2370.

if the discrimination could be avoided by changing the domicile of the corporation through which the foreign business was conducted.<sup>40</sup>

The third argument advanced by Iowa was that the statute did not discriminate against foreign commerce because it did not treat Iowa subsidiaries more favorably than subsidiaries located elsewhere.<sup>41</sup> While admitting this to be true, the Court stated that favoritism towards state interests is not a necessary part of a Foreign Commerce Clause violation.<sup>42</sup> The Court recognized that discrimination against foreign commerce may create problems for the nation as a whole, and it concluded that even if a state's discrimination against foreign commerce in favor of domestic commerce does not directly benefit the state's own economy it is still inconsistent with the Commerce Clause because the absence of a local benefit does not remove the international implications of the discrimination.<sup>43</sup>

Iowa's fourth argument was that the statute was not discriminatory because the benefit to domestic subsidiaries from the statute might be offset by the taxes imposed on the domestic subsidiaries by other states and the federal government.<sup>44</sup> Therefore, Iowa argued that its tax system did not generally favor domestic business activity over foreign business activity.<sup>45</sup>

The Court admitted that it was likely that if a subsidiary is located in another state that its earnings would be subject to federal as well as the other state's taxes.<sup>46</sup> Furthermore, the Court acknowledged that the sum of these taxes may possibly be more than the sum of the foreign taxes that a foreign subsidiary would pay on its foreign earnings plus the dividend taxes that its domestic parent corporation would pay to Iowa.<sup>47</sup> However, the Court concluded that these possibilities did not alter the fact that Iowa puts a burden on foreign subsidiaries that it does not put on domestic

---

40. *Id.*

41. *Id.* This argument was the one that prevailed in the Iowa Supreme Court. *Id.*

42. *Id.* The Court pointed out that it had held in earlier decisions that the constitutional prohibition against state taxation of foreign commerce is broader than the protection afforded to interstate commerce. *Id.*

43. *Id.*

44. *Id.* at 2370-71. Corporate income is taxed by forty-five states and by the District of Columbia. *Id.* at 2371 n 22.

45. *Id.* at 2370.

46. *Id.* at 2371.

47. *Id.*

subsidiaries.<sup>48</sup> The Court also stated that it found no authority that justified discrimination against foreign commerce if the benefits to domestic subsidiaries may be offset by taxes imposed by the federal government and other states.<sup>49</sup>

The final argument that Iowa made was that the goal of the statute was to promote administrative convenience and not economic protectionism, and that this goal justified Iowa's differential treatment of foreign commerce.<sup>50</sup>

The Court recognized the value and convenience of having state tax systems mimic the federal system, but it also recognized that a state, absent a compelling justification, may not advance its legitimate goals by means that facially discriminate against foreign commerce.<sup>51</sup> Based on this idea, the Court concluded that Iowa could make adjustments in its taxing statute that would stop the discrimination against foreign commerce while still mimicking the federal tax system and having substantially the same administrative benefits as before the adjustments.<sup>52</sup>

The Court summarized its holding by stating that Iowa did not have to adopt the federal definition of federal income in whole or in part, and that if it did adopt the federal system, in whole or in part, the adoption would not protect the state tax statute from Commerce Clause scrutiny.<sup>53</sup> The Court concluded by finding that the Iowa statute facially discriminated against foreign commerce and therefore violated the Foreign Commerce Clause.<sup>54</sup> Finally, the Court reversed the judgment of the Iowa Supreme Court and remanded the case for further proceedings not inconsistent with its opinion.<sup>55</sup>

Chief Justice Rehnquist dissented from the Court's majority opinion.<sup>56</sup> The Chief Justice began his dissent by stating that Kraft had brought only a facial challenge to the Iowa statute, and that the burden on one making a facial challenge to a statute is to show that there is no set of circumstances under which the statute would

---

48. *Id.*

49. *Id.*

50. *Id.*

51. *Id.*

52. *Id.*

53. *Id.* at 2372.

54. *Id.* Having concluded that Iowa's statute violates the Foreign Commerce Clause the Court did not consider the challenge to the statute under the Equal Protection Clause. *Id.* at 2372 n 25.

55. *Id.* at 2372.

56. *Id.* (Rehnquist dissenting). Justice Blackmun joined in the dissent. *Id.*



be valid.<sup>57</sup> The Chief Justice stated that just because a tax might act unconstitutionally under one specific set of circumstances does not invalidate the tax entirely.<sup>58</sup>

Chief Justice Rehnquist continued by criticizing the majority for relying almost exclusively on the decision in *Japan Line, Ltd. v County of Los Angeles*,<sup>59</sup> because in his view the facts of that case were substantially different than in the present case.<sup>60</sup> There, the Chief Justice pointed out that the tax imposed was imposed on Japanese companies and on containers used almost exclusively in interstate commerce while Japan levied no tax on similar property of United States shipping companies.<sup>61</sup>

Chief Justice Rehnquist continued by saying that the present case was more like *Container Corporation of America v Franchise Tax Board*,<sup>62</sup> where a tax was upheld against a Foreign Commerce Clause challenge, because in that case the tax was imposed on a domestic, not foreign, corporation, and the United States remained neutral by not filing a brief urging the tax be struck down.<sup>63</sup> He then pointed out that in this case the United States had actually submitted a brief urging that the tax be upheld against the Foreign Commerce Clause challenge.<sup>64</sup>

Chief Justice Rehnquist then continued by basically agreeing to several of the arguments put forward by Iowa in support of its statute.<sup>65</sup> He pointed to the fact that the Iowa tax did favor domestic subsidiaries over foreign subsidiaries but did not favor Iowa subsidiaries over foreign subsidiaries.<sup>66</sup> Therefore, he continued, the Iowa tax lacked the selfish local motive so often present in Commerce Clause decisions.<sup>67</sup>

Next, the Chief Justice opined that Kraft had failed to show sufficient evidence that the Iowa taxing scheme systematically discriminated against foreign commerce to the advantage of domestic

---

57. *Id.*

58. *Id.*

59. 441 US 434 (1979). See notes 76-95 and accompanying text for a discussion of *Japan Line*.

60. *Kraft*, 112 S Ct at 2372 (Rehnquist dissenting).

61. *Id.*

62. 463 US 159 (1983). See notes 107-21 and accompanying text for a discussion of *Container Corporation*.

63. *Kraft*, 112 S Ct at 2372 (Rehnquist dissenting).

64. *Id.*

65. *Id.*

66. *Id.* at 2373.

67. *Id.*

commerce to sustain a facial challenge of the statute.<sup>68</sup> He then pointed to several ways he believed that Kraft had failed in its arguments in opposition to the Iowa tax.<sup>69</sup> First, he agreed with Iowa that the place of a business' incorporation did not correspond with the place where its primary business activity takes place, and that some foreign domiciled subsidiaries may do little or no business in foreign markets.<sup>70</sup> From this view he concluded that it cannot be assumed that the Iowa statute always unconstitutionally discriminated against foreign commerce.<sup>71</sup> Also if a foreign subsidiary does no foreign business, Chief Justice Rehnquist questioned whether the transfer of dividends from such a subsidiary to a domestic parent really constituted foreign commerce.<sup>72</sup>

Chief Justice Rehnquist admitted that the Iowa taxing scheme will sometimes come up with a different tax total for domestic and foreign subsidiaries.<sup>73</sup> However, the fact that many of the other states also tax corporate net income, coupled with the fact that no evidence was put forward to show the existence and size of local level foreign taxes, domestic corporations could very possibly have a higher tax burden than foreign subsidiaries might have.<sup>74</sup> Chief Justice Rehnquist concluded that based on these findings the Iowa statute did not violate the Foreign Commerce Clause, and he therefore rejected Kraft's facial challenge to the statute.<sup>75</sup>

The first case in which the Foreign Commerce Clause of the Constitution was used to invalidate a state tax was in 1979 in *Japan Line, Ltd. v County of Los Angeles*.<sup>76</sup> In *Japan Line*, California applied an ad valorem property tax<sup>77</sup> to Japanese shipping

---

68. Id.

69. Id.

70. Id.

71. Id.

72. Id. Chief Justice Rehnquist offered the example of a subsidiary which is incorporated in a foreign country but has no assets in the foreign country and conducts all of its business in the United States; if this company declares and pays a dividend to its domestic parent, this payment may involve just a transfer of funds from one New York bank account to another. Id.

73. Id.

74. Id.

75. Id at 2374. Chief Justice Rehnquist then went on to consider Kraft's challenge of the statute under the Due Process Clause. Id. He concluded that the statute did not violate the Due Process Clause because the statute served a legitimate state interest by promoting administrative efficiency. Id.

76. 441 US 434 (1979).

77. An ad valorem tax is "levied on property or an article of commerce in proportion to its value, as determined by assessment or appraisal." *Black's Law Dictionary* 51 (West, 6th ed 1991).

companies' cargo containers.<sup>78</sup> These containers were based, registered, and subject to property tax in Japan and were used exclusively in foreign commerce.<sup>79</sup> The Supreme Court considered the issue of whether instrumentalities of commerce that are owned, based, and registered abroad, and that are used exclusively in international commerce, may be subjected to an apportioned ad valorem property tax by a state.<sup>80</sup>

To determine if a state tax impermissibly burdened foreign commerce, the Court adopted the standards set forth in *Complete Auto Transit, Inc. v Brady*<sup>81</sup> which determined if a state tax impermissibly burdens interstate commerce.<sup>82</sup> If a state tax is applied to an activity with a substantial nexus with the taxing state, is fairly apportioned, does not discriminate against foreign commerce, and is fairly related to the services provided by the state, no impermissible burden on foreign commerce will be found.<sup>83</sup> Additionally, however, the Court found that when construing Congress' power to regulate foreign commerce a more extensive constitutional inquiry is required.<sup>84</sup> The Court, therefore, added two additional considerations when dealing with a possible violation of the Foreign Commerce Clause: (1) whether a state tax creates a substantial risk of international multiple taxation;<sup>85</sup> and (2) whether a state tax prevents the federal government from speaking with one voice when regulating commercial relations with foreign governments.<sup>86</sup> Finally, the Court determined that if a state tax is incon-

---

78. *Japan Line*, 441 US at 436.

79. *Id.*

80. *Id.*

81. 430 US 274 (1977). In *Complete Auto*, Mississippi imposed privilege taxes on businesses for the privilege of doing business within Mississippi. *Complete Auto*, 430 US at 274. General Motors shipped vehicles by rail from other states to Jackson, Mississippi, destined for Mississippi dealers. *Id.* *Complete Auto*, a contract motor carrier, hauled the vehicles from Jackson to the dealers. *Id.* The Court unanimously upheld the application of the tax to *Complete Auto*'s Mississippi business and gross income. *Id.* If a state tax is applied to an activity with a substantial nexus with the taxing state, is fairly apportioned, does not discriminate against interstate commerce, and is fairly related to the services provided by the state, then no impermissible burden on interstate commerce will be found. *Id.*

82. *Japan Line*, 441 US at 444-45.

83. *Id.*

84. *Id.* at 446.

85. *Id.* The Court is especially worried about this kind of multiple taxation based on the fact that neither the Court nor the Nation can ensure that the aggregation of taxes was computed on no more than one full value when one of the taxing entities is a foreign sovereign. *Id.* at 447-48.

86. *Id.* The Court was concerned with state interference because of the fact that foreign commerce is a matter of national concern. *Id.* If one state discriminates against foreign commerce, foreign entities most likely would retaliate with discriminatory practices that

sistent with either of these principals, it is unconstitutional under the Commerce Clause.<sup>87</sup>

The Court assumed that the California tax satisfied the four provisions taken from the interstate commerce cases and analyzed the two additional requirements for foreign commerce.<sup>88</sup> First, the Court considered the problem of multiple taxation. The Court concluded that the California tax led to multiple taxation in fact since the containers were already rightfully taxed in full in Japan.<sup>89</sup> Therefore, the Court continued, if the tax was sustained the appellants would be paying a double tax.<sup>90</sup>

Next, the Court attempted to determine if the tax interfered with the nation's speaking with one voice in regulating foreign commerce.<sup>91</sup> The Court looked to several factors to make this determination, including: (1) the fact that the United States and Japan had signed customs treaties which attempt to provide uniform treatment to containers used exclusively in foreign commerce; (2) the fact that American-owned containers were not taxed in Japan, and this asymmetry could lead Japan to take retaliatory measures that would effect the entire nation; and (3) the fact that if other states imposed like taxes then the total tax paid on the containers would depend on which American ports they entered.<sup>92</sup> The Court stated that these factors made it impossible for the United States to speak with one voice.<sup>93</sup>

The Court concluded that because California's ad valorem tax, as applied to appellants' containers, resulted in multiple taxation of the instrumentalities of foreign commerce, and because it prevented the federal government from speaking with one voice in international trade, the tax was inconsistent with Congress' power to regulate foreign commerce.<sup>94</sup> Therefore, the Court held the tax, as applied, unconstitutional under the Commerce Clause.<sup>95</sup>

A year later in 1980, the Supreme Court again faced the issue of whether a state tax violated the Foreign Commerce Clause in the

---

would discriminate against the whole Nation, not just the state with the discriminatory practice. *Id.* at 450.

87. *Id.* at 451.

88. *Id.*

89. *Id.* at 452.

90. *Id.*

91. *Id.* at 452-53.

92. *Id.*

93. *Id.*

94. *Id.*

95. *Id.* at 454.

case of *Mobil Oil Corporation v Commissioner of Taxes of Vermont*.<sup>96</sup> At issue in *Mobile Oil* was a Vermont tax statute that included foreign source dividend income in a corporate taxpayer's tax base.<sup>97</sup> Vermont imposed the tax on an apportioned basis to corporations not domiciled in Vermont.<sup>98</sup> At the same time, this foreign source dividend income was also taxable in full by the corporation's state of domicile.<sup>99</sup> The Court looked at whether the tax imposed a burden on foreign commerce by subjecting the corporation's dividend income to a substantial risk of multiple taxation.<sup>100</sup>

The taxpayer attempted to use the reasoning of *Japan Line* to invalidate the Vermont tax, but the Court rejected this comparison.<sup>101</sup> The Court stated that *Japan Line* was concerned with multiple taxation problems arising when both the states and foreign nations tax the same item.<sup>102</sup> This kind of multiple taxation, the Court stated, the United States' courts cannot control and therefore is subject to the stricter requirements of Foreign Commerce Clause scrutiny.<sup>103</sup> However, the Court concluded that the problem of the Vermont tax involved multiple taxation of foreign source income by two or more of the states and not multiple taxation from a state and a foreign nation.<sup>104</sup> The Court stated that this type of double taxation are the same as that found in double taxation of interstate commerce, and that this type of duplicative taxation was correctable by the Court.<sup>105</sup> Therefore, the Court concluded that the Vermont tax did not impose an impermissible burden on foreign commerce.<sup>106</sup>

In 1983, the Supreme Court again upheld a state tax against a Foreign Commerce Clause challenge in *Container Corporation of*

---

96. 445 US 425 (1980).

97. *Mobil Oil*, 445 US at 442.

98. *Id.* at 429. For corporations doing business but not domiciled in Vermont, Vermont used a three factor apportionment formula to determine what portion of corporate net income was attributable to Vermont. *Id.* The portion is determined by multiplying net income by a fraction representing the "average of the ratios of sales, payroll, and property values within Vermont to those of the corporation as a whole." *Id.*

99. *Id.* at 433. New York was the corporation's state of commercial domicile. *Id.*

100. *Id.* at 442.

101. *Id.* at 446.

102. *Id.*

103. *Id.*

104. *Id.* at 448.

105. *Id.* at 447.

106. *Id.* at 449. The Court also held that the absence of any explicit directive from Congress as to how the states should treat foreign income allows the states to adopt or not adopt the way that foreign income is treated at the federal level. *Id.* at 448.

*America v Franchise Tax Board*.<sup>107</sup> The Court considered the issue of whether a California franchise tax as applied to multinational corporations caused impermissible double taxation<sup>108</sup> or impaired federal uniformity in violation of the Foreign Commerce Clause.<sup>109</sup>

The Court examined the California tax by following the standards set in *Japan Line*.<sup>110</sup> The Court noted that although the cases were similar, in that they both involved double taxation by a state and foreign nation, there were several important differences between the two.<sup>111</sup> First, the tax at issue in *Container Corporation* was a tax on income, not property.<sup>112</sup> Second, the double tax came from the use of two different methods of allocation, not because one taxing agent had the right to tax in full and the other had the right to tax an apportioned share.<sup>113</sup> Third, the tax fell on a United States corporation, not on a foreign corporation.<sup>114</sup>

The Court determined that these differences were constitutionally significant.<sup>115</sup> Because the tax was on income and not property, the Court reasoned it would be virtually impossible to avoid all double taxation no matter the method used by California, unless the state did not tax any of the income.<sup>116</sup> The Court concluded that the avoidance of double taxation did not require California to go to such extremes.<sup>117</sup>

Next, the Court determined that the tax did not violate the "one voice in regulating foreign commerce" standard set forth in *Japan Line*.<sup>118</sup> The Court stated that the possibility of retaliation by foreign countries was limited in this case because the tax did not create an automatic asymmetry in international taxation and was imposed on a domestic corporation and not on a foreign corporation.<sup>119</sup> Also, the Court pointed out that the California tax was not pre-empted by any federal law or inconsistent with any

---

107. 463 US 159 (1983).

108. *Container Corporation*, 463 US at 189.

109. *Id.* at 193.

110. *Id.* at 185.

111. *Id.* at 187.

112. *Id.* at 187-88.

113. *Id.* at 188.

114. *Id.*

115. *Id.* at 189.

116. *Id.* at 191. The Court stated that it does not make sense to force California to change from one system that may cause double taxation to a different system that also might cause double taxation. *Id.* at 192.

117. *Id.* at 193.

118. *Id.*

119. *Id.* at 195.

federal policy.<sup>120</sup> Therefore, the Court concluded that the California tax did not violate the Foreign Commerce Clause.<sup>121</sup>

More recently, the Court considered the Foreign Commerce Clause limitations on the state's taxing power in *Wardair Canada, Inc. v Florida Department of Revenue*.<sup>122</sup> The issue in the case was whether a Florida sales tax on the sale of aviation fuel was a violation of the Foreign Commerce Clause.<sup>123</sup>

In resolving this issue, the Court again pointed out the standards articulated in *Japan Line* to determine if the Florida state tax violated the Foreign Commerce Clause.<sup>124</sup> The Court recognized that the only part of the *Japan Line* analysis which might not be met was the question of whether the tax on aviation fuel prevented the federal government from speaking with one voice when regulating the commercial relations with foreign governments.<sup>125</sup>

The Court concluded that the tax did not interfere with the federal government's speaking with one voice when regulating commercial relations with foreign governments.<sup>126</sup> The Court reasoned that while the government itself had made agreements not to tax the sale of aviation fuel nationally, it had never restricted the states from imposing a state sales tax on the sale of aviation fuel.<sup>127</sup>

The Court determined that the federal government, by its actions, had affirmatively decided to allow the states to put these sales taxes on aviation fuel.<sup>128</sup> Therefore, the Court stated that the sales taxes did not interfere with the federal government's speaking with one voice when regulating commercial relations with foreign governments.<sup>129</sup> Accordingly, the Court did not find that the sales tax violated the Foreign Commerce Clause.<sup>130</sup>

The Court in *Kraft* once more used the standards set out in *Japan Line* for determining when a state tax impermissibly burdened

---

120. Id at 196.

121. Id at 197.

122. 477 US 1 (1986).

123. *Wardair Canada*, 477 US at 3.

124. Id at 8.

125. Id at 8-9. The appellant conceded that the tax satisfied the four part test of *Complete Auto*. Id. Also, appellant realized that there was no threat of multiple taxation since the sale of fuel was a discrete transaction occurring in only one national jurisdiction. Id at 9.

126. Id.

127. Id at 11.

128. Id at 12.

129. Id at 13.

130. Id.

foreign commerce.<sup>131</sup> However, it appears that the Court extended the application of *Japan Line* by broadening the definition of “instrumentalities of commerce.”<sup>132</sup> “Instrumentalities of commerce” have traditionally been defined as tangible property used as an instrument of commerce.<sup>133</sup> Therefore, “instrumentalities of commerce” were generally equated with vehicles such as the shipping companies’ vessels and cargo containers involved in *Japan Line*.<sup>134</sup>

In *Kraft*, the Court included in “instrumentalities of commerce” the receipt of dividend income.<sup>135</sup> Therefore, since the transmission of dividend income between domestic parent corporations and foreign subsidiaries was an instrumentality of foreign commerce, it was now subject to regulation and protection by the federal government and, hence, it was as entitled to freedom from discriminatory intrusions by state taxation as was the shipment of freight containers.<sup>136</sup>

The effect of the Iowa income tax scheme was to impose a duty or excise on the importation of dividends from foreign countries. By doing so, the Iowa tax code provisions deprived corporations wanting to invest in foreign countries of the right to establish or acquire foreign subsidiaries subject to the same beneficial state tax treatment given to investments in subsidiaries incorporated in the United States. The fundamental effect of all this was to discourage corporations that wanted to do business in Iowa from exporting capital for investment abroad.<sup>137</sup>

---

131. *Kraft General Foods, Inc. v Iowa Department of Revenue and Finance*, US 112 S Ct 2365, 2370-72 (1992). See notes 26-75 and accompanying text for a discussion of *Kraft*. See notes 76-95 and accompanying text for a discussion of *Japan Line*.

132. *Kraft*, 112 S Ct at 2369, 2373.

133. Philip M. Tatarowicz and Rebecca F. Mims-Velarde, *An Analytical Approach to State Tax Discrimination Under The Commerce Clause*, 39 Vand L Rev 879, 894 n 65 (1986).

134. Tatarowicz and Mims-Velarde, 39 Vand L Rev at 894 n 65 (cited in note 133).

135. *Kraft*, 112 S Ct at 2369.

136. *Id.* The Court’s analysis in *Kraft* was different from its reasoning in *Mobil Oil Corporation v Commissioner of Taxes of Vermont*, 445 US 425 (1980).

The tax scheme in *Kraft* was essentially the same as that upheld by the Court in *Mobil Oil*. However, in *Mobil Oil*, the Court did not consider whether the distinction in the tax treatment of dividends, depending on whether they originated domestically or abroad, caused discrimination against foreign commerce in violation of the Foreign Commerce Clause. See notes 96-106 and accompanying text for a discussion of *Mobil Oil*.

In *Kraft*, the Court squarely confronted the issue of whether Iowa’s disparate treatment of dividends, based solely on the domicile of the corporation paying the dividends, was an impermissible discrimination against foreign commerce. See notes 29-49.

137. Often, the decision to set up a foreign subsidiary is based on legitimate reasons. In *Kraft*, the parties stipulated that the decision to do business abroad through foreign subsidiaries is typically supported by legitimate business reasons. *Kraft*, 112 S Ct at 2369 n



The Court's decision in *Kraft*, holding the Iowa tax scheme unconstitutional, could have a substantial impact on how state taxing schemes are constructed.<sup>138</sup> A state, by tailoring its tax scheme to the federal tax system, is not guaranteed that its system is constitutional. If states used the federal system as a starting point for their tax schemes, they will have to make modifications to avoid discriminatory treatment of foreign source dividends absent a compelling reason that would allow permissible discrimination.<sup>139</sup>

States have two options: they can tax both foreign source dividends and domestic source dividends; or they can decide not to tax any dividends at all. The majority of states choose not to tax dividends at all.<sup>140</sup>

The *Kraft* decision leaves at least one issue unanswered: will a retroactive application entitle corporations to obtain refunds for taxes paid under the unconstitutional systems in prior years?<sup>141</sup>

The Iowa tax scheme subjected dividends received from foreign subsidiaries to Iowa income tax, but exempted domestic subsidiaries dividends. This discrimination violated the limitations placed

---

15. Examples of reasons for setting up foreign subsidiaries and thereby exporting capital for investment abroad are: the host country may require incorporation in that country; incorporating abroad would insulate the United States parent from liability for the subsidiary's actions; a foreign corporation would be perceived by customers in the host country as a local company; the ability to own property and manufacture in the host country; and there would be a greater ease in repatriating earnings and in borrowing funds in the host country. *Id.*

Considering the troubles in today's economy many states might find it appealing to discourage United States corporations from exporting capital to acquire foreign subsidiaries. A tax such as Iowa's could be a means of attempting to protect a state's industry from the loss of jobs to overseas manufacturing plants. While the economic wisdom of protectionism in general is debatable, the taxation and regulation of foreign commerce is a matter of national concern and is the responsibility of the federal government and not the individual states. *Japan Line*, 441 US at 446-50.

138. *Wary States, Refund Claims, Uncertainties Seen After Supreme Court's "Kraft" Ruling*, Daily Rep for Executives (BNA) (Monday, June 22, 1992) ("*Daily Report*" June 22, 1992).

139. The decision could affect the other dozen or so states besides Iowa that now employ similar or identical tax schemes. *Daily Report* June 22, 1992 (cited in note 138). Three states—New Mexico, Vermont, and Pennsylvania—have statutory provisions identical to Iowa's scheme. *Id.* Colorado, Kansas, Maine, Missouri, Oklahoma, and Rhode Island have similar systems with various modifications. *Id.* Also, while Alabama and the District of Columbia do not follow the Iowa scheme, they nevertheless do discriminate against foreign commerce. *Id.*

140. *Id.* Exempting dividends from taxation enhances a state's standing in the business community and can lead to business investments and job opportunities within the state. *Id.* Therefore, the only economically feasible decision for states that currently tax foreign source dividends is to stop taxing all dividends. *Id.*

141. *Id.* Whatever application is ultimately given the decision, corporations affected by the unconstitutional tax schemes most likely will begin to file refund claims to protect any interests they might have. *Id.*

on state tax powers by the Foreign Commerce Clause and was an impermissible intrusion into the exclusive power of the federal government to regulate foreign commerce.

*Michael W. Gleba*

