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Alternatives to Worldwide Unitary Apportionment--An Analysis

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ALTERNATIVES TO WORLDWIDE UNITARY APPORTIONMENT — AN ANALYSIS

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I. INTRODUCTION

Alexander Hamilton wrote in 1788 that each state should possess independent authority to gather its own revenue to fund its needs.[1] This notion of state directed taxation is fundamental to the United States' federal system of government. Equally fundamental is the power of the federal government to regulate commerce with foreign nations. James Madison believed it essential that the United States act as one entity in its relations with other nations.[2] State taxation of multinational corporations often leads to conflict between these two basic principles. The body of this paper is comprised of three parts. Initially, judicial treatment of the unitary method of state taxation of multistate and multinational businesses will be analyzed. This analysis will include consideration of opinions from the United States Supreme Court and certain state courts. Cases involving both worldwide unitary taxation and domestic unitary taxation will be discussed in terms of the methodology employed. Second, the mechanics of proposed federal legislation regulating the states' use of the worldwide unitary taxation method will be analyzed. Finally, proposals submitted by the Treasury Department's Task Force on Worldwide Unitary Taxation will be discussed. These proposals suggest alternatives to both federal regulation in this area as well as continued use of worldwide unitary apportionment by some states. This note provides an overview of the issues, problems, and proposed solutions for the worldwide apportionment scheme which is increasingly being utilized by the states.

Essential to an understanding of the issues regarding worldwide unitary apportionment is a general overview of this method of taxation. The right of a state to levy an income tax upon a foreign corporation operating in interstate commerce was affirmed by the United States Supreme Court in *Northwestern States Portland Cement Co. v. Minnesota.*[3] The taxpayer there was a non-domestic corporation engaged exclusively in interstate commerce. The only business conducted in Minnesota was the maintenance of an office staffed by

1. THE FEDERALIST No. 32, at 127 (A. Hamilton) (C. Beard ed. 1948).

2. THE FEDERALIST No. 42, at 181 (J. Madison) (C. Beard ed. 1948).

3. 358 U.S. 450 (1959). There is some dispute among commentators concerning the origin of the unitary tax concept. Professor Jerome Hellerstein notes that the State Railroad Tax Cases, 92 U.S. 575 (1875) and Adams Express Co. v. Ohio, 165 U.S. 194 (1897) espoused the "unit rule" which determined the portion of an interstate railway's capital stock taxable by a state, and that this is the progenitor of the unitary business concept. 1 J. HELLERSTEIN, STATE TAXATION ¶ 8.5 (1983). Eugene Corrigan, Executive Director of the Multistate Tax Commission, expressed doubts as to whether the "unit rule" is properly equated with the "unitary business" concept. *Letters to the Editor,* 13 TAX NOTES (TAX ANALYSTS) 1210 (Nov. 16, 1981) (letter of Eugene Corrigan).

salesmen who actively solicited product purchase orders within the state.[4] Upholding the constitutionality of the Minnesota income tax against due process and commerce clause challenges,[5] the Court ruled that the entire net income of a corporation, whether generated by interstate or intrastate activities, may be fairly apportioned among the states for tax purposes.[6] In an argument which is consistently set forth by proponents of worldwide unitary apportionment, the Court stated that "it is axiomatic that the founders did not intend to immunize interstate commerce from carrying its fair share of the costs of the state government in return for the benefits it derives from the state."[7] The determination of this "fair share" necessitates the concededly imperfect apportionment of the business' income.[8]

The formula apportionment method presently employed by most states is the three-factor Massachusetts formula incorporated in the Uniform Division of Income for Tax Purposes Act (UDITPA).[9] This formula compares the average of the property, payroll and sales factors within the taxing state with the average of the total of such factors everywhere. The resulting fraction is then applied to the income from the unitary business to determine the income properly subject to tax by the particular state. The apportionment formula does not involve a determination of the tax base; rather, it merely provides an equitable means of apportioning the income among the individual states in which the taxpayer conducts business. The worldwide unitary apportionment controversy concerns the scope of the unitary business and the unitary tax base and not the mechanics of a state's apportionment formula.

All forty-five states that levy coporate income taxes utilize unitary apportionment to determine the taxable income of a single corporation operating in two or more states.[10] Approximately one-half of these states apply their apportionment formulas to income determined by combining the income of two or more separate legal enti-

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4. 358 U.S. at 454.

5. *Id.* at 458-63.

6. *Id.* at 460.

7. *Id.* at 461-62. *See also* Department of Revenue v. Association of Washington Stevedoring Cos., 435 U.S. 734, 750 (1978) (affirming the proposition that interstate commerce must bear its fair share of the state tax burden).

8. P. Hartman, Federal Limitations on State and Local Taxation 523 (1981). Professor Paul J. Hartman notes that no one method of accounting of a multijurisdictional corporation's income can accurately determine the amount of income generated within the boundaries of a particular state. *Id.*

9. Unif. Division of Income for Tax Purposes Act § 9, 7A U.L.A. 93, 100 (1957).

10. *Text of Report by Treasury's Unitary Task Force,* 23 Tax Notes (Tax Analysts) 637 (May 7, 1984) [hereinafter cited as *Treasury Report*].

ties.[11] Twelve states, which are the source of current controversy, apply their apportionment formulas to income derived from abroad as well as from within the United States.[12] Six of the states, Alaska, California, Florida, Idaho, North Dakota, and Oregon, include the income of foreign parents in the tax base of domestic taxpayers.[13] Proponents of this worldwide unitary apportionment method argue that it is merely a logical extension of the apportionment formula.[14] Opponents, however, contend that this practice is so damaging to the nation as a whole that it is constitutionally proscribed.[15]

II. Judicial Treatment of the Scope of the Unitary Business

A. *The Constitutional Considerations*

State taxation of multijurisdictional corporations must neither pose an undue burden upon interstate commerce nor interfere with the power of Congress to regulate commerce with foreign nations.[16] The United States Supreme Court in *Complete Auto Transit, Inc. v. Brady*[17] stated that a state tax does not violate the Interstate Commerce Clause if four criteria are met. A state tax is valid if it is applied to an interstate activity with a substantial nexus with the taxing state, is fairly apportioned, does not discriminate against interstate commerce, and is fairly related to services provided by the taxing state.[18]

An embellishment on the foregoing principle was provided in *Japan Line, Ltd. v. County of Los Angeles.*[19] At issue in *Japan Line* was a California ad valorem property tax placed on cargo containers of Japanese shipping companies doing business in California.[20] In considering the four *Complete Auto* prerequisites,[21] the Court first considered whether the tax created a substantial risk of multiple taxation, and second, whether the tax prevented the federal government from "speaking with one voice" when regulating foreign commercial

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11. *Id.*

12. *Id.*

13. Rusch & Kennedy, *Once Again, We Question the Alleged Revenue Effects of Restricting Use of the Worldwide Unitary Tax,* 22 Tax Notes (Tax Analysts) 724, 726 (Feb. 20, 1984).

14. *Treasury Report, supra* note 10, at 637.

15. *See, e.g.,* 129 Cong. Rec E2097 (daily ed. May 5, 1983) (extension of remarks by Representative Conable). Congressman Conable believes that retaliatory taxing methods would place U.S. companies at a disadvantage when competing in worldwide markets.

16. U.S. Const. art. I, § 8.

17. 430 U.S. 274 (1977).

18. *Id.*

19. 441 U.S. 434 (1979).

20. 441 U.S. at 436.

21. *Id.*

relations.[22] Multiple taxation did exist because the cargo containers in question were registered and based in Japan and therefore subject to a Japanese property tax.[23] The tax also prevented the federal government from speaking with one voice in regulating foreign trade.[24] The Court based this finding on the possibility of a foreign nation's retaliation for an individual state's overreaching, thereby harming the entire nation.[25] Consequently, the state's power to tax instruments of foreign trade was restricted by the Court in *Japan Line.*[26]

Japan Line appeared to be the tool needed to eliminate the risk of international multiple taxation. Subsequent cases, however, have weakened its impact by limiting its applicability to property taxes.[27] The rationale favoring non-apportionability in the context of a property tax has no applicability to an income tax.[28] As a result, a *Japan Line* attack on an apportioned income tax is not likely to be successful.

B. The Three Contexts of the Unitary Business

Litigation regarding the scope of the unitary business has involved three distinct factual situations.[29] Labelled the "two or more business," "combined reporting," and "dividend apportionment" categories, careful adherence to the distinctions among these three is essential for analytical clarity.[30] A failure to carefully adhere to these distinctions has led to decisions in which the taxing authority contends that a unitary business exists for purposes of "dividend apportionment," but no unitary business exists for purposes of "combined reporting."[31] Theoretically, however, the distinction should be irrelevant because all three categories depend upon the existence of a unitary business. Thus, if no unitary business exists for combined reporting, then no unitary business for dividend apportionment should

22. *Id.* at 445.
23. *Id.* at 451-52.
24. *Id.* at 453.
25. *Id.*
26. *Id.*
27. *See, e.g.,* Container Corp. of Am. v. Franchise Tax Bd., 463 U.S. 159, 187-88 (1983).
28. Mobil Oil Corp. v. Commissioner of Taxes, 445 U.S. 425, 448 (1980).
29. *See generally* Floyd, *The "Unitary" Business in State Taxation: Confusion at the Supreme Court?,* 1982 B.Y.U. L. REV. 465, 469-71.
30. *Id.* Floyd criticizes ASARCO, Inc. v. Idaho State Tax Comm'n, 458 U.S. 307 (1982) for confusing the two distinct inquiries of "combined reporting" and "dividend apportionment." *Id.*
31. Respondent taxing authority in ASARCO, Inc. v. Idaho State Comm'n, 458 U.S. 307 (1982) conceded that the taxpayer's relationship with its subsidiaries was not sufficient to constitute a unitary business for "combined reporting" purposes. However, it was nevertheless contended that a unitary business existed for "dividend apportionment" purposes.

exist either. Nevertheless, these categories do exist and must be understood.

The "two or more business" inquiry concerns whether a taxpayer's group of separate functional activities constitute one unitary business or separate, discrete businesses. This inquiry involves only one legal entity whereas the "combined reporting" and "dividend apportionment" inquiries involve more than one legal entity.

The "combined reporting" inquiry considers whether income from two or more separate corporate entities should be combined for the purpose of apportionment because of the functional unity of the business entities. The potential disregard of legal form and piercing of the corporate veil involved in determining unity arouses great controversy. The essentially factual nature of the inquiry guarantees continued litigation as courts define the unitary business on a case-by-case basis.

The "dividend apportionment" inquiry involves a determination of whether a particular form of income is derived from an activity separate from the unitary business and is therefore excludable from the apportionable tax base. The Uniform Division of Income for Tax Purposes Act (UDITPA), requires that business income[32] be included in the taxpayer's income subject to formulary apportionment.[33] Interest and dividends, however, are separately allocated to the taxpayer's state of commercial domicile.[34] Some states which have adopted modified versions of the uniform act expanded the definition of business income to include certain interest, dividends, and capital gains.[35] The issue often litigated is whether dividends received by a taxpayer are properly characterized as business income and thereby subject to apportionment. The key to apportionability in this regard is the unitary business principle.[36]

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32. UNIF. DIVISION OF INCOME FOR TAX PURPOSES ACT § 1(a), 7A U.L.A. 93, 93 (1957) (defines "business income" as "income arising from transactions and activity in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations").

33. *Id.* § 9, 7A U.L.A. at 100.

34. *Id.* § 7, 7A U.L.A. at 99.

35. *See, e.g.*, IDAHO CODE § 63.3027(a)(1) (1976 & Supp. 1985).

> Gains and losses and dividend and interest income from stock and securities of any foreign or domestic corporation shall be presumed to be income from intangible property, the acquisition, management, or disposition of which constitute an integral part of the taxpayers' trade or business; such presumption may only be overcome by clear and convincing evidence to the contrary.

Id.

36. Mobil Oil Corp. v. Commissioner of Taxes, 445 U.S. 425, 439 (1980).

1. The "Dividend Apportionment" Cases

At issue in *Mobil Oil Corp. v. Commissioner of Taxes*[37] was whether dividends received from foreign owned and operated subsidiaries were includable in the taxpayer's apportionable tax base. The taxpayer advanced four distinct arguments. First, the Federal Due Process Clause requires that dividend income be distinguishable from operating income and, therefore, is excepted from general apportionability.[38] The Court, persuaded by economic reality, rejected the argument because taxpayer could have maintained the same operations in single corporate form with different functional divisions. Here, the gains would be characterized as operating income and properly included in the unitary tax base.[39]

In addition to relying on the form of dividend income argument, the taxpayer also advanced a source of dividend income argument. Mobil argued that because the dividends were derived from a foreign source they could not properly be included in the apportionable tax base.[40] The court dismissed this argument relying on a 1924 Supreme Court decison, *Bass, Ratcliff & Gretton, Ltd. v. State Tax Commission,*[41] in which a unitary business, incorporating both production and sales functions, was found to exist. Taxpayer's status as a foreign corporation did not preclude an apportioned tax on the income generated within the state. This reasoning supported the *Mobil* conclusion that the status of the dividend payors as foreign corporations did not preclude apportionability.[42]

Abandoning the due process arguments, Mobil next attempted a constitutional challenge based on the commerce clause. Emphasizing that dividends are taxable in full by the state of commercial domicile, Mobil contended that any apportionment of dividends would result in possible multiple taxation constituting an undue burden on interstate commerce.[43] Noting that there was no actual multiple tax, the Court dismissed the commerce clause challenge. No interest of the state of commercial domicile was adversely affected by the state tax at issue.[44] Apparently a showing of actual duplicative taxation is necessary to invalidate a state income tax under the interstate commerce clause.

37. 445 U.S. 425 (1980).
38. *Id.* at 437-38.
39. *Id.* at 440-41.
40. *Id.* at 436.
41. 266 U.S. 271 (1924).
42. 445 U.S. at 438.
43. *Id.* at 442.
44. *Id.* at 444.

Taxpayer's final attack on the Vermont tax was based on the foreign commerce clause. Applying the reasoning in *Japan Line*, taxpayer asserted that a tax on foreign source dividends creates a substantial risk of international multiple taxation.[45] The Court rejected this argument by citing the distinction between ad valorem property taxes at issue in *Japan Line* and income taxes currently at issue. The factors involved in a property tax context have little applicability to an income tax context; thus the *Japan Line* approach was easily distinguished.[46]

Having rejected each of Mobil's arguments, the Court noted that the "linchpin of apportionability . . . is the unitary business principle."[47] Taxpayer failed to carry its burden of establishing a lack of unity. Therefore, after rejecting the due process and commerce clause arguments, the Court held for the taxing authority.[48]

A shift in emphasis from the due process and commerce clause arguments in *Mobil* to a factual inquiry regarding the existence of a unitary business occurred in *ASARCO Inc. v. Idaho State Tax Commission*[49] and *Woolworth Co. v. Taxation & Revenue Department*.[50] In *ASARCO*, taxpayer owned stock in five foreign corporations with ownership ranging from 34 percent to 52.7 percent. Combined reporting was not at issue, as the respondent Tax Commission specifically conceded that the relationship between taxpayer and the foreign subsidiaries was not sufficient to justify unitary treatment for combination purposes.[51] Nevertheless, the Commission did contend that dividends and interest received from the foreign subsidiaries constituted apportionable business income to taxpayer.[52]

Armed with knowledge of Mobil's evidentiary mistakes, taxpayer presented evidence intended to establish that the business of the dividend payors were of a separate, discrete enterprise, thereby justifying characterization of the dividends as non-business income. Different factual criteria, including the lack of an ability of the taxpayer to elect a majority of directors of the subsidiaries, the relatively low percentage of the subsidiaries' output which was sold to the taxpayer, and the absence of an integrated relationship among the subsidiaries permitted the conclusion that unitariness did not exist.[53] Unlike the

45. *Id.* at 446.
46. *Id.* at 448.
47. *Id.* at 439.
48. *Id.* at 449.
49. 458 U.S. 307 (1982).
50. 458 U.S. 354 (1982).
51. *ASARCO, Inc.*, 458 U.S. at 312-14.
52. *Id.*
53. *Id.* at 320-24.

taxpayer in *Mobil,* the taxpayer in *ASARCO* realized its burden and presented factual evidence of the lack of unitariness.

A similar argument disproving unitariness was advanced by the taxpayer in *Woolworth.* The factual setting in *Woolworth* differed from *ASARCO* only in that all but one of taxpayer's four foreign subsidiaries were not wholly owned and taxpayer elected all the subsidiaries' directors.[54] Consistent with the approach taken in *Mobil* and *ASARCO* the Court analyzed the operational relationships between taxpayer and its subsidiaries and found little functional integration. Each of the subsidiaries engaged exclusively in the business of retailing and maintained separate accounting, advertising, legal and other departments. The facts also established a lack of centralized management or economies of scale. Consequently, no unitary business was found to exist.[55]

Realizing the success of the *ASARCO* and *Woolworth* arguments showing lack of unitariness, state taxing authorities pursued a new approach to proving unitariness. State taxing authority aggressiveness in the dividend apportionment area is well illustrated by *James v. International Telephone & Telegraph Co.*[56] IT&T was required to sell several of its subsidiaries as a result of an antitrust suit filed by the United States Department of Justice. A consequence of the forced sale was long-term capital gain which the Department of Revenue argued should be considered apportionable business income.[57] The taxing authority argued that the acquisition and management of subsidiaries was an integral part of the taxpayer's business, and any economic gains from divestiture of subsidiaries should be considered part of the business income of a conglomerate.[58] Applying the *ASARCO/Woolworth* factors of functional integration, centralization of management, and economies of scale, the Missouri Supreme Court concluded that the long-term capital gain did not arise from an integral part of the taxpayer's regular trade or business operations and was therefore not apportionable business income.[59] An acceptance of the Department of Revenue's argument would have subjected all gains of large corporate conglomerates to apportionment, regardless of their capital or investment nature.

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54. *Woolworth,* 458 U.S. at 364-72.
55. *Id.* at 372.
56. 654 S.W.2d 865 (Mo. 1983).
57. *Id.* at 866.
58. *Id.* at 868.
59. *Id.* at 870.

2. The "Two or More Business" Cases

The taxpayer in *Exxon Corp. v. Wisconsin Department of Revenue*[60] maintained a single corporation with three departments consisting of exploration and production, refining, and marketing and management. Each department functioned independently of the others.[61] Although this structure provided for a vertically integrated operation, transfers of products from exploration and production to refining and finally to marketing were based on competitive wholesale market prices.[62] No corporate exploration and production or refining operations were conducted in Wisconsin. Marketing was the only activity conducted in the taxing state.[63] The taxpayer's corporate income and franchise tax returns were based upon separate accounting methods and, therefore, only the Wisconsin marketing operation was reflected in the corporation's state returns. This accounting method produced losses for the tax year, thus establishing no tax liability.[64]

The Wisconsin Department of Revenue assessed a deficiency based upon taxpayer's total corporate income, pursuant to the state's tax apportionment statute.[65] In affirming this assessment, the Wisconsin Supreme Court concluded that marketing operations within the state were an integral part of the unitary business along with the exploration and production and refining departments.[66] Reasoning that the corporation's refining and production functions relied upon marketing operations to provide a market for its products, the court concluded that such a vertically integrated operation is ordinarily a unitary business.[67] The taxpayer's method of separately accounting for income generated within Wisconsin itself was therefore ignored.

On appeal to the United States Supreme Court, Exxon, arguing substance over form, asserted that considering total corporate income as unitary per se is improper.[68] In affirming the finding of a unitary business, the Court held that a taxpayer's showing of separate functional accounting does not demonstrate that application of the unitary business principle violates constitutional standards. Although the application of a state's apportionment formula may produce dis-

60. 447 U.S. 207 (1980).
61. *Id.* at 212.
62. *Id.* at 210-12.
63. *Id.* at 212-13.
64. *Id.* at 213.
65. *Id.* at 214.
66. Wisconsin Dep't of Revenue v. Exxon Corp., 90 Wis. 2d 700, 721, 281 N.W.2d 94, 105-06 (1979), *aff'd*, 447 U.S. 207 (1980).
67. *Id.* at 719-20, 281 N.W.2d at 104.
68. Brief for Appellant at 17-30, *Exxon*, 447 U.S. 207 (1980).

tortion constituting a violation of due process,[69] the Court stated that separate accounting, though useful or necessary as a business aid, "may not fit the different requirements when a state seeks to tax values created by business within its borders. . . ."[70] A comparison of the Wisconsin assessed taxable income for the years in question, 0.22 percent of total corporate net income, with the taxpayer's Wisconsin sales for those years, 0.41 percent of total corporate sales, permitted the conclusion that no constitutionally proscribed distortion existed.[71]

Exxon also argued that the income generated by its exploration and production department was situs income, which traditionally is taxed entirely by the situs state. Inclusion of such income in the unitary tax base may therefore result in impermissible multiple taxation.[72] The Court, however, was not persuaded that the commerce clause required specific allocation of such income to the situs state when such income was generated as part of a unitary business.[73] The Court rejected the argument that a mere risk of multiple taxation is sufficient to invalidate a levy, instead of requiring an actual showing of multiple taxation.[74] Proof of actual multiple taxation in the context of an income tax is not to be confused with the *Japan Line* criterion of a "substantial risk" of international multiple taxation. The latter criterion is relevant only in connection with a property tax on the instrumentalities of foreign commerce.

When a corporation doing business both within and without the state includes losses incurred outside the state in its apportionable tax base, state taxing authorities may take a position contrary to that of the Wisconsin taxing authority in *Exxon*. Two pre-*Exxon* California cases argued that no unitary business exists with regard to corporations doing business both in California and in a foreign state.[75] As

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69. *See* Hans Rees' Sons, Inc. v. North Carolina *ex rel.* Maxwell, 283 U.S. 123 (1931). Evidence of separate accounting revealed that income having its source in the manufacturing operations within the state was 17% of total company income, while the apportionment method applied by the state resulted in allocation to the state for tax purposes of 66% to 85%. *Id.* at 127-28. It was held that this evidence was sufficient to prove that the apportionment method and the resulting taxes were beyond the state's authority. *Id.* at 135-36. *But see* Butler Bros. v. McColgan, 315 U.S. 501, 506-07 (1942) (finding taxpayer's showing of separate accounting insufficient to prove impermissible distortion created by formulary apportionment).

70. *Exxon,* 447 U.S. 207, 222 (quoting Butler Bros. v. McColgan, 315 U.S. 501, 407-08 (1942)).

71. *Id.* at 227.

72. *Id.* at 227-28.

73. *Id.* at 229. *Cf.* Mobil Oil Corp. v. Commissioner of Taxes, 445 U.S. 425, 442 (1980) (advancing a similar argument in a dividend apportionment case).

74. *Exxon,* 447 U.S. at 228 (relying on Mobil Oil Corp. v. Commissioner of Taxes, 445 U.S. 425, 444 (1980)).

75. Superior Oil Co. v. California Franchise Tax Bd., 60 Cal. 2d 406, 412, 386 P.2d 33, 36,

is typical of the result in such cases,[76] the California taxing authority was unsuccessful and the foreign tax losses were included in the taxpayers' apportionable tax bases.

A post-*Exxon* case in which a unitary business was found in favor of the taxing authority is *Russell Stover Candies, Inc. v. Department of Revenue.*[77] Taxpayer's activities consisted of seven functional divisions. The divisions located outside of Montana were involved in the manufacture, sale, and distribution of paper products, while the sole function of the Montana operation was the maintenance of two cattle ranches.[78] On remand from the United States Supreme Court, the Montana court was required to reconsider the case, not in light of the principles enunciated in *Exxon,* but rather in light of the principles of two dividend apportionment cases.[79] The latter inquiry mandated consideration of whether a taxpayers' intra-corporate divisions exhibited functional integration, centralized management, and economies of scale.[80] In support of its conclusion that the corporate business was unitary, the Court found that taxpayer's in-state ranch divisions had little independence from overall corporate operations and did not have the capacity to operate independently. Also persuasive was the taxpayer's inclusion of the Montana ranch divisions within the unitary business when filing corporate tax returns in other states.[81] The

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34 Cal. Rptr. 545, 549-50 (1963); Honolulu Oil Co. v. California Franchise Tax Bd., 60 Cal. 2d 417, 423, 386 P.2d 40, 43, 34 Cal. Rptr. 552, 555 (1963). The California Franchise Tax Board twice argued that oil production operations in California were sufficiently distinct from exploration and production activities outside the state to justify separate accounting treatment for all California operations. Thus, in both cases, the Tax Board refused to consider the corporate taxpayer's out-of-state losses in determining the taxpayer's California apportionable tax bases. The California Supreme Court held in both cases that the operations were unitary in nature. In so holding, the court was aided by application of the three unities test. This test finds a unitary business exists if there is unity of ownership; unity of operation evidenced by central purchasing, advertising, accounting, and management; and unity of use in the centralized executive force and general system of operation. However, the three unities test is generally considered unique to California jurisprudence, and is therefore rarely relied upon in non-California state tax cases.

76. Other "two or more business" state cases in which a unitary business was found to taxpayer's benefit are Drake v. Department of Revenue, 263 Or. 26, 500 P.2d 1041 (1972) and Western Cont. Corp. v. State Tax Comm., 18 Utah 2d 23, 414 P.2d 579 (1966).

77. 665 P.2d 198 (Mont), *reh'g denied,* 459 U.S. 808 (1983).

78. *Id.* at 199.

79. Russell Stover Candies, Inc. v. Department of Revenue, 459 U.S. 808 (1982). The case was remanded to the Supreme Court of Montana for further consideration in light of F.W. Woolworth v. Taxation & Revenue Dep't, 458 U.S. 354 (1982) and ASARCO, Inc. v. Idaho State Tax Comm., 458 U.S. 307 (1982).

80. *See* F.W. Woolworth Co. v. Taxation & Revenue Dep't, 458 U.S. 354 (1982). The unitary business criteria of functional integration, centralized management, and economies of scale articulated in the context of dividend apportionment, probably evolved from the "three unities" test of use, operation, and ownership articulated in Butler Bros. v. McColgan, 315 U.S. 501, 508-09 (1942).

81. 665 P.2d at 200.

Court correctly noted the distinction between the case before it and a dividend apportionment case.[82] Although not dispositive of its decision, the court considered the fact that the taxpayer was a single entity, as contrasted to a parent corporation with several subsidiaries, to be sufficient to distinguish the case from *ASARCO* and *Woolworth.*[83] The United States Supreme Court, however, failed to so distinguish between a case of dividend apportionment and a case involving the two or more businesses inquiry.

3. The "Combined Reporting" Cases

The taxpayer in *Container Corp. of America v. Franchise Tax Board*[84] was a Delaware corporation doing business in California as a manufacturer of customer-ordered paperboard packaging. It also controlled twenty foreign subsidiaries located in eight different countries. Percentage ownership in these subsidiaries ranged from 66.7 percent to 100 percent. All but two of the subsidiaries were engaged in essentially the same business as the taxpayer.[85]

The Court affirmed the state court's finding of a unitary business made up of the taxpayer and its subsidiaries. Illustrating the essentially factual nature of this inquiry, the Court noted the taxpayer's assistance to its subsidiaries in obtaining equipment, in filling personnel needs, in providing loans, and in providing general supervision and guidance to the subsidiaries.[86] The relationship maintained by taxpayer and its subsidiaries, as evidenced by the above factual findings, permitted the Court to distinguish the case from *ASARCO* and *Woolworth,* where no unity was found.[87]

The Court's reference to *ASARCO* and *Woolworth* once again illustrates its analytical imprecision regarding the distinctions among the three types of unitary business issues. At issue in those dividend apportionment cases was whether dividends received from the taxpayers' subsidiaries were properly considered "business income," and hence apportionable. Combination of the income of the subsidiaries into the apportionable tax base of the taxpayer-parent, however, was not in controversy.[88]

Noting that the tax levy in question affected an international, as

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82. *Id.* 201.
83. *Id.*
84. 463 U.S. 159 (1983).
85. *Id.* at 171-72.
86. *Id.* at 179-80.
87. *Id.* at 176-77.
88. *ASARCO,* 458 U.S. 307, 314 (1982) (the Idaho State Tax Commission specifically determined that the subsidiaries' links with ASARCO were not sufficient to justify unitary treatment for combination purposes). *Id.*

constrasted with a solely domestic unitary business, the Court proceeded to scrutinize the tax in a manner required by the foreign commerce clause.[89] Before applying the dual criteria, however, three distinctions were noted between the factual situation at bar and the *Japan Line* facts: first, the tax involved was on income, as contrasted to a property tax; second, double taxation would not necessarily occur in similar factual settings, because no one jurisdiction would have the right to tax the income in full; and third, the tax fell not upon a foreign instrumentality, but upon a domestic taxpayer.[90]

In purporting to apply the first *Japan Line* inquiry of whether the tax creates a substantial risk of multiple taxation, the Court effectively altered the test. Emphasizing that the tax in question would not result in double taxation in all instances, the Court held that to replace the California apportionment method with another apportionment plan containing equal risks of double taxation would be senseless.[91] The first element of the *Japan Line* test is thereby weakened to the extent of being ineffectual when applied to an income, as contrasted with a property tax.

The second element of the *Japan Line* test, whether the levy in question prevents the federal government from speaking with one voice when regulating commercial relations with foreign government, was also easily dismissed. The one voice standard was held to be violated if the state tax either implicated a foreign policy issue which must be left to the federal government or violated a clear federal directive.[92] The only foreign policy implication of the California tax considered by the Court was the possibility of retaliatory taxing methods being taken by foreign sovereigns. This issue, however, could not be competently addressed by the Court because it was determined to be more appropriately considered by the executive branch. Additionally, the Court found no clear federal directive prohibiting such a tax.[93]

The Court intentionally failed to take a position on the issue of whether inclusion of the income of a foreign parent, as contrasted to a foreign subsidiary, in the apportionable tax base of a taxpayer would violate constitutional standards.[94] The Court also indicated its hesitance to establish an analysis for determining the unitary business in a combined reporting case.[95] This restraint illustrates the in-

89. Container Corp. of Am. v. Franchise Tax Bd., 463 U.S. 159, 185 (1983).
90. *Id.* at 185-87.
91. *Id.* at 193.
92. *Id.* at 194.
93. *Id.* at 196-97.
94. *Id.* at 189 n.26.
95. *Id.* at 178 n.17.

adequacy of judicial lawmaking in an area more appropriately reserved for the legislative branch.

Significant increases in the tax base of a corporation doing business in a state can be achieved by including the income of all related, but legally separate, entities in the total income of the unitary business. This combined reporting is most objectionable when the income of an out-of-state parent is included in the apportionable tax base of a subsidiary doing business within the state. This presents a great possibility of state taxation of extraterritorial income because the income of an out-of-state parent may include revenue from subsidiaries or sources separate from the unitary business. Combined reporting in such situations can, therefore, produce distortion.

The Alaska Supreme Court decision of *Earth Resources Co. v. State Department of Revenue*[96] illustrates this proposition. There the taxpayer was a corporation doing business in Alaska with 83 percent of its stock owned by a Delaware corporation.[97] In concluding that the out-of-state parent was part of the unitary business, the Court found that the domestic subsidiary received contributions from, and was functionally integrated with, its parent. Centralization of management and economies of scale provided by the parent were additional factors considered by the Court.[98] This application of the functional integration/centralization of management/economies of scale test of unity once again illustrates the Court's analytical imprecision. To the extent the foregoing test is applicable only to dividend apportionment cases, reliance upon it was misplaced.

The Court noted that the income of other subsidiaries of the taxpayer's parent is also a part of the unitary tax base. Consequently, income generated outside the unitary business may constitutionally be included in the tax base. The taxpayer carries the burden of establishing that the income of its subsidiaries should not be included in its tax base due to lack of unity with the parent.[99] Such inclusion would not be so cavalierly condoned if taxpayer's parent had been incorporated outside of the United States, thereby triggering the foreign commerce clause issue.

96. 665 P.2d 960 (Alaska 1983).

97. *Id.* at 968.

98. *Id.* at 969-70.

99. *Id.* at 970 n.24. The court cites *Exxon,* 447 U.S. at 224, for this proposition although that was a "two or more business" case with little relevance to the subsidiary/parent relationship in the case under review. Also cited and readily distinguishable was *ASARCO,* 458 U.S. at 320-23, which dealt with a parent taxpayer's relationship with its subsidiaries, as contrasted to a taxpayer subsidiary's relationship to its parent. 665 P.2d at 970 n.24.

Florida Law Review, Vol. 36, Iss. 5 [1984], Art. 5

III. A Proposed Legislative Solution — The Mathias/Conable Bill

The Mathias/Conable Bill[100] proposes to add a general rule to the 1954 Internal Revenue Code that will prohibit taking into account the income of a foreign corporation which is a member of an affiliated group when determining the taxable income of a corporation which is a member of the same affiliated group.[101] Although this prohibition will effectively preclude inclusion of a foreign corporation's income in the apportionable tax base of a taxpayer, the income of domestic corporations within the unitary group will remain subject to combined reporting. In addition, the prohibition does not apply to the extent such amount is includable in the federal gross income of the corporation for the purposes of Chapter 1 of the Internal Revenue Code. The effect of the Bill is therefore to limit a state's ability to tax corporate income to the same extent as the federal government. Congress is prohibited, however, from interfering with integral state governmental functions to the extent that it impairs the ability of the states to function effectively in a federal system.[102] Therefore, questions arise regarding the constitutionality of such statutorily mandated parallelism.

State taxing authority is limited by the Mathias/Conable bill's redefinition of key terms upon which the unitary tax is based. The Bill's definition of "affiliated group"[103] differs from the definition of the same term in Chapter 6 of the Internal Revenue Code. While the Internal Revenue Code[104] requires as a prerequisite to the finding of an affiliated group the existence of 80 percent ownership among a

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100. S.1225, 98th Cong., 1st Sess., 129 Cong. Rec. 6167-68 (daily ed. May 6, 1983) (proposed I.R.C. § 7518). See appendix for reproduction of the Bill.

101. *Id.* (proposed I.R.C. § 7518(a)).

102. One commentator argued that the state's power to tax was an integral governmental function of the state and therefore the Mathias/Conable Bill was unconstitutional under the rationale of National League of Cities v. Usery, 426 U.S. 833 (1976). Dexter, *State Taxation of Multinationals: Are the Mathias and Conable Bills Constitutional?*, 14 Tax Notes (Tax Analysts) 715 (Mar. 22, 1982).

The holding in *National League of Cities* was overruled by the United States Supreme Court in Garcia v. San Antonio Metropolitan Transit Auth., 105 S. Ct. 1005 (1985). The Court held that the standard established in *National League of Cities* of "traditional governmental functions" as the boundary of state regulatory immunity was unworkable and inconsistent with established principles of federalism. *Garcia*, 105 S. Ct. at 1016. Instead of maintaining a definitional standard of state sovereignty, the Court stated that the basic limit on federal power is state participation in federal governmental action and the political process itself. *Id.* at 1020. The apparent effect of this decision is to impose a greater burden upon opponents of the Mathias-Conable Bill to use the political process to prevent its passage.

103. S.1225, 98th Cong., 1st Sess., 129 Cong. Rec. 6167-68 (1983) (proposed I.R.C. § 7518(c)).

104. I.R.C. § 1504(a) (West 1985).

common parent corporation and one or more chains of corporations connected through stock ownership with the common parent corporation, no such control requirement is included in the Bill. This broad definition of affiliated group is consistent with the intent of the drafters of the Bill to "bring uniformity to this country's taxation of foreign source income."[105] Although successfully establishing that a corporation owning less than 20 percent of a foreign corporation with which it was vertically integrated in a unitary business is unlikely, the drafters of the Bill have defined "affiliated group" to remove any doubt in this regard. Foreign source operating income is simply not to be included in a taxpayer's apportionable tax base.

Domestic corporations will, under certain circumstances, be treated as foreign corporations under the Bill. The Bill refers to the rules of Subchapter N of Chapter 1 of the Internal Revenue Code, dealing with taxation of income from sources both within and without the United States. A domestic corporation will be treated as a foreign corporation for purposes of the Bill if, under Code section 861(a)(2)(A), a dividend received from such corporation in the taxable year would not be treated as income from sources within the United States.[106] In other words, domestic corporations will be treated as foreign corporations if they have an election in effect under section 936, regarding the elective tax credit for corporations in United States possessions or Puerto Rico, or if less than 20 percent of their gross income for the three-year period ending at the close of their preceding taxable year was derived from sources within the United States. Domestic corporations which are treated as foreign corporations also merit special rules in the section of the Bill dealing with dividend apportionment.[107]

The Bill additionally provides a special rule with respect to dividends received from domestic corporations which are treated as foreign corporations.[108] This provision requires both the consideration of a hypothetical dividend (special rule dividend) and a hypothetical tax deemed paid (special rule tax). The amount of both the special rule dividend and the special rule tax is the portion of the foreign income tax paid or deemed paid by the dividend-payor which bears

105. 129 CONG. REC. E2097 (daily ed. May 5, 1983) (extension of remarks by Representative Conable).

106. S.1225, 98th Cong., 1st Sess., 129 CONG. REC. 6167-68 (1983) (proposed I.R.C. § 7518(d)).

107. *Id.* (proposed I.R.C. § 7518(e)). The Bill also proposes to limit the extent to which a state may include foreign source dividends in a taxpayer's apportionable tax base. Embodied in subsection (e) of proposed section 7518, the provision can be understood best if read backwards. *Id.*

108. *Id.* (proposed I.R.C. § 7518(e)(3)).

the same ratio as the dividend actually paid to the amount of accumulated profits in excess of all income taxes actually paid.[109] Only a tax for which the foreign tax credit under section 901 would be allowed is to be considered for this purpose. The special rule dividend and special rule tax computed in this manner are crucial to the determination of the amount of the foreign source dividend which is excluded from the apportionable tax base.

A formula for determining the excluded portion of a dividend is also provided by the Bill.[110] The dividend received must first be increased by any special rule dividend amount or dividend "gross up" required by section 78 as a prerequisite to entitlement to the foreign tax credit.[111] This modified dividend is then multiplied by a fraction, the denominator of which is 46 percent of the modified dividend.[112] The numerator of the fraction is the sum of three components: the total amount withheld from all such dividends at the source, the total amount of tax which the domestic corporation is deemed to have paid under sections 902 or 960, and any special rule tax amount.[113] The excluded portion computed in this manner is also crucial to the determination of the amount of the foreign source dividend which is excluded from the apportionable tax base.

In determining the amount of the foreign source dividends excluded from tax, the Bill delineates rules for three distinct situations.[114] In the case of a dividend received from a corporation to which an election under section 936 is in effect for the taxable year in which such dividends are paid, a state may not tax or otherwise take into account the amount of the deduction allowed by section 243.[115] In the case of dividends received from a domestic corporation which is treated as a foreign corporation and which does not have an election under section 936 in effect, a state may not include the lesser of two amounts. These two amounts are one, the dividend received exclusive of the special rule dividend, or two, the amount by which the

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109. *Id.* (proposed I.R.C. § 7518(e)(3)(B)).

110. *Id.* (proposed I.R.C. § 7518(e)(2)).

111. If a domestic corporation which owns at least 10% of the stock of a foreign corporation elects the foreign tax credit of subpart A of Part III of subchapter N, it may treat as foreign taxes paid that portion of the foreign income taxes paid by the subsidiary which bears the same ratio as the amount of the dividend attributed to its accumulated profits bears to the subsidiary's total accumulated profits. I.R.C. § 902(a) (1982). However, a prerequisite to this deemed foreign tax paid is a hypothetical "gross-up" of the domestic corporation's dividend income in the amount of the foreign tax deemed paid. I.R.C. § 78 (West 1985).

112. S.1225, 98th Cong., 1st Sess. 129 CONG. REC. 6167-68 (proposed I.R.C. § 7518(e)(2)(B)).

113. *Id.* (proposed I.R.C. § 7518(e)(2)(A)).

114. *Id.* (proposed I.R.C. § 7518(e)(1)).

115. *Id.* (proposed I.R.C. § 7518(e)(1)(A)).

sum of the dividend and the special rule dividend exceeds the excluded portion.[116] In the case of dividends received from any other foreign corporation, a state may not include the lesser of one, the dividend received exclusive of any section 78 gross-up, or two, the amount by which the sum of the dividend and the section 78 gross-up exceeds the excluded portion.[117]

Both Senate Bill 1225 and House Bill 2918 were introduced in Congress on May 5, 1983, at which time the former was referred to the Senate Finance Committee and the latter was referred to the House Judiciary Committee.[118] As of this writing, no action has been taken in committee with regard to this proposed legislation. This inaction infers that these bills will not be promulgated into law in the 98th Congress. While this is undoubtedly pleasing to opponents of the bill who fear federal infringement upon the states' fundamental right to tax, it nevertheless leaves unresolved the controversy generated by worldwide unitary apportionment.

IV. Alternatives to Worldwide Unitary Apportionment and Federal Regulation — The Report of the Task Force of the Working Group on Worldwide Unitary Taxation

The Task Force of the Treasury's Worldwide Unitary Taxation Working Group completed a report on May 1, 1984 delineating six options to the current use of worldwide unitary apportionment by some states.[119] The intent of these proposals is to provide feasible alternatives to both the worldwide unitary method and to separate accounting of a corporation's taxable income. Competing interests agree that a cooperative voluntary solution to the current controversy is preferable to federal legislation in this area. This attitude is reflected in the decision of the group to defer consideration of a federal legislative solution.[120]

Each of the proposed options reveals in its provisions the particular influence of state or taxpayer interests. Option One proposes an alternative tax in lieu of unitary apportionment for foreign-based unitary groups, while options Two through Six propose limiting apportionment to a "water's edge" group. Differences among the water's edge proposals derive primarily from different treatment of the dividend apportionment issue.

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116. *Id.* (proposed I.R.C. § 7518(e)(1)(B)).
117. *Id.* (proposed I.R.C. § 7518(e)(1)(C)).
118. 129 Cong. Rec. H.2697, S.6167 (daily ed. May 5, 1983).
119. *See Treasury Report, supra* note 10, at 639.
120. *Id.* at 638.

A. Option One — An Alternative Tax

Option one is described as an "Activities Tax in lieu of unitary apportionment solely for foreign-based unitary groups."[121] This proposal permits a corporation which is part of a unitary business and whose parent corporation is neither organized nor conducts business in the United States to elect to pay an alternative tax based on its in-state payroll, property, and sales. The applicable tax rate would be calculated on an industry basis with reference to the tax paid by members of the industry conducting a unitary business within the state. This proposal ostensibly prevents the potential inequity presented by *Container Corporation* of a foreign parent's income being included in the apportionable tax base of a domestic subsidiary.

Proponents of option one point out its ease of administration and avoidance of objectionable worldwide unitary apportionment qualities. Opponents contend, however, that determination of the tax rate upon an industry basis within the state will nevertheless increase the state tax liabilities of some foreign-based multinational corporations, while decreasing the liabilities of others. Those taxpayers whose liabilities would be increased will not elect the alternative tax, thereby remaining subject to worldwide unitary apportionment. Consequently, many taxpayers would still assert that income earned outside the state was being taxed.

B. Options Two Through Six — Limitation of Apportionment to the "Water's Edge"

1. Common Elements

The five "Water's Edge" options all share common elements.[122] The intent of these options is to limit apportionment to a specifically defined group of corporations which are part of a unitary business. This "water's edge" group includes:

> (1) U.S. corporations included in a consolidated return for federal corporate tax purposes;
> (2) U.S. possessions corporations;
> (3) Companies incorporated in U.S. possessions or territories;
> (4) Domestic International Sales Corporations (DISC's) (or foreign sales corporations (FSC's) if applicable);
> (5) Certain tax-haven corporations presumed to be part of

121. *Id.* at 639.
122. *Id.* at 640.

the unitary business;[123]
(6) Foreign corporations with at least a threshold level of business activity in the U.S.;[124] and
(7) U.S. corporations not included in (1) and with more than 50% of their stock owned or controlled, directly or indirectly, by another U.S. corporation.

The effective implementation of this method necessitates increased disclosure requirements, enforcement through civil penalties, and a presumption of unity for failure to comply. Federal involvement would include a federal law requiring taxpayers to file information disclosing tax liability in each state of operation as well as increased cooperation between the IRS and state revenue departments regarding the necessary disclosure. Although the Task Force desires to avoid federal legislation in this field, it is nevertheless willing to accept federal compliance regulations regarding the functioning of the water's edge proposals.

Worldwide combination would still remain available for corporations which fail to comply with the disclosure requirements or for those situations in which separate accounting fails to prevent the evasion of taxes or to clearly reflect income. The meaning of the latter provison is confusing, as the water's edge proposals neither adopt separate accounting nor abandon formulary apportionments. The apportionable tax base is simply limited to corporations within the water's edge that constitute a unitary business.

2. Option Two — "Comprehensive Water's Edge Combination with Taxation of Cash or After-Tax Foreign Dividends, without Factor Relief"[125]

This state-oriented proposal incorporates the common water's edge elements with the following four primary modifications:
(1) Any U.S. corporation is treated as being within the water's edge, without regard to the source of its income or location of its business activities. The comprehensive character of option two is illu-

123. *Id.* at 645-46 n.2. A "tax haven" is defined as any country which does not impose a corporate income tax or whose income tax rate is less than a certain percentage of the U.S. tax rate. A corporation doing business or incorporated in a tax haven will be treated as being within the water's edge if 50% or more of its sales or purchases or 80% of all expenses are made to one or more members of a water's edge group. A tax haven corporation will also be presumed to be within the water's edge if it performs "no significant economic activity." *Id.*

124. *Id.* at 646 n.3. The "threshold level of business activity" is the lower of either more than 20% of their average payroll, property, and sales or 10 million dollars of payroll and/or property and/or sales and/or purchases assignable to a location in the United States according to the law of the taxing state. *Id.*

125. *Id.* at 643.

sory, as it is unlikely that a significantly greater number of U.S. corporations will be brought within the combined group. The U.S. corporation not included in the common water's edge group is a corporation which is part of a unitary business but which is not part of an affiliated group that has elected to file a consolidated return or 50% of the stock of which is not owned, directly or indirectly, by another U.S. corporation. The existence of a unitary business is a prerequisite to inclusion within the water's edge group. A corporation which is technically within the comprehensive definition of the water's edge group will, nevertheless, often be outside the unitary business. In this instance, combination is constitutionally proscribed.[126]

(2) The definition of "tax haven" would be modified to include any country which does not impose an income tax or whose income tax rate is less than 90% of the U.S. tax rate;[127]

(3) The Federal Interstate Income Tax Law would be modified to provide a de minimis jurisdictional standard of sales in excess of $500,000 per year.[128] Therefore, corporations whose only activity in the state is the solicitation of sales orders totaling more than $500,000 may be subject to that state's corporate income tax, if any. Current law does not prohibit the income of a corporation which only solicits sales orders within the state from being included in the apportionable tax base of a domestic corporation which is part of the same unitary business.[129] This provision, therefore, relates minimally to the worldwide unitary apportionment controversy.

(4) All "functionally-related" cash foreign dividends would be subject to allocation and apportionment for state tax purposes with-

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126. Mobile Oil Corp. v. Commissioner of Taxes, 445 U.S. 425, 439 (1980). *See also Treasury Report, supra* note 10, at 645 n.1.

127. *See Treasury Report, supra* note 10, at 643.

128. 15 U.S.C. § 381 (1982) (originally enacted in response to the decision in Northwestern States Portland Cement Co. v. Minnesota, 358 U.S. 450 (1959)). The statute generally prohibits a state from levying a net income tax on a business which has as its only activity in the state the solicitation of sales orders. 15 U.S.C. § 381 (1982).

129. Assume that ABC, Inc., which is in the business of manufacturing widgets, maintains its principal place of business in State X. State X utilizes the combined unitary apportionment method of computing the taxable income of corporations subject to the state income tax. ABC, Inc., owns 80% of the stock of DEF, Inc., which is incorporated in State Y and which is in the business of distributing widgets. ABC, Inc. sells all of its widgets to DEF, Inc. The only activity of DEF, Inc. within State X is the solicitation of sales orders.

The Federal Interstate Income Tax Law prohibits State X from levying an income tax directly on DEF, Inc., because the only activity of the corporation within the state is the solicitation of sales orders. 15 U.S.C. § 381 (1982). However, as DEF, Inc. is a controlled subsidiary of ABC, Inc. and purchases the entire output of ABC, Inc., the two corporations will likely constitute a unitary business. Consequently, in determining the taxable income of ABC, Inc., the appropriate apportionment formula will be applied to the combined income of the two corporations.

out adjustment to the apportionment formula for any portion of the factors of the divided-paying corporation. The amount so subject would not include the dividend "gross-up" required by section 78 as a prerequisite to the foreign tax credit.[130] This option is therefore described as including only after-tax foreign dividends in the apportionable tax base, because the inclusion does not cover foreign tax paid on the corporate income which generated the dividends.[131]

Functionally related foreign dividends are presumed to be those received from a corporation that meets two criteria. The foreign subsidiary must be engaged in the same general business as the parent with more than 50 percent of its voting stock owned by members of the unitary group. Additionally, the foreign subsidiary must supply or sell 15 percent or more of its output to the unitary group, or it must purchase or obtain 15 percent or more of its raw materials from the unitary group.[132] Whether this presumption of functionally-related foreign dividends is an attempt to codify the definition of the unitary business is unclear. A similar relationship in *ASARCO* was specifically found to be non-unitary.[133]

This comprehensive dividend apportionment provision is the crux of the criticism of option two's opponents. While fully including dividends in the apportionable tax base, it fails to adjust the apportionment formula for any portion of the factors, such as sales, payroll, or property of the dividend-paying corporation. Proponents emphasize that only after-tax dividends, that is, net dividends exclusive of foreign tax paid, are included in the apportionable tax base. By including only after-tax dividends, proponents assert that any inequity generated by the lack of "factor relief" is balanced out.[134]

3. Option Three — "Comprehensive Water's Edge Combination with Taxation of Grossed-Up or Pre-Tax Foreign Dividends, with Factor Relief"[135]

This proposal is identical to option two, except that dividends are included in the apportionable tax base along with the section 78 gross-up for foreign taxes paid.[136] This option is therefore described as including pre-tax foreign dividends in the apportionable tax base.

130. *See supra* note 111.
131. *See Treasury Report, supra* note 10, at 643.
132. *Id.* at 643.
133. ASARCO, Inc. v. Idaho State Comm'n, 458 U.S. 307 at 320, 321 (1982) (a subsidiary 51.5% of the voting stock of which was owned by ASARCO, and which sold 35% of its output to ASARCO, was not included in the unitary group).
134. *See Treasury Report, supra* note 10, at 643.
135. *Id.* at 643.
136. *Id.* at 644.

Also, the apportionment formula provides factor relief in that it is adjusted by a pro-rata portion of the factors of the dividend paying corporations. A predicate to comprehension of factor relief is cognizance of the fact that although dividends paid by foreign subsidiaries may be includable in the tax base, the dividend paying corporations are not within the water's edge. As a result, the sales, property, and payroll of such corporations are not included within the 3-factor apportionment formula. Inclusion of dividends received from such corporations in the apportionable tax base creates a distortion because the apportionment formula does not take account of the fact that some of the tax base was generated beyond the water's edge. Factor relief in option three would include a pro-rata portion of the dividend payor's factors in the denominator of the apportionment fraction, thereby decreasing the amount of the base included in taxpayer's taxable income. The portion of the dividend payor's factors which are included in the apportionment formula is that which bears the same ratio as total dividends paid to the unitary group bears to the pre-tax income of the payor corporation.

Critics of option three allege that inclusion of pre-tax dividends in the apportionable tax base may create significant phantom income.[137] The fact that income earned by the dividend payor, but paid as taxes to a foreign government, is included in the tax base means that the taxpayer will pay taxes on income never received. Proponents of this method contend, however, that factor relief offsets any alleged inequity resulting from the inclusion of pre-tax dividends in the unitary tax base.

4. Option Four — "Modified Water's Edge Combination, with Exclusion of Foreign Dividends"[138]

While the preceding two options manifest the product of strong state influence, options four and five relect a corresponding business influence. Option four includes all common elements of the water's edge with a few modifications. These modifications are:

> (1) Any U.S. corporation with more than 80% of its payroll and property outside the United States would be excluded from the water's edge group. Such a corporation is referred to as an "80/20 Corporation."
> (2) This proposal defines tax haven restrictively to include only a country which does not impose an income tax or whose income tax rate is less than 65% of the U.S. tax rate.

137. *Id.*
138. *Id.*

(3) Dividends from a corporation in which the taxpayer owns at least 80% of the stock are excluded from the apportionable tax base. For corporations with less than 80% owned by the taxpayer, only 15% of the dividends would be included in the apportionable tax base. This provision parallels the federal rule for treatment of dividends received by corporations.[139]

5. Option Five — "Modified Water's Edge Combination with a Special 'Foreign Income' Rule"[140]

This proposal includes all the elements of option four except that the dividend provision is replaced by a "Special Foreign Income Rule." It differs from Option Four only in that instead of excluding foreign source income directly, it does so by means of a complex formula.[141] A "foreign income component" consisting of dividends, interest, royalties, etc., received from foreign affiliates as well as the net income (or loss) from "80/20" subsidiaries would reduce the taxable income of the combined water's edge group.[142] The resulting amount of income is referred to as "U.S. Source" income, which is the minimum level of income to be taxed on an apportioned basis among the states. This minimum level of apportionable U.S. Source income would be increased in some circumstances, however.[143] An after-tax amount of U.S. Source income is first computed by subtracting federal income tax deemed paid. The foreign-income component is then similarly reduced for taxes deemed paid and combined with the after-tax U.S. Source income, resulting in the worldwide after-tax income. This worldwide after-tax income is then apportioned to the U.S. on the basis of the combined group's U.S. business activities relative to its worldwide activities. If the amount of the worldwide after-tax income apportionable to the U.S. is greater than the pre-tax U.S. Source income, the former would be the amount apportioned among the states.[144] Therefore, the income apportionable among the states is the greater of the pre-tax U.S. Source income or the after-tax worldwide income apportioned to the U.S.

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139. *Id. Cf.* I.R.C. 243 (West 1985).
140. *Treasury Report, supra* note 10, at 644.
141. *Id.* at 645.
142. *Id.*
143. *Id.*
144. *Id.*

6. Option Six — "Comprehensive Water's Edge Combination with Nondiscriminatory Treatment of Intercorporate Dividends"[145]

Option six is proposed by the Advisory Commission on Intergovernmental Relations. This alternative includes all the elements of option two, except that the dividend provision would be modified to require states to pursue a non-discriminatory policy with respect to the taxation of foreign and domestic dividends.[146] This policy of nondiscrimination would give states considerable leeway in implementing its dividend taxation policy. Considering the hunger for revenue of those states currently pursuing the worldwide unitary method, it is questionable whether granting such discretion to taxing authorities would ameliorate the controversy generated by the practice.

V. Conclusion

Formulary apportionment is a judicially sanctioned means for states to maximize tax revenues. Income derived from a taxpayer's "unitary business" is includable in the apportionable tax base whether it is attributed to the out-of-state functional activities of a taxpayer, generated by a taxpayer's affiliates, or is non-operating income. The shortcomings of judicial law-making in this area are apparent as courts have provided inadequate criteria for determining the scope of the unitary business.

Extension of the unitary business beyond the boundaries of the United States raises objections from multinational corporations and foreign governments. Application of formulary apportionment on a worldwide basis usurps Congress' power to regulate commerce with foreign nations, thereby raising issues rooted in federalism. Although states utilizing this method experience short-term benefits from enhanced tax revenue, they flirt with the possibility of federal legislation prohibiting worldwide apportionment.

The Mathias-Conable Bill eliminates one federalist conflict but generates another. Limiting combined reporting to domestic corporations and prohibiting inclusion of foreign-source dividends in a taxpayer's apportionable tax base protects the federal government's power to regulate commerce with foreign nations. This, however, also limits state power to raise revenue in a manner which impairs sovereignty. Federal regulation of a state's ability to raise revenue is an undesirable solution to the current controversy.

A voluntary, cooperative agreement satisfactory to both international business and revenue-hungry states is a more palatable alter-

145. *Id.*
146. *Id.*

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native. The Report of the Task Force of the Working Group on Worldwide Unitary Taxation is a step in the right direction. Adoption of any the water's edge options would signal a willingness on the part of state legislatures to restrict the scope of the unitary business for purposes of combined reporting. However, the dividend apportionment provisions of these options offer little in the way of compromise. Options two and three take an extreme position by effectively including all foreign source dividends in the apportionable tax base. Options four and five, however, take an equally extreme position by effectively excluding all foreign source dividends from the base.

State legislatures considering adoption of any of the Task Force's options should weigh carefully the twin objectives of maintaining a healthy source of tax revenue and stemming federal regulation of worldwide unitary apportionment. A realistic alternative would be a composite method combining a provision of the state-oriented options two and three with a provision of the taxpayer-oriented options four and five. For example, a method incorporating "Comprehensive" water's edge combination with the dividend exclusion provision of option four would come close to reaching a balanced compromise. With continued dialogue between competing interests, the current situation should progress to a mutually satisfactory stage.

LLOYD V. CRAWFORD

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Appendix

S. 1225, 98th Congress, 1st Session

To amend the Internal Revenue Code of 1954 to clarify the extent to which a State, or political subdivision, may tax certain income from sources outside the United States.

In the Senate of the United States

May 5 (legislative day, May 2), 1983

Mr. MATHIAS (for himself, Mr. FORD, and Mr. HUDDLESTON) introduced the following bill; which was read twice and referred to the Committee on Finance.

A Bill

To amend the Internal Revenue Code of 1954 to clarify the extent to which a state, or political subdivision, may tax certain income from sources outside the United States.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That (a) Chapter 77 of the Internal Revenue Code of 1954 (relating to miscellaneous provisions) be amended by adding at the end thereof the following new section:

SEC. 7518. INCOME OF CORPORATIONS ATTRIBUTABLE TO FOREIGN CORPORATIONS.

(a) IN GENERAL.—Where two or more corporations are members of the same affiliated group of corporations—(1) for purposes of imposing an income tax on any corporation which is a member of such group, no State, or political subdivision thereof, may take into account, or include in income subject to such tax, any amount of income of, or attributable to,

(2) any other corporation which is a member of such group and which is a foreign corporation, unless such amount is includable in the gross income of the corporation described in paragraph (1) for purposes of chapter 1 (including any amount includable in gross income under subpart F of part III of subchapter N of chapter 1) for the taxable year in which or with which the taxable period (for purposes of State or local law) ends.

(b) INCOME TAX DEFINED.—For purposes of this section, the term "income tax" means any tax which is imposed on, according to, or measured by net income.

(c) AFFILIATED GROUP DEFINED.—For purposes of subsection (a), the term "affiliated group" means a common parent corporation and one or more chains of corporations connected through stock ownership with such common parent corporation.

(d) CERTAIN CORPORATIONS TREATED AS FOREIGN CORPORATIONS.—For the purpose of this section, a domestic corporation shall be treated as a foreign corporation if under section 861(a)(2)(A) a dividend received from such corporation in the taxable year referred to in subsection (a) would not be treated as income from sources within the United States.

(e) CERTAIN DIVIDENDS PAID OR DEEMED PAID.—(1) *Dividends Excluded from Tax.*—If a corporation receives in any taxable year a dividend from a foreign corporation (or is by application of section 951 treated as having received such a dividend), in imposing an income tax on such corporation no State, or political subdivision thereof, may tax, or otherwise take into account—

(A) in the case of a dividend received from a corporation with respect to which an election under section 936 is in effect for the taxable year in which such dividends are paid, the amount of the deduction allowed by section 243,

(B) in the case of a dividend received from a corporation described in subsection (d) which is not described in paragraph (A), more than the lesser of—

(i) the amount of the dividend exclusive of any amount of dividend determined under paragraph (3), or

(ii) the amount by which the dividend plus any amount of dividend determined under paragraph (3) exceeds the excluded portion of the dividend determined in accordance with paragraph (2).

(C) in the case of a dividend received from any other foreign corporation more than the lesser of—

(i) the amount of the dividend (exclusive of any amount determined under section 78), or

(ii) the amount by which the dividend plus any amount determined under section 78 exceeds the excluded portion of the dividend determined in accordance with paragraph (2).

(2) *Excluded Portion of a Dividend.*—The excluded portion of any dividend shall be determined by multiplying the amount of the dividend (including the amount of dividend determined under section 78 or paragraph (3)) by a fraction—

(A) the numerator of the fraction shall be the sum of—

(i) the total amount of tax withheld from all such dividends at the source.

(ii) the total amount of tax which by application of section 902 or

960 to all such dividends, the domestic corporation is deemed to have paid, and

(iii) the total amount of tax deemed paid by application of paragraph (3).

(B) the denominator of the fraction shall be 46 percent of all such dividends.

(3) *Special Rule With Respect to Dividends Received from Domestic Corporations Treated as Foreign Under Subsection (d).*—A corporation that receives a dividend which is described in subparagraph (b) of paragraph (1) shall—

(A) treat as a dividend for purposes of subparagraph (B) of paragraph (1), and

(B) treat as a tax deemed paid for purposes of subpargraph (A) of paragraph (2), foreign income taxes which such other corporation has paid or deemed paid in the same proportion on or with respect to the accumulated profits of such corporation from which such dividend was paid, which the amount of such dividend bears to the amount of such accumulated profits in excess of all income taxes (other than those deemed paid). For purposes of this section, only a tax for which a credit against tax would be allowable under section 901 (determined without regard to the limitations in section 904 and 907) shall be taken into account. Nothing in this section shall subject any dividend, other income item or portion thereof to taxation if such taxation is otherwise prohibited by any law, or rule of law, of the Untied States.

(c) EFFECTIVE DATE.—The amendment made by this section shall apply to taxable periods (for purposes of State or local law) beginning after December 31, 1980.

(d) AMENDMENT OF THE TABLE OF SECTIONS.—The table of sections for chapter 77 of such Code is amended by adding at the end thereof the following new item:

Sec. 7518. Income of Corporations Attributable to Foreign Corporations.