State Income Taxation of Multijurisdictional Corporations: An Historical Perspective

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A state may constitutionally tax only that amount of a multijurisdictional corporation's income which bears a rational relationship to the taxing state.¹ This prevents the jurisdiction from taxing more income than what can reasonably be considered as earned within its borders. Usually, the state will apportion part of a corporation's income based on the values of property, payroll and sales of the corporation within the state.² The instate values of property, payroll and sales for a business are compared with property, payroll and sales located everywhere. The resultant fraction is multiplied against the total income subject to apportionment (i.e. income derived only from that business), to arrive at the amount of income taxable by the state.³ The apportionable income however, must be derived only from a business with which the taxing state has a sufficient nexus.⁴ A problem frequently occurs in trying to ascertain the scope of this business, as not all income earned by a company will always be connected with the business carried on in the taxing state. Complexities arise when a corporation operates diverse businesses through a multitude of divisions, subsidiaries and other associated companies in a number of jurisdictions and perhaps even countries.⁵ The related business activities over which

¹. The due process clause imposes two restrictions upon a state's power to tax income generated by instate activities of an interstate business. First, there must be "some minimal connection between those activities and the taxing State." Moorman Mfg. Co. v. Bair, 437 U.S. 267, 273 (1978) (quoting Miller Bros. v. Maryland, 347 U.S. 340-45 (1954)). Second, "the income attributed to the State for tax purposes must be rationally related to 'values connected with the taxing State.'" 437 U.S. at 273. See also infra note 146 and accompanying text.

². See G.A.O. REPORT TO THE CHAIRMAN, HOUSE COMMITTEE ON WAYS AND MEANS: KEY ISSUES AFFECTING STATE TAXATION OF MULTIJURISDICTIONAL CORPORATE INCOME NEED RESOLVING, (1982) [hereinafter cited as G.A.O. REPORT]. The alternative to apportioning income in this manner is to use separate accounting. Separate accounting requires a company to isolate income-producing activities and income sources in one state from all others, in determining income attributable to that state. Regardless, most states use some sort of formulary apportionment to ascertain taxable income. See, e.g., infra notes 10 and 197 and accompanying text.

³. See infra note 161.

⁴. See supra note 1.

⁵. To further compound this problem, each of the 45 states that levy an income tax against multijurisdictional corporations apply formulary apportionment in somewhat of a
the taxing state has jurisdiction for tax purposes is often called the "unitary business."

Three major subjects of controversy are prevalent in this area. Much litigation has ensued over the years in attempts to define what actually constitutes a unitary business. The propriety of the particular formula used to apportion income has also been questioned quite regularly. If this is not enough, aggressive state legislatures and revenue departments have now expanded the concept of "unitary business" to comprehend worldwide operations of a corporation.

Therefore, in *F. W. Woolworth Co. v. Taxation & Revenue Department* and *ASARCO, Inc. v. Idaho State Tax Commission* the United States Supreme Court attempted to further clarify the definition of a unitary business. Last term in *Container Corp. of America v. Franchise Tax Board*, the Court sustained the constitutionality of the states' taxing of a "worldwide unitary business."

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6. To constitute a unitary business there must be some "sharing or exchange of value not capable of precise identification or measurement—beyond the mere flow of funds arising out of a passive or a distinct business operation—which renders formula apportionment a reasonable method of taxation." *Container Corp. of Am. v. Franchise Tax Bd.*, 103 S. Ct. 2933, 2940 (1983). *See infra* note 10 and accompanying text; *infra* notes 178-216 and accompanying text.

7. Originally, the scope of a unitary business was confined primarily to domestic business activity.


10. 103 S. Ct. 2933 (1983). *Container* was the first case considered by the United States Supreme Court that specifically challenged the constitutional validity of worldwide unitary taxation. The Court did, however, narrowly limit its holding to taxation of a domestic parent company and foreign subsidiary, leaving unanswered the constitutionality of taxation of a foreign parent and domestic subsidiary. *Id.* at 2956 n.32. Justice Brennan, writing for the majority, stated:

The unitary business/formula apportionment method is a very different approach to the problem of taxing businesses operating in more than one jurisdiction. It rejects geographical or transactional accounting, and instead calculates the local tax base by first defining the scope of the "unitary business" of which the taxed enterprise's activities in the taxing jurisdiction form one part, and then apportioning the total income of that "unitary business" between the taxing jurisdiction and the rest of the world on the basis of a formula taking into account objective measures of the corporation's activities within and without the jurisdiction.

*Id.* at 2940.

Forty-four states (and the District of Columbia) presently levy some sort of income tax on multijurisdictional corporations. Of these, 13 states apply worldwide combined reporting to corporations operating within and outside the United States, in determining taxable income subject to apportionment. However, 27 other states restrict application of combined reporting to a domestic basis only. *G.A.O. Report*, *supra* note 2, at Appendix II.
This comment will discuss the evolution of state income taxation of a unitary business beginning with the early property tax cases, and subsequently review how this concept has been refined over the years. Next, the formulary apportionment of unitary business income will be analyzed with particular emphasis placed on the sometimes distortive results. Finally, the Supreme Court’s recent decision in Container will be evaluated with a view towards the future implications for state income tax practitioners.

I. EVOLUTION OF UNITARY TAXATION

Unitary taxation first emerged in the ad valorem property tax cases respecting the multi-state operations of railroads. A state was initially permitted to assess for tax purposes a portion of the value of the railroad’s total property, in the proportion that the railroad’s track in the taxing jurisdiction bore to its track as a whole, regardless of where such track or property was located. The essential theory behind unitary taxation was succinctly stated by Mr. Justice Holmes in Wallace v. Hines as follows:

The only reason for allowing a State to look beyond its borders when it taxes the property of foreign corporations is that it may get the true value of the things within it, when they are part of an organic system of wide extent, that gives them a value above what they otherwise would possess.

12. One commentator has noted: The property cases do establish the unit rule or unitary concept for state tax purposes. These cases permit a state to determine the in-state privilege, property or income by reference to the total privileges, properties or income of the multistate business, regardless of whether the business is conducted in a single or multiple corporate form, if there is a unitary relationship between the in-state activities or properties. They also establish the proposition that all of the properties of a unitary business utilized in carrying on the unitary business are subject to a reasonable rule of apportionment. These cases also support the principle that an apportionment formula is presumed to be reasonable and the burden is on the taxpayer to establish otherwise. See Dexter, The Unitary Concept in State Income Taxation of Multistate - Multinational Businesses, 10 URB. LAW. 243 (1978).
13. 253 U.S. 66 (1920). The taxpayer railroad here had protested apportionment of property value based on track located within North Dakota, asserting that the large and valuable terminals located outside the state did not contribute to the value of property located within the state. The United States Supreme Court sustained the taxpayer’s contentions. Id. at 70.
14. Id. at 69. See also Ford Motor Co. v. Beauchamp, 308 U.S. 331 (1939), which essentially reiterated this principle in a state income tax context. Id. at 336.
A. Development of the Unitary Concept for State Income Taxation

One of the earlier cases extending the unitary concept from property cases to state income taxation is Underwood Typewriter Co. v. Chamberlain. The State of Connecticut had applied its two percent tax rate against Underwood’s income for federal tax purposes, having attributed as income to Connecticut the same percentage as the taxpayer’s real and tangible property located in that state bore to its real and tangible personal property located everywhere. This apportionment resulted in Connecticut taxing $629,668.50 (47%) of the company’s net income, instead of the mere $42,942.18 (3%) that Underwood claimed had been earned in Connecticut.

Mr. Justice Brandeis, writing for the Court, indicated that the company had not attempted to show that forty-seven percent of its income was not actually earned in Connecticut, and therefore it was conceivable that a higher percentage may have been more appropriate. Thus, the unitary concept application to state income taxation was affirmed. However, the clear implication by the Court was that if the taxpayer could have established that the method of apportionment used by the state was “inherently arbitrary” or that it produced an “unreasonable result,” the decision might have been different.

Several years later, the Court again upheld formulary apportionment of income for a vertically integrated business in Bass, Ratcliff v. State. Although in that case the taxpayer’s business tran-
scended national boundaries, Underwood was deemed to be controlling. The tax at issue was considered to be levied for the privilege of doing business in the State of New York, and was only measured by the income allocated for tax purposes which derived from the business conducted during the preceding year.

Nevertheless, Underwood and Bass, Ratcliff did not portend a mechanical approval of all methods of formulary apportionment. This fact was soon established in Hans Rees' Sons v. North Carolina, in which the Court held unconstitutional the application of a single-factor formula, similar to the formulas previously sustained in Underwood and Bass, Ratcliff. The taxpayer asserted that the treatment of its business as unitary for purposes of allocating income grossly distorted the amount of income that was actually attributable to North Carolina, and that application of the formula to its specific factual situation was arbitrary and unreasonable. The United States Supreme Court agreed, indicating that Hans Rees' Sons had made the necessary showing of distortion that was required to invalidate the tax.

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21. *Id.* at 280.

22. *Id.*

23. One wonders now if this is still the case, particularly after Container. See infra notes 193-200 and accompanying text.

24. 283 U.S. 123 (1930). Hans Rees' Sons had a manufacturing plant located in North Carolina at which the manufacture of heavy leathers occurred. It also purchased leather in the open market for resale through a New York warehouse and New York offices. The company offered evidence that established that its income was derived from three sources: (1) buying profit; (2) manufacturing profit; and (3) selling profit. During the four year period in question (1923-1926), Hans Rees' Sons demonstrated that the portion of income attributable to operations in North Carolina averaged 17%. In contrast, the state by using its formulary apportionment, had concluded that an average of 80% of the taxpayer's total income in each of these years should be subject to the North Carolina tax. *Id.* at 125-34.

25. *Id.* at 125-26. On this basis, it was asserted that the tax was violative of the commerce clause and also section 1 of the 14th amendment of the United States Constitution (due process and equal protection). U.S. Const. amend. 14.

26. 283 U.S. at 134-36. Hans Rees' Sons has been cited as recently as Container for the principle that if the taxpayer meets its burden of proof and proves gross distortion, the tax will be struck down. 103 S. Ct. at 2942. See also infra notes 195-199 and accompanying text. Notwithstanding this, the Court's actions in recent years have prompted one prominent scholar on state and local taxation to comment: "Hans Rees stands alone as an isolated monument to the ability of one taxpayer to use separate accounting evidence to challenge successfully a state's apportionment of unitary business income." See Hellerstein, *State Income Taxation of Multijurisdictional Corporations: Reflections on Mobil, Exxon, and H. R.* 5076, 79 Mich. L. Rev. 113 (1980). See also infra notes 54-68 and accompanying text, and Kent-Coffey Mfg. Co. v. Maxwell, 204 N.C. 365, 168 S.E. 397, aff'd, 291 U.S. 642 (1933)(per curiam). In Kent-Coffey, the taxpayer tried to include intangible property (capital stock with a situs of Delaware where the corporation was headquartered) into the denominator of the property factor used to apportion net income. The United States Supreme Court, in upholding the North Carolina Supreme Court's judgment against the taxpayer, merely
The Court has subsequently ruled in favor of the taxpayer when attempts were made to tax transactions which bore no relationship to the taxing state. For example, in *Connecticut General Life Insurance Co. v. Johnson,* the insurance company which was doing business in California, had additionally entered into reinsurance contracts with other insurers doing business within that state. These contracts were entered into in Connecticut where the premiums were paid and where the losses, if any were payable. Mr. Justice Stone, writing for the majority, indicated that taxation of these reinsurance premiums by the State of California, was violative of due process on the basis that a state cannot tax or regulate a corporation's property and activities located elsewhere.

Shortly thereafter in *Wisconsin v. J. C. Penney Co.*, Mr. Justice Frankfurter paraphrased the due process of law test in a state taxation contest as being nothing more than "whether the state has given anything for which it can ask return." It was further observed that a tax being contingent upon events occurring outside the state will not destroy the nexus between that state and the taxable transactions occurring therein.

The Supreme Court had its first opportunity to review the property, payroll and sales three-factor formula in *Butler Brothers v. McColgan.* The taxpayer in *Butler Brothers* had attempted to invalidate the results of the apportionment of its income through the use of separate accounting. Justice Douglas, who wrote the opin-

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stated that *Underwood* and not *Hans Rees' Sons* was controlling. *Id.*
27. 303 U.S. 77 (1938).
28. *Id.* at 81. A reinsurance contract will indemnify an insurance carrier against losses on policies it has written. *Id.*
29. *Id.* at 78.
30. *Id.* at 82.
31. 311 U.S. 435 (1940). Wisconsin imposed a tax upon domestic and foreign corporations on the privilege of declaring and paying dividends derived from income earned within Wisconsin and payable to Wisconsin residents and non-residents alike. *Id.* at 440 n.1. J. C. Penney was a Delaware corporation, having its principal place of business in New York where its Board of Directors declared the dividends, among other things. *Id.* at 443.
32. *Id.* at 444. The Court distinguished *Connecticut General* as outlining the scope of state taxing power, and not being applicable to the facts in the instant case. *Id.* at 445-46.
33. *Id.* at 445.
34. See supra text accompanying notes 1-4.
35. 315 U.S. 501 (1942). In *Butler Bros.* the taxpayer was an Illinois corporation doing business in California. It had wholesale distributing houses for the sale of dry goods and general merchandise located in seven states, including one at San Francisco, California. Each of the houses had a separate sales staff, credit collection department and maintained its own books of account. However, the purchasing was performed for all houses through a central division. Certain of the other activities were also centralized. *Id.* at 504-06.
36. See supra note 2 and accompanying text.
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ion for the Court, indicated that such an accounting did not, and hinted perhaps could not, impeach the propriety of the formulary apportionment.\textsuperscript{37} Though it was implied that had the taxpayer made a showing that certain of the income was unconnected with the unitary business, it would have been excluded from the apportionable income base.\textsuperscript{38}

Additionally, in determining whether or not there was a unitary business, the Court endorsed the three-unities test earlier set forth in that case by the California Supreme Court.\textsuperscript{39} For a finding that a business is unitary, there must be: "(1) unity of ownership; (2) unity of operation as evidenced by central purchasing, advertising, accounting and management divisions; and (3) unity of use in its centralized executive force and general system of operation."\textsuperscript{40}

Thus, after Butler Brothers perhaps the only way to exclude income from the apportionment of a purported unitary business would be to demonstrate that such income was totally unconnected with the business. The merits of a separate accounting analysis are now particularly suspect after Container Corporation of America, in which the Court stated: "The problem with this method is that formal accounting is subject to manipulation and imprecision, and often ignores or captures inadequately the many subtle and largely unquantifiable transfers of value that take place among the components of a single enterprise."\textsuperscript{41}

B. Refinement of the Unitary Concept

One of the most vexing and controversial issues confronting corporate taxpayers today, is what constitutes a unitary business.\textsuperscript{42} Naturally, most states attempt to include as much of a taxpayer's operations (and profit) as possible within the scope of its unitary business.\textsuperscript{43} The existence of a unitary business provides the mini-

\begin{itemize}
\item \textsuperscript{37} 315 U.S. at 507-08.
\item \textsuperscript{38} Id. at 509.
\item \textsuperscript{39} Id. at 508.
\item \textsuperscript{40} Butler Bros. v. McColgan, 17 Cal. 2d 664, 111 P.2d 334 (1941), and 315 U.S. at 508. This test has frequently been used over the years, but recently has been displaced by a multi-faceted and more sophisticated analysis. See infra notes 181-192 and accompanying text.
\item \textsuperscript{41} 103 S. Ct. at 2940. See supra note 6, and infra notes 193-199 and accompanying text.
\item \textsuperscript{42} See G.A.O. Report, supra note 2, at Digest.
\item \textsuperscript{43} Multijurisdictional corporations are generally opposed to the use of worldwide combined reporting for a number of reasons. Primarily, opponents of worldwide combined reporting assert that it poses risks of international multiple taxation; that such reporting misallocates to a state more than its proper share of income because of incomparability of
\end{itemize}
mum nexus that a state must have with the out-of-state activities of a multijurisdictional business in order to justify the state’s taxing an apportioned share of the unitary business’ income. This is because once a unitary determination has been made for a multijurisdictional business, the state has some connection with its entirety.44

Although the “three-unities” test set forth in Butler Brothers45 related to unincorporated wholly controlled branches of a business located in different jurisdictions, the California Supreme Court subsequently extended this test for unitary characterization to incorporated wholly controlled businesses so located. In Edison California Stores v. McColgan46 the court refined the three-unities test by stating that, “[i]f the operation of the portion of the business done within the state is dependent upon or contributes to the operation of the business without the state, the operations are unitary. . . .”47

The authority of Butler Brothers and Edison California Stores

factors in an international environment; and that reporting requirements create an undue administrative burden. See G.A.O. Report, supra note 2, at 35-38.

Certain states allocate “non-business” income to a single state, which income typically includes such things as dividends, interest and rental income. Income is allocated to a state based on criteria such as location of the income-producing assets or the site of the corporation’s headquarters. Therefore, a determination of unitary is without consequence regarding non-business income when such income is allocated by the taxing state. See G.A.O. Report, supra note 2, at 48. There are currently 24 states which recognize the distinction between business versus non-business income, allocating the latter. Another 10 states apportion business income and allocate other types of income which they classify in various ways. Id. at 66.

Furthermore, not all taxpayers will contest a finding of unitary in respect of “business” income, and may even assert unitary to the maximum extent possible. See, e.g., Caterpillar Tractor Co. v. Lenckos, 84 Ill. 2d 102, 417 N.E.2d 1343 (1981), in which Caterpillar sought relief after concluding that it had overpaid its Illinois state income tax liability by almost $11,000,000 between the years 1969-1974, because it had not filed tax returns on a worldwide combined basis. Id. at 112, 417 N.E.2d at 1350. Instead, Caterpillar had originally compared only the instate totals of each corporation with the instate and out of state totals for property, payroll and sales of the same corporation and not of the unitary business group. Id. at 110, 417 N.E.2d at 1347. In Caterpillar, the Illinois Supreme Court sustained the validity of worldwide combined reporting as interpreted under Illinois law. See also infra notes 47-51 and accompanying text.

45. See supra notes 35-40 and accompanying text.
46. 30 Cal. 2d 472, 183 P.2d 16 (1947). Edison California Stores comprised 15 subsidiary corporations located in as many states, including one in California which was the plaintiff in the instant case. The parent company, a Delaware corporation, performed many centralized functions for the subsidiaries, similar to what was performed for the branch offices in Butler Bros. Id. at 474, 183 P.2d at 18. See supra notes 34-40 and accompanying text.
47. 30 Cal.2d at 481, 183 P.2d at 21. See infra note 53.
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persisted throughout the next several decades, with no further definitive pronouncements by the United States Supreme Court on what constituted a unitary operation prior to 1980. However, in the interim period state courts continued to grapple with the problem. It was not unheard of for a state revenue department to change positions on whether unitary business apportionment or a separate accounting should determine what income was subject to taxation. The method preferred would be dependent upon which technique would yield the highest tax revenue. For example, the State of California Franchise Tax Board asserted in both Superior Oil Co. v. Franchise Tax Board and Honolulu Oil Corp. v. Franchise Tax Board that a separate accounting of what income was reasonably attributable to California was the correct method to use, whenever such an accounting was possible. Notwithstanding Butler Brothers and Edison California Stores, the Board argued that in order for a determination that a business was unitary to prevail, "it must appear that the operations within and without the state are 'necessary and essential' to each other and to the functioning of the business as a whole." The California Supreme Court summarily dismissed this argument indicating that it was without basis in law, and reaffirmed the three-unities test originally propounded in Butler Brothers.

It was not until 1980, that the United States Supreme Court again confronted the unitary business dilemma. In Mobil Oil Corp. v. Commissioner of Taxes and Exxon Corp. v. Wisconsin Department of Revenue, the Court resolved unitary business questions but failed to do much to clarify existing law. The majority simply

48. See infra notes 54-55 and accompanying text.
49. 60 Cal. 2d 406, 34 Cal. Rptr. 545, 386 P.2d 33 (1963). Superior Oil Co. sold crude petroleum derived from California operations to only California customers, and sold crude petroleum derived from outside of the state to only those customers located outside of the state. Id.
50. 60 Cal. 2d 417, 34 Cal. Rptr. 552, 386 P.2d 40 (1963). The facts were essentially the same as in Superior Oil. In both instances, the companies lost money in out of state operations, notwithstanding that operations within the State of California were highly profitable. Formulary apportionment would look at the net operating results of total operations, while separate accounting isolated the profits associated with California, but disregarded the out-of-state losses.
51. 60 Cal. 2d at 412, 34 Cal. Rptr. at 549, 386 P.2d at 37.
52. Id.
53. Id. For other state courts subsequently endorsing the test as articulated in Edison California Stores, see, e.g., Joslin Dry Goods Co. v. Dolan, 200 Colo. 291, 615 P.2d 16 (1980); Coca Cola Co. v. Dept of Revenue, 271 Or. 517, 533 P.2d 788 (1975).
reaffirmed the broad taxing powers of the states, while indicating that any uniformity in state income taxation could be mandated only by Congress.66

In Mobil, the primary issue was whether or not a nondomiciliary state (Vermont) could constitutionally tax foreign source income received by a domestic corporation in the form of dividends from subsidiaries and affiliates doing business abroad.67 The taxpayer asserted that on due process and commerce clause grounds, foreign source dividends were by their very nature, not apportionable income.68 Justice Black, in writing for the majority, stated that "the linchpin of apportionability in the field of state income taxation is the unitary business principle."69 Therefore, in order for the dividends to be excluded from taxation, a showing had to be made "that the [dividend] income was earned in the course of activities unrelated to the sale of petroleum products in that State [Vermont]."70 It was noted that Mobil Oil had not even attempted to make such a showing.71 The Court further indicated that due process considerations might well preclude the taxability of dividends when the activities of the dividend payor were not part of the unitary business associated with the taxing state.72 Thus, after Mobil there seemed to be no question that given the existence of a unitary business, separate accounting would not be a permissible way to demonstrate that certain of the taxpayer's income was not apportionable to a particular state.73 So long as there was some in-

56. 445 U.S. at 449. For an excellent in-depth analysis of Mobil and Exxon, see Hellerstein, supra note 26.

57. 445 U.S. at 427. See also E. Christian, State Taxation of Foreign Source Income (1981), a research study prepared for the Financial Executive Research Foundation. The study, which assembles and analyzes data provided by 123 firms, concludes that states apply their taxes to a substantially larger part of foreign source income than does the federal government.

58. 445 U.S. at 436. These assertions essentially comprised three main arguments: (1) there was no nexus between Vermont and either Mobil's management of its investments, or the payor corporations' business activities; (2) taxation of the dividends by Vermont would constitute multiple taxation (a burden not imposed upon corporations operating solely intrastate) because the domiciliary state, New York, had the power to tax 100% of the dividends (even though it did not exercise this power); and (3) the foreign source of these dividends precluded their taxation, at least in states other than the payee's commercial domicile, because of risk of multiple taxation at the international level. Id.

59. Id. at 439.

60. Id.

61. Id.

62. Id. at 442. Justice Black stated that "[o]ne must look principally at the underlying activity, not at the form of the investment, to determine the propriety of apportionability." Id. at 440.

63. In Mobil, the Court noted that "separate accounting, while it purports to isolate
state activity giving rise to sufficient nexus for due process purposes, that state could constitutionally tax any income not clearly shown to be unconnected with the unitary business.

Several months later, the Court in *Exxon Corp. v. Wisconsin Department of Revenue*, reelying largely on the principles enunciated in *Mobil*, upheld the State of Wisconsin's income tax against due process and commerce clause challenges. Exxon, a vertically integrated petroleum company, did business through a functional organization comprising a department of exploration and production, a refining department, and a marketing department. Each function was responsible for its own operating performance, and income was determined by way of a corporate-wide separate accounting system. Because the marketing department alone operated in Wisconsin, Exxon calculated its tax liability for that state by apportioning only marketing department income.

Justice Marshall, in a unanimous opinion, concurred with the Wisconsin Supreme Court, stating that "[w]hile Exxon may treat its operational departments as independent profit centers, it is nonetheless true that this case involves a highly integrated business which benefits from an umbrella of centralized management and controlled interaction." This case, which appeared to represent a clear-cut unitary business situation, did nothing more than provide the United States Supreme Court with an opportunity to reaffirm its earlier holding in *Butler Brothers*. Exxon did not even purport to establish further guidelines as to how a unitary business should actually be defined, despite the dramatic increase in the number of states now employing this concept in the taxation of multijurisdictional corporations.

Several years after *Mobil* and *Exxon* were decided, the Supreme Court again confronted the unitary issue. In *ASARCO, Inc. v. Idaho State Tax Commissioner*, and *F. W. Woolworth Co. v. Taxation & Revenue Department*, an effort was finally made to portions of income received in various States, may fail to account for contributions to income resulting from functional integration, centralization of management, and economies of scale." *Id.* 458 U.S. 354 (1982).

64. 447 U.S. 207 (1980).
65. *Id.* at 211-13.
66. *Id.* at 213.
67. *Id.* at 217-19.
68. *Id.* at 224.
70. 458 U.S. 354 (1982).
explicate the outer boundaries of a unitary business.\textsuperscript{71} The Court also reiterated its position, established in \textit{Mobil} that, in order for intangible income to be apportionable, such income \textit{must be derived from a unitary business}.\textsuperscript{72} For the first time, the taxpayer proffered an extensive factual record signifying that the income at issue was derived from other than the unitary business operating in the state attempting to levy its income tax. The record clearly established the relationship between the parent-payee and the subsidiary-payors. In retrospect, a factor proving to be highly critical to the Court in its favoring the taxpayer, was that the trial court had initially made a finding of nonunitary based on this record.\textsuperscript{73}

\textit{ASARCO} involved a taxpayer, ASARCO, Inc., which was a New Jersey corporation domiciled in New York engaged in operating a silver mine in Idaho.\textsuperscript{74} The State of Idaho sought to include as apportionable "business income,"\textsuperscript{75} inter alia, intangible income\textsuperscript{76}

\begin{thebibliography}{99}
\bibitem{71} For an excellent in-depth analysis of \textit{ASARCO} and \textit{Woolworth}, see Hellerstein, \textit{supra} note 44. See also Peters, \textit{Supreme Court Requires Unitary Relationship Before States Can Tax Investment Income}, J. Tax'n 314 (Nov. 1982).
\bibitem{72} 458 U.S. at 317-19.
\bibitem{73} \textit{Id.} at 314. See \textit{Container}, 103 S. Ct. at 2946, in which the Court stated "our task must be to determine whether the state court applied the correct [legal] standards to the case; and if it did, whether its judgment 'was within the realm of permissible judgment.'" Justice Brennan also indicated that "\textit{ASARCO} and \textit{F. W. Woolworth} are consistent with this standard of review." \textit{Id.} at 2946 n.15. He further stated that "[w]e concluded, relying on factual findings made by the state courts, that a unitary business finding was impermissible. . . ." \textit{Id.} (original emphasis).
\bibitem{74} 458 U.S. at 309. ASARCO mines, smelts and refines nonferrous metals in various states. Approximately 2.5\% of ASARCO's total business activities were calculated to have taken place in Idaho during the years in question (1968-1970). \textit{Id.}
\bibitem{75} \textit{Id.} at 309. Idaho adopted its version of UDITPA, see \textit{infra} notes 108-109 and accompanying text, in 1965 under which income from intangible property is classified as either "business" or "nonbusiness" income. See \textit{Idaho Code} § 63-3027(a)(1) (Supp. 1981), which provides in pertinent part:

"Business income" means income arising from transactions and activity in the regular course of the taxpayers' trade or business and includes income from the acquisition, management, or disposition of tangible and intangible property when such acquisition, management, or disposition constitute[s] integral or necessary parts of the taxpayers' trade or business operations. Gains or 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 taxpayers' trade or business; such presumption may only be overcome by clear and convincing evidence to the contrary. \textit{Id.} 458 U.S. at 310 n.4. Idaho apportions "business" income according to a three-factor formula. \textit{Id.} at 310-11. See also \textit{supra} note 2 and accompanying text.

"Nonbusiness" income is defined as including all income except "business" income. 458 U.S. at 311. Idaho allocates "nonbusiness" income associated with intangibles, in its entirety, to the taxpayer's state of commercial domicile in lieu of any apportionment. \textit{Id.} See also \textit{supra} note 43 and accompanying text.
\end{thebibliography}
that ASARCO had received from five corporations in which it held major interests. Idaho, which had not disputed any of the facts, argued that "corporate purpose should define unitary business." The assertion was that income from intangible property (e.g. shares of stock) should be considered to derive from the unitary business, whenever such property was used for purposes that would contribute to that business. However, Justice Powell stated "[t]his definition of unitary business would destroy the concept," since it would be all-encompassing. Therefore, the Court

<table>
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<th>Subsidiary (line of business)</th>
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<th>% of sub. output purchased by ASARCO</th>
<th>% of ASARCO output purchased by sub.</th>
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<td>-</td>
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<tr>
<td>General Cable Corp. (fabricates metal products)</td>
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<td>0.1</td>
<td>6</td>
</tr>
<tr>
<td>Revere Copper and Brass, Inc. (fabricates metal products)</td>
<td>34</td>
<td>1-2</td>
<td>3-4</td>
</tr>
<tr>
<td>ASARCO Mexican, S. A. (mines and smelts lead &amp; copper in Mexico)</td>
<td>49</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Southern Peru Copper Corp. (mines copper in Peru)</td>
<td>51.5</td>
<td>35</td>
<td>-</td>
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</table>

Notes:
1. Although ASARCO had the potential to control M. I. M., the trial court found that this company operates entirely independent of, and has minimal contact with ASARCO.
2. A management contract with the other shareholders precluded ASARCO from controlling Southern Peru, notwithstanding the majority interest owned therein. The Court indicated that this company presented the closest question, presumably because of the percentage of ownership and the substantial portion of Southern Peru's output that was purchased by ASARCO.
3. All inter-company sales and purchases were made at arms-length prices.

See id. at 321-24.
76. Id. at 314. The intangible income included dividends and interest payments remitted by the subsidiary corporations to ASARCO, in addition to capital gains on the sale of stock held therein by ASARCO. Id.
77. Id. at 309 n.2. The facts connected with the ownership in these corporations by ASARCO are highly relevant, and can be summarized as follows:

See id. at 325-26.
78. Id.
79. Id.
80. Id.
struck down Idaho's attempt to tax this income on due process grounds. It relied on Mobil and J. C. Penney for the proposition that when the business activities of the dividend payor have nothing to do with the activities of the payee in the taxing state, then the latter has "given nothing for which it can ask return."\textsuperscript{81}

Not to be overlooked in ASARCO was a most critical footnote, which states in part: "In both of those cases [Mobil and Exxon], that we follow today, the states prevailed because it was clear that the corporations operated unitary businesses with a continuous flow and interchange of products. ASARCO has proved that these essential factors are wholly absent in this case."\textsuperscript{82}

Based on the facts in Mobil and Exxon, the implication of Justice Powell's footnote is that such unitary businesses were made evident as a result of the "continuous flow and interchange of products" between subsidiaries (or divisions) and parent companies. Thus, given this footnote it would seem doubtful that a unitary relationship could exist between two companies absent a substantial and continuous flow and interchange of products. This would be especially true if less than a majority of stock (controlling interest) was owned by the purported parent company in the subsidiary. In four of the five subsidiary companies in ASARCO, a substantial flow of products did not exist, nor did the parent have controlling interest in any instance.\textsuperscript{83} Consequently, the Court summarily dismissed the charges of a unitary relationship in all four cases.\textsuperscript{84} However, with respect to the other subsidiary, Southern Peru, where both majority interest and substantial interchange of products coexisted, the Justices seemed to apply a much higher level of scrutiny in ascertaining the nature of the company's relationship with ASARCO. It was noted that not only did a management contract preclude ASARCO from exploiting its majority interest, but also that the output contract was at arm's length and termination thereof held no operational implications for either party.\textsuperscript{85} Based on these facts it was concluded that Southern Peru

\textsuperscript{81} Id. at 327. The Court indicated that the same standard applied to the interest and capital gains, as well as dividends. Id. at 329-30. Quoting Mobil, it reiterated that "[o]ne must look principally at the underlying activity, not at the form of investment, to determine the propriety of apportionability." Id. Justice Powell further stated that just adding to the "riches" of the parent was not enough to bring the five subsidiaries within the scope of ASARCO's unitary business. Id.
\textsuperscript{82} Id. at 329 n.24 (emphasis added).
\textsuperscript{83} Id. at 321 nn.16-21.
\textsuperscript{84} See supra note 82 and accompanying text.
\textsuperscript{85} 458 U.S. at 321-22, 321 n.17.
was not unitary with ASARCO. In summary, although a continuous flow and interchange of products apparently may result in a prima facie case of unitary characterization, such a condition is not \textit{unitary per se} and may be controverted by the taxpayer producing persuasive evidence to the contrary.

Despite Justice Powell's well-reasoned opinion in \textit{ASARCO}, Justice O'Connor dissented. She submitted that the subsidiary companies were unitary with ASARCO based on three major factors: (1) that the subsidiaries were engaged in the same general line of business as the parent (consequently, the related investment decisions by ASARCO turned heavily upon knowledge of its own business); (2) that there was a failing by ASARCO to show that such investments were other than merely an efficient use of idle funds which had been accumulated for future operations in its own primary business; and finally (3) that since ASARCO purportedly had \textit{effective} operational control of at least three of the subsidiaries, it also had the power to use them for operational advantage in ASARCO's own metals business, regardless of whether or not it had yet done so. Therefore, Justice O'Connor concluded that "the Court unwisely substitutes for the multifaceted analysis used to determine whether the businesses in \textit{Mobil Oil} and \textit{Exxon} were unitary the oversimplified test of \textit{active operational control}."

Additionally, the dissent pointed out that the majority only compounded its error by relying on the due process clause as authority, since a holding predicated upon the commerce clause would have been more susceptible to congressional action.

The principles enunciated in \textit{ASARCO} were further developed in \textit{F.W. Woolworth Co. v. Taxation & Revenue Department}, the

\begin{itemize}
  \item 86. \textit{Id.} at 330.
  \item 87. \textit{Id.} at 331 (O'Connor, J., dissenting). She was joined by Justices Blackmun and Rehnquist. \textit{Id.}
  \item 88. \textit{Id.} at 335-37 (O'Connor, J., dissenting). Justice O'Connor indicated that "this alone warrants affir ming the Idaho Supreme Court's due process ruling." \textit{Id.} at 337. (O'Connor, J., dissenting).
  \item 89. \textit{Id.} at 337-39 (O'Connor, J., dissenting).
  \item 90. \textit{Id.} at 340-43 (O'Connor, J., dissenting).
  \item 91. \textit{Id.} at 343 (O'Connor, J., dissenting) (emphasis added).
  \item 92. \textit{Id.} at 349-53 (O'Connor, J., dissenting). A fear was expressed that the decision in the instant case might be beyond Congress' power to correct, because of the supposed due process ramifications. \textit{Id.} Due process violations, which essentially comprise extraterritorial taxation, can alternatively be held as violative of the commerce clause in most situations, as intrastate businesses not subject to such taxation will in all probability experience a lower effective tax rate than the business operating interstate. \textit{Id.} at 350 n.4 (O'Connor, J., dissenting).
  \item 93. 458 U.S. 354 (1982). \textit{See supra notes} 70-73 and accompanying text.
\end{itemize}
companion case to *ASARCO.* Justice Powell, author of the majority opinion in *ASARCO,* also wrote the opinion for the Court in *Woolworth.* The primary issue was whether or not due process considerations precluded New Mexico from taxing a portion of dividends remitted to F. W. Woolworth by its foreign subsidiaries, when the latter did absolutely no business in New Mexico. The focus again was essentially on the relationship between the subsidiary-payors and the parent-payee, F. W. Woolworth. Of the four foreign subsidiaries at issue, three were wholly owned by Woolworth, while only 52.7% of the stock was owned in the fourth.

Justice Powell started the opinion in *Woolworth* by referring to *ASARCO* for the proposition that the mere potential for the parent to exercise control over the subsidiary was not dispositive in determining whether the companies were unitary. It was pointed out that the New Mexico Supreme Court had used an incorrect legal standard in its unitary finding—which had largely been based on only the potential advantages accruing to the parent through ownership of the subsidiaries, in disregard of what the actual advantages were. Justice Powell submitted that the proper inquiry entailed that of looking at the "underlying unity" of the businesses, i.e., the actual relationship between the parent and subsidi-

94. 458 U.S. at 362.
95. Id. at 356. Justice O'Connor dissented for the same reasons expressed in her *ASARCO* dissent. Id. at 373 (O'Connor, J., dissenting). She was again joined in her dissent by Justices Blackmun and Rehnquist. Id.
96. 458 U.S. at 356.
97. Id. at 356-57. The three wholly-owned subsidiaries were: F. W. Woolworth GmbH, in Germany; F. W. Woolworth, Ltd., in Canada; and F. W. Woolworth, S. A. de C. V. Mexico. The fourth, in which Woolworth only owned 52.7%, was F. W. Woolworth Co., Ltd., in England. The four subsidiary corporations engaged in chain store retailing, as F. W. Woolworth also did. Id. In the fiscal year ending January 31, 1977, Woolworth's New Mexico sales represented 0.5%, or approximately $13,000,000 of the company's approximately $2.5 billion total domestic sales. Id. New Mexico's statutes defining business versus nonbusiness income, including the three-factor formula used in apportioning business income, were practically the same as those adopted by Idaho which were cited in *ASARCO.* Id. at 357-58 nn.2-5 See also supra note 75 and accompanying text.
98. 458 U.S. at 362.
99. Id. The New Mexico Supreme Court reversed the lower appellate court. The latter had disagreed with the New Mexico Taxation and Revenue Department, and had excluded the dividends from apportionable business income. Id. at 360. Another facet of the New Mexico Supreme Court's holding was that the mere possession of ownership in the subsidiaries enhanced the parent company's business standing, creditworthiness, etc., sufficiently to bring the subsidiaries within the scope of the unitary business. Id. at 363. This logic was quickly rejected by the Court, on the basis that some economic benefit will always derive from the ownership of stock in another corporation. Id. at 363-64.
ary, not merely the potential relationship.\textsuperscript{100}

In its analysis, the Court found that there was little functional integration between the parent company and its subsidiaries.\textsuperscript{101} It also noted an absence of the requisite centralized management and economies of scale deemed indicative of a unitary business, notwithstanding certain of the managerial links Woolworth maintained with the subsidiary companies.\textsuperscript{102} Apparently some communication between the parent and subsidiaries is permissible. As the Court explained in its finding of nonunitary, "'[e]xcept for the type of occasional oversight—with respect to capital structure, major debt, and dividends—that any parent gives to an investment in a subsidiary, there is little or no integration . . ." between the parent and the subsidiary.\textsuperscript{103}

\textit{ASARCO} and \textit{Woolworth} indicate that mere ownership is not per se unitary, even when coupled with a substantial interchange of goods between companies. Furthermore, the Court apparently views the unitary issue as largely one of fact, and appears reluctant to reverse a lower court so long as correct legal standards have been applied. In both \textit{ASARCO} and \textit{Woolworth}, the United States Supreme Court reversed the state supreme courts, and affirmed the lower courts' original decisions of nonunitary, each of which had previously been reversed by respective state supreme courts.\textsuperscript{104}

The essence of a unitary relationship between parent and subsidiary companies seems to be "active, operational control" resulting from functional integration, centralized management and economies of scale arising from the intercompany relationship. But, it is obvious that there are no clearcut answers as to how "unitary" is defined, except that the totality of the circumstances is critical in

\textsuperscript{100} \textit{Id.} at 363-64 (quoting \textit{Mobil}, 445 U.S. at 440).

\textsuperscript{101} \textit{Id.} The Court noted that there was a "critical distinction" between a retail merchandising business as compared to one in which manufactured products are produced in one or more countries, and subsequently marketed worldwide (e.g. \textit{Mobil} and \textit{Exxon}). It was inferred that the economies of scale, mutual interdependence, etc. that typically exist in the latter are much less apt to prevail in a retail merchandising business. \textit{Id.} One can conclude therefore that the taxpayer will usually find it more difficult to meet the burden of proof when manufacturing operations are involved. \textit{See also infra} note 183 and accompanying text. Furthermore, Justice Powell observed that there was no record of interchange of products between companies. \textit{Id.} at 365 n.13.

\textsuperscript{102} \textit{Id.} at 366-67. Managerial links included the fact that several of the subsidiaries' board members also sat on the board of directors for the taxpayer and vice versa. \textit{Id.} at 368 n.18. There was also occasional contact between top managements of the companies, and regular communication by mail, telephone, etc. \textit{Id.} at 368.

\textsuperscript{103} \textit{Id.} at 369. Woolworth had to approve major financial decisions, such as the amount of dividends to be declared and the creation of substantial new debt. \textit{Id.} at 368-69.

\textsuperscript{104} For \textit{ASARCO}, see 458 U.S. at 314-15. For \textit{Woolworth}, see 458 U.S. at 360.
ascertaining whether the requisite active operational control exists with the resultant unitary benefits flowing therefrom.\textsuperscript{105}

II. FORMULARY APPORTIONMENT

Currently, all forty-five states which have adopted a corporate income tax apportion income to some extent.\textsuperscript{106} However, no two states apply formulary apportionment in exactly the same manner. While generally, most states employ the standard three-factor formula, some states use only one or two factors. Additionally, there is significant variation from state to state as to what comprises a particular factor, as well as which income is apportionable. A recent report by the Comptroller General indicates that the two reasons for state income overtaxation most frequently cited during its survey were: (1) income considered 100\% taxable to one state was considered apportionable by another state; and (2) income was subject to apportionment by factors not uniform from one state to the next.\textsuperscript{107}

Thus, it is not surprising that in 1957, the Uniform Division of Income for State Tax Purposes Act (UDITPA) was conceived.\textsuperscript{108} UDITPA was drafted by the National Conference of Commissioners in response to mounting concern over the nonuniformity of state income taxation.\textsuperscript{109} In order for the provisions of UDITPA to

\textsuperscript{105} The Court's opinion in ASARCO can be read as implying that these benefits must include those other than which would accrue to any ordinary investor making a similar kind of investment.

\textsuperscript{106} See generally G.A.O. REPORT, supra note 2.

\textsuperscript{107} G.A.O. REPORT, supra note 2, at 18.

\textsuperscript{108} UDITPA provides that nonbusiness income be allocated to a single taxing jurisdiction, and that only business income be apportioned among the states based on an equally weighted three-factor formula, comprising property, payroll, and sales. Business income is defined as that arising from transactions and activities in the regular course of the taxpayer's trade or business. Nonbusiness income is considered to be all other income, including income from rents, royalties, interest, dividends, capital gains, etc. See supra note 75 and accompanying text. See also State Tax News - New Uniform Act for Dividing Income Between States Approved, 35 TAXES at 631 (August, 1957).

For an interesting overview of UDITPA in its original version, see Pierce, The Uniform Division of Income for State Tax Purposes, 35 TAXES at 747 (October, 1957). The author, William J. Pierce, was one of the draftsmen of this particular proposal. Id. Two critical assumptions upon which UDITPA is based are: (1) The state has jurisdiction to levy the particular tax; and (2) Existing state law has already defined the base of the tax and the only problem remaining is what proportion of that base should be assigned to the taxing jurisdiction. Id.

\textsuperscript{109} The states' initial response to UDITPA was less than enthusiastic. See, e.g., Kinnear, The Multistate Tax Commission, 19 CANADIAN TAX J. 136, 141 (1971). However, two major events occurred within the next several years to change that. First, legislation was passed by Congress that precluded a state from exercising jurisdiction over a corporate tax-
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become law, they must be enacted by the legislature of a particular state. Unfortunately, the states have not fully embraced the provisions of UDITPA. At present, only twenty-five states have adopted most or all of UDITPA's provisions, while the remaining twenty states with a state income tax have adopted few or none. Nevertheless, some believe that even if all of the states were to adopt UDITPA in its entirety, substantial nonuniformity would continue to prevail. One commentator suggests that certain concepts would inevitably be carried over from the administration of states' prior apportionment statutes. For instance, separate accounting principles used to allocate income are not specifically dealt with under UDITPA and would therefore remain as is under pre-existing law.

Section 18 of UDITPA provides for relief in the event that the results of the formula do not "fairly represent the extent of the taxpayer's activity in this state . . ." However, difficulties associated with the administration of this provision in conjunction with overly aggressive state agencies will probably keep relief to a minimum.

payer, if the latter's only activity within that state was solicitation of sales orders with the orders being accepted and filled in a different state. See 15 U.S.C. §§ 381-84 (1959). Second and more importantly, the Willis Subcommittee report on taxation of interstate business was issued in 1964. See H.R. REP. No. 1480, 88th Cong., 2d sess. (1964) which states in pertinent part:

It is . . . a system which works badly for both business and the States. It is . . . a system in which the States are reaching farther and farther to impose smaller and smaller liabilities on more and more companies. It is . . . a system which calls upon tax administrators to enforce the unenforceable, and the taxpayer to comply with the uncompliable. . . . The future [does not] hold out any prospect of improvement. The number of income tax jurisdictions increases. Laws seem to become more complex rather than less. Improved enforcement procedures may add taxpayers to the rolls, but still it is inconceivable that they can make any substantial impact on noncompliance.

Id. at 598-99. See also G.A.O. REPORT, supra note 2, at 21, wherein after the above paragraph of the Willis Report was quoted, the conclusion by the Comptroller General was: "Unless action is taken, the current system of multijurisdictional corporate income taxation will continue to produce inefficiency and uncertainty, burdening both State tax administrators and increasing numbers of taxpayers." Id.

Furthermore, as a result of the above, not only did the states begin to embrace UDITPA, but they also adopted the Multistate Tax Compact to help promote greater uniformity of tax law administration, and thereby head off additional federal legislation. See Madere and Smith, State Taxation of Multijurisdictional Enterprises: Overview for 1982, THE TAX EXECUTIVE 115, 123 (January, 1982). The UDITPA has been adopted as Article IV of the Multistate Tax Compact. See also United States Steel Corp. v. Multistate Tax Comm'n, 434 U.S. 452 (1978), wherein the validity of the Multistate Tax Compact was sustained.


111. See infra note 160.

112. Boren, supra note 110, at 481.
Over the years, deliverance from formulary apportionment has been more illusory than real to many taxpayers. This comment will proceed to review some of the inequities and distortive effects inherent in formulary apportionment, as demonstrated by a sample of issues previously adjudicated.

A. Proving Distortion

_Hans Rees' Sons v. North Carolina_113 was first to establish the proposition that for tax purposes, a state cannot attribute income as being taxable to the taxpayer, which is “out of all appropriate proportion” to the business transacted in that state.114 Consequently, the Supreme Court struck down, as violative of due process and equal protection, the results of a single-factor property formula.115

Yet shortly thereafter in _Norfolk & Western Railway Co. v. North Carolina_,116 the Court upheld application of a North Carolina statute that set forth a formula by which the amount of income subject to state tax would be determined for interstate railways doing business in North Carolina. The ratio of instate track mileage compared to total system mileage, was applied first to gross operating revenues and then to operating expenses, with the resultant difference being taxable net income.117 The taxpayer proffered evidence that actual North Carolina expenses were far in excess of those derived under the statutory formula, but failed to either substantiate or impeach the validity of the apportioned gross revenues. Justice Cardozo, speaking for the majority, indicated that such a partial and fragmentary showing of facts was not sufficient.118 He further stated that “the burden is on the taxpayer to make oppression manifest by clear and cogent evidence.”119

Even today, the standard by which distortion must be proven to sustain a taxpayer’s assertion that a state is trying to tax extraterritorial values is that conceived in _Hans Rees' Sons_ and _Norfolk & Western Railway Co_. Consequently, the burden still remains on

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113. 283 U.S. 123 (1930). See also supra notes 24-26 and accompanying text.
114. 283 U.S. at 135.
115. Id. at 136.
117. Id. at 684. Justice Cardozo stated that the “[t]axpayer and state would be swamped with administrative difficulties if left without the aid of a formula of ready application.” Id. at 685.
118. Id. at 688.
119. Id. Witnesses for the state had testified that gross revenues were underestimated to a much greater extent than were operating costs. Id. at 686.
the taxpayer to show "by clear and cogent evidence" that the in-
come the state is endeavoring to tax is "out of all appropriate pro-
portion" to the business transacted therein. Despite these cases
having dealt with single-factor formulas, the same criteria have
been applied by the courts in evaluating three-factor formulas.\footnote{120} It is
enigmatic how such "clear and cogent evidence" could ever be
presented under many factual situations today, based on what is
now acknowledged to be the highly suspect nature of separate
accounting.\footnote{121}

B. Apportionment Formulas Attacked

The Tax Commissioner's wide discretion and authority in
originating and prescribing an apportionment formula was sus-
tained early on by a California appellate court in \textit{Pacific Fruit Ex-
press Co. v. McColgan}.\footnote{122} \textit{Pacific Fruit Express Co.} was primarily
in the business of renting refrigerator cars to railroads operating
interstate, and also repaired and reconditioned these cars as neces-
sary to keep them in suitable condition.\footnote{123} The taxpayer appor-
tioned nine percent of its net income to California for the years at
issue, as determined by the miles the refrigerator cars were hauled
in California, compared to total miles hauled everywhere.\footnote{124} The
Commissioner recomputed income, allocating instead about
twenty-six percent to California, on the basis of a statutory three-
factor formula comprising property, payroll and mileage associated
with that state.\footnote{125} It was contended that the statutory formula did

\textit{Id.} at 423. Additionally, the majority stated that "this Court has long realized the practical
impossibility of a state's achieving a perfect apportionment of expansive, complex business
activities such as those of appellant, and has declared that 'rough approximation rather
than precision' is sufficient." \textit{Id.} at 422.

\textit{See supra} note 63 and accompanying text. \textit{See also generally} G. \textit{Harley, International
Division of the Income Tax Base of Multinational Enterprise - A Treatise on
the Unitary Business Concept} (1980).

\footnote{122} 67 Cal. App. 2d 93, 153 P.2d 607 (1944).
\footnote{123} \textit{Id.} at 95, 153 P.2d at 608.
\footnote{124} \textit{Id.}
\footnote{125} \textit{Id.} The statute provided in pertinent part as follows:
The portion of net income derived from business done within this State, shall be
determined by an allocation upon the basis of sales, purchases, expenses of manufac-
ture, pay roll, value and situs of tangible property, or by reference to these or other
factors, or by such other method of allocation as is fairly calculated to assign to the
not prescribe a precise method of allocating net income, and that the Commissioner lacked authority to himself originate such a formula. However, the court disagreed, and further indicated that there was a presumption that the formula used by the Commissioner produced a fair result which could only be overcome "by clear and cogent evidence."  

Not long thereafter, several other challenges to the Commissioner's use of a three-factor formula (property, payroll and sales) to apportion net income were also found to be without merit by the California Supreme Court. The taxpayer in El Dorado Oil Works v. McColgan had used the statutory five-factor formula to apportion income. It argued that since all five factors (especially the factor comprehending purchases) were applicable, there was a violation of due process and equal protection by the Commissioner recalculating income with the three-factor formula. Regardless, the California Supreme Court concluded that this formula fairly assigned income, relying largely on the district court of appeals' previous decision in Pacific Fruit.

The Commissioner used the same three-factor formula to recompute income in John Deere Plow Co. v. Franchise Tax Board. The taxpayer had originally used separate accounting to compute California income, and asserted that the formulary apportionment "produced unreasonable results by assigning to this state [California] extra-territorial values in the apportionment of the unitary income . . ." John Deere argued that California operations were

State the portion of net income reasonably attributable to the business done within this State and to avoid subjecting the taxpayer to double taxation.

Id.

126. 67 Cal. App. 2d at 97, 153 P.2d at 609.
129. Id. at 734, 215 P.2d at 6. See also supra note 125 and accompanying text.
130. Id. at 735-36, 215 P.2d at 6. The taxpayer was in the business of processing and selling coconut oil and meal. Although its manufacturing facilities were located in California, it purchased the bulk of its raw material, copra, in the Philippine Islands through offices located there which were maintained expressly for that purpose. Id. Thus, including purchases as a factor in apportioning income to California would have the result of drastically reducing the apportionment factor, i.e., the denominator of the formula would be increased by the amount of purchases, with no effect to the numerator.
131. 34 Cal. 2d at 735-36, 215 P.2d at 7-8.
132. Id. See supra notes 122-127 and accompanying text.
133. 38 Cal. 2d 214, 238 P.2d 569 (1951).
134. Id. at 222, 238 P.2d at 573.
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unusually more expensive than those in other states. However, the California Supreme Court summarily dismissed this contention, while revealing that results from a separate accounting system could not be used to impeach formulary apportionment. The court stated that the only requirement in apportioning income of a unitary business is that "the formula used be not intrinsically arbitrary or produce an unreasonable result." Apparently, this would now be the only grounds upon which a taxpayer could successfully attack the Commissioner's apportionment.

Notwithstanding the validity of three-factor formulas, it appeared that single-factor formulas would continue to be susceptible to assertions of distortion and therefore, to protestations on constitutional grounds. However, in recent years the United States Supreme Court has appeared much less eager to strike down the application of such a formula on that basis, as it seemingly was in Hans Rees' Sons.

For example, in General Motors Corp. v. District of Columbia, GM submitted that an apportionment formula comprising only a sales-factor, which had been adopted by regulation, not only lacked statutory authority but was also violative of the interstate commerce and due process clauses. Therein, the District of Columbia Income and Franchise Tax Act of 1947 imposed a five percent tax on the net income of any corporation operating within

135. Id. John Deere cited figures for 1937 as follows: San Francisco ratio for wages and salaries was $6.76/$100 of sales, compared to $4.46/$100 for all locations. Investment in net tangible assets in San Francisco was established at $18.26/$100 of sales, compared to $6.76/$100 for all locations, etc. Id.

136. 38 Cal. 2d at 223, 238 P.2d at 574. During an analysis of this case, one scholar has commented:

Along the way, it [the California Supreme Court] made a classic statement on relative productivity and unitary theory. Since what goes on in California can be presumed to have an effect on the business of an entity nationwide, it is not necessary that any activity reflected in a formula be equally productive in all states. Higher costs in California may lead to reduced costs elsewhere and hence greater national profits. For example, increased sales costs may lead to higher production, lower per unit manufacturing costs, and greater total profit. Though the opinion is directed against separate accounting, the court's language leaves no doubt that the FTB [Franchise Tax Board] need not adjust the formula itself.


137. 38 Cal. 2d at 224, 238 P.2d at 574.
138. See supra notes 113-115 and accompanying text.
139. 380 U.S. 553 (1965).
140. Id. at 555.
141. Id. at 554.
the District.\textsuperscript{142} The Act also provided that in the event a business was carried on within and without the District, it would be presumed that the business' income was derived from both within and without the District.\textsuperscript{143} Writing for the majority, Justice Stewart hinted that this kind of formula could very well be unconstitutional, but deemed it unnecessary to consider the constitutional question since the regulation was held to exceed statutory authority.\textsuperscript{144} He stated that a sales-factor formula would apportion 100\% of the net income for an interstate business to a single jurisdiction when all of the sales were made therein. This would occur regardless of the fact that the manufacturing plant may be entirely located within another jurisdiction.\textsuperscript{145}

Based on this decision, it was not surprising that someone would subsequently challenge the Iowa single-factor sales formula on constitutional grounds.\textsuperscript{146} In \textit{Moorman Manufacturing Co. v. Bair},\textsuperscript{147} the issue was whether or not the single-factor sales formula used by the State of Iowa to apportion income of an interstate business, was violative of the due process and commerce clauses of the federal constitution.\textsuperscript{148} Although Moorman Manufacturing Co. did

\begin{itemize}
  \item \textsuperscript{142} Id.
  \item \textsuperscript{143} Id. at 554-55.
  \item \textsuperscript{144} Id. at 556. The regulation was found to allocate income to the District of Columbia in disregard of the provision of the Act governing interstate businesses. Id. Justice Stewart pointed out that this type of apportionment formula was at serious variance with the formulas used by the majority of other states, thereby creating "substantial dangers of multiple taxation." Id. at 557.
  \item \textsuperscript{145} Id. at 557-58. The Court noted that states where the property and payroll might be located, which use the standard three-factor formula, would simultaneously allocate 67\% of the corporation's income to themselves. Id. at 559-60. However, the majority also stated that it took no position on the constitutionality of a single sales-factor state income tax formula. Id. at 561. That statement seems contradictory in light of its comments earlier in the opinion. See \textit{supra} note 144 and accompanying text. This disclaimer became of paramount importance when the Court subsequently sustained the constitutionality of a similar formula in \textit{Moorman}. See \textit{infra} notes 146-159 and accompanying text.
  \item \textsuperscript{146} See Moorman Mfg. Co. v. Bair, 437 U.S. 267 (1978). At the time \textit{Moorman} was decided by the United States Supreme Court, 44 of the 45 states imposing a corporate state income tax used a three-factor formula comprising property, payroll, and sales. Id. at 283-84 (Powell, J., dissenting). Iowa, the 45th state, was the only one continuing to employ a single-factor formula, the validity of which was sustained in \textit{Moorman}. Id. at 296 (Powell, J., dissenting).

  It is also interesting to note that eight years after General Motors v. District of Columbia, 380 U.S. 553 (1965), was decided, GM challenged the constitutionality of a two-factor formula (property and sales) taking it up before the Colorado Supreme Court. See General Motors Corp. v. State, 181 Colo. 360, 509 P.2d 1260 (1973). That court concluded such a formula was valid, and that it did not tax extraterritorial values as claimed by GM. Id.
  \item \textsuperscript{147} 437 U.S. 267 (1978).
  \item \textsuperscript{148} Id. at 269, 271, 276.
\end{itemize}
business in many states, the feed products it sold in Iowa were solely produced in Illinois, with Iowa sales accounting for about twenty percent of the total.  

Moorman's due process arguments were rejected by the majority, largely on the premise that the record was devoid of any separate accounting analysis that might have shown Iowa taxing income not fairly attributable to activities conducted within its borders. The distinct implication was that if such an analysis had been made and the results were supportive of the taxpayer, the single-factor formula might have been found to infringe upon due process. Furthermore, Justice Stevens distinguished General Motors Corp. v. District of Columbia upon which Moorman had placed substantial reliance, stating that the statutory requirement was unique to the District of Columbia, while also pointing out in that case that the Court had expressly declined to rule on the constitutionality of a single-factor sales formula. The majority concluded that the Iowa statute could be invalidated only if the commerce clause were construed to prohibit any overlap of taxation by the states.  

In his analysis, Justice Stevens acknowledged that no two states have identical income tax laws, and that each of the forty-four other states applied the three-factor formula somewhat differently. Consequently, if duplicative taxation were held to violate the commerce clause in Moorman, the Court would be forced to prescribe uniform guidelines for all of the states including those using the generally accepted three-factor formula. Since this was considered to be essentially a legislative task within the scope of the power granted to Congress, the single-factor sales formula in Moorman was held to be constitutional.

149. Id. at 269. Moorman Manufacturing Company had over 500 salesmen and six warehouses in Iowa for the servicing of customers in that state. Id.  
150. Id. at 272.  
151. Id. Therefore, Justice Stevens termed as “speculative” the taxpayer’s claim that Illinois operations were responsible for a portion of the profits associated with Iowa sales. Id. He stated that a separate accounting analysis might even have shown that Illinois operations prevented Iowa sales from being as profitable as they may have been otherwise. Id.  
152. Id. at 274-75. See supra note 145.  
153. Id. at 278.  
154. Id. at 278-79. E.g., what comprises apportionable business income, when a sale takes place, what is comprehended in the property, payroll, and sales factors, etc.  
155. Id. at 279.  
156. Id. at 280-81. The Court viewed the Iowa tax at issue as nothing more than a 1% gross receipts tax, similar to that levied by the State of Washington which had been upheld in Standard Pressed Steel Co. v. Washington Revenue Dep’t, 419 U.S. 560 (1975). 437 U.S. at 280-81.  

In a dissent, Justice Powell submitted that the Iowa statute violated the interstate com-
After *Moorman*, it was apparent that duplicative taxation, at least to some extent, was permissible and would withstand commerce clause scrutiny. The Court also extended one of its many invitations to Congress to enact remedial legislation in the event that it did not agree with the determination in *Moorman*.\(^{157}\) Additionally, it appeared from this decision that infringement of due process by a state's efforts to tax an interstate business' extraterritorial income, could still be established by a separate accounting analysis. Nevertheless, subsequent decisions by the Court have made it clear that when dealing with a unitary business, the results of a separate accounting analysis are practically irrelevant.\(^{158}\)

These cases have illustrated that the key to excluding income from apportionment is to prove that such income has been derived from sources other than the unitary business.\(^{159}\)

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merce clause. *Id.* at 297 (Powell, J., dissenting). It was noted that the Court has consistently held that when one state's practice is significantly out of step with all of the other states' rules, it must be struck down unless a legitimate local interest outweighs the harm such practice causes to interstate commerce. *Id.* at 295 (Powell, J., dissenting). Justice Powell cited *Bibb v. Navajo Freight Lines, Inc.*, 359 U.S. 520 (1959) (the Court found unconstitutional an Illinois law banning mudguards on trucks operating in that state; such mudguards were required in Arkansas and permitted in forty-five other states), 437 U.S. at 294 (Powell, J., dissenting). Justice Powell was joined by Justice Blackmun.

157. 437 U.S. at 280.

158. *See, e.g.*, *Exxon*, 447 U.S. at 221. Therein, the taxpayer proffered separate accounting evidence, contending that *Moorman* sanctioned such proof. This showing was rejected by the Court, which stated that “the taxpayer's accounting evidence was insufficient...” *Id.* at 222. *See supra* notes 64-68 and accompanying text.

159. *See supra* note 72 and *infra* note 197, and accompanying text. This is not to say that distortion cannot still be proven in respect to a unitary business. *See, e.g.*, *Norfolk & W. Ry. Co. v. Tax Comm'n*, 390 U.S. 317 (1968). In this case, the taxpayer, N & W, leased the Missouri property of the Wabash Railroad, and became obligated to pay the 1965 ad valorem (property) taxes thereon. N & W's coal-related operations required a great deal of specialized equipment, virtually none of which was used in Missouri. Additionally, traffic density on Missouri tracks was only about 54% of the traffic density of the N & W system as a whole.

To assess tax, Missouri used a statute which apportioned to that State a part of the total value of the railway, in the proportion that the mileage of track located in Missouri bore to the system track mileage as a whole located everywhere. The Missouri Tax Commission consequently calculated the assessed property value of N & W's rolling stock at $19,981,757. (The fixed property assessment of $12,177,597 within Missouri was not challenged.)

N & W contested this assessment, offering proof that the value of its rolling stock in Missouri never ranged far above $7,600,000. In the preceding year, it was brought up that the rolling stock assessment against Wabash was only $9,177,683. The United States Supreme Court sustained the taxpayer, while reversing the Missouri Supreme Court. The latter had relied on the so-called theory of “enhancement,” which Justice Fortas, writing for the majority, determined was erroneous. The Court found the assessment violative of the due process and interstate commerce clauses. *Id.* at 322, 329-30.
C. Adjustments to the Standard Formula

Taxpayers will frequently petition for adjustment to the standard three-factor formula, on the grounds that its effects are not fairly representative of income-producing activity within the state. This is permitted under Section 18 of UDITPA and most of its predecessor statutes. Often at issue is what exactly constitutes a particular factor, e.g., what property is to be included in the property factor, and how is it to be valued?

160. Section 18 of UDITPA states:

If the allocation and apportionment provisions of this Act do not fairly represent the extent of the taxpayer's business activity in this state, the taxpayer may petition for or the [tax administrator] may require, in respect to all or any part of the taxpayer's business activity, if reasonable:

(a) separate accounting;
(b) the exclusion of any one or more of the factors;
(c) the inclusion of one or more additional factors which will fairly represent the taxpayer's business activity in this state; or
(d) the employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income.

See State Tax News - New Uniform Act for Dividing Income Between States Approved, 35 TAXES at 633 (August, 1957). See also Northwestern Cement Co. v. Minnesota, 358 U.S. 450 (1958), in which the Court expressly sanctioned the state taxation of net income generated purely from an interstate business, so long as the net income was apportioned by using "in-state aspects of interstate affairs." Id. at 460.

161. For an informative review of equitable apportionment, see Boren, supra note 136. It should be noted that many of these sort of problems pre-dated enactment of UDITPA, which recognized the existing ambiguities and did much in the way of clarification. See, e.g., Sections 10-17 of UDITPA, which purport to define the composition of property, payroll, and sales factors. These provisions, in their unadulterated version, are as follows:

SECTION 10. The property factor is a fraction, the numerator of which is the average value of the taxpayer's real and tangible personal property owned or rented and used in this state during the tax period and the denominator of which is the average value of all the taxpayer's real and tangible personal property owned or rented and used during the tax period.

SECTION 11. Property owned by the taxpayer is valued at its original cost. Property rented by the taxpayer is valued at eight times the net annual rental rate. Net annual rate is the annual rental rate paid by the taxpayer less any annual rental rate received by the taxpayer from sub-rentals.

SECTION 12. The average value of property shall be determined by averaging the values at the beginning and the ending of the tax period but the [tax administrator] may require the averaging of monthly values during the tax period if reasonably required to reflect properly the average value of the taxpayer's property.

SECTION 13. The payroll factor is a fraction, the numerator of which is the total amount paid in this state during the tax period by the taxpayer for compensation, and the denominator of which is the total compensation paid everywhere during the tax period.

SECTION 14. Compensation is paid in this state if:

(a) the individual's service is performed entirely within the state; or
(b) the individual's service is performed both within and without the state, but the service performed without the state is incidental to the individ-
The property factor has probably been subject to the most contention. In *McDonnell Douglas Corp. v. Franchise Board*\(^{162}\) the California Supreme Court, in 1968, was confronted with the issue of whether or not government-owned property used by a taxpayer to generate income should be included in the property factor.\(^{163}\) During World War II, McDonnell Douglas Corporation had used such property, in the construction of aircraft for the United States government. Virtually all of the government-owned property was located *outside* of California, while McDonnell Douglas itself owned substantial property within that state.\(^{164}\) Thus, if government property were included in the property factor (it would be in the denominator, thereby reducing the fraction), the taxpayer would be entitled to a refund of one million dollars for the years

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(\(c\)) some of the service is performed in the state and (1) the base of operations or, if there is no base of operations, the place from which the service is directed or controlled is in the state, or (2) the base of operations or the place from which the service is directed or controlled is not in any state in which some part of the service is performed, but the individual's residence is in this state.

SECTION 15. The sales factor is a fraction, the numerator of which is the total sales of the taxpayer in this state during the tax period and the denominator of which is the total sales of the taxpayer everywhere during the tax period.

SECTION 16. Sales of tangible personal property are in this state if:

(a) the property is delivered or shipped to a purchaser, other than the United States government, within this state regardless of the F.O.B. point or other conditions of the sale; or

(b) the property is shipped from an office, store, warehouse, factory, or other place of storage in this state and (1) the purchaser is the United States government or (2) the taxpayer is not taxable in the state of the purchaser.

SECTION 17. Sales, other than sales of tangible personal property, are in this state if:

(a) the income-producing activity is performed in this state; or

(b) the income-producing activity is performed both in and outside this state and a greater proportion of the income-producing activity is performed in this state than in any other state, based on costs of performance.


162. 69 Cal. 2d 506, 446 P.2d 313, 72 Cal. Rptr. 465 (1968).

163. *Id.* at 509, 446 P.2d at 314, 72 Cal. Rptr. at 466.

164. *Id.* at 510, 446 P.2d at 315, 72 Cal. Rptr. at 467. The property allocated to California by the taxpayer, as compared with that allocated by the Franchise Tax Board, is as follows.
1942-1945. The California Supreme Court emphasized the statutory directive that the tax was to be levied upon income "derived from or attributable to sources within this State." It concluded that the use of the plants, regardless of who owned them, was essential to production of the income. On that basis, the judgment was reversed and the case remanded to the superior court for further proceedings.

Several years after McDonnell Douglas came Montgomery Ward & Co. v. Franchise Tax Board. The taxpayer contended that property "in-transit" to the State of California should be included in the denominator of the property factor but not the numerator, when apportioning California income. The court rejected Montgomery Ward's position, stating that it had failed to prove that this application of the formula was arbitrary and reached an unreasonable result.

The problem of property valuation was much more esoteric in United States Steel Corp. v. Franchise Tax Board. The trial

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Id. at 509, 446 P.2d at 314, 72 Cal. Rptr. at 466.

Id. at 513, 466 P.2d at 317, 72 Cal. Rptr. at 469. The California Supreme Court also deemed as significant the fact that the taxpayer had no option under wartime exigencies as to whether or not it could own the property. Id.

Id. The court dismissed the Franchise Tax Board's "invested capital" theory, on the ground that ownership or lack thereof in the instant case had no bearing on the production of income. Id.

Id. at 515, 446 P.2d at 318, 72 Cal. Rptr. at 470.


6 Cal. App. 3d at 154, 85 Cal. Rptr. at 894.

Id. at 159, 85 Cal. Rptr. at 898. See also Chase Brass & Copper Co. v. Franchise Tax Bd., 70 Cal. App. 3d 457, 138 Cal. Rptr. 901 (1977). Chase argued that the Board erred in using original cost rather than fair market value for its mining properties. "Value" had not been defined in the pre-UDITPA California statutes which governed the controversy. However, the court ruled that cost valuation was a "logical and reasonable" approach. The difficulty in ascertaining a market value was noted, particularly regarding mining properties which were seldom exchanged through buying and selling. Id. at 471-72, 138 Cal Rptr. at 911.

court there initially held that United States Steel Corporation (USS) and the four subsidiaries at issue were non-unitary. Nevertheless, the court went on to say that the failure of the State of California to properly adjust the property factor when combining the subsidiaries with their parent was "intrinsically arbitrary" and produced a "gross distortion of income in favor of the State of California."  

Orinoco Mining Company (Orinoco), a Delaware corporation, and Quebec Cartier Mining Company (QCM), a Canadian corporation, produced iron ore in Venezuela and Quebec, Canada, respectively. The ore reserves of these two subsidiaries represented major income producing assets of the companies. However, the Franchise Tax Board assigned them a value of zero when computing the property factor for USS on a combined basis, because the reserves represented only "concessionary interests" and were not owned outright. In his decision, Judge Lucas cited a consequent distortive effect, similar to that in McDonnell Douglas Corp. v. Franchise Tax Board. The judge further noted four methods for valuing the reserves that would have proven suitable substitutes for an "original cost" valuation. It therefore seems that ques-
tions of unitary and distortion must be resolved at the audit level whenever possible, precluding the formalization of these issues for subsequent determination by an administrative or judicial tribunal.

III. Container Corporation of America

Container Corporation of America v. Franchise Tax Board

Proven reserves "on-line" were defined as "proven reserves once committed to the process of exploitation, without deduction for actual production." Id. (4) Average Net Profit Method - average net profit per ton multiplied by proven reserves "on-line" (e.g., for QCM, about $8.59 per ton times 2,069,000,000 tons, and for Orinoco, about $4.31 per ton times 857,797,977 tons). Id. at 12, 13.

Another fascinating problem regarding property valuation in United States Steel Corp. concerned the "time charters" for ships used by Navios Corporation and Navigen Company subsidiaries. Id. at 12, 13. (The time charters were essentially nothing more than long-term leases with a purchase option. Id.) Both companies were Liberian corporations based in the Bahamas, engaging in maritime bulk shipping operations. Id. at 5. The state assigned a value of zero to these charters. However, the trial court indicated that this was inappropriate, suggesting that a substitute for original cost be used, such as "vessel recovery cost." This method entails the taking of 50% of "vessel operations expense" and multiplying it by a factor of eight. Id. at 18. Although not actually applied to the facts of the case, the proposed alternative valuations in United States Steel Corp. could be of use to taxpayers in the future when confronting an absence of "original cost."

See also Kenecott Copper Corp. v. State Tax Comm'n, 27 Utah 2d 119, 493 P.2d 632 (1972), wherein the taxpayer contended that the Tax Commission was required to exclude from the numerator of the sales factor, sales of products shipped outside of the State of Utah. A literal reading of the Utah statute seemed to support this position, but the Utah Supreme Court upheld the Commission's authority to adjust the factors to "fairly represent the extent of the taxpayer's business activity in this state [Utah]," relying on Utah's statutory counterpart to Section 18 of UDITPA. Id. See supra note 160 and accompanying text.

See also Lukenbach Steamship Co. v. Franchise Tax Bd., 219 Cal. App. 2d 710, 33 Cal. Rptr. 544 (1963). The taxpayer was a steamship company engaged in interstate commerce. Because much of its time was spent on the high seas, the Franchise Tax Board adjusted the three-factor formula by preliminarily multiplying the vessel's value, payroll, and revenue by a "port-day" formula. This comprised a fraction of number of days in California ports divided by number of days in all ports (e.g. 10/40 = 25%). Luckenbach urged use of a "voyage-day" formula, which would replace the denominator by one including all days in and out of California, including those on the high seas (e.g. 10/100 = 10%). The California Court of Appeals sustained the "port-day" formula as reasonably reflecting contribution of instate activities to total income. Id. at 549-50.

See also Anaconda Co. v. Franchise Tax Bd., 130 Cal. App. 3d 15, 181 Cal. Rptr. 640 (1982). The taxpayer in Anaconda asserted that adjustments should be made for the income taxes it paid to the governments of Chile and Mexico. The appellate court rejected this notion, indicating that Anaconda failed to establish that application of the formula had yielded a distorted result. Id. at 32, 181 Cal Rptr. at 651.

178. 103 S. Ct. 2933 (1983). Worldwide combined reporting combines the incomes of all businesses in a unitary relationship, including that income which has not yet been remitted by the subsidiaries to the parent, e.g., dividends. Naturally, the property, payroll and sales of these subsidiaries are comprehended in the denominator of the apportionment formula. See, e.g., 103 S. Ct. at 2945 n.11.
decided one year after ASARCO and Woolworth, was the first case in which the United States Supreme Court would address the validity of worldwide combined reporting. Mobil, ASARCO, and Woolworth were concerned only with dividends and other intangible income remitted by foreign and domestic subsidiaries to their parent companies. Exxon did involve combined reporting, but in a domestic context.

The taxpayer in Container raised three major issues: (1) Whether or not Container Corporation conducted a unitary business with its overseas subsidiaries? (2) If so, did California’s using a three-factor apportionment formula in a worldwide context violate the due process and commerce clauses? (3) Regardless, was California required under the foreign commerce clause to employ the “arms-length” analysis in ascertaining taxable income, instead of formulary apportionment? At first blush the Container Court appears, perhaps, to obfuscate the clarity with which unitary had earlier been expounded by ASARCO and Woolworth. But, the decision actually does nothing more than further refine the principles articulated in ASARCO and Woolworth.

A. Implications for Defining Unitary

The Court initially considered whether or not a unitary relationship existed between Container Corporation and its twenty foreign subsidiaries, and found that it did. The latter, like Container itself, were fully integrated manufacturers of paperboard products. Container’s ownership of these subsidiaries, either directly or through other subsidiaries, ranged between 66.7% and 100%. Thus, in light of these facts Container Corporation already had two significant factors against it based on ASARCO and

See supra notes 54-105 and accompanying text. Mobil was the only case prior to Container, wherein foreign subsidiaries were held to be in a unitary relationship with the parent company. However, Mobil dealt only with apportionment of dividends remitted to the parent company and not the subsidiaries’ entire incomes. 445 U.S. at 433. The Mobil Court indicated that the issue of what constituted a fair apportionment formula was not presented and therefore would not be reviewed. Id. at 449. Vermont had completely excluded the subsidiaries’ payroll, sales, and property values from the formula (which would have increased the denominator, thereby decreasing Vermont’s share of the income), while nevertheless apportioning the income associated therewith. Id. at 460-61. See also 103 S. Ct. at 2942 n.5. See supra notes 64-73 and accompanying text.

179. 103 S. Ct. at 2939.
180. Id. at 2943. The subsidiaries were located in four Latin American and four European countries. Id.
181. Id. In the instances where less than 100% was owned by Container, the balance was owned by local nationals. Id.
Woolworth. First, it owned a controlling interest in each of the subsidiaries. Although the potential to control may not be dispositive, it is requisite to a finding of unitary.\textsuperscript{182} Secondly, as the Court had previously noted in Woolworth, multinational manufacturing companies are much more susceptible to "substantial mutual interdependence" than are certain other businesses such as retail merchandising.\textsuperscript{183}

The majority opinion noted that several other factors were also significant as grounds for sustaining the California Court of Appeals' finding of unitary. Justice Brennan observed that the parent had provided substantial loans and loan guarantees to the subsidiaries as part of a conscious effort to nurture them.\textsuperscript{184} Additionally, the managerial role played by Container Corporation in the affairs of its subsidiaries, was deemed much more than the "occasional oversight . . . any parent gives to an investment in a subsidiary."\textsuperscript{185} Finally, Justice Brennan concluded that the state court had properly acted within its discretion when it endorsed the administrative presumption that related corporations in the same line of business are unitary.\textsuperscript{186}

\textsuperscript{182} See 103 S. Ct. at 2946 n.15, where it is stated that "a unitary business finding [in ASARCO] was impermissible because the partial subsidiaries were not realistically subject to even minimal control by ASARCO, and were therefore passive investments in the most basic sense of the term." Id.

\textsuperscript{183} See 458 U.S. at 371, and see supra note 101 and accompanying text. Neither ASARCO nor Woolworth had both of these elements present.

\textsuperscript{184} 103 S. Ct. at 2944, 2948 n.19. About 50% of the subsidiaries' long-term debt was either held directly or guaranteed by Container Corporation. Id. at 2944. Contrast this with the factual situation in Woolworth, wherein the Court noted that "each subsidiary was responsible for obtaining its own financing from sources other than the parent." See 458 U.S. at 356.

\textsuperscript{185} 103 S. Ct. at 2943, 2947, and 2948 n.19. It was pointed out that even though day to day decisions were made by local management, the parent had one senior vice-president and four other officers responsible for policy, resolving major problems, and making long-term decisions. Id. at 2944. Container also provided a number of services to the subsidiaries, including technical assistance. Id. Thus, the subsidiaries had ready access to the parent's expertise. They were only charged for these services at cost and an apportionment of overhead; sometimes the charges were never even passed on. See Container Corp. of Am. v. Franchise Tax Bd., 173 Cal. Rptr. at 128, 117 Cal. App. 3d at 998-99. Sales of services were also made by the parent to a subsidiary in ASARCO, but at arms-length negotiated fees as set forth in a formalized agreement. See 458 U.S. at 321 n.17.

\textsuperscript{186} 103 S. Ct. at 2947. Justice Brennan observed that:

When a corporation invests in a subsidiary that engages in the same line of work as itself, it becomes much more likely that one function of the investment is to make better use — either through economies of scale or through operational integration or sharing of expertise — of the parent's existing business-related resources.

Id. It is particularly interesting that in ASARCO, Justice O'Connor, dissenting from a finding of nonunitary, cited such a presumption as one of the bases for her position. See 458
Even though it may be interesting to compare the factual circumstances of Container with those of prior cases, facts will usually not be critical during appellate review. Justice Brennan stated in Container that the Court's task was "to determine whether the state court applied the correct [legal] standards to the case; and if it did, whether its judgment 'was within the realm of permissible judgment.'"\textsuperscript{187} He noted that ASARCO and Woolworth were consistent with this principle.\textsuperscript{188} The trial courts in both of these cases had made a finding of nonunitary, which was reversed by the respective state supreme courts, but reinstated by the United States Supreme Court.\textsuperscript{189} Similarly, in Container the lower courts both held unitary.\textsuperscript{190} It is therefore apparent that success at the trial court level is extremely important.

However, any taxpayer litigating an issue of unitary should be careful not to stipulate the facts. The facts were stipulated in Container, which caused the California Court of Appeals to observe that the case presented no conflicting evidence.\textsuperscript{191} That appellate court noted that "[t]herefore, this court is not constrained by the substantial evidence rule. The trial court's findings are not binding on us and we must make our own determination of the questions of law presented by the stipulated facts."\textsuperscript{192} Thus, to limit the scope of appellate review, a taxpayer should always litigate the facts.

\textbf{B. Distortion}

The second question confronted by the Court after a finding of
unitary, was whether or not application of the three-factor formula in a worldwide context was distortive beyond constitutionally permissible dimensions.\textsuperscript{198} Container Corporation asserted that lower wage rates in the foreign countries wherein the subsidiaries operated, which purportedly were not offset by lower productivity levels, skewed the results of formulary apportionment in favor of the United States and in particular, California.\textsuperscript{194}

In reviewing the merits of the three-factor formula in \textit{Container}, Justice Brennan cited \textit{Hans Rees' Sons} for the proposition that application of a formula with an outrageously distortive effect would still be struck down.\textsuperscript{199} Distortion in that case was proven by a "separate accounting analysis skewed to resolve all doubts in favor of the State."\textsuperscript{194} Still, it is highly unlikely that separate accounting, because of its acknowledged inherently "suspect" nature, can be used to prove unacceptable distortion.\textsuperscript{197} A taxpayer seeking to establish distortion in the future would be wise to adopt an alternative approach, such as that employed in \textit{Norfolk & Western Railway Co. v. Tax Commissioner}.\textsuperscript{198} It is also relevant to note that in the past, whenever application of a formula has been struck down, the distortive effects have been substantial.\textsuperscript{198} The Court

\begin{itemize}
\item \textsuperscript{193.} 103 S. Ct. at 2939, 2948. The essence of fair apportionment is that the income attributed to a state bear a "rational relationship" with the "intra-state values of the enterprise." \textit{Id.} at 2948. Of course, the burden of proof is always upon the taxpayer to establish the contrary. \textit{Id.}
\item \textsuperscript{194.} \textit{Id.} at 2949. A showing was made that one foreign plant had labor costs that approximated 40\% of similar costs for Container's California plants.
\item Recent challenges of apportionment factors have dealt primarily with application of a single-factor formula. \textit{See, e.g., Moorman Mfg. Co. v. Bair}, 437 U.S. 267 (1978) and General Motors Corp. v. District of Columbia, 380 U.S. 553 (1965). \textit{See supra} notes 139-157 and accompanying text. The validity of the three-factor formula, at least in a domestic context, had been sustained at least several times some years earlier by the California courts. \textit{See supra} notes 122-137 and accompanying text.
\item \textsuperscript{195.} 103 S. Ct. at 2949. \textit{See supra} notes 113-115 and accompanying text. The \textit{Hans Rees' Sons} Court had addressed the validity of a single-factor property formula. \textit{Id.} \textit{See supra} 283 U.S. 123 and \textit{supra} notes 113-138.
\item \textsuperscript{196.} 103 S. Ct. at 2949.
\item \textsuperscript{197.} \textit{Id.} at 2940, where Justice Brennan observed that "formal accounting is subject to manipulation and imprecision, and often ignores or captures inadequately the many subtle and largely unquantifiable transfers of value that take place upon the components of a single enterprise." \textit{Id.} \textit{See also supra} note 158 and accompanying text.
\item \textsuperscript{198.} 390 U.S. 317. \textit{See supra} note 159.
\item \textsuperscript{199.} \textit{See, e.g., Hans Rees' Sons}, where the formula distorted the taxpayer's income by 250\%. The alleged distortion in \textit{Container} however, was only 14\%. 103 S. Ct. at 2950. Justice Brennan compared the taxpayer's calculation of net income using the three-factor formula (\textit{excluding} the subsidiaries' factors and income) to the state's calculations (which \textit{included} the subsidiaries' factors and income). A summary of the tax implications is shown below:
\end{itemize}
failed to conclude that constitutionally impermissible distortion had occurred in Container, apparently based on: (1) the Court's recent reluctance to strike down application of a single-factor formula; (2) the widespread popularity and acceptance of the three-factor formula; (3) the Court's skepticism regarding the accuracy and merits of separate accounting for a unitary business; and (4) the degree of distortion being alleged.

C. The Foreign Commerce Clause

The final issue in Container was whether or not California was obligated, under the foreign commerce clause, to use a separate accounting (arms-length) analysis in place of formulary apportionment. This method of calculating income is used by the federal government and most foreign nations. Citing Japan Line Ltd. v. County of Los Angeles, Justice Brennan indicated that because foreign subsidiaries were involved, two additional factors had to be evaluated beyond those normally present in strictly a domestic setting: (1) whether this was a fairly-apportioned state tax that subjected foreign commerce to multiple taxation to which domestic commerce was not exposed; (2) if there was the possibility that the "state tax will 'impair federal uniformity in an area where federal uniformity is essential.'"

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Id. at 2945.

Of course, like many other tax cases, subsequent intervening years will be affected by any conclusive determinations.

200. 103 S. Ct. at 2939. See supra note 199. The Constitution provides that "Congress shall have Power... [t]o regulate Commerce with foreign Nations, and among the several States, and with the Indian Tribes." See U.S. Const. art. I, § 8, cl. 3.

201. 103 S. Ct. at 2962. It was acknowledged that the federal government has indicated a preference for the arms-length separate accounting method. Id. at 2952. However, the Court also concluded that there was no basis for federal pre-emption of California's usage of worldwide formulary apportionment. Id. at 2956-57.

202. 441 U.S. 434 (1979). This case involved an attempt by California to levy a fairly apportioned, nondiscriminatory, property tax on cargo containers used in foreign commerce which were temporarily located in California ports. The containers were also subjected to an unapportioned property tax in their home port of Japan. The Court held that the California tax was invalid because of its failure to pass constitutional muster under the foreign commerce clause. 103 S. Ct. at 2951. See also infra notes 203, 215, and accompanying text.

203. 103 S. Ct. at 2951 (quoting from Japan Line). The interstate commerce clause governs domestically, but the foreign commerce clause comes into play when foreign com-
The multiple taxation in *Container* allegedly occurred because California apportions the income earned by foreign subsidiaries, while the foreign countries in which the subsidiaries are located levy an *unapportioned* income tax on income determined by the arms-length method.\(^{204}\) *Container* Corporation’s assertion of multiple taxation was especially appealing in light of the Court’s rationale in *Japan Line* for striking down the unapportioned property tax. The majority therein had noted that unlike within the United States “the absence of an [international] authoritative tribunal capable of ensuring that the aggregation of taxes is no more than one full value” does not exist.\(^{205}\) Therefore, it seemed that one could logically deduce that, because California was so far out of step with the rest of the world, impermissible multiple taxation would be found in *Container*. However, Justice Brennan distinguished *Japan Line*, noting that it concerned a tax on property rather than income,\(^{206}\) with the incidence of tax falling on a domestic corporation,\(^{207}\) not an instrumentality of foreign commerce. Furthermore, in the instant case double taxation was not the inevitable result of formulary apportionment, unlike the property tax in *Japan Line*.\(^{208}\) It was suggested that California could avoid double taxation by foregoing any tax on the taxpayer’s income, which was not a fair alternative.\(^{209}\) Justice Brennan failed to mention that perhaps California should limit its taxation to a domestic unitary business, which is the basis on which *Container* Corporation had originally calculated its tax liability.\(^{210}\) Another alternative noted was for the state to adopt the arms-length method, but that would not necessarily preclude double taxation either, according to the majority.\(^{211}\)

The Court then went on to address the other leg of the argument...
under *Japan Line*, as to whether impairment of federal uniformity occurred. It essentially reiterated the reasons given for rejecting the assertions of multiple taxation.\(^2\) Additionally, the majority indicated foreign policy was much more the province of the Executive Branch and the Congress, than that of the Supreme Court. On that basis, and after a review of the relative inaction by Congress on the matter, it was concluded that foreign policy was not implicated.\(^2\) Nonetheless, Justice Brennan made it clear that *Container* did not concern the propriety of a tax whose incidence would fall upon a foreign parent and a domestic subsidiary.\(^2\)

Although the arguments raised pursuant to *Japan Line* had significant merit, their rejection was highly predictable. In both *Exxon* and *Mobil*, *Japan Line* had been distinguished as applying to a property tax, and the narrowly articulated holding therein was consistent with this construction.\(^2\) There was no reason to believe that in *Container*, this position would be reversed.\(^2\)

### IV. Conclusion

The *Container* decision is a clear indication that broad discre-

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212. *Id.* at 2956-56. See supra notes 206-207 and accompanying text.

213. 103 S. Ct. at 2956-57.

214. *Id.* at 2956 n.32. Justice Powell suggested that levying the tax against a foreign parent could invite international disputes or retaliation against American corporations. *Id.* at 2960 (Powell, J., dissenting). But failing to do so results in discrimination against domestic parents. *Id.*

215. *Id.* at 2952 n.24. The issue in *Japan Lines* was "whether instrumentalities of commerce that are owned, based, and registered abroad and that are used exclusively in international commerce, may be subjected to apportioned ad valorem property taxation by a State." *Id.* See 441 U.S. at 444. The Court held that the tax resulted in the impermissible multiple taxation of the instrumentalities of foreign commerce, in addition to preventing "the Federal Government from 'speaking with one voice' in international trade." *Id.* at 453.

216. Justice Powell wrote a persuasive dissent in which he was joined by The Chief Justice and Justice O'Connor. 103 S. Ct. at 2957 (Powell, J., dissenting). Justice Stevens took no part in deciding the case.

The dissent intimated that constitutionally impermissible double taxation occurred because "California has rejected accepted international practice in favor of a tax structure that is fundamentally different in its basic assumptions." *Id.* at 2959 (Powell, J., dissenting). Justice Powell contended that while the majority discussed the exacting scrutiny required under *Japan Line*, they failed to apply it. *Id.* at 2957 (Powell, J., dissenting). See also 441 U.S. at 451. He suggested that California could simply apply its apportionment formula to *Container Corporation*'s income, as reported on its federal tax return. 103 S. Ct. at 2957 n.1 (Powell, J., dissenting). He noted that double taxation would be avoided to the extent that the federal government had negotiated with the foreign government. *Id.* (Powell, J., dissenting).

Justice O'Connor's siding with the taxpayer in *Container* was unexpected, since she had authored the dissents in *ASARCO* and *Woolworth*. 458 U.S. at 331, 373 (O'Connor, J., dissenting).
tion will be afforded state tax administrators in the future. It has become apparent that so long as state courts adjudicate related disputes within proper legal standards, their decisions are not likely to be disturbed upon appellate review. Thus, it becomes critical that the taxpayer win at the trial court level any contested matter of state taxation.

Since a determination of the scope of a unitary business is essentially a factual question, insofar as the trial court articulates the correct legal standards as a basis for its decision it will probably not be reversed. To further limit the scope of appellate review, a taxpayer should never agree to stipulate the facts. With no contested issues of fact, any issue raised on appeal by implication is of a legal nature. Therefore, the appellate court will not be constrained by the substantial evidence rule when facts are stipulated.

It has also become obvious in recent years that a sufficient showing of distortion through separate accounting to invalidate a state tax is virtually impossible. The only way to exclude income from apportionment and consequent taxation, is to establish that it is not derived from the unitary business. In light of this, the necessary factual predicate becomes even more important.

It will be interesting to see if Congress can reconcile the diversity of affected interests, to permit development of a more uniform system of state taxation than currently exists. Whether state courts can exercise the necessary objectivity to restrain aggressive state tax administrators in the meantime remains to be seen. Regardless, the Court may be correct in concluding that its hands-off resolution of the unitary issue is better than band-aid legislation by judicial fiat.

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