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The Impact of the *Mobil* Case on Apportionment of Income

Frank M. Keesling*

*Mobil Oil Corp. v. Commissioner of Taxes of Vermont*¹ is a landmark case in the area of tax law relating to the allocation and apportionment of income for state tax purposes. The case ranks with other "greats" in the field such as *Underwood Type-writer Co. v. Chamberlain*,² *Bass, Ratcliff & Gretton, Ltd. v. State Tax Commission*,³ and *Butler Brothers v. McColgan*.⁴ The issue before the Court was whether a state could require a corporation that conducted a portion of its business in the state but had its commercial domicile elsewhere to include in apportionable income dividends from foreign subsidiaries engaged with the taxpayer in conducting a worldwide unitary business. In upholding the state's taxing power, the Court made new law respecting the taxation of dividends. This alone is very important; the opinion's implications are even more significant.

I. APPORTIONMENT POLICIES PRIOR TO *Mobil*

A review of the allocation and apportionment policies in effect prior to *Mobil* may help define the problem and indicate the significance of the Court's decision.

All of the forty-five states that impose taxes on net income confine their taxes to income from sources within their respective states. For a business conducted partly within and partly

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¹ 445 U.S. 425 (1980).

² 254 U.S. 113 (1920). This was the first United States Supreme Court decision involving a state's use of a formula for apportioning the income of a multistate business. The Court upheld the formula, which consisted of a single factor of property. In the course of his opinion, Justice Brandeis stated: "The legislature in attempting to put upon this business its fair share of the burden of taxation was faced with the impossibility of allocating specifically the profits earned by the processes conducted within its borders." *Id.* at 120-21.

³ 266 U.S. 271 (1924). In this case the Court upheld the application of a formula consisting of a single factor of property to a foreign corporation with sales offices in New York.

⁴ 315 U.S. 501 (1942). For a short discussion of this case, see note 36 *infra*.

outside the state, all of these states employ an apportionment formula to determine the income attributable to the taxing state. The formula most commonly used is the three-factor formula of property, payroll and sales. (A few states substitute manufacturing costs for the payroll factor; Iowa uses a formula consisting of a single factor of sales.)

In 1936 the California Franchise Tax Commissioner (the predecessor of the present Franchise Tax Board) began requiring the use of the formula method for a unitary business, even though conducted by two or more legally separate but commonly owned corporations. Each corporation doing business in the state was required to file a return or report showing the combined income of all the corporations engaged in the operation of the unitary business. The combined income was apportioned in much the same manner as if the business had been operated by a single corporation. Shortly after its inception, this procedure was upheld by the California Supreme Court⁵ and has since been upheld by several other state supreme courts, including, quite recently, the Illinois Supreme Court.⁶ However, until the *Mobil* case, the United States Supreme Court had not intimated its attitude toward the validity of the combined report.

Income from permanently located real or tangible personal property not used in a corporation's business has always been allocated to the state where the property is located. A somewhat similar policy has been followed with respect to intangible personal property such as stocks and bonds. Such property by its very nature does not have an actual location. It is convenient for some purposes, including taxation, to give such property a fictitious location. For many years intangible property was considered to have its location in the owner's state of domicile. A corporation was considered domiciled in its state of incorporation. Thus for many years, except in specific instances in which stocks and bonds were used in a state in such a manner as to acquire a business situs in that state, intangible property and the income therefrom were taxable only in the state of incorporation.

In 1936, *Wheeling Steel Corp. v. Fox*⁷ held that accounts receivable could be taxed by the state in which the corporate owner's principal place of business was located and the accounts

⁵ Edison California Stores, Inc. v. McColgan, 30 Cal. 2d 472, 183 P.2d 16 (1947).

⁶ Caterpillar Tractor Co. v. Lenckos, 417 N.E.2d 1343 (Ill. 1981).

⁷ 298 U.S. 193 (1936).

were managed and controlled, even though the corporation was incorporated under the laws of another state. In the course of its opinion, the United States Supreme Court coined the phrase "commercial domicile."⁸ At the time many tax attorneys felt that the case was simply another business situs case, with no particular general significance. The California Franchise Tax Commissioner, however, took the position that a corporation's commercial domicile should be substituted for the state of incorporation in determining jurisdiction to tax income from intangibles. This view was upheld by the California Supreme Court in *Southern Pacific Co. v. McColgan*.⁹ It has since been followed by most states. As a consequence, before *Mobil* the state of commercial domicile, not the state of incorporation, was the controlling criterion in determining where income from intangibles may be taxed.

II. THE *Mobil* DECISION

Mobil significantly changes one of the foregoing policies and foreshadows the possibility of other related changes. Furthermore, although the validity of the combined report was not before the Court, the reasoning of *Mobil* leaves no doubt that the Court considers the combined report a valid method for the apportionment of corporate income.

A. Facts and Arguments

Mobil Oil Corporation was incorporated in New York and had its commercial domicile there. Mobil and numerous subsidiaries were engaged extensively in the oil business and related activities in the United States and in various foreign countries,

⁸ *Id.* at 211.

⁹ 68 Cal. App. 2d 48, 156 P.2d 81 (1945). Apparently this is the first case extending the commercial domicile doctrine to the corporate income tax field. For related cases, see *International Harvester Co. v. Wisconsin Dep't of Taxation*, 322 U.S. 435 (1944); *Wisconsin v. J. C. Penney Co.*, 311 U.S. 435 (1940); *Montgomery Ward & Co. v. Commissioner of Taxation*, 267 Minn. 479, 151 N.W.2d 294 (1967); *Great Lakes Pipe Line Co. v. Commissioner of Taxation*, 272 Minn. 403, 138 N.W.2d 612 (1965). For discussions of the treatment of income from intangibles, see Dexter, *The Business Versus Nonbusiness Distinction Under the Uniform Division of Income for Tax Purposes Act*, 10 URB. LAW. 243 (1978); Dexter, *The Unitary Concept in State Income Taxation of Multistate-Multinational Business*, 10 URB. LAW. 181 (1978); Dexter, *Taxation of Income from Intangibles of Multistate-Multinational Corporations*, 29 VAND. L. REV. 401 (1976); and Peters, *The Distinction Between Business Income and Nonbusiness Income*, 1973 SO. CALIF. TAX. INST. 251.

and Mobil annually received substantial dividends from these subsidiaries. Mobil itself conducted a portion of its business in Vermont. Vermont requires corporations doing business in the state to pay a tax on income derived from sources within the state. The tax is based on federal taxable income. For a business operating both within and outside the state, the portion of its income attributable to Vermont and subject to the tax is determined by the application of an apportionment formula consisting of the three factors of property, payroll and sales.

In its Vermont tax returns, Mobil reported its federal taxable income but deducted from that income the dividends received from foreign subsidiaries on the grounds that such dividends were nonapportionable. Dividends from domestic companies, for the most part, had already been deducted in arriving at federal taxable income.¹⁰

The Vermont Department of Taxes restored the foreign dividends to income, applied the apportionment formula, and made an additional assessment. Mobil protested the assessment on the following grounds: (1) The stock from which Mobil received dividends was deemed to be located in New York, Mobil's state of commercial domicile. The resulting dividends were thus derived from property located in New York, and, in accordance with existing policy, New York was the only state that could tax such dividends. (2) Inasmuch as the dividends could be taxed in their entirety by the recipient's commercial domicile state, taxation by any other state of any portion of the dividends would result in double taxation, imposing a prohibited burden on interstate commerce. Although New York did not in practice tax such dividends, the presence of forbidden double taxation should be based upon the existence of jurisdiction to tax, regardless of whether a particular state does in fact tax. (3) The apportionment formula attributes to a state only a rough approximation of the amount of income earned there; in particular cases, a state may be attributed an excessive amount of income. Thus, application of Vermont's apportionment formula to the foreign dividends might result in double taxation of foreign commerce, which would violate the principles of *Japan Line, Ltd. v. County of Los Angeles*.¹¹

¹⁰ Internal Revenue Code § 243 allows a 100% deduction of dividends from domestic affiliated corporations and an 85% deduction for other dividends.

¹¹ 441 U.S. 434 (1979).

B. Dividends from Foreign Subsidiaries Held Apportionable Business Income

In determining whether income from property is apportionable as business income, or whether it should be specifically allocated as nonbusiness income, the usual criterion has been whether the property producing the income is used in the conduct of a business. Thus, for example, interest on accounts receivable is considered business income subject to apportionment because the accounts receivable arise from and constitute an integral part of the business.¹²

The Court did not follow this approach in *Mobil*. Instead, it inquired whether the income from which the foreign dividends were paid constituted unitary business income. It stated that although the taxpayer had not conceded that such income was unitary, Mobil likewise had not offered any proof that such income was not unitary.¹³ The Court therefore concluded that the dividends in question were declared from worldwide unitary business income. In this connection the Court made the following statement, which doubtlessly will be frequently quoted: "[T]he linchpin of apportionability in the field of state income taxation is the unitary business principle."¹⁴ The Court reasoned that Mobil's receipt of income in the form of dividends did not change its character from apportionable unitary business income to nonbusiness income specifically allocable to the state of commercial domicile. "So long as dividends from subsidiaries and affiliates reflect profits derived from a functionally integrated enterprise, those dividends are income to the parent earned in a unitary business. One must look principally at the underlying activity, not at the form of investment, to determine the propriety of apportionability."¹⁵

The Court further stated that the business organization's structure may have nothing to do with the underlying unity or diversity of the business enterprise. If the businesses of the foreign subsidiaries had been operated as divisions of a single

¹² Income from the sale or licensing of copyrights or patents developed and used in a business likewise constitutes apportionable business income because the copyrights and patents are an integral part of the business.

¹³ The Court stated, "[Mobil] has offered no evidence that would undermine the conclusion that most, if not all, of its subsidiaries and affiliates contribute to appellant's worldwide petroleum enterprise." 445 U.S. at 435.

¹⁴ *Id.* at 439.

¹⁵ *Id.* at 440.

enterprise,

there is little doubt that the income derived from those divisions would meet due process requirements for apportionability. . . . Transforming the same income into dividends from legally separate entities works no change in the underlying economic realities of a unitary business, and accordingly it ought not to affect the apportionability of income the parent receives.¹⁶

For these reasons, the Court concluded that it was permissible for Vermont to treat the dividends from foreign subsidiaries as part of Mobil's apportionable business income.¹⁷

1. *Mobil's double taxation argument*

With respect to Mobil's domestic double taxation argument, the Court confirmed that the controlling consideration is jurisdiction to tax rather than actual taxation: "We agree with Mobil that the constitutionality of a Vermont tax should not depend on the vagaries of New York tax policy."¹⁸ The Court noted that intangibles such as accounts receivable and stocks and bonds are commonly accorded a fictitious location in the owner's state of commercial domicile or in the state where the owner may have acquired a business situs. The Court further noted, however, that the rule permitting such states to tax income from intangibles is not an inflexible one.¹⁹ The use of a fiction to give intangibles a situs at the owner's commercial domicile for property tax purposes does not necessarily mean that for income tax purposes the income from intangibles is taxable entirely by the state of commercial domicile.²⁰

The Court discussed the taxation of income from intangibles by the state of commercial domicile at some length. Although the Court did not reach a definite conclusion, the tenor of its discussion intimates that the state of commercial domicile may not tax the entire income from intangibles if the income, as in *Mobil*, is unitary in character and subject to taxation by other states on an apportioned basis. To hold that the state of commercial domicile may tax only that portion of the

¹⁶ *Id.* at 441 (citation omitted).

¹⁷ *Id.* at 449.

¹⁸ *Id.* at 444.

¹⁹ *Id.* at 445.

²⁰ *Id.* at 445-46.

dividends reasonably attributable to business done in the state would not only change prevailing conceptions as to the source of dividends, but would also limit the power of the state of commercial domicile to tax the income of the corporation.

If income from intangibles is held to be apportionable unitary income, the conclusion that the state of commercial domicile may no longer tax the entire income, but only an apportioned part thereof, is supported by analogy to developments in property taxation of movable tangible property. For years it was held that movable tangible property, such as ships, ferryboats, and airplanes, could be taxed only at its home port, which for a corporate owner was usually the corporation's principal place of business.²¹ In time, however, the Court held that even though movable property was not permanently located in any state, if similar items were present in a state more or less continuously, the property could be taxed by that state on an apportioned basis.²² Subsequently, to prevent double taxation, the Court concluded that the home port doctrine was not applicable where the movable property could be taxed on an apportioned basis.²³

A similar development may well occur with respect to the taxation of dividend income. For years, a corporation's commercial domicile was considered the source of dividend income, and only that state could tax the dividends. Now that *Mobil* has held that dividends declared out of unitary business income may be taxed on an apportioned basis by the other states in which the owner of the stock is conducting a unitary business, the Court may well conclude that the state of commercial domicile may likewise be permitted to tax only on an apportioned basis. If this next step is taken, unless the states take remedial action, the decision in *Mobil* may have serious adverse effects on state tax revenues.

²¹ In *Hayes v. Pacific Mail Steam-ship Co.*, 58 U.S. (17 How.) 596 (1854), a ship operating primarily between San Francisco and Oregon was held taxable only in New York, which was considered its home port. In *Southern Pac. Co. v. Kentucky*, 222 U.S. 63 (1911), boats operating between New York, Havana, New Orleans and Galveston were held taxable in Kentucky, where the owner was incorporated and had its principal place of business. In *Northwest Airlines, Inc. v. Minnesota*, 322 U.S. 292 (1944), a similar rule was applied to a fleet of airplanes based in Wisconsin.

²² This rule was first applied in 1891 to the moving equipment of railroads. *Pullman's Palace Car Co. v. Pennsylvania*, 141 U.S. 18 (1891). *Ott v. Mississippi Valley Barge Line Co.*, 336 U.S. 169 (1949), extended the rule to barges operating on inland waters.

²³ *Standard Oil Co. v. Peck*, 342 U.S. 382 (1952).

2. *Double taxation of foreign commerce*

With respect to Mobil's double taxation of foreign commerce argument, the Court pointed out that Mobil itself insisted that the dividends could be taxed entirely by the commercial domicile state even though they were declared out of foreign source income which may have also been taxed by a foreign country. According to the Court, Mobil did not establish that Vermont's taxation of such dividends on an apportioned basis would result in any greater burden on foreign commerce than taxation on an allocation basis by the state of commercial domicile. Therefore, it concluded that Mobil was not in a position to complain of multiple taxation of its foreign commerce.²⁴

3. *Application of Japan Line to income taxes*

The Court made a number of significant observations concerning the application of *Japan Line* to the income tax field. *Japan Line* was a property tax case involving sea vans used exclusively in foreign commerce which had their home port in Japan and were fully taxed by Japan. The County of Los Angeles taxed the vans on an apportioned basis, a method which had repeatedly been upheld by the Court in the case of railroad rolling stock, airplanes, and barges operating in interstate commerce. Although none of the sea vans were permanently located in Los Angeles County, similar vans were present in the county more or less continuously throughout the year. Thus, the conditions existed for applying the apportionment method of taxation.

The California Supreme Court unanimously upheld the tax.²⁵ The United States Supreme Court, however, reversed, observing that unlike taxation of equipment moving in interstate commerce, double taxation of foreign-owned equipment used in foreign commerce could not be prevented by requiring all involved jurisdictions to tax such equipment on an apportioned basis. Thus, the Court could not ensure against Japan taxing the entire equipment on the basis of a doctrine similar to the home port doctrine, which the Court had invalidated in favor of the apportionment method. To avoid double taxation and possible re-

²⁴ 445 U.S. at 447-48.

²⁵ *Japan Line, Ltd. v. County of Los Angeles*, 20 Cal. 3d 180, 571 P.2d 254, 141 Cal. Rptr. 905 (1977), *rev'd*, 441 U.S. 434 (1979).

tialiation by Japan, the Court struck down the tax.²⁶

Since *Japan Line* was decided, there has been great speculation as to the extent of its application. Many tax advisers have anticipated a broad application, predicting that the states and their political subdivisions would be prohibited from applying the apportionment method of taxation to all foreign-owned equipment used in foreign commerce, regardless of whether the equipment is taxed by the home port country. Thus, they have asserted, merely the risk of taxation by the home port country should be sufficient to preclude the use of the apportionment method in this country. Some attorneys have even asserted that all equipment used in foreign commerce would be exempt from taxation by the states or their political subdivisions, regardless of whether the owner's domicile is in a foreign country or in the United States.

It was also commonly thought that the *Japan Line* principle would be broadly applied to the income taxation of businesses conducted partly in one or more foreign countries. In particular, it was thought that the states would be prohibited from using the apportionment formula method for computing the amount of business income attributable to in-state sources, and that such computation could be made, if at all, only by separate accounting. Many tax counselors confidently expected that the combined report method would be outlawed for businesses conducting part of their operations outside the country.

The *Mobil* Court's discussion of *Japan Line* must necessarily "chill" any expectations that the *Japan Line* principle will be accorded extensive application. The Court in *Mobil* pointedly observed that "in *Japan Line* the Court was confronted with actual multiple taxation that could be remedied only by adoption of an allocation approach."²⁷ This suggests that for property tax purposes the *Japan Line* principle will be extended neither to instrumentalities of foreign commerce owned by a domiciliary of a foreign country which does not actually tax such instrumentalities, nor to instrumentalities owned by a domiciliary of the United States. In both of these instances, the states and their political subdivisions may well be allowed to continue to tax instrumentalities of foreign commerce on an apportioned basis.

²⁶ 441 U.S. 434 (1979). For a critical discussion of the United States Supreme Court decision, see Keesling, *California's Contributions to State and Local Taxation*, 1979 B.Y.U. L. REV. 809.

²⁷ 445 U.S. at 448.

If the *Japan Line* principle is extended to the income tax field, then by analogy it should be limited to businesses owned or controlled by a corporation domiciled in a foreign country that actually taxes the entire business income, including income from sources within the United States. In such a case the states where the business is carried on in part would not be permitted to tax any portion of the income regardless of whether apportionment formula or separate accounting computations are made. In any event, *Japan Line* would have no application to domestic corporations deriving income from foreign sources. Nor would it have any application to a foreign-controlled business if the portion of the business in the United States is operated by a subsidiary corporation or corporations. So far as is known, no foreign country attempts to tax subsidiaries of its domestic companies that operate wholly outside the country. Hence, there is no possibility of double taxation in such cases unless the use of the formula method for a combined return has the effect of taxing extraterritorial income, a result which its proponents vigorously insist does not occur.

It is likely that the *Japan Line* principle will not be extended to the income tax field at all. The Court itself declared that the principles relating to income taxation are different than those relating to property taxation.²⁸ Furthermore, unlike the property tax situation, the federal government itself taxes income of foreign corporations from sources outside the United States. Thus, it can hardly be asserted that the taxation of such income by the states interferes with any federal policy.²⁹ Also, it is a common practice for foreign countries to tax American corporations on income from sources within such countries. Under these circumstances, it would be highly inconsistent for foreign countries to complain about the states following a comparable practice with respect to foreign corporations doing business in this country.

III. RELATED ISSUES NOT DECIDED BY *Mobil*

A. *Dividends from Domestic Corporations*

Consideration will now be given to a few related issues not directly raised in the *Mobil* case. First, is the Court's holding

²⁸ *Id.*

²⁹ *Id.*

regarding the apportionability of foreign dividends declared out of unitary business income equally applicable to domestic dividends declared out of unitary business income? It is difficult to see why there should be any difference in treatment. It appears that a state may include in apportionable unitary income any dividends received by a company from either foreign or domestic subsidiaries, as long as the subsidiaries are engaged in the conduct of a unitary business. Likewise, it seems clear that the *Mobil* holding respecting dividends should also be applicable to other items of income, such as interest on loans to subsidiaries and charges for various services performed by the parent corporation for the subsidiaries.³⁰

B. Dividends from Corporations Not Engaged in a Unitary Business with the Recipient

The issue of the treatment of dividends from affiliated companies not engaged in a unitary business and dividends received from nonaffiliated companies (*i.e.*, dividends from a minority stock interest in an unrelated company) was not before the Court in *Mobil*. The Court, however, made some statements relevant to this question which may change the rule that such dividends are taxable only by the state of commercial domicile.

As previously indicated,³¹ the Court noted that the rule

³⁰ The parent of a group of companies engaged in a unitary business quite commonly borrows money and loans it to the subsidiaries and also performs many services, such as advertising, accounting, and research, that substantially benefit the subsidiaries. A significant portion of the cost of these items should be charged to the subsidiaries. However, where the subsidiaries of domestic corporations are doing business in foreign countries, such costs are often not charged to the subsidiaries in the belief that for tax purposes the costs would be "wasted." Some foreign countries do not impose income taxes, others tax at rates lower than those prevailing in the United States, and others only loosely enforce their taxes, with the result that much of the foreign income of the unitary business escapes taxation in foreign countries. Therefore, instead of charging these costs to the foreign companies, the domestic parent company files a consolidated return in which it includes its own income and the income of domestic subsidiaries. The parent company then has the benefit of deducting all of the charges for services to its subsidiaries in the computation of its United States taxable income.

Similar tax avoidance policies are followed in computing state taxable income for states which do not use the combined report. Since the combined report takes into account total worldwide income, in states like California which use the combined report it is a matter of indifference whether the charges are made against the parent company or against the foreign subsidiaries. This is one significant reason why the income of a worldwide unitary business should be computed on a combined basis and then apportioned, rather than computed on a corporation-by-corporation basis.

³¹ See text accompanying note 9 *supra*.

which permits the state of commercial domicile to tax income from intangibles is not an inflexible one. The fact that intangibles are given a fictitious situs at the owner's commercial domicile for property tax purposes does not necessarily mean that the income is entirely taxable by the state of commercial domicile for income tax purposes. This point is well illustrated by *Wheeling Steel Corp. v. Fox*³², which is the origin of the commercial domicile doctrine. The *Wheeling Steel* case was concerned with the situs of accounts receivable for property tax purposes. Clearly, income from the collection of such accounts and interest received thereon constitute business income, since such accounts arise from and are an integral part of the business. It follows that if the business is carried on in more than one state, the income from such accounts is unitary business income subject to apportionment.

There is a growing sentiment among tax administrators that a similar rule should be applied to income from other intangible property, such as stocks and bonds, particularly where the stocks and bonds are acquired to further or promote the corporation's business. The case of *Southern Pacific v. McColgan*,³³ which upheld the extension of the commercial domicile doctrine to the income tax field, is well in point.

The Southern Pacific Company was incorporated in Kentucky in 1884. For a number of years its principal place of business was located there, but prior to the *Southern Pacific* litigation, it had withdrawn its business operations from Kentucky and no longer had property or employees in that state. The company maintained executive offices in San Francisco, California, where its vast railroad empire was managed and controlled. It also maintained offices in New York City, where the directors met, investment decisions were made, and the stock certificates and bonds evidencing the company's ownership of a substantial amount of intangible property were kept.

Testimony indicated that the company's investments were made with an eye toward furthering or promoting its railroad business. For example, it purchased securities of the Baldwin Locomotive Company to assure itself of a priority in obtaining locomotives. Southern Pacific also acquired a fifty-percent interest in a large refrigerated-car company in order to promote the

³² 298 U.S. 193 (1936).

³³ 68 Cal. App. 2d 48, 156 P.2d 81 (1945).

operation of refrigerated cars over its railroad lines.

The California District Court of Appeal held that the company's commercial domicile was in San Francisco and that the entire income from the company's stocks and bonds was taxable in California.³⁴ This result was preferable to the former rule under which all of the company's income from securities would have been attributed to Kentucky, the state of incorporation. Since the company no longer engaged in business activities in Kentucky, to allow only Kentucky to tax the company's income from securities would have exalted form over substance in an arbitrary and capricious manner.

If Southern Pacific's securities were to be given a fictitious situs in some state, there is considerable merit to the idea that New York should have been the location, since the board of directors met there, investment policies were determined there, and the securities were managed and controlled in that state. In *Wheeling Steel*, one of the reasons for subjecting the accounts receivable of Wheeling Steel Corporation to a property tax in West Virginia was the fact that they were managed and controlled in that state.³⁵

Perhaps a better rule would be to consider the income derived from securities in a case such as *Southern Pacific* as business income to be apportioned among the states in which the company's business is conducted, regardless of the situs accorded the securities for property tax purposes. This would solve many problems. It would eliminate the often difficult task of determining where the corporate domicile is located. It would also eliminate various accounting problems. For example, for many years Southern Pacific Company attributed its income from securities to Kentucky but offset all of its considerable interest expenses against its railroad operations income. As a result, although its overall net income was substantial, it paid little income tax in any state where it carried on its business activities.

The proposed rule should be followed in any situation where the securities are acquired with the objective of promoting the corporation's business, as in the *Southern Pacific* case. If this rule were adopted, income from intangibles would be taxable exclusively in the state of commercial domicile only in the

³⁴ *Id.* at 81, 156 P.2d at 100.

³⁵ 298 U.S. at 211-15.

relatively rare instances in which the intangibles were acquired strictly for investment purposes and their acquisition does not in any way benefit the corporation's business operations.

C. Gain from Sale of Apportionable Unitary Income Stock

If dividends on stock are considered unitary apportionable income, it seems clear that gains from the sale of the stock should similarly be considered apportionable income. Even before *Mobil* was decided, it was believed that such a result should apply in the states employing the combined report. For example, assume that the owners in *Butler Brothers v. McColligan*³⁶ had sold their California store at a substantial profit. Since the store was used in Butler Brothers' business, the gain clearly would constitute apportionable business income. Next, assume that the California store was operated by a subsidiary, rather than by Butler Brothers itself, and that the subsidiary sold the store. The states using the combined report combine the income of affiliated corporations engaged in the conduct of a unitary business; hence, the sale of the store by a subsidiary corporation rather than by Butler Brothers should make no difference insofar as the treatment of the gain is concerned. Because the store

³⁶ 17 Cal. 2d 664, 111 P.2d 334 (1941), *aff'd*, 315 U.S. 501 (1942). Butler Brothers operated wholesale department stores in several states, including one in California. Its business was managed and controlled from its principal office in Illinois. The business as a whole was quite profitable; however, Butler Brothers claimed that it sustained losses from the operation of the California store.

The California Franchise Tax Commissioner took the position that the company's business was unitary and that its California income should be determined by computing the entire unitary income and apportioning it by the three-factor formula of property, payroll, and sales. In support of his position, the Commissioner argued two principal points: (1) By buying in large quantities, the company was able to buy merchandise for all of its stores at a discount; however, it was able to buy in large quantities only by selling merchandise in large quantities. The California store contributed to sales and thereby assisted the company in acquiring merchandise for all of its stores at a lower cost than would otherwise have been possible. (2) By doing business in California as well as in other states, the company was able to obtain better managerial personnel than would otherwise have been possible. Therefore, in these two ways California contributed to the company's earnings as a whole. According to the Commissioner, Butler Brothers' income should be apportioned by the formula method, which gave weight to the contributions by different states in which the business was conducted, rather than by separate accounting, which ignored such contributions.

The Commissioner's position was unanimously upheld by both the California Supreme Court and the United States Supreme Court. In *Mobil*, the Court referred to *Butler Bros.* with approval and specifically stated that the formula method may be employed where the portion of the business conducted within the taxing state contributes to the functioning of the entire business. 445 U.S. at 438.

was used in the conduct of a unitary business, even though it was owned by a legally separate corporation, the gain should be added to the other business income and apportioned.

Finally, suppose that instead of the subsidiary selling the store, the parent sold its stock in the subsidiary. In all three hypotheticals, property used in the unitary business is disposed of for a profit. Since the results of the three transactions are much the same, the results for apportionment purposes should likewise be the same, especially since the purpose of the combined report is to ensure that the income of a unitary business is apportioned in the same manner regardless of whether the business is conducted by one corporation or by multiple corporations.

The *Mobil* case emphasizes the correctness of the foregoing conclusion and extends it to all states whether or not they use the combined report. Thus, in all cases, gains realized from a parent corporation's sale of the stock of an affiliated corporation engaged in the conduct of a unitary business should be considered apportionable unitary income. This is an extremely important development which will radically change the allocation and apportionment policies of most states.

IV. PROBLEMS RELATING TO THE APPORTIONMENT FORMULA

Normally in the apportionment of unitary income by the three-factor formula of property, payroll, and sales, all of these factors involved in the production of the unitary income are taken into account in the apportionment formula. Hence, if dividends from unitary business subsidiaries are to be treated as unitary income, it would seem that at least some of the property, payroll, and sales of the subsidiaries should be included in the formula factors.

To include the subsidiaries' income in apportionable income to the extent of the dividends without including in the apportionment formula's denominator any of the factors which produced the subsidiaries' income would result in a serious distortion in the apportionment. Far too much income would be apportioned to states where the parent operates a portion of the unitary business, and too little income would be apportioned to the jurisdictions where the subsidiaries function. Conversely, the inclusion of all of the subsidiaries' property, payroll, and sales in the formula's denominator while including only a portion of their income in apportionable income would result in attributing

too much income to the jurisdictions where the subsidiaries function and too little income to the states where the parent operates a portion of the unitary business.³⁷

It has been suggested that the property, payroll, and sales of the subsidiaries should be included on a pro rata basis, i.e., if the dividends are equal to fifty percent of the subsidiaries' total income, then fifty percent of their property, payroll, and sales should be included in the formula.³⁸ There is some logic to this suggestion; however, it is entirely novel. A pro rata inclusion has never been utilized in the apportionment of income for state tax purposes. This suggestion is certainly preferable to either entirely excluding from the formula the property, payroll, and sales of the subsidiaries, or including the entire amount of their property, payroll, and sales. It is, however, far from a satisfactory solution.

Under this proposal, the apportionable income would consist of the parent company's entire income from the unitary business plus the dividends which represent a portion of the subsidiaries' income from the unitary business. This total would be apportioned by a formula with a denominator that would include all the parent's property, payroll, and sales and only a portion of the subsidiaries' property, payroll, and sales. The result is highly confusing. The probable effect would be to apportion too much income to the states where the parent does business and too little to the jurisdictions where the subsidiaries function. These problems concerning the apportionment formula simply point out that the policy of treating dividends as unitary appor-

³⁷ These conclusions assume that dividends declared by a subsidiary will be less than the subsidiary's current income, which is usually the case. A substantial portion of the subsidiary's income may be used to pay income taxes, which under some state laws is not deductible in computing apportionable income. Other income may be used to establish reserves for capital improvements, capital acquisitions, and other purposes.

Occasionally the amount of dividends may exceed the subsidiary's current income and thus be declared in part out of prior years' earnings. This situation existed in one of the years involved in the *Mobil* case. When this occurs, the dividends consist of all of the subsidiary's income for the current year and, in addition, some income earned in prior years. Presumably, then, under the suggestion described in the text, all of the property, payroll, and sales for the current year should be included in the formula's factors; and a portion of the property, payroll, and sales for the prior years should be included in apportioning the dividends declared out of the income of those prior years. This complicated procedure can boggle the imagination.

³⁸ Peters, *Sup. Ct.'s Mobil decision on multistate income apportionment raises new questions*, 53 J. Tax. 36, 39 (1980). See also, Feinschreiber, *State Taxation of Foreign Dividends After Mobil v. Vermont; Adjusting the Apportionment Formula*, 6 INT'L TAX. J. 267 (1980).

tionable income has its limitations. Other problems, even more serious, should also be considered.

A. Discrimination Resulting from Treating Dividends as Apportionable Income

The policy of treating dividends as apportionable income will inevitably result in discrimination between instances in which the parent corporation itself conducts a portion of the unitary business in a state other than its commercial domicile, and instances in which a subsidiary corporation conducts a portion of the unitary business in a state other than the commercial domicile of its parent. For example, suppose the XYZ Corporation is engaged in the oil business and related activities on much the same scale as Mobil, with numerous subsidiaries from which it derives substantial dividends declared out of unitary income. XYZ's operations are comparable to Mobil's with one significant exception. Unlike Mobil, in Vermont XYZ's unitary business is conducted by a legally separate corporation that receives no dividends from subsidiaries. Since Vermont looks only to the book income of the corporations doing business in the state, it will not be able to tax any of the subsidiaries' dividends. The discrimination against Mobil is obvious and substantial. Such inequities will inevitably occur in a state that includes in taxable corporate income dividends from subsidiaries declared out of income from a unitary business.

B. Avoidance of Vermont's Tax on Dividends

Vermont's tax officials undoubtedly think they have achieved a great victory in *Mobil*. This victory, however, can be turned into defeat at the taxpayer's will. Mobil can eliminate the tax simply by conducting its Vermont business through a subsidiary such as Mobil of Vermont.³⁹ California faced a similar

³⁹ If states like Vermont are unable to tax dividends from unitary income because the corporation conducting a portion of the unitary business in the state is a subsidiary which does not receive dividends, and if it is decided that the state of commercial domicile may not tax the entire amount of dividends but only a pro rata portion thereof, then unless the states adopt the combined report, the *Mobil* case will have the anomalous result of reducing rather than increasing state tax revenues.

There are other possible anomalous consequences of the *Mobil* case. If the parent company does not engage in business anywhere, but simply functions as a holding company, or if it confines its business activities to the state where its commercial domicile is located, then all its dividends will be taxable by the domiciliary state even if dividends

situation years ago in *Butler Brothers*. California won a great victory when the courts upheld its contention that Butler Brothers was engaged in the conduct of a unitary business and that the income from the California store should be computed by the application of a formula rather than by separate accounting. However, except for the fact that California had previously adopted the combined report method, Butler Brothers could have reversed the result by organizing a subsidiary corporation to operate the California business.

V. ADOPTION OF COMBINED REPORT

California's experience suggests the solution to the problems under discussion. Vermont and other states similarly situated should adopt the combined report, as many states have done. The old saying that "half a loaf is better than no loaf" is not applicable here. The problems arising from the inclusion of dividends in unitary income can be solved by including all of the subsidiaries' income in apportionable income, not just the amount declared in dividends. This eliminates the problems relating to the apportionment formula. If all of the subsidiaries' income is included in the formula, then all of the property, payroll, and sales figures can likewise be included without causing distortion. This solution also eliminates the discrimination problem, because all taxpayers similarly situated will be treated alike regardless of whether the parent or a subsidiary corporation conducts the business within the taxing state. Best of all, the states may continue to tax a share of a unitary enterprise's worldwide income commensurate with the amount of business done in such states without being frustrated by the taxpayers practicing what has aptly been called the "corporate shell game."⁴⁰

There can be no doubt that the Court will uphold the constitutionality of the combined report if and when the issue is

are apportionable—not because of specific allocation, but because no other state will have a claim to tax any portion of the dividends on an apportionment basis. Such a result would be highly favorable to a corporation like Mobil that has its commercial domicile in a state, such as New York, that does not tax dividends.

A corporation with its commercial domicile in a state that taxes corporate income, including dividends, might well confine its own business activities either to a state which does not tax corporate income (there are five such states) or to a state like New York which does not tax dividends. By such a maneuver, all of the corporations's apportionable dividends would be apportioned to states where they would not be taxed.

⁴⁰ This expression has been attributed to William Dexter, General Counsel for the Multistate Tax Commission.

presented to it. From the Court's holding that the dividends declared by Mobil's subsidiaries constituted unitary income because they were declared out of unitary income, it necessarily follows that the subsidiaries were engaged in the conduct of a unitary business. The Court stated that if the business of Mobil and its subsidiaries had been conducted by one corporation with divisions rather than legally separate corporations, "there is little doubt that the income derived from those divisions would meet due process requirements for apportionability."⁴¹

This statement, coupled with the declaration that the character of a business as separate or unitary is to be determined by the underlying business activities, not by the corporate structures, leaves no doubt that a state in which any portion of a unitary business is conducted may tax the income attributable to the state by the use of an appropriate formula and may do so even though the business is operated by two or more affiliated but legally separate corporations. This is exactly what the combined report does.

It may well be that in a proper case the United States Supreme Court will hold that the formula method utilized by the combined report must be used.⁴² Quite commonly the combined report method results in attributing less income to a given taxing state than would be attributed to that state under some other method, such as computation of taxable income based upon the book income of an affiliated corporation doing business in the state.

The Supreme Court of Illinois recently decided a case in which both the Illinois Department of Revenue and the taxpayer corporation urged the use of the combined report method.⁴³ Although one group of intervening corporations opposed this position, another group of influential corporations filed an amicus brief urging that the combined report method be approved. Thus, a considerable number of corporate taxpayers prefer the combined report. This area of tax law may see some additional important developments in the future if various states continue

⁴¹ 445 U.S. at 441.

⁴² Mobil urged that Vermont should have employed the combined report, presumably because the result would have been advantageous to Mobil. *Id.* at 441 n.15. The Court did not reject this argument, but instead left the issue open because the record did not contain sufficient evidence for the Court to rule on the point, and because the Court believed the argument had been made as an afterthought.

⁴³ *Caterpillar Tractor Co. v. Illinois Dep't of Revenue*, Nos. 58218, 58228, 52903. — Ill. —, — N.E.2d — (1981).

to insist upon computing taxable corporate income on a corporation-by-corporation basis.