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ATTRIBUTION OF A MULTINATIONAL CORPORATION'S NET INCOME: THE POSITION OF UNITARY STATES REGARDING COMBINED REPORTING

*William D. Dexter**

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I. INTRODUCTION

A complex and controversial aspect of state taxation of business income involves the attribution[1] of a multinational corporation's (MNC's) net income. This Article examines the nature and scope of the controversy that stems from the conflicting views of states that promote a unitary taxation system, and MNCs as well as the Department of Treasury (Treasury) that oppose this position. Section IV illustrates why the unitary business principle[2] is currently the only viable, fair, and feasible method available to the states for the geographical assignment of an MNC's net income. Section V analyzes the MNCs' arguments both against worldwide combined reporting and in favor of alternative accounting methods. In addition, this Article also considers the different positions of foreign and domestic MNCs in regard to worldwide combined income reporting.

Section II explores the basic assumptions upon which various attribution rules are based and sets forth the consequences of competing alternative rules. This section also examines the underlying conflict between: (1) the "sourcing" of net income and "separate accounting," subject to Internal Revenue Code (IRC) § 482 adjustments (as administered by the Internal Revenue Service (IRS)); and (2) the unitary business principle.

Substantial differences between the theory and application of these various rules have surfaced as states exert their individual powers of taxation within the limits of constitutional and practical restraints. As applied to MNCs, the appropriateness and reasonableness of any of these rules depend on one's view of what constitutes an MNC and a reasonable exercise of state taxing power. If an MNC is viewed as a single economic unit[3] rather

1. Attribution, as used in this article, describes the assignment by geographic region of the "net income" of corporations conducting business in more than one taxing jurisdiction.

2. As used herein, "unitary business principle" refers to the aggregation for tax purposes of a corporation's business activities that are functionally interrelated and interdependent regardless of whether the business is conducted as one or more corporations.

3. This single economic unit has also been described as a "cluster of corporations of diverse nationality joined together by ties of common ownership and responsive to a common management strategy." Vagts, *The Multinational Enterprise: A New Challenge for Transnational Law*, 83 HARV. L. REV. 739, 740 n.4

than as a group of independent businesses, then combined tax reporting is appropriate.[4] When an MNC is viewed as a unitary economic entity, though, nationality becomes a consideration. An attribution rule that is reasonable when used to determine the domestic income of a foreign MNC is not necessarily appropriate as applied to a domestic MNC. Different attribution rules may be necessary for domestic MNCs with world operations headquartered in the United States, as compared with foreign MNCs headquartered in other nations. A discussion of concepts basic to these methods follows.

II. Attribution of Net Income: Basic Concepts

A. Abstract Nature of a Tax on Net Income

"Net income" is the end product of the numerous intermingled transactions and operating events conducted by a taxpayer within an arbitrary time period called a taxable year.[5] When these trans-

(1970) (quoting from Vernon, *Economic Sovereignty at Bay,* 47 Foreign Aff. 110, 114 (1968)).

4. The following general description of MNCs accords with common sense and business reality:

> Although MNC subsidiary corporations are legally separate, in fact MNC parents tend to view them as parts of the single global system whose overall success, rather than that of any individual component, is considered critical. From a business viewpoint, then, the operations of the MNC largely transcend the geographic boundaries of the various nations of incorporation.

Note, *Multinational Corporations and Income Allocation Under Section 482 of the Internal Revenue Code,* 89 Harv. L. Rev. 1202, 1202 (1976).

5. A comparison of Peck & Co. v. Lowe, 247 U.S. 165 (1918), with Crew Levick Co. v. Pennsylvania, 245 U.S. 292 (1917) illustrates the abstract nature of net income. In *Crew Levick,* the Supreme Court invalidated a state gross receipts tax on receipts from goods sold in foreign commerce because such a tax was barred by the Import-Export Clause of the United States Constitution. This clause (art. 1, sec. 10, cl. 2) provides in part: "No State shall, without the Consent of the Congress, lay any Imposts or Duties on Imports or Exports, except what may be absolutely necessary for executing it's [sic] inspection laws." In *Peck,* however, the Court rejected the argument that a tax on net income from export sales constituted a tax on export receipts banned by the import-export clause. Rather, the Court held that the tax:

> . . . is not laid on the income from exportation because of its source. . . . The tax is levied after exportation is completed, after all expenses are paid and losses adjusted, and after the recipient of the income is free to use it as he chooses. Thus what is taxed—the net income—is as far removed from exportation as are articles intended for export before the exportation

actions and events transcend interstate borders, each taxing state must devise some means to determine that portion of net income attributable to properties and activities within its borders. Such determination necessarily must fall within constitutional limitations. Consequently, the abstract nature of net income complicates all income tax apportionment cases.[6]

B. Complex Nature of Modern Corporate Business

The complexity of modern business transactions adds to the difficulties associated with the attribution of net income. Factors contributing to this complexity include: (1) the size and international scope of business operations; (2) developments in business organization, operation and structure, such as conglomeration; (3) diversification; (4) use of affiliated corporations to hold property and/or to conduct business; (5) substantial income from investments in intangible assets; (6) treatment of each corporation, irrespective of control or ownership by another, as a distinct legal entity; (7) technological changes in the way businesses are being conducted; and (8) different kinds and levels of control exercised by a multinational corporation over its various operating divisions and/or affiliated corporations.

C. Conflicting Attribution Rules in General

Given the abstract nature of net income and the complexity of modern business enterprises, any state income attribution rule necessarily utilizes some rough approximation rules or standards. Consequently, the traditional idea that income can be sourced geographically must be discarded.[7] Thus, it is not surprising that

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begins.

Peck, 247 U.S. at 174-75.

6. *See, e.g.*, Container Corp. of Am. v. Franchise Tax Bd. 103 S. Ct. 2933 (1983); Exxon Corp. v. Wisconsin Dep't of Revenue, 447 U.S. 207 (1980); Mobil Oil Corp. v. Commissioner, 445 U.S. 425 (1980); Moorman Mfg. Co. v. Bair, 437 U.S. 267 (1978); Butler Bros. v. McColgan, 315 U.S. 501 (1942); Bass, Ratcliff & Gretton, Ltd. v New York Tax Comm'n, 266 U.S. 271 (1924); Underwood Typewriter Co. v. Chamberlain, 254 U.S. 113 (1920). In these cases, the Supreme Court noted the impossibility of attributing some items of income to any specific segment of the taxpayer's integrated business.

7. In Moorman Mfg. Co. v. Bair, 437 U.S. 267, 272-73 (1978), the Supreme Court upheld Iowa's single sales factor apportionment formula. The Court noted that the sourcing of portions of multijurisdictional income attributable to any one jurisdiction was impossible, but that Iowa's formula did not attempt to

"rough approximations" have produced different and conflicting methods of attributing net income to each taxing jurisdiction (states as well as nations) where a unitary business is conducted.

Taxing jurisdictions currently use at least four rough approximation methods. One of these methods is "separate accounting," which relies upon the corporate taxpayer's internal accounting, subject to so-called "arm's-length" adjustments by taxing authorities. Regardless of whether such adjustments are made, separate accounting still suffers from inherent defects.[8] Separate accounting is based upon the principle that the income components of a multiple-corporate unitary business can be ascertained and assigned to a geographical location.

A second rough approximation method is "allocation." Under this method, net income may be assigned by employing certain legal fictions such as the concept of the country of incorporation or the commercial domicile of the corporation. Alternatively, net income may be assigned to the geographic locations of particular income-producing activities or properties. Allocation generally has been relied upon in assigning income unrelated to the unitary business of the taxpayer.[9] In addition, allocation is often used to "source" net income into the jurisdiction that otherwise would be "outside" the taxing jurisdiction under the separate accounting method.

Unitary apportionment is a third rough approximation method. This method is based on the premises that: (1) it is impossible to separately account for the income of an integrated unitary business geographically, irrespective of the location of the business or the form in which the business is conducted; and (2) an apportionment formula reasonably distributes the income of a multijurisdictional unitary business among the geographic locations in which that business is conducted.[10] Although apportionment tra-

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source net income geographically.

8. The Supreme Court has held that multijurisdictional integrated business activities have no single, identifiable source, Mobil Oil Corp. v. Commissioner, 445 U.S. 425, 438 (1980), and that "separate accounting . . . may fail to account for contributions to income resulting from functional integration, centralization of management and economies of scale." *Id.* (quoting Butler Bros. v. McColgan, 315 U.S. 501, 508-09 (1942)).

9. *See* UNIFORM DIVISION OF INCOME FOR TAX PURPOSES ACT (UDITPA), 7A U.L.A. 331, (1985).

10. The UDITPA formula (consisting of the factors of tangible property, payroll and sales) is the generally-accepted formula. As is true of most appor-

ditionally has been used and accepted for a unitary business carried on by a single corporation, separate entity accounting (SEA) is promoted by both the Treasury and MNCs as the appropriate standard to adjust profits between two or more corporations carrying on a single integrated multinational unitary business.

The attribution of net income by "source" constitutes a fourth, but generally unrecognized, attribution method. Source allocation is closely associated with specific allocation and separate accounting. Unlike specific allocation, however, it is applied to both the business and nonbusiness income of a unitary business. Unlike separate accounting, it is not dependent on internal accounting methods. However, the method is often used to support separate accounting results. Source attribution is often used to justify geographic assignment of income from natural resources; for example, the exploration and production profits of the oil industry.[11] It is also relied upon by MNCs to attribute income on the basis of legal fictions, such as by the country of incorporation or by the commercial domicile of the owner of income-producing properties. MNCs use the concept of sourcing to distinguish income attributable to the United States from income attributable to foreign jurisdictions. MNCs also attribute a payee's dividend income on the basis of the payor's activities under this method. The "source" method is the least realistic concept, however, because the true source of any income stream usually involves multijurisdictional incidents and activities.

These methods are not mutually exclusive, although they differ in concept and result and generally are conflicting. In particular, interdependencies exist between these methods. For example, separate accounting may be dependent on apportionment and/or specific allocation of certain items of income and expense. As a limitation common to all the methods, however, a state may not constitutionally attribute to a state any income not rationally related to the presence and activities of the corporate taxpayer within the state.[12]

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tionment statutes, UDITPA contains relief provisions if the formula unfairly assigns net income to instate business activities. *Id.* § 18, 7A U.L.A. 355 (1985).

11. In Exxon Corp. v. Wisconsin Dep't of Revenue, 447 U.S. 207 (1980), Exxon argued that its profits from exploration and production of crude oil could be clearly segregated from the remainder of its unitary income because established field prices existed for the crude oil and because the expenses associated with exploration and production could be isolated geographically.

12. *See* Norfolk & Western Ry. Co. v. Missouri State Tax Comm'n, 390 U.S.

D. Conflicting Attribution Rules Under Sourcing Principles

Separate accounting, whether specific or separate entity accounting, is based upon the erroneous assumption that net income from a unitary business can be geographically segregated. The error of this assumption is compounded by its use in conjunction with conflicting "sourcing" rules. Net income may be attributed on the basis of residence (i.e., where individuals reside or where corporations either are incorporated or have their commercial domicile), or it may be sourced by reference to what is deemed the location of the income-producing property, event or activity. In turn, alternative rules control the definitions of segregated income-producing activity.[13] Moreover, these rules may vary between different classes of income.[14]

The following hypotheticals demonstrate the diversity of sourcing rules:

> 1. Corporation A is a financial institution in State X. It loans money to individual B, a resident of State Y. Security for the loan is a mortgage on property located in State Z. What is the geographic source of the interest income which Corporation A derives from this loan? Is it State X where the loan transaction took place, where the funds were paid out, and where Corporation A is located? Or is it State Y where the payor is located, or State Z where the property securing the loan is located? Each of these states has a legal basis for attributing this income to its jurisdiction by sourcing rules.[15] Because Corporation A does business only in State X, it

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317, 325 (1968) (noting that "[a]ny formula used must bear a rational relationship, both on its face and in its application, to property values connected with the taxing State"); Hans Rees' Sons, Inc. v. North Carolina, 283 U.S. 123 (1931).

13. As noted by the Court in *Mobil Oil*, whenever a unitary business exists, "[b]ecause . . . factors of profitability arise from the . . . business as a whole, it becomes misleading to characterize the income of the business as having a single identifiable 'source.'" *Mobil Oil*, 445 U.S. at 438. The Court further noted in *Container Corp.* that "geographical accounting and formula apportionment are imperfect proxies for an ideal which is not only difficult to achieve in practice, but also difficult [to achieve] in theory." *Container Corp.*, 103 S. Ct. at 2949.

14. For an analysis of various "source" rules, see REPORT, SPECIAL SUBCOMMITTEE ON STATE TAXATION OF INTERSTATE COMMERCE OF THE HOUSE COMMITTEE ON THE JUDICIARY, H.R. REP. No. 1480, 88th Cong., 2d Sess. 1, 197-220 (1964). As noted, "[I]t is futile to search for even in theory a single true source of any particular item of income earned by a multistate taxpayer." *Id.* at 216-17 n.34.

15. *See, e.g., Mobil Oil*, 445 U.S. 425; Curry v. McCanless, 307 U.S. 357 (1939); First Bank Stock Corp. v. Minnesota, 301 U.S. 234 (1937); Wheeling Steel Corp. v. Fox, 298 U.S. 193 (1936); Metropolitan Life Ins. Co. v. City of

will pay no tax on this interest income to any state if it can convince State X to source the income to taxable incidences in either State Y or State Z. On the other hand, if Corporation A also did business in States Y and Z, Corporation A could be subject to triple taxation of the same income under sourcing rules.

2. Assume that Corporation B has developed a patent used both by Corporation B and by Corporation C. Corporation B receives royalties from Corporation C for C's use of the patent. Corporation B is located in State X. Corporation C has its legal and commercial domicile in State Y. Corporation C uses the patent in State Z. What is the source of the royalty income? Is it State X where the patent was developed and where its owner is located? Is it State Y where the payor has its legal and commercial domicile and from where the payments are made? Is it State Z where the patent is used in the business operations for which the royalties are paid? The same potential tax consequences result here as in Example 1, i.e., possibilities for both nontaxation and triple taxation.

What if Corporation B formed subsidiary D in a tax haven country and transferred the patent to subsidiary D in exchange for D's stock? Corporation B and other users of the patent then would pay royalties to Corporation D. Is the source of the net income now the tax haven country? If it is, as would be the case under the separate entity accounting method, then the source of net income from intangibles easily can be shifted to any geographic location.[16] Such shifting ignores the true source of net income.

3. Assume that Corporation C, as in the second hypothetical above, pays royalties to Corporation B in the form of dividends, after nominal tax haven taxes. What is the source of the dividend income? Is it the tax haven country in which the payor is located or the location of the payee's stock? Is it the legal or commercial domicile of the payee? Or is it where Corporation B conducts its business activities? What if Corporation B forms both Subsidiary D and a holding company, and then transfers its stock in Subsidiary D to the holding company in exchange for holding company stock?

Under the United States tax system, the taxation of dividends is not considered as taxing either the property or the income of the payor.[17] Rather, dividends are attributable solely to the owner

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New Orleans, 205 U.S. 395 (1907).

16. An example of this shifting is found in Dittler Bros. v. Commissioner, 72 T.C. 896 (1979).

17. *See, e.g., Container Corp.*, 103 S. Ct. 2933; 1 T. COOLEY, THE LAW OF TAXATION, § 245, 519-20 & n.69 (4th ed. 1924); Hawley v. City of Malden, 232

of the stock.[18] MNCs, however, argue that the dividends should be attributed by sourcing methods to the payor. When owned by a corporation, dividends potentially may be sourced to several tax jurisdictions: the legal domicile, commercial domicile, location of stock, business situs, or location of business activities.[19]

Thus, the "sourcing" of net income by separate accounting leaves unanswered several complex sourcing questions including how to source the net income from integrated business operations. In contrast to the sourcing method, the unitary business principle affords a reasonable method for resolving the conflict between alternative "sourcing" rules.

E. Results Sought by Use of Attribution Rules

Conflicting opinions exist regarding the proper purpose of state corporate net income attribution rules. Most MNCs advocate that attribution rules should determine what portion of any MNC's net income is attributable to in-state "sources." Unfortunately, it is impossible to accomplish that purpose. The amount of MNC income attributable to any specific geographic area can only be estimated at best.[20]

When a multijurisdictional unitary business is conducted by a *single* corporation, the net income assignable to any jurisdiction should not exceed the net income of the unitary business. It is anomalous and irrational, therefore, that the application of "sourcing" concepts could produce such a result if business profits are derived solely from "sources" within the taxing jurisdiction while losses are incurred in other taxing jurisdictions. In this situ-

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U.S. 1 (1914); Darnell v. Indiana, 226 U.S. 390 (1912); People v. Commissioner, 71 U.S. 244 (4 Wall.) (1866); Van Allen v. The Assessors, 70 U.S. 573 (3 Wall.) (1865).

18. *E.g., Darnell*, 226 U.S. at 391.

19. *See, e.g.,* Curry v. McCanless, 307 U.S. (1939) 357.

20. The U.S. Supreme Court recognized this fact in Underwood Typewriter Co. v. Chamberlain, 254 U.S. 113 (1920), in which the Court stated:

> The profits of the corporation were largely earned by a series of transactions beginning with manufacture in Connecticut and ending with sale in other States. In this it was typical of a large part of the manufacturing business conducted in the State. 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.

ation, an MNC would correctly contend that the "source" of the net income is the *total* activities of the unitary business.

Because the net income of a multijurisdictional unitary business cannot be sourced precisely by separate accounting methods or otherwise, attribution rules must then relate to another purpose. Consistent with the nature of state taxes imposed upon or measured by net income of corporations, the purpose of attribution rules must be to assign income proportionate to the ratio of the business' in-state activities with its total activities both in-state and out-of-state.

F. Inconsistency of Residentially-Oriented Federal Attribution Rules and Geographically-Oriented State Attribution Rules

The United States has jurisdiction to tax the total worldwide income of domestic MNCs.[21] Subpart F of the IRC specifically addresses this issue.[22] Significantly, the tax code parallels the unitary business principle as it treats a U.S. domestic parent and its worldwide affiliated corporations as a single unit for federal income tax purposes.[23] The United States justifies the taxation of a foreign affiliate's income on the basis of the parent's stock ownership and its control of affiliated corporations.[24]

In some instances, the United States applies separate accounting to its own (domestic) MNCs to determine the "source" of income. Primarily, this method is used to compute foreign tax credits and to determine income subject to deferred taxation. Otherwise, any arm's-length adjustments are made only for the purpose of determining the true net taxable income of the corporate taxpayer. For example, the IRS is not interested in whether

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21. *See* Park, *Fiscal Jurisdiction and Accrual Basis Taxation: Lifting the Corporate Veil to Tax Foreign Company Profits*, 78 COLUM. L. REV. 1609, 1613-15 (1978) [hereinafter cited as Park]; Note, *Comparative Analysis of Systems of Domestic Taxation of Controlled Foreign Corporations*, 14 VAND. J. TRANSNAT'L L. 99, 109-31 (1981); *see also* Norr, *Jurisdiction to Tax and International Income*, 17 TAX L. REV. 431, 433 (1962) [hereinafter cited as Norr]. The United States tax consequences of such a broad jurisdictional claim are affected by complex provisions in the IRC, including sections on tax credits, tax deferrals and income sourcing. Such provisions are designed to alleviate double taxation of income by both the United States and foreign nations. There is no guarantee, however, that these provisions will accomplish that result.

22. Park, *supra* note 21, at 1613-14.

23. *See* Norr, *supra* note 21, at 433.

24. Park, *supra* note 21, at 1614.

the net income of IBM is derived from U.S. sources or foreign sources in determining the taxable income of IBM and its affiliated corporations. Only the amount of that net income is relevant for purposes of determining the federal income tax base.[25]

In contrast, however, the states' jurisdiction to tax corporations is limited constitutionally to corporate activities and corporate presence within their respective borders.[26] Simply because income is subject to tax by the United States and is included in federal taxable income, it does not follow that any state necessarily has jurisdiction to tax any or all of that income.[27] The inclusion of Subpart F income of a domestic MNC in federal taxable income illustrates this point. Although such income is within federal jurisdictional scope, no state can tax it by either separate accounting or source rules. A state can tax Subpart F income only by application of the unitary business principle.[28] That principle, however, requires the income to be apportioned by the factors of the combined group and would attribute that income to Subpart

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25. Definitions of foreign source income have nothing to do with what constitutes taxable income under the federal income tax code. The MNCs' arbitrary definitions of "foreign source" income do not parallel any definition of federal taxable income in the IRC, including the definition of taxable income of the domestic operations of foreign MNCs which are "sourced" to the United States. *See* I.R.C. § 864(c) and I.R.C. Reg. 1.864-3. The largest item of such sourced domestic income is the dividend income received by domestic MNCs from their foreign affiliates as a result of their domestic ownership of the affiliates' stock.

26. *See supra* note 12 and accompanying text; *see also Container Corp.*, 103 S. Ct. 2933; ASARCO Inc. v. Idaho Tax Comm'r, 458 U.S. 307 (1982); F. W. Woolworth Co. v. Taxation and Revenue Dep't, 454 U.S. 812, 819 (1982).

27. This distinction may have led the staff of the Advisory Commission on Intergovernmental Relations and Treasury to recommend that Congress limit the states' use of combined reporting to foreign MNCs. *See* Report of the Advisory Commission on Intergovernmental Relations, *State Taxation of Multinational and Multistate Corporations* (Aug. 10, 1981); Letter from Donald C. Lubick, Assistant Treasury Secretary to Kenneth Christup, Director of Taxes, Xerox Corp. (Dec. 7, 1979) (discussing H.R. 5076 and S. 1688, 96th Cong. 1st Sess. (1979)), *reprinted in* Brief of Amicus Curiae, Chicago Bridge & Iron Co. v. Caterpillar Tractor Co., No. 81-349, app. G (*reh'g granted* May 3, 1982); Statement of Assistant Treasury Secretary Donald C. Lubick before the House Commission on Ways & Means on H.R. 5076 (Mar. 31, 1980) (Treasury does not oppose states' use of combined reporting in regard to U.S. controlled corporations; Treasury supports restrictions on states' use of combined reporting for foreign controlled corporations).

28. *See, e.g., supra* note 6; Ford Motor Co. v. Beauchamp, 308 U.S. 331 (1939) (discussion of net worth); *see also* Northwestern States Portland Cement Co. v. Minnesota, 358 U.S. 450 (1959); *Hans Rees' Sons*, 283 U.S. 123.

F "sources" based on apportioned business activities. Consequently, attribution rules designed for federal taxation of domestic MNCs are not relevant for state taxation purposes.[29]

G. Basis for Applying Different Attribution Rules to Domestic and Foreign MNCs

United States jurisdiction to tax domestic operations of foreign MNCs differs from its jurisdiction to tax domestic MNCs.[30] Jurisdictional contact in the former instance is the source of the income.[31] The only income of a foreign MNC taxable by the United States is income defined in the IRC as domestic source income. Although separate accounting, sourcing rules, tax treaties, and similar regulations do not and cannot restrict the United States' right to tax as much of the income of domestic MNCs as it chooses, this is not true for foreign MNCs. Bilateral tax treaties and other means limit the United States taxation of foreigners' income to income attributable to United States sources. Moreover, the federal government applies different attribution rules to the two classes of MNCs. For example, dividends paid to foreign corporations are sourced on the basis of domestic business operations and are subject to a withholding tax.[32] In contrast, dividends paid to domestic corporations are sourced to the recipients.[33]

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29. *See supra* note 25 and accompanying text.

30. Owens, *United States Income Tax Treaties: Their Role in Relieving Double Taxation,* 17 RUTGERS L. REV. 428, 431 (1963)[hereinafter cited as Owens]. In some instances, foreigners are exempt from United States taxation; *see, e.g.,* I.R.C. §§ 103(c), 872(b), 883, 892, 893, 895.

31. *See* Owens, *supra* note 30, at 431.

32. *See* I.R.C. § 881(a)(1) (1982).

33. I.R.C. § 861(a)(2) (1982). The different positions held by MNCs regarding the elimination of worldwide combination illustrates the significance of this difference. Without more, elimination of worldwide combination is favorable to foreign MNCs because their foreign dividends are not taxed by the United States. To domestic MNCs, however, it is unacceptable because dividends from foreign affiliates, which are eliminated as inter-affiliate transactions in a combined report contribute to income in a report eliminating combination. Such dividends can be included in the domestic recipient's apportionable income base and are thus subject to state taxation.

III. Controversy Between Unitary States and MNCs

It is erroneous to speak of the controversy between unitary states and MNCs as involving a unitary tax. The controversial taxes are corporate taxes on or measured by net income. They are imposed on corporations for the privilege of conducting business within the taxing states. The sole issue is how best to determine and distribute the net income of a unitary corporate business among the various taxing jurisdictions in which that business operates. The so-called unitary tax is simply a method used to make such a determination. The unitary method applies a formula that takes into account the activities of a business within each taxing jurisdiction.[34] For example, if the apportionment formula uses the equally-weighted factors of tangible property, payroll, and sales, and if ten percent of its tangible property, twenty percent of its payroll and thirty percent of its sales are attributable to the taxing jurisdiction, then twenty percent of the net income (10% + 20% + 30% ÷ 3 = 20%) of the unitary business would be attributable to the taxing jurisdiction.

If a business is conducted by two or more corporations, the taxing state applies the group's apportionment factors to the group's apportionable income to attribute to the taxing jurisdiction an appropriate portion of the income of any group member. This method of net income computation and geographic distribution is referred to as combined reporting or combination. If the combined corporations are incorporated in or do business within the United States, its possessions or territories, the apportionment method is known as "water's edge" combination. If all corporations composing a unitary group are combined without regard to place of incorporation or where group members' business activities are conducted, the apportionment method is referred to as worldwide combination. In addition, combination is further clas-

34. The Supreme Court recognized the appropriateness of the use of a formula in developing the unit rule for *ad valorem* property taxation of interstate utilities. *Adams Express Co. v. Ohio State Auditor,* 165 U.S. 194 (1897), *aff'd on reh'g,* 166 U.S. 185 (1897). In *Adams Express,* the Court held that an apportionment formula, based on the geographic location of tangible personal property, rationally and constitutionally distributed the total value of the unitary business among the geographic locations where business was conducted. The Court has issued similar rulings in corporate net worth cases. *See, e.g.,* Ford Motor Co. v. Beauchamp, 308 U.S. 331 (1939). *But cf.* Fleming v. Oklahoma Tax Comm'n 157 F.2d 888 (10th Cir. 1946).

sified to indicate whether an MNC is domestic or foreign.[35]

The utilization of an apportionment formula as the sole method of attributing a tax base is peculiar to the states of this country. Consequently, the Treasury and both domestic and foreign MNCs are seriously challenging the application of apportionment-formula attribution by the states beyond "water's edge" combination. This challenge generally is based on the premise that the "sourcing" of net income by "separate accounting" should be used instead of worldwide combination for all MNCs. This premise is unsound.

MNCs generally concede that the unitary business principle is appropriately applied to those corporate businesses that derive their net income from United States sources (as defined by the MNCs), whether or not subject to combined reporting. Nevertheless, MNCs oppose the application of the unitary business principle to income they attribute, directly or indirectly, to foreign operations or sources. Moreover, MNCs insist that domestic "water's edge" net taxable income should exclude income defined in the IRC as foreign source income for federal foreign tax credit purposes and also income traceable to foreign sources.

The states, however, insist on retaining their constitutional right to employ worldwide combined reporting. They generally have been willing to limit application of the combination method to "water's edge" unitary corporations, but only in exchange for certain tradeoffs. These tradeoffs include: (1) better enforcement of the "arm's-length" standard by Treasury (a standard used to adjust separate accounting results in particular instances); (2)

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35. The attempts of the MNCs to confine combined reporting to domestic combination were examined at length in the numerous briefs filed in Caterpillar Tractor Co. v. Lenckos, 84 Ill. 2d 102, 417 N.E.2d 1343 (1981), *aff'g* 77 Ill. App. 3d 90, 395 N.E.2d 1167 (1979), *appeal filed sub nom.*, Chicago Bridge & Iron Co. v. Caterpillar Tractor Co., No. 81-349 (*reh'g granted* May 3, 1982), and *Container Corp.*, 103 S. Ct. 2933. Some of these briefs indicate a vast difference between attribution rules appropriately used to determine state taxable income of foreign MNCs (MNCs whose parent corporations are domiciliaries of foreign countries) and rules appropriately used to determine state taxable income of domestic MNCs (MNCs whose parent corporations are domiciliaries of the United States).

For example, Sony is a foreign MNC and General Motors (GM) is a domestic MNC, even though Sony's domestic activity may be conducted by domestic subsidiaries and GM's foreign activity may be conducted by foreign subsidiaries. There are many significant differences between these two MNCs in their relationship to the United States.

joint studies by the states and Treasury on the feasibility of alternatives to separate accounting at the international level (a consequence of the states' belief that separate accounting cannot be applied properly to unitary income); and (3) assistance from Treasury and cooperation from MNCs in the full disclosure of information so states may better enforce their corporate income taxes. The states also insist on defining "water's edge" combination broadly and demand full apportionment of the unitary income of a unitary business. These tradeoffs would have little impact on foreign MNCs. They also would have limited effect on domestic MNCs apart from making dividends from subsidiaries includable in apportionable net income. Domestic MNCs, however, are unwilling to agree to the states' application of "water's edge" combination to all MNCs unless dividends from their foreign subsidiaries are virtually exempt from state taxation and unless the definition of "water's edge" combination is severely restricted. As a result, the basic issues of dividend treatment and combined reporting remain in controversy.

IV. Development of Unitary Business Principle Supports States' Position

Long before MNCs constituted a significant portion of world business enterprise, states were faced with devising attribution rules to accommodate their tax systems to multistate corporate businesses. However, states were required to conform these rules to constitutional limitations. The major restrictions flowed from the equal protection, commerce and due process clauses of the United States Constitution.

The earliest tax on multistate businesses was the *ad valorem* property tax imposed on interstate utilities.[36] The states had to determine what portion of the going-concern value of each interstate utility was available for taxation in each state. Utilities claimed that a state, other than a state of legal or commercial domicile, could tax only the value of tangible property used within its borders. The states replied that they were entitled to tax a portion of the utilities' entire going-concern value, including intangible values and investments in intangible properties used by the utilities in their businesses.

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36. *See Adams Express Co.*, 165 U.S. 194 (1897), *aff'd on reh'g*, 166 U.S. 185 (1897).

The United States Supreme Court upheld the states' view in the 1897 landmark case of *Adams Express Co. v. Ohio State Auditor.*[37] The Court recognized that separate accounting for the value of tangible property used in the taxing state did not represent the true value of the utilities' franchises and activities in the state. Consequently, the Court approved instead the application of a tangible property formula to the entire going concern value of each utility.

The Court has consistently adhered to this case's rationale in a variety of attribution disputes involving different types of taxes.[38] The *Adams Express* rationale is well stated in a Tenth Circuit Court decision:

> The very nature of a vast continental or interstate transportation system brings it especially within this concept of a unitary business. A railroad may be likened to a spider's web, in which all the strands are necessary to the common design and each contributes its necessary part to a single goal. It may be true, as urged by the Railroad, that the Chicago to Denver branch could be operated profitably by itself and that the income realized from its operation can be ascertained. It does not, however, follow that it could be operated as profitably by itself or that its income would be as great as it is as a part of a large railway network in which other parts lessen overhead burdens or funnel business to the system, which ultimately finds its way to this branch. No doubt its connection with the rest of the system brings it business which otherwise might well go elsewhere. To this extent it is dependent upon the rest of the system, and it cannot be said that no part of the income realized from the operation of this branch does not accrue by virtue of its connection with a large railway transportation system.[39]

In applying the principles of *Adams Express,* the Court has never regarded the form in which a business is conducted as determinative of its analysis.[40]

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37. *Id.*

38. *See supra* note 28 and accompanying text.

39. Fleming v. Oklahoma Tax Comm'n, 157 F.2d 888, 891 (10th Cir. 1946).

40. *See Container Corp.*, 103 S. Ct. at 2933; *Mobil Oil Corp.*, 445 U.S. at 425; Exxon Corp. v. Dep't of Revenue, 447 U.S. 207 (1980) (the Court held that the unitary business principle controls the constitutional use of an apportionment formula, irrespective of corporate form). In fact, the Court suggested in *Mobil* that combination may be constitutionally required when a state seeks to apportion the net income of a business.

A. Similarity of Application of Unitary Business Principle to a Multicorporate Unitary Business (Combined Reporting) and a Single Corporation

Business substance rather than business form should control the geographic attribution of net income for corporate tax purposes. The location of a business or where it is incorporated should not affect that attribution. Any attribution rule should be based on corporate presence and business activities in a taxing jurisdiction, not on the manipulation of the legal form in which that activity is conducted. The unitary apportionment principle is fairly based upon these criteria, which basically are due process requirements.[41] Any attribution rule employed by a state must fit within these constitutional parameters.[42] In fact, these requirements may dictate the use of combination in some instances.[43]

B. Comparison of Separate Accounting and Combination

The unitary business method treats an MNC's unitary business as a single economic unit. It applies the factors of the entire business to the MNC's entire "business income." "Business income" is generally defined as the income derived from functionally integrated multijurisdictional business activities. The apportionment formula geographically distributes this income in accordance with apportionment factors that reflect the business activity producing the income. These factors attribute income as though the composite business elements represented by these factors—for example, tangible property, payroll and sales—appropriately reflect the entire business income. If the factors of tangible property, payroll, and sales, which generally are used for state income tax purposes, are employed, the formula assumes that these factors only produce business income. Application of such a formula to the entire business income attributes all of the income to one or more taxing jurisdictions. The result is full accountability, in a jurisdictional sense, of the entire income of the business.

The unitary apportionment method is based on the further as-

41. *See generally* Norfolk & Western Ry. Co. v. Missouri State Tax Comm'n, 390 U.S. 317, 326 (1968) (Missouri tax based on mileage formula struck down as violative of Due Process and Commerce Clauses of the United States Constitution).

42. *See, e.g., supra* text accompanying note 28.

43. *See supra* text accompanying note 40.

sumption that the apportionment factors, as a composite, roughly approximate a fair geographic distribution of the net income of the business. The result is not necessarily accurate despite presumptions to that effect. Consequently, apportionment statutes, such as UDITPA, provide for the use of other attribution methods in special circumstances. It is up to the challenger (either the state or the taxpayer), however, to prove that the apportionment resulting from the use of the prescribed formula is unreasonable as applied to the particular business of a particular taxpayer for a specific tax period. Moreover, the unitary business method looks solely to the activities that produce income. It ignores matters of form that should not affect the tax results of an attribution system. Consequently, the unitary business method is independent of an MNC's organizational structure, place of incorporation, and stockholders' domicile.

The general soundness of this approach is readily apparent. In fact, the unitary business method is generally regarded as appropriately applied to the income of any business conducted by a single corporation. Any weaknesses or strengths in the application of formulary apportionment of business income exist to the same degree within the framework of the branches or division of a single corporation as they do within the framework of a parent and subsidiary corporation.[44] The same is true regarding the issues of what constitutes a unitary business and what constitutes the apportionable business income of the business.

Unlike the unitary business principle, separate accounting rules and sourcing rules do not subject the entire net income to attribution. They seek to attribute specific portions of net income without regard to the manner in which the entire net income of the business has been produced. Furthermore, separate accounting rules are not governed by a consistent objective standard as that of the unitary business principle. Separate accounting rules can vary with the organization, structure and internal accounting of the business. These rules depend on the apportionment of

44. No domestic MNC would acquiese if a state disallowed losses resulting from the operation of a unitary business by a single (multinational) corporation. The same reasoning that requires out-of-state *losses* of an integrated business conducted by a single corporation to be taken into account in determining in-state net income also requires that the out-of-state *net income* of an integrated unitary business conducted in multiple corporate form be taken into account, regardless of where that business is conducted.

some items of income and expense. They are also intertwined with other, conflicting sourcing rules since they attempt to source net income geographically. To the extent that these rules rely upon legal fictions such as business form, they depart from business and economic reality. Each application of separate accounting is under the control of the MNC's business management decisions, which can be tailored to minimize taxes. An MNC can conduct its business with as few or as many separate corporations as it chooses, subject to the incorporation rules of some countries. An MNC can transfer any assets or part of the business enterprise to separately incorporated members, which may or may not carry on significant business activities. These discretionary actions do not change the economic realities of the MNC's business, and hence should not be permitted to affect the application of a tax system.

While legal fictions and legal form may be accorded some respect between nations, they have no place in matters of economics and business. Despite their role in the United States relations with its "trading partners," they have nothing to do with how any nation or its political subdivision wishes to view its domestic MNCs and those MNCs' foreign subsidiaries. Treaties and other international negotiations do not affect these internal relations.[45]

V. The Nature of the Existing Controversy Between Unitary States and MNCs

Inasmuch as unitary states are willing to forego the use of worldwide combination for both domestic and foreign MNCs in exchange for trade-offs that significantly affect only domestic

45. This raises some interesting questions about the purpose of tax treaties in regard to taxation. Tax treaties operate to grant some party a tax concession. Accordingly, they have a discriminatory effect unless extended to everyone by a nation's substantive laws. If so extended, they become inoperative, except to conform the tax laws of one nation to the tax laws of another nation. In such circumstances, the tax treaty would have a discriminatory effect only in the nation whose tax laws did not otherwise conform to the treaty provisions. In the United Kingdom-United States tax treaty debate in 1978, no mention was made of discrimination resulting from restricting the states' power to use worldwide combination only to U.K. MNCs. In fact, the treaty benefitted United States MNCs so greatly that any such concession to U.K. MNCs, although achieved at the sole expense of state revenues, was deemed a modest price to pay. In substance, domestic MNCs are insisting upon an extension of benefits obtained from other countries under treaty provisions to curb state tax jurisdiction.

MNCs, the existing controversy centers on the domestic MNCs' objections to those trade-offs. These objections in turn relate to the application of the unitary business principle. Domestic MNCs argue that they would be in a worse position than under worldwide combination if "water's edge" combination included dividends from foreign subsidiaries in the apportionable tax base but did not utilize the dividend payor's factors in the apportionment formula.

Consequently, domestic MNCs advocate the following:

1. Eliminating worldwide combination.
2. Restricting the definition of a "water's edge" group to which domestic combination can apply.
3. Relying on constitutional limits to state taxing power.
4. Eliminating dividends from the apportionable state tax base.

Domestic MNCs contend that to subject them to worldwide combination when foreign MNCs are not similarly subjected would result in tax discrimination against domestic MNCs. Moreover, the domestic MNCs contend that separate accounting, subject to arm's-length adjustments, is the international standard; and therefore, double taxation of the same income will result if the states employ worldwide combination.[46] The domestic MNCs also

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46. To the author's knowledge, no congressional or state investigation has ever required any MNC to proffer all tax returns filed by it for any year in all the locations in which it does business. Consequently, no empirical evidence of the present tax systems' effect on MNCs exists to support any position in the debate over the tax consequences of differing interstate or international attribution rules. Moreover, confidentiality provisions protect from public disclosure *any* information obtained from the returns or investigations of a particular MNC. Returns rarely are introduced into evidence in litigation, even where representations as to their contents may be asserted. For example, although international double taxation was a cornerstone of Container's argument in *Container Corp.*, 103 S. Ct. 2933, Container produced no foreign tax returns to substantiate its argument.

Effective tax rates are generally far below statutory rates. The extent to which various attribution rules contribute to this gap is unknown. The United States Treasury Department (purportedly representing the nation, rather than MNCs) and spokesmen for foreign nations (purportedly representing their own national interests) maintain that separate accounting, subject to arm's-length corrections and sourcing rules, is workable. Whether separate accounting is workable in fact is questionable. Furthermore, the feasibility of using these rules at the national level is not indicative of their feasibility at the state and local levels.

argue that worldwide combination subjects foreign source income to domestic taxation.

Worldwide combination depends on what constitutes a unitary business, a term which the MNCs assert is poorly defined. Consequently, the domestic MNCs contend that use of worldwide combination will result in difficult compliance and administrative problems. Finally, domestic MNCs contend that foreign operations are more profitable than domestic operations and that this is not taken into account by an apportionment formula. The domestic MNCs assert that domestic income thus becomes overstated and foreign income understated when worldwide combination is applied.

The Supreme Court carefully considered all of these arguments in *Container Corp.*[47] The Court there rejected them because they were based on hypothetical facts[48] and on the tenuous assumption that separate accounting, as policed by the arm's-length adjustments method, arrives at a proper income attribution result.[49]

The application of adjustments to the separate accounting method is a futile exercise. It is impossible to distribute net income geographically by reference to hypothetical circumstances. Arm's-length adjustments can address only the relationship between two or three corporations even if there are hundreds in an affiliated group (which is not uncommon). The adjustments are dependent upon a transaction-by-transaction analysis of intercorporate transactions of a magnitude and complexity that defy

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47. Container Corp. of Am. v. Franchise Tax Bd., 103 S. Ct. 2933 (1983).

48. *Container Corp.*, 103 S. Ct. at 2949-50. Before the states or Congress seriously consider any of these arguments, domestic MNCs should produce concrete evidence supporting their positions. Reference to isolated or hypothetical circumstances, as in *Container Corp.*, is insufficient support for those arguments when factual evidence is available.

49. *Id.* at 2948. The arm's-length issue is considered in depth in the amicus curiae brief by the Multistate Tax Commission and participating states in the *CBI-Caterpillar* case, United States Supreme Court, October Term 1980, Docket No. 81-349. The issue was thoroughly explored in G. HARLEY, INTERNATIONAL DIVISION OF THE INCOME TAX BASE OF MULTINATIONAL ENTERPRISE, (1981) (University of Michigan Law School dissertation published by the Multistate Tax Commission). Harley concluded that separate accounting, subject to arm's-length adjustments, has proven to be an unworkable mechanism at the international level and should be abandoned in favor of the unitary business concept. One of Harley's main objections to the arm's-length/separate accounting method is the arbitrary manner in which it must be administered. Harley characterized the method as taxation without due process safeguards.

description. In the end, any arm's-length adjustments become matters of compromise and administrative fiat.[50] No nation relies upon them to define the taxable income of its own MNCs.

Although domestic MNCs have focused their attention on asserted defects in worldwide combination and on the merits of separate accounting for the income from foreign affiliates, the states have responded by offering "water's edge" combination as an alternative and focusing on issues relating to both the apportionment of dividends from foreign affiliates and the make-up of the corporate group subjected to "water's edge" combination. The domestic MNCs would resolve these questions with selective use of sourcing rules, which are dependent on selective formation and use of subsidiary corporations and on intercorporate accounting.

Domestic MNCs would attribute dividends to the profits of their affiliates and not to the owners of stock. This is clearly contrary to economic reality. The dividends that a parent corporation receives by virtue of stock ownership constitute its own income and no one else's.

The Supreme Court noted in *Container Corp.*:

> If the arm's-length method were entirely consistent, it would tax inter-corporate dividends when they occur, just as all other investment income is taxed. . . . It could also be argued that this would not, strictly speaking, result in double taxation, since the income taxed would be income "of" the parent rather than income "of" the subsidiary.[51]

The domestic MNCs assert that they should be treated differently than other taxpayers for dividend attribution purposes and be permitted to report income as though they did not own their subsidiaries. There is little reason to exempt MNCs from this type of taxation, however, when other taxpayers are uniformly taxed on dividends from stock.

The dividend issue is significantly affected by the fact that dividends as a class of income can be created by corporate formation and by intercompany transactions. The domestic MNCs essentially ask the states to treat their affiliates as separate, bona fide business enterprises for combination purposes while treating them either as totally nonexistent or as an integral part of their business operations for dividend attribution purposes.

50. *See* G. HARLEY, *supra* note 49.
51. *Container Corp.*, 103 S. Ct. at 2954, n.30.

If dividend income is really only a part of the profits of a global business, then the business should be treated as a unit by worldwide combined reporting. Thus foreign subsidiary dividends would be automatically eliminated from profits. On the other hand, if foreign subsidiaries conduct discrete businesses, then their dividends to the parent should be subject to taxation as is any other income, depending on state tax policy.[52]

VI. SUMMARY

As a result of many decades of controversy between multistate and multinational businesses, the courts have developed the unitary business principle as an economically and legally sound system for the attribution of net income. Only this system reasonably and fairly distributes the net income of a multijurisdictional enterprise. Use of any other attribution rule, in whole or in part, departs from this equitable principle and creates irrational and unjustifiable complexity. Parties affected by the states' use of the unitary business principle would do well to focus their energies on improving and making the system work better. Arguments opposed to the use of the unitary business principle are directed at problems irrelevant to the particular territorial scope of a business enterprise or the form in which it is conducted. Opponents do not and cannot attack its essential concepts.

Worldwide combination, however, is criticized because (1) separate entity accounting allows MNCs to use jurisdictional limitations to immunize from state taxation vast amounts of income truly attributable to activities in the state and (2) worldwide combination enables states to cope effectively with such tactics. Unitary apportionment produces a favorable result that separate entity accounting or the application of conflicting sourcing rules can never produce. Separate accounting never takes into consideration the income attributable to the business as a whole. Rather, it is designed to manipulate income presumed to be related to a single, specific taxing jurisdiction. One example is income from intangibles that is a product of the business as a whole and that is used generally in the business. States can tax the value of or in-

52. The domestic MNCs' position on the taxation of dividends illustrates the conflicting attribution rules used by domestic MNCs to support their arguments. Their position on this issue inconsistently combines separate entity accounting, unitary rules and sourcing principles. Moreover, the position fails to effectively define foreign source income and allows the use of internal accounting.

come from those intangibles either by apportionment or by a legal fiction that may not satisfy constitutional limitations. In fact, the more intangible or indirect the source of the income, the more the need for an apportionment formula to achieve equitable taxation.

Foreign MNCs are affected differently by worldwide combination than domestic MNCs. Although the intangible going-concern value of a foreign MNC is related to the business as a whole, that value is more closely associated with the MNC's home country than with the United States. Therefore, the United States does not attempt to assess this value for federal tax purposes. Domestic MNCs, however, derive benefits throughout the world as a result of the protective international policies and actions that both federal and state branches have developed. Accordingly, there is no valid reason why the total income of U.S. MNCs should not be exposed to the same level of state taxation as a locally-owned hardware store. The unitary business principle seeks to achieve this equity in domestic taxation. This method does not tax foreign source income; rather, the unitary business principle enables the states first to reach income attributable to the United States, then apportion that income according to activities conducted by MNCs within state borders.

VII. Conclusion

The States have conceded too much by abandoning worldwide combination for domestic MNCs. Rather, states should have compromised the use of worldwide combination only with respect to foreign MNCs. Domestic MNCs should not be immunized from worldwide combination, even if foreign MNCs are protected. Domestic MNCs already adequately benefit from tax treaties entered into by the United States on their behalf. States should not be compelled to make additional concessions to domestic MNCs that already enjoy advantages conferred by foreign countries. Finally, the national interest in protecting trade relations with foreign nations should not be bartered for domestic MNCs' interest in avoiding equitable state taxation.