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Taxation of Income from Intangibles of Multistate-Multinational Corporations

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Taxation of Income from Intangibles of Multistate-Multinational Corporations

*William D. Dexter**

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I. INTRODUCTION

One of the most vexing problems facing the states and the business community in application of state income tax laws is the development of appropriate attribution rules for the taxation of income derived from intangible property interests by multistate-multinational corporations and their intertwined, affiliated and subsidiary corporations.[1] A strong trend has developed to treat such

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1. The Report of the Special Subcommittee on State Taxation of Interstate Commerce of the Committee on the Judiciary, House of Representatives, has set forth the wide variety of the states' positions of this complex subject matter under the heading "Specific Allocation" at pages 197-217. From this report no rational basis or pattern for the assignment of income from intangible properties for state income allocation or apportionment purposes is discernible. SPECIAL SUBCOMM. ON STATE TAXATION OF INTERSTATE COMMERCE, HOUSE COMM. ON THE JUDICIARY, STATE TAXATION OF INTERSTATE COMMERCE, H.R. REP. No. 1480, 88th Cong.,

income as apportionable "business income," a view that is staunchly opposed by multinational and multistate businesses. The purpose of this article is to examine this trend and possible alternatives, to test the rationale behind each, and to recommend the approach that appears to be preferable among the alternatives.

The historic treatment of income from intangible properties for state corporate income tax purposes has contained the seed of multiple taxation.[2] A legal basis has long existed for the claim to the right to subject the same intangible income of a corporation to taxation by as many as five different classes of states: (1) state of legal domicile, that is, state of incorporation;[3] (2) state of commercial domicile, that is, state in which the headquarters of the business is located or where its principal operations are carried on;[4] (3) state(s) in which the stock is said to have a "business situs";[5] (4) all states from which the corporation derives income (apportionment); and (5) all other states that have conferred any protection on the intangible or its owner.[6] In addition, intangibles may be taxed in the

2d Sess. (1964), and 89th Cong., 1st Sess. (1965) [hereinafter cited as WILLIS SUBCOMMITTEE REPORT].

2. Curry v. McCanless, 307 U.S. 357 (1939).

3. *See, e.g.*, Miller v. McColgan, 17 Cal. 2d 432, 110 P.2d 419 (1941). *See generally* 1 WILLIS SUBCOMMITTEE REPORT 201-02.

4. *See, e.g.*, First Bank Stock Corp. v. Minnesota, 301 U.S. 234 (1937); Wheeling Steel Corp. v. Fox, 298 U.S. 193 (1936); Cargill v. Spaeth, 215 Minn. 540, 10 N.W.2d 728 (1943). *See generally* 1 WILLIS SUBCOMMITTEE REPORT 201-02.

5. *See, e.g.*, First Bank Stock Corp. v. Minnesota, 301 U.S. 234 (1937); Southern Pac. Co. v. McColgan, 68 Cal. App. 2d 48, 156 P.2d 81 (1945). *See generally*, 1 WILLIS SUBCOMMITTEE REPORT, 201-02. The term "business situs" is used herein to refer to the state or states where an intangible is used in the conduct of a corporation's business and is not meant to invoke the now discredited fiction that an intangible has a location and may be taxed only by the state where located. The United States Supreme Court, in Curry v. McCanless, 307 U.S. 357 (1939), rejected such a situs test for determination of power to tax under the due process clause:

> We find it impossible to say that taxation of intangibles can be reduced in every case to the mere mechanical operation of locating at a single place, and there taxing, every legal interest growing out of all the complex legal relationships wbich may be entered into between persons . . . We [decline] to press to a logical extreme the doctrine that the Fourteenth Amendment may be invoked to compel the taxation of intangibles by only a single state by attributing to them a situs within that state.

Id. at 373.

In *Curry*, the Court explicitly recognized that the state in which an intangible is used has power to tax income from the intangible by reason of the benefit and protection that the state laws conferred on the owner enabling him to enjoy the fruits of ownership. The Court stressed, however, that the state in which an intangible is used in business does not enjoy exclusive power to tax the intangible; every state that provides any protection to the intangible or its owner enjoys a similar taxing power. *Id.* at 372-73.

6. *See, e.g.*, Appeal of Capital Southwest Corp., CCH CAL. TAX REP. ¶ 204-881 (S.B.E. Jan. 16, 1973); Appeal of the U.S. Steel Corp., Appeal No. 73-I-20 (Idaho B.T.A. Nov. 1, 1973); F.W. Woolwortb Co. v. Director of Div. of Tax., 45 N.J. 466, 213 A.2d 1 (1965); F.W.

state(s) in which they are located.[7] Thus, if each state were to press its claim successfully, a corporation theoretically could be subject to at least quintuple taxation.

Ironically, the practical result of this theoretical possibility of multiple taxation has been under-taxation of intangible income, stemming from the fact that each state with the constitutional right to tax intangible income may be reasonably persuaded that legitimate tax jurisdiction lies elsewhere. Assume that Corporation X is incorporated in State A, carries on in State B corporate activities dealing with its investment portfolio, has as its principal place of business in State C, and engages in some business operations in State D. Traditionally, jurisdiction could properly be claimed by State A on the basis of legal domicile, by State B on the basis of physical "situs" of evidence of the intangibles, by State C on the basis of commercial domicile, and by State D on the basis that the intangibles are used in the conduct of Corporation X's business in that state as well as elsewhere (business situs).

In resisting the jurisdictional claim of any one of these states, the corporation could argue that the state had no jurisdiction to tax the income from the portfolio investments and that one or more of the other three states did have that jurisdictional right. Since intangibles represent investments that do not require significant business activity in any state, it was not unusual for a corporation to use this argument successfully in all four states, with the result that none of those states taxed the income. In recent years, tax administrators have used the term "nowhere income" to describe income that thus escapes all state taxation.[8] The jurisdictional picture is complicated by the fact that the great bulk of the intangible income of corporations in this country is derived from investments in affiliated corporations and by the argument that the properties, profits, and business activities that give rise to the intangible income of the receiving corporation already have been subjected to tax at the paying corporation level. The complication is compounded by the argument that

Woolworth Co. v. Commissioner of Taxes, 130 Vt. 544, 298 A.2d 839 (1972); Gulf Oil Corp. v. Morrison, 120 Vt. 324, 141 A.2d 671 (1958).

7. Metropolitan Life Ins. Co. v. New Orleans, 205 U.S. 395 (1907); State Bd. of Assessors v. Comptoir National d'Escompte, 191 U.S. 388 (1903); Bristol v. Washington County, 177 U.S. 133 (1900); New Orleans v. Stempel, 175 U.S. 309 (1899).

8. For further discussion of "nowhere income" see Corrigan, *Interstate Corporate Income Taxation—Recent Revolution and a Modern Response*, 29 VAND. L. REV. 423, 426 (1976). Professor Hellerstein refers to this as "no man's land income." Hellerstein, *State Taxation and the Commerce Clause: An Historical Perspective*, 29 VAND. L. REV. 335, 341 (1976).

the state's taxing jurisdiction should be limited to that part of a tax base which can be traced definitively to "sources" within the taxing state and by the elusiveness of the "source" of intangible income.[9]

II. Taxation of Income From Intangible Properties—The Current Controversy

The Multistate Tax Commission has recommended regulations[10] to be used in attributing corporate income among the states under the provisions of the Uniform Division of Income for Tax Purposes Act (UDITPA).[11] Controversy has developed concerning the manner in which those regulations attribute intangible income in general and dividend income in particular. The Committee on State Taxes of the Council of State Chambers of Commerce (COST), which is composed of ninety-two of the nation's one hundred largest corporate businesses, apparently takes the basic position that intercorporate dividend income should be exempt from state taxation since it has no "source" apart from the underlying income-producing activities of the payor corporation. Thus, COST argues that if a domestic corporation receives a million dollars in dividend income from a foreign affiliate, this income should be excluded from the domestic corporation's tax base for state tax purposes since it has a source not attributable to any of the states. As a compromise position, COST is willing to attribute domestic intercorporate dividend income from unaffiliated corporations to the commercial domicile of the payee corporation and exempt all other dividend income. Generally, COST would allocate intangible income other than the dividends to the commercial domicile of the taxpayer. Furthermore, COST contends that the regulations pro-

9. As indicated in 1 WILLIS SUBCOMMITTEE REPORT 197-217, the problem is further compounded by the fact that different tests are employed irrespective of the specific jurisdictional stance taken by a particular state and is further compounded by the fact that not all kinds of intangible income are treated the same by the respective states. For example, interest income may be treated differently than dividend income and these sources of intangible income treated again differently than rents and royalties from intangibles as well as capital gains from intangibles.

10. These regulations were adopted as the "Multistate Tax Commission Allocation and Apportionment Regulations" of February 21, 1973, and are reproduced in MULTISTATE TAX COMMISSION, SEVENTH ANNUAL REPORT, App. J, 64-84 (1974). Nine states (Arkansas, California, Idabo, Missouri, Nebraska, New Mexico, North Dakota, Oregon, and Utah) have adopted these regulations, and four (Alaska, Colorado, Indiana, and Montana) are in the process of doing so. *See* Corrigan, *supra* note 8, at 437.

11. UDITPA contains the rules for the division of income between 2 or more states when a taxpayer is subject to tax in 2 or more states. The Act was promulgated by the Conference of Commissioners on Uniform State Laws in 1957 and is reported in 7 U.L.A. 365 (1970). UDITPA is reproduced in P-H STATE & LOCAL TAXES, ALL STATES UNIT ¶ 91,409-A.

mulgated by the Multistate Tax Commission in implementing UDITPA do not conform to its provisions dealing with the treatment of dividend income of the payee corporation.[12] On the other hand, when the investment, management, and disposition of intangible property or the business it represents are an integral part of the corporation's business activities, many states espouse the position that income from intangible property should be attributable to the states in which the taxpayer carries on its business activities.

The basic issues of the above controversy are: (1) the extent to which dividend income and other intangible income should be exempt or specifically allocated to the commercial domicile; and (2) the extent to which such income should be subject to the apportionment rules that generally are applied to other classes of income.[13]

Four basic alternatives may be employed in attributing income from intangibles to the respective states: (1) assign the income to the payor source from which the intangible income is derived; (2) attribute the income to the commercial domicile of the payee corporation; (3) apportion the income among the states in which the payee corporation carries on its business activities; or (4) apportion the income among the states concerned by taking into account in the formula some or all of the property, payroll, and sales of the payor as well as the payee corporation, particularly if the payor is a foreign corporation (a combination of (1) and (3)). These alternatives, as well as apportionment and allocation rules, generally embody the "source" concept. Other alternatives would exempt intangible income outright or eliminate it from transactions between affiliated corporations by means of the device of combined reporting. Existing rules employed by the states appear to incorporate a variety of these concepts in a conflicting and inconsistent manner.[14]

Since the intangible properties involved here are fairly closely associated with the general business activities of the payee corpora-

12. In the language of UDITPA, "business income" means "income arising from transactions and activity in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management, and disposition of the property constitutes integral parts of the taxpayer's regular trade or business operations." *Id.* at ¶ 91,409-A.10.

13. It should be noted that the varied jurisdictional claims for the taxation of income from intangible properties were formulated primarily by following property tax tangible property situs concepts and not to deal with modern complex multistate and multinational business interests, which are more and more being reflected by "intangible" sources of income. In many instances, this intangible income represents the major part of large multinational and multistate corporations' income. For this reason greater emphasis must be placed on the rationale behind the assignment or attribution of intangible income to the respective states.

14. *See* notes 1 & 9 *supra*.

tion, the outcome of the controversy between COST and the states over the Multistate Tax Commission regulations will depend ultimately upon judicial interpretation and application of the definition of "business income" as used in UDITPA. With that in mind, let us now examine the following: (1) the rules for attribution of corporate income for intangibles under UDITPA; (2) some of the alternatives available to the states in taxing intangible income either under or apart from UDITPA; and (3) some considerations affecting these alternatives. Inasmuch as the most critical problems in this area pertain to the dividend income attribution rules, these alternatives will be examined in the context of dividend income. What is said with respect to the dividend income problem, however, is relevant generally to income from other intangible property as well.

III. Rules for Attribution of Corporate Income from Intangibles Under UDITPA

UDITPA initially classifies all corporate income into two categories, "business income" and "nonbusiness income."[15] Business income, irrespective of its nature or source, is attributed to the states by application of the three factor (property, payroll, and sales) UDITPA apportionment formula.[16] Certain classes of nonbusiness income (net rents and royalties, capital gains and losses, interest and dividends, and patents and copyrights) are subject to specific allocation.[17] Significant to this discussion is UDITPA's attribution of intangible income to the respective states by employing concepts in assigning income from intangibles different from those used in assigning income from tangible property. Business income (from both tangible and intangible property) is attributable to the source on the basis of the three-factor formula. Nonbusiness income is attributable to various other sources: (1) net rents and royalties and capital gains and losses from sales of real property are allocated to the state where the real property is located; (2) net rents and royalties from tangible personal property are allocated to the state where that property is used or, if the taxpayer is not organized under the laws or taxable in the state in which the property is used, to the taxpayer's commercial domicile; (3) capital gains and losses from the sales of tangible personal property are allocated to the state of its situs at the time of the sale, or if he is not subject to tax in that

15. *See* note 12 *supra*.
16. For a discussion of this formula see Corrigan, *supra* note 8, at 430-36.
17. *See* P-H State & Local Taxes, All States Unit ¶¶ 91,409-A.120 to -A.130.

state, to the commercial domicile of the taxpayer; (4) income from patent and copyright royalties is allocated to the state where they are used, or, if he is not subject to tax in that state, to the state of the taxpayer's commercial domicile; (5) capital gains and losses from the sale of intangible personal property are allocated to the state of the taxpayer's commercial domicile; and (6) interest and dividends are allocated to the state of the taxpayer's commercial domicile. UDITPA does not specify the treatment to be applied to other nonbusiness intangible income. Consistency would appear to dictate its allocation to the state of the taxpayer's commercial domicile since the "commercial domicile" rationale is that income from intangibles is necessarily produced by activities carried on at the commercial domicile directly related to the management of the intangible properties.

This marked difference between the attribution rules concerning "business income" and those concerning "nonbusiness income" lies at the heart of the controversy over the Multistate Tax Commission regulations between COST and the states. The UDITPA distinction between "business" and "nonbusiness" corporate income appears to lack any rational basis and has created confusion for taxpayers and tax administrators alike. The Multistate Tax Commission has, therefore, concluded that the distinction should be eliminated by treating all corporate income as apportionable business income. This "full apportionment" position also seems to be favored by several states that have not yet enacted the Multistate Tax Compact.[18] Since UDITPA, an integral part of the Compact, specifically contemplates the designation of at least some income as nonbusiness income, and since the Multistate Tax Commission is reluctant to recommend amendments to the Compact that would be necessary to implement the "full apportionment" concept under UDITPA, the Commission has chosen to rely for the present upon its regulations to clear up as much of the confusion as possible. That nine states already have adopted those regulations and other states use them as guidelines strongly indicates that the Commission has chosen the wisest course, as a practical matter.[19]

18. The allocation and apportionment rules of Massachusetts, Idaho, Vermont, and Florida appear to require full apportionment. *See* Corrigan, *supra* note 8, at 435 n. 24.

19. Rather than attempt to attribute a source to the limited activity pertaining to passive investments, the Multistate Tax Commission regulations look to the relationship of the intangible investments to the overall business activities of the income-receiving corporation. It is becoming increasingly apparent that modern businesses do not make substantial investments, particularly in subsidiary and affiliated corporations, without actively engaging in the conduct of those businesses that are represented by their investments.

IV. ALTERNATIVE METHODS OF TAXATION OF INTANGIBLES

A. *Attribution of Dividend Income to the Jurisdiction(s) Where the Payor Carries on its Business Activities*

COST argues that dividends received from foreign affiliates should be excluded from the income tax base of domestic corporations. COST describes this income as "foreign source income," not because of any activities carried on overseas by the domestic corporation, but because of income-producing activities carried on overseas by affiliated foreign payor corporations. To attribute dividend income to the source of the underlying business activities of the payor corporation, however, is to treat the payee corporation and the payor corporation as one legal entity for this limited purpose. If the parent and foreign affiliated corporations are to be treated as one entity for dividend attribution purposes, why should they not be treated as one entity for all state income tax purposes? Why, at least, should those corporations not be required to file a combined report?[20]

Further, if dividend income from foreign affiliated corporations is to be attributable to the underlying activity of the payor foreign corporation, why should the same rule not be followed in attributing dividend income to the states from domestic payor corporations? It appears inconsistent to argue that dividend income from foreign affiliates should be attributable to the underlying activity of the foreign payor corporation and at the same time maintain that com-

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20. "Combined report" and "combination" as used herein mean the California approach of combining the income and apportionment factors of an affiliated group of corporations conducting a unitary business to determine the income tax liability of any member of the affiliated group.

In determining whether corporations carry on a unitary business, courts have relied upon (a) the test of unity of ownership and unity of use and operations, *see* Butler Bros. v. McColgan, 17 Cal. 2d 664, 111 P.2d 334 (1941), *aff'd*, 315 U.S. 501 (1942) (3-factor apportionment formula validly applied to multistate business of foreign corporation and all its branches); and (b) the interdependency and contribution test, *see* Edison California Stores, Inc. v. McColgan, 30 Cal. 2d 472, 183 P.2d 16 (1947) (3-factor formula validly applied to include income from a foreign parent corporation of taxpayer-subsidiary). *See also* John Deere Plow Co. v. Franchise Tax Bd., 38 Cal. 2d 214, 238 P.2d 569 (1951) (wholly owned subsidiary-taxpayer considered as integral unit in entire business of John Deere Co.; taxes on apportioned net income of all the affiliated companies); Zale Salem, Inc. v. State Tax Comm'n, 237 Ore. 261, 391 P.2d 601 (1964) (wholly owned subsidiary taxed or apportioned income of parent and all subsidiaries); Gulf Oil Corp. v. Clayton, 267 N.C. 15, 147 S.E.2d 522 (1966) (parent-taxpayer not taxable on dividends paid by subsidiaries because parent and subsidiaries transact business with each other as distinct entities so not part of unitary enterprise).

For a discussion of the question of when a business is unitary see Lavelle, *What Constitutes a Unitary Business*, 1973 So. CAL. TAX INST. 14, and for a discussion of combined reporting see Keesling, *The Combined Report and Uniformity in Allocation Practices*, MULTISTATE TAX COMMISSION, SEVENTH ANNUAL REPORT App. G (1975).

bined reporting should be prohibited and that the taxable "source" of domestic income is the commercial domicile of the payee corporation.

In asking for income tax exemption for dividend income received from foreign affiliates, multinational businesses, in substance, argue for "combination" or "combined reporting" for the limited purpose of excluding dividends from their foreign affiliates. Any reasoning that would support such an exemption of dividend income received from foreign affiliates would justify combined reporting and the attribution of domestic dividend income to the states in which the payor corporations carry on the activities that generate the profits giving rise to the dividend income.

The exemption of "foreign source income" also cannot be justified by the argument that to the extent they constitute business income, intercorporate dividends are eliminated in combined reporting. Combination would produce an entirely different result because it would include in the apportionable income base all of the income of the payor corporation for the tax year and not just that portion distributed as dividends. Furthermore, combination would reflect the appropriate apportionment result by including the property, payroll, and sales of the combined corporations in the apportionment factors. Combination with foreign affiliates also would protect the states from the problems associated with the application of adjustments provided for in section 482 of the Internal Revenue Code.

If the business activities of payor corporations constitute the basis for the assignment of dividend income, it logically follows that the states in which payor corporations conduct their business can tax this income to the payee corporation and that presence of the payor corporation in the taxing state constitutes jurisdictional presence of the payee corporation for this purpose. An additional conclusion follows: if dividend income received from foreign affiliated corporations is to be attributable on the basis of the underlying activity of the payor corporations, then all dividend income should be treated in the same way, regardless of whether the payee is a corporation, trust, partnership, or natural person.

In the final analysis, the multinational corporations are asking the states to treat them for domestic income tax purposes as though they really do not own any stock in affiliated corporations and do not derive any income from those affiliates. This is based on an assumption that this writer considers to be erroneous: that dividend income received by a corporation, attributable to the ownership of

stock, is not legally distinguishable from the profits of the payor corporation for state income tax purposes. This amounts to an historical "double taxation" argument that has been soundly rejected by the courts.[21] The argument has no validity when the taxing jurisdiction lacks power to tax the profits of both the payor and payee corporations in the first instance.[22]

This writer is aware of no case that would permit taxation of dividends to the payee corporation by the state of the payor corporation based solely on the "source" of the dividends. Only two decisions of the United States Supreme Court, *Wisconsin v. J.C. Penney Co.*[23] and *International Harvester Co. v. Department of Taxation*,[24] address this question in any meaningful way. Both cases involved a Wisconsin statute imposing a tax on dividends of nondomiciliary foreign corporations that did business in Wisconsin. The Wisconsin tax was measured by that portion of the dividends paid by the payor corporation that was deemed attributable to income from Wisconsin sources, as determined by Wisconsin's usual apportionment formula. In *International Harvester Co.* the court rejected the argument that because the burden of the tax fell on the stockholders, the apportionment procedure was unconstitutional. If the tax had been imposed on nonresident stockholders, however, the constitutionality of the apportionment would have been open to question.[25]

The COST approach lacks economic merit as well. Dividend income to the payee corporation is a separate class and source of income from the income produced by the business activities of the payor corporation. There is no reason, therefore, for the states to exempt or exclude foreign-source dividend income from their income tax bases. In *F.W. Woolworth Co. v. Commissioner of Taxes*,[26] *Gulf Oil Corp. v. Morrison*,[27] and *F.W. Woolworth Co. v. Director of Division of Taxation*,[28] the courts sustained the taxation of dividend income on the basis of the same formulary apportionment as

21. *See* Klein v. Tax Supervisors, 282 U.S. 19 (1930); Hawley v. Malden, 232 U.S. 1 (1914).

22. By analogy, the special dividend deduction in the Internal Revenue Code is not applicable when the profits of the payor corporation have not been subject to the federal income tax.

23. 311 U.S. 435 (1940).

24. 322 U.S. 435 (1944).

25. In both cases the Supreme Court upheld the constitutionality of the Wisconsin income tax. Thus it is clear that dividends may be taxed by apportionment of the payor's business income. It would seem *a fortiori* that dividends can be counted in apportioning the business income of the recipient of the dividends.

26. 130 Vt. 544, 298 A.2d 839 (1972).

27. 120 Vt. 324, 141 A.2d 671 (1958).

28. 45 N.J. 466, 213 A.2d 1 (1965).

applied to any other business income of the corporations. In light of these decisions, the argument that such income does not have as a source the place of business of the payee corporation clearly is without merit. Thus, however the dividend question is finally resolved, it cannot be determined meaningfully by attributing the payor corporation's activities to the payee corporation for the limited purpose of attributing dividend income. This conclusion follows from the proposition that the payor corporation's activities (except as controlled by the payee corporation) are not the income-producing activities of the payee corporation.

B. *The Attribution of Dividend Income to the Commercial Domicile of the Payee Corporation*

As discussed above, UDITPA apportions income classified as "business" income and allocates to the commercial domicile of the payee corporation income classified as "nonbusiness" income. The rationale seems to be that the commercial domicile state has a special relationship to intangible property and to income from such property when that property is disassociated from the taxpayer's regular trade or business operations. The business/nonbusiness distinction appears to have been premised on the assumption that intangibles do not acquire a "business situs"[29] in states other than the state of commercial domicile of the corporation owning the corporate stock if they are disassociated from a corporation's regular trade or business. The ultimate question is whether the taxing state has conferred any benefits and protection pertaining to income derived from intangible investments.[30] This is equally as germane in reference to commercial domicile as it is in reference to any other place where a corporation carries on its activities.

UDITPA seems at first to reflect a reasonable accommodation to the interests of the commercial domicile states. Great difficulty has been experienced, however, in distinguishing between business

29. *See* note 5 *supra.*

30. *See* Curry v. McCanless, 307 U.S. 357 (1939), discussed in note 5 *supra*. In Wisconsin v. J.C. Penney Co., 311 U.S. 435 (1940), the court said:

> A state is free to pursue its own fiscal policies, unembarrassed by the Constitution, if by the practical operation of a tax the state has exerted its power in relation to opportunities which it has given, to protection which it has afforded, to benefits which it has conferred by the fact of being an orderly, civilized society . . . .
>
> . . . The simple hut controlling question is whether the state has given anything for which it can ask return.

311 U.S. 435, 444 (1940). This language has been approved repeatedly in suhsequent Supreme Court cases. *See, e.g.*, Standard Pressed Steel Co. v. Washington Dept. of Revenue, 419 U.S. 560 (1975); General Motors Corp. v. Washington, 377 U.S. 436 (1964).

and nonbusiness income in various factual situations. The task is complicated by other considerations: (a) a corporation may be carrying on more than one trade or business; (b) intangible investment activities may themselves constitute a trade or business; (c) intangible investment activities may be so minimal in the case of a particular taxpayer that it is difficult to associate them with any trade or business activity, including that at the "commercial domicile"; and (d) a trade or business may be carried on by a group of affiliated corporations. Corporate ability to create non-operating corporations to hold stock for the operating corporations and/or their stockholders and to shift profits between members of the affiliated group complicates the picture even more.

Apart from these complications, the more provocative questions pertain to the circumstances under which passive intangible investments[31] can be assigned to the "commercial domicile" and still conform to constitutional due process and equal protection requirements. When no activity pertaining to passive investments is conducted by the payee corporation in the state of "commercial domicile" and when passive investments are not associated with the corporation's overall business activities, assigning the entire income from such investments to the "commercial domicile" constitutes an arbitrary application of a legal fiction. UDITPA would apply this legal fiction in circumstances in which the investments in intangibles have not acquired a "business situs" by being closely associated with the business activities of the taxpayer. If they are so associated, however, then the income from such intangibles would be apportioned.

Controversy over implementation of UDITPA's language has detracted from the real issue of how dividend income ideally should be assigned: should dividend income be assigned on the basis of commercial domicile of the payee corporation, or should it be included in apportionable income? Essentially, commercial domicile means the main office or the place in which the corporation conducts its principal operations. Many large multinational corporations, however, have more than one business location that could qualify as the commercial domicile. Arbitrary assignment of intangible income from passive investments to the state of the payee corporation's commercial domicile is based upon the legal fiction that mobile property has a *situs* at the domicile of the owner and

31. "Passive investments" refers to those investments that require no business activity on the part of the payee corporation other than receiving and accounting for the income.

that the source of this income is this situs.[32] This legal fiction could apply equally to the assignment of intangible income to the state of incorporation—the legal, as distinguished from the commercial, domicile.[33] The application of the commercial domicile test under UDITPA does not require that the intangibles be located at the commercial domicile or that any activity in regard to them take place at the commercial domicile. The question really is: should billions of dollars of dividend income of large multinational corporations be attributed solely on the basis of a legal fiction to the commercial domicile; and should this be done even though the corporate activity there may have little or nothing to do with the intangibles and may be minimal when compared to far-flung business operations of the corporation that has generated, invested, and controlled the intangible wealth in the first instance?

In considering the assignment of income on the basis of commercial domicile, four important factors should be considered. First, for a state constitutionally to tax "intangible" income, case law indicates that the intangible property must have benefited from or been protected by the laws of the "commercial domicile." This requires a tie-in of activities at the commercial domicile with the intangible investments. If no activity is carried on at the commercial domicile in regard to the intangible investments and if these investments are not related to the commercial domicile activities of the corporation, there would appear to be no constitutional justification for taxation of the intangibles or income from them by the commercial domiciliary state. Secondly, the facts that support taxation at the commercial domicile by reference to the utilization of the intangibles in the overall business of the payee corporation (unitary concept)[34] also support taxation of the intangibles or income derived from them by the "business situs" states.[35] Thirdly, to assign passive intangible investments to the state where minimal activities concerning the investments take place would be unrealistic. In the case of investments of a parent corporation in controlled affiliated corporations, it is more logical to assign the income on the basis of the location of the parent corporation's activities associated with the business operations of the affiliated corporations.[36]

32. *See* notes 5 & 6 *supra*.

33. *See* text accompanying note 3 *supra*.

34. *See* note 4 *supra* and accompanying text.

35. *See* note 5 *supra* and accompanying text.

36. Of course, if the parent's control over the affiliated corporations results in the parent conducting a unitary business with the affiliated corporations, combined reporting should be required. This will eliminate intercorporate transactions between the combined group. The

Fourthly, if no one state can legitimately claim a right to tax intangible income to the exclusion of other states, apportionment of intangibles and income from intangibles on the basis of the overall activities of the payor corporation, if not constitutionally required, is the only fair and equitable way of assigning intangible income. This supports full accountability without duplicate taxation, and lends substance to the benefit and protection doctrine by assignment of income to those states that confer benefits and protection to the corporate taxpayers.

When these factors are taken into account, the assignment of intangible income to the commercial domicile obviously is arbitrary. The commercial domicile concept was developed as a preferable alternative to the legal domicile concept for use in assigning intangible property and income derived from intangible property. Nevertheless, to the extent that activities pertaining to intangibles and to intangible income are disassociated from the commercial domicile activities of the corporation, the commercial domicile approach is obsolete and inappropriate.

More importantly, since the commercial domicile activities are closely associated with a unitary corporation's business activities everywhere, facts that support taxation of income from passive investments in intangibles at the commercial domicile also support taxation on an apportionment basis by the states in which the corporation carries on its business activities. It is incongruous to assign income solely to the commercial domicile predicated on the assumption that the corporation's activities in the commercial domicile further the overall corporate business wherever it is conducted and thus, to disregard the claims of the other states where the corporation carries on its business.

C. *The Attribution of Intangible Income to the States in Which the Payee Corporation Carries on its Business Activities*

When a corporation acquires, manages, and disposes of intangible property to produce income in the regular course of the corporation's trade or business, that income should be attributable among all the states in which that trade or business is conducted. In substance, this assigns intangible income to the "business situs" on the basis of benefits and protection afforded as a result of the activities of the corporation. Business situs concepts also form the basis for

parent would exclude from its taxable income the intangible income it would receive from the combined affiliates.

assigning intangible income to the commercial domicile of a corporation.[37] Certainly this business situs concept offers an alternative that is preferable to the assignment of intangible income on the basis of the legal fictions of commercial or legal domicile or on the basis of the activities of the payor corporation.

The more difficult question involves the assignment of income from intangible property that represents passive investments of the corporation. If these passive investments have been made possible by the business activities of the corporation in the states in which those business activities have been conducted, and if the income from these passive investments is used generally by the corporation in carrying on its trade or business, should not income from these investments be attributable to the states in which the corporation carries on its business activities? Is it reasonable to use the corporate activity test, rather than the legal domicile or commercial domicile test, for the assignment of such income? Stated otherwise, is it reasonable and constitutionally permissible to require the entire income tax base of the corporation to be subject to apportionment? This practice is followed by Massachusetts, Vermont, and Idaho and is preferred by the Multistate Tax Commission. It is also the method recommended by the Congressional Subcommittee on State Taxation of Interstate Commerce in 1965.[38]

Whether the corporate activity test is best depends upon the reason for resorting to an apportionment method of assigning income in the first instance. Income of multistate and multinational businesses is apportioned because it is not possible to allocate the income accurately to the sources or to the activities that these businesses carry on in each taxing jurisdiction. The purpose of apportionment is to divide the entire income tax base of a corporation among those states that have an otherwise indeterminate but legitimate claim to a portion of that tax base. A uniform formula is designed to eliminate any potential multiple taxation of a corporation's entire income and to require the income to be assigned to states that have jurisdiction to impose an income tax on the corporation. Under the apportionment method the source of the income is determined on the basis of the underlying business activities of the corporation. Thus, UDITPA makes the apportionment determination on the bases of where the corporation uses its employees and

37. *See* Wheeling Steel Corp. v. Fox, 298 U.S. 193 (1936); Southern Pac. Co. v. McColgan, 68 Cal. App. 2d 48, 156 P.2d 81 (1945); Cleveland-Cliffs Iron Co. v. Michigan Corp. & Sec. Comm'n, 351 Mich. 652, 88 N.W.2d 564 (1958).

38. REPORT OF THE SPECIAL SUBCOMM. ON STATE TAXATION OF INTERSTATE COMMERCE OF THE COMM. ON THE JUDICIARY, H.R. REP. No. 952, 89th Cong., 1st Sess. 1135 (1965).

its property and where it makes its sales. The determination is made in the same way for all business income, whether from tangible or intangible property. UDITPA still considers the state of commercial domicile to be the source of most nonbusiness income. As previously indicated, as to passive investments this is arbitrary and as to active investments it may be equally arbitrary if the corporation's activities concerning such investments are not carried on solely at the commercial domicile. Even when the investment activity is carried on at the commercial domicile, it may be so much a part of the unitary business that the investments are required to be apportioned.[39]

Nevertheless, under UDITPA the nonbusiness intangible income of a corporation has its source at the corporation's commercial domicile. Ostensibly, this position traces back to the California rule first enunciated in *Southern Pacific Co. v. McColgan*,[40] which in turn was based on *Wheeling Steel Corp. v. Fox*.[41] The difficulty with that rule is that the *Wheeling Steel* case dealt solely with constitutional jurisdiction to tax trade accounts receivable and bank accounts for ad valorem property tax purposes. Moreover, the holding of the Supreme Court was based on the proposition that intangibles (choses in action) may be subject to taxation other than at the domicile of their owner if they have become integral parts of some local business.[42] If the intangibles are integral parts of some local business, it is obvious that such intangibles are business income by definition. Intangibles cannot be an integral part of a local business and at the same time be disassociated from the business of the corporation. Thus, the underlying jurisdictional basis for taxation at the commercial domicile, apart from arbitrary property situs concepts, is the notion that the intangibles are business assets, and income from intangibles is income attributable to the business.

The Supreme Court in *Wheeling Steel* distinguished the ad valorem property tax involved there from an income tax by noting:

> The tax is not on the net profits of a unitary enterprise demanding a method, not intrinsically arbitrary, of making an apportionment among different jurisdictions with respect to the processes by which the profits are earned. [citations omitted] Such a tax on net gains is distinct from an ad valorem property tax on the various items of property owned by the Corporation and

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39. *See* Cleveland-Cliffs Iron Co. v. Michigan Corp. & Sec. Comm'n, 315 Mich. 652, 88 N.W.2d 564 (1958).

40. 68 Cal. App. 48, 156 P.2d 81 (1945).

41. 298 U.S. 193 (1936).

42. *Id.* at 210.

laid according to the location of the property within the respective tax jurisdiction . . . .[43]

In applying the commercial domicile concept to California's franchise tax measured by net income, the California appellate court in *Southern Pacific Co. v. McColgan*[44] supported its decision by referring to facts and circumstances that support the unitary and business situs concepts, as had the Supreme Court in *Wheeling Steel.* The California court denied apportionment by holding that California apportionment rules applied only to "business done," which the court found Southern Pacific's dividend income did not represent. In this connection, the California court treated the passive investment of Southern Pacific as though it were an investment from a separate holding company that did not do business in California under its franchise tax act. The California court recognized that the "commercial domicile" concept was an application of the "business situs" concept, and it noted that the income taxation in this case was based solely on property tax situs concepts.[45]

The Supreme Court, in *Wheeling Steel*, and the California appellate court, in *Southern Pacific*, both recognized the jurisdictional claims of the states when the intangibles had been utilized in the conduct of a business and the appropriateness of apportionment when more than one state had a legitimate right to tax the intangible income of the corporation. In *Wheeling Steel* Ohio had taxed part of the accounts receivable that were permitted as a deduction and in *Southern Pacific* the California court found that neither the state of legal domicile nor the state in which the stock was located imposed any tax on the intangibles. Thus, regardless of their specific holdings, the *Wheeling Steel* and *Southern Pacific* cases demonstrate the validity of the full apportionment approach. These decisions lend credence to the proposition that intangible income should be assigned on the basis of the underlying corporate activi-

43. *Id.* at 212.

44. 68 Cal. App. 2d 48, 156 P.2d 81 (1945). In its resolution of the "commercial domicile" issue, the court noted:

> The true test must be to consider all the facts relating to the particular corporation, and all the facts relating to the intangibles in question, and to determine from those facts which state, among all the states involved, gives the greatest protection and benefit to the corporation, which state, among all the states involved, from a factual and realistic standpoint is the domicile of the corporation.

68 Cal. App. at 80, 156 P.2d at 99.

45. It is difficult to reconcile *Southern Pacific* with the "unitary" and "combined reporting" cases of California. *See, e.g.*, John Deere Plow Co. v. Franchise Tax Bd., 38 Cal. 2d 214, 238 P.2d 569 (1951). Nevertheless, California apparently stills treats *Southern Pacific* as authority for the taxation of dividends at the commercial domicile.

ties that originally give rise to the income and pursuant to which the intangible investments and income are used. In recognition of this principle, some states have made intangibles and intangible values subject to apportionment.[46]

It is the writer's opinion that the "commercial domicile" rule is an unjustifiable extension of the "business situs" rule and should have no application under UDITPA when intangible property or income from intangible property is utilized by corporate businesses in their overall business operations. The California appellate court held in *Southern Pacific* that the limited activities of managing passive investments in affiliated corporations are not business activities, and it ruled that Southern Pacific's passive investments were taxable in California. The wholly inconsistent basis for this holding was that the investments were closely connected with Southern Pacific's business activities in California but were not equally closely connected with the corporation's other business activities in operating a unitary business, the income of which is subject to apportionment.

If a corporate business maintains an investment portfolio and uses the income derived from that portfolio in its overall business operations, each state in which the corporation conducts its overall business operations has a legitimate claim to its share of tax on that intangible income based upon the well accepted and recognized three-factor UDITPA formula. When more than one state taxing jurisdiction has a legitimate claim to the right to tax income from passive investments in intangibles based on the activities of the payee corporation, the assignments of such income by an apportionment formula produces the most equitable result. Indeed, it may be constitutionally required unless the intangible investments are not integrally related to the corporation's business activities. Even if the intangibles are not utilized by a corporation in the conduct of its

46. *See* International Harvester v. Department of Tax., 322 U.S. 435 (1944), and Wisconsin v. J.C. Penney Co., 311 U.S. 435 (1940) (upholding the apportionment of income from dividends against the payor corporation based on its in-state activities); Appeal of U.S. Steel Corp., Appeal No. 73-I-20 (Idaho B.T.A. Nov. 1, 1973), and Appeal of Capital Southwest Corp., CCH CAL. TAX REP. ¶ 204-881 (S.B.E. Jan. 16, 1973) (wherein the Boards respectively upheld dividends and interest income as business or unitary income). In addition, *see* Montgomery Ward & Co. v. Commissioner of Tax., 276 Minn. 479, 151 N.W.2d 294 (1967); Great Lakes Pipe Line Co. v. Commissioner of Tax., 272 Minn. 403, 138 N.W.2d 612 (1965), *appeal dismissed*, 384 U.S. 718 (1966) (wherein the courts held that interest income was business income subject to apportionment); F.W. Woolworth Co. v. Director of Div. of Tax., 45 N.J. 466, 213 A.2d 1 (1965), and F.W. Woolworth Co. v. Commissioner of Taxes, 130 Vt. 544, 298 A.2d 839 (1972) (in which dividend income was subject to apportionment either as business income or part of the unitary income of the payee corporation).

business, assignment of the income to the "commercial domicile" is constitutionally suspect. Even when investments in intangibles require corporate activity, the most reasonable rule is to assign the resulting income to the states in which the overall corporate activity is conducted. Otherwise, the income would be assigned on the basis of a meaningless fiction, with the result that large segments of corporate income would be totally exempt, "nowhere income."[47]

D. *Full Apportionment with Combined Reporting*

Combined reporting along with full apportionment[48] produces equitable state taxation and is consistent with corporate operations. If Corporations A, B, and C carry on an integrated or unitary business, the proper method of determining the income tax liability of any member of this affiliated group to a particular state is by combined reporting because the operations of Corporations A, B, and C are so interrelated that it is impossible to determine the income of any one corporation without considering the income of the others. Similarly, in the assignment of such income by the apportionment method, the property, payroll, and sales, as well as the combined income, of all the members should be taken into account. This in essence is an accounting or auditing device that treats separate corporations engaged in a single unitary trade or business as one for the limited purpose of properly accounting for and assigning the income of any member. The device does not subject any corporate member not doing business in the taxing state to its jurisdiction.

When properly understood and applied, combined reporting should be readily acceptable to both the states and the business community. If multistate and multinational corporations are required to assign income from intangibles by apportionment to the states where they carry on their business operations (a strict interpretation of "business income" under UDITPA), there would seem to be little practical objection to the elimination of large segments of such income (intercorporate dividends within an affiliated group) by the combined reporting method. Corporations have resisted combined or unitary reporting because of the preference given income from intangibles by the domiciliary states, but with this problem eliminated by full apportionment of any unitary income, much of the objection to combined reporting should disappear.

Full apportionment and combined reporting would eliminate the problems associated with the so-called "state tax climate" and

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47. *See* note 8 *supra* and accompanying text.

would allow both the states and the business community to devise their respective tax and business policies free from tax considerations otherwise involved in "headquarters" or "commercial domicile" locations. Furthermore, it places substance over form by eliminating differing tax consequences depending on whether the corporate business is to be operated by many corporate entities or just one. Full apportionment with combined reporting eliminates the possibility of inequitable tax treatment of competing businesses and opens the door to full accountability of a tax base without the threat of any duplicate taxation of the same income. As a practical matter, large multistate and multinational corporations with substantial income from intangible properties generally are involved in the operations of their affiliated and subsidiary corporations' businesses. While a parent's activities with its investment portfolio may be characterized as passive, this is not true for the businesses in which the investments have been made. In fact, intangible investments of most COST members represent property interests in business enterprises over which they exercise control and have a definable interest over and above mere investment. In modern business practices, large corporate investments in affiliated corporations seldom are made without any operational tie-in to the general business activities of the parent corporation. On occasion an investment may be viewed in a different light, but examples of such an investment are few in the operations of the large international corporations that make up most of COST. This is especially true when substantial corporate indebtedness exists. Business tie-ins generally are reflected in corporate accounting practices. The basic relationships between the parent and affiliates must be revealed through consolidated reporting if the true business of the corporation is depicted by its profit and loss statements and balance sheets. Thus, full apportionment and combined reporting are concepts that merely reflect the realities of the business world, and they should be employed to prevent state tax avoidance and possible state tax duplication.[49]

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48. Full apportionment refers to attributing *all* income to taxing jurisdictions by an apportionment formula and not specifically allocating any income to a specific "situs" or "source." For the meaning of "combined reporting" see note 20 *supra*.

49. The problems associated with the proper attribution of income from multinational corporate groups exist on the federal as well as the state level. The Internal Revenue Code uses various approaches to solve the problem of attributing the income of multinational groups to the United States, including the tax credit device for foreign taxes paid. Some feel the proper way to take care of foreign source income is to permit the deduction of foreign taxes as an expense rather than to allow a credit against federal income taxes for such taxes. It is

V. Conclusion

In determining whether income from intangible investments should be subject to general apportionment rules or assigned to the commercial domicile or elsewhere the challenge to the states currently is to ascertain the true facts surrounding large corporate investments in intangible properties. The distinctions in UDITPA between business and nonbusiness income mandate this kind of factual inquiry. It is questionable, however, whether this distinction should continue to be given any significant effect, since it lacks substance and leads to endless conflict between large multistate and multinational corporations and each state in which they do business. Furthermore, in determining the state income tax liability of each member of a group of corporations carrying on a unitary or integrated business, it is unrealistic to treat each member as completely distinct. For this reason, full apportionment of income from intangibles should be coupled with combined reporting. This eliminates tax results flowing from the corporate shell game and places competing states and businesses on a tax parity. Under full apportionment and combined reporting, "nowhere income" and duplicate taxation are avoided, producing state income taxation that is constitutionally permissible and equitable. These are proper and achievable tax objectives.

submitted tbat the problems of attributing income of multinational groups to the United States are not unlike the problems associated with dividing up their income among the states. It might be appropriate for Congress to consider the assignment of income of a unitary group of corporations on the basis of consolidated or combined reporting coupled with the use of the generally accepted three factor apportionment formula. This is certainly a reasonable way to determine what portion of the income of unitary multinational corporations is reasonably assignable to the United States. The foreign tax credit or deduction approaches do not accomplish this result.