

State Taxation of Foreign -Source Income: Mobil Oil Corp. v. Commissioner of Taxes

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RECENT DEVELOPMENTS

STATE TAXATION OF FOREIGN-SOURCE INCOME:

Mobil Oil Corp. v. Commissioner of Taxes

In *Mobil Oil Corp. v. Commissioner of Taxes*,¹ the Supreme Court upheld Vermont's tax on foreign² source dividends of a non-domiciliary corporation. For the first time, the Court held that a state other than a corporation's legal or commercial domicile³ can tax corporate dividends received from affiliates and subsidiaries⁴ operating abroad. *Mobil* underscores the vitality of the unitary business concept⁵ and minimizes the importance of corporate form. The decision also contains several important implications for future review of state taxation schemes. First, the Court intimated what burden of proof a party must sustain in order to challenge successfully the constitutionality of a state taxa-

¹ 445 U.S. 425 (1980).

² "Foreign" can refer either to another state of the United States or to a foreign country. The *Mobil* Court discussed both types: "The first consists of dividends from domestic corporations, organized under the laws of States other than Vermont, that conduct all their operations . . . outside the United States. The second type consists of dividends from corporations both organized and operating abroad." *Id.* at 435 (footnote omitted). Only the latter type, however, was central to the case. *See id.* at 435 n.12. *See also* I.R.C. § 243.

³ "The legal domicile of a corporation is the state of incorporation." Sabine, *Constitutional and Statutory Limits on the Power to Tax*, 12 HASTINGS L.J. 23, 33 (1960). The concept of commercial domicile developed from a growing realization that a state other than the legal domicile may have a substantial relation to corporate earnings. *See* Sabine, *supra*, at 31-33. Professor Sabine suggests a factorial inquiry to determine a corporation's commercial domicile: (1) is the state the real center of the corporation's business activity; (2) is the corporation's headquarters in the state; (3) is the corporation's principal management office in the state; (4) is the corporation's control and management in the state; (5) does the corporation receive its greatest benefits from the state; and (6) is the corporation's center of authority in the state? *Id.* at 34-35. *See* Chestnut Sec. Co. v. Oklahoma Tax Comm'n, 125 F.2d 571 (10th Cir.), *cert. denied*, 316 U.S. 668 (1942) (commercial domicile may tax the income from intangibles of a corporation even if those intangibles do not have their business situs in that state). For a general discussion of taxation of income from intangibles, see Dexter, *Taxation of Income from Intangibles of Multistate-Multinational Corporations*, 29 VAND. L. REV. 401 (1976).

⁴ An affiliate is generally defined as a company controlled by another corporation. An affiliate is also a subsidiary if the controlling corporation owns more than 50% of the affiliate's voting stock. BLACK'S LAW DICTIONARY 54, 1280 (5th ed. 1980). Statutory definitions vary. *See, e.g.*, Investment Advisers Act of 1940, § 201-20, 15 U.S.C. § 80a-2(a)(3) (1976) ("affiliate" is company having five percent or more of its outstanding stock owned by another company); I.R.C. § 165(g)(3)(A) ("affiliate" for purpose of loss deduction is corporation in which "stock possessing at least 80 percent of the voting power of all classes of its stock and at least 80 percent of each class of stock is owned directly by the taxpayer"). The *Mobil* Court adopted the traditional definition of a subsidiary: a corporation "more than 50% owned" by another corporation. *See* 445 U.S. at 438 n.1.

⁵ *See* note 14 *infra*.

tion scheme. Second, the Court appeared to substantially limit the taxing power of the domiciliary state. Finally, the *Mobil* Court applied a more lenient standard for review of domestic taxation of foreign commerce than it had in prior cases.

I

STATE TAXATION OF NON-DOMICILIARY CORPORATIONS: HISTORICAL BACKGROUND

The power of states to tax the income of businesses domiciled and operating solely within their borders is clear.⁶ It is also well settled that, subject to limitations imposed by the due process⁷ and commerce clauses⁸ of the Constitution, states may tax a portion of the income of multistate businesses.⁹ In *Mobil*, the taxpayer argued that the Vermont apportionment formula violated both constitutional restrictions.

A. *The Due Process Clause*

The due process clause imposes two limitations on a state's power to tax multistate businesses. First, it requires "a 'minimal connection' between the [corporation's] interstate activities and the taxing State."¹⁰ The Supreme Court has found that the requisite minimum connection, or nexus, exists when a corporation carries on business in the taxing state.¹¹ Moreover, "[t]he fact that a tax is contingent upon events brought to pass without a state does not destroy the nexus between such a tax and transactions within a state for which the tax is an exaction."¹² Second, the due process

⁶ See, e.g., *International Harvester Co. v. Wisconsin Dep't of Taxation*, 322 U.S. 435, 443-44 (1944) ("So long as the earnings actually arise [in the state] . . . the conditions of state power to tax are satisfied . . .") (citation omitted); *Consolidation Coal Co. v. Bailey*, 467 F.2d 1124, 1125 (3d Cir. 1972) ("A state can tax income produced within its borders . . .") (per curiam), cert. denied, 410 U.S. 930 (1973); *American Consumers Ass'n v. Levitt*, 279 F. Supp. 40, 47 (S.D.N.Y. 1967), aff'd, 405 F.2d 1148 (2d Cir. 1969).

⁷ U.S. CONST. amend. XIV.

⁸ U.S. CONST. art. 1, § 10.

⁹ "It long has been established that the income of a business operating in interstate commerce is not immune from fairly apportioned state taxation." *Mobil Oil Corp. v. Commissioner of Taxes*, 445 U.S. at 436. See *Underwood Typewriter Co. v. Chamberlain*, 254 U.S. 113 (1920) (foreign corporation); *United States Glue Co. v. Town of Oak Creek*, 247 U.S. 321 (1918) (domestic corporation).

¹⁰ *Mobil Oil Corp. v. Commissioner of Taxes*, 445 U.S. at 436-37.

¹¹ See *id.* at 437 (quoting *Wisconsin v. J.C. Penney Co.*, 311 U.S. 435, 444-45 (1940)); *Moorman Mfg. Co. v. Bair*, 437 U.S. 267, 269, 273 (1978) (minimum connection being 500 salesmen, 6 warehouses, and 20% of total sales in taxing state).

¹² *Wisconsin v. J.C. Penney Co.*, 311 U.S. 435, 445 (1950), quoted in *Mobil Oil Corp. v. Commissioner of Taxes*, 445 U.S. 425, 437 (1980).

clause permits a state to tax only income that is rationally attributable to the business's relationship with the state.¹³

States have used the unitary business concept and have devised tax apportionment formulas to facilitate the exercise of their taxing power within these constitutional limits. An enterprise is generally considered a unitary business¹⁴ when its "properties and

¹³ See *Hans Rees' Sons, Inc. v. North Carolina*, 283 U.S. 123 (1931) (invalidating an arbitrary taxing scheme).

There are three methods for attributing the income of a multistate business to the taxing state. Under the "specific allocation" method, the state taxes the business's entire income derived from certain in-state activities. "Certain classes of income, such as rentals from real property, gains and losses from the sale or other disposition of capital assets, interest, dividends, and income from intangibles are customarily attributed to the state where the property from which derived is located or is deemed to be located." Keesling & Warren, *The Unitary Concept in the Allocation of Income*, 12 HASTINGS L.J. 42, 42 (1960). Under the "separate accounting" method, states treat the portion of business within the state as separate from that outside the state, and tax only income generated by the intrastate portion of the business. See *id.* at 43. The "apportionment formula" method is used when the business activities within the state are inseparable from the out-of-state activities. The total income of the entire business is plugged into a formula to determine the appropriate tax base. The formula usually involves a ratio that relates in-state activities to out-of-state activities. For example, a common formula divides the business's in-state sales, wages, and property by the business's total sales, wages, and property.

In *Mobil*, Vermont used an apportionment formula. 445 U.S. at 429. See note 24 *infra*. Some states have used other combinations and other factors. See, e.g., *Butler Bros. v. McColgan*, 315 U.S. 501, 505 (1942) (property, sales, and wages factors); *Hans Rees' Sons, Inc. v. North Carolina*, 283 U.S. 123, 129 (1931) (one-factor property ratio held unconstitutional where income attributed to the state was substantially disproportionate to the business transacted therein); *Bass, Ratcliff & Gretton, Ltd. v. State Tax Comm'n*, 266 U.S. 271, 278 (1924) (real property and tangible property, bills and accounts receivable, and shares of stock owned in other corporations); *Underwood Typewriter Co. v. Chamberlain*, 254 U.S. 113, 118 (1920) (ratio of fair cash value of in-state real estate and personal property to total fair cash value of real estate and personal property); *United States Glue Co. v. Town of Oak Creek*, 247 U.S. 321, 324-25 (1918) (ratio of gross business and value of property in state to total business and property).

¹⁴ A unitary business is "an interstate business which is so integrated as to make separate accounting for the in-state business impossible, or . . . an interstate business in which the in-state activities contribute to the out-of-state business and the out-of-state activities contribute to the in-state business." Rudolph, *State Taxation of Interstate Business: The Unitary Business Concept and Affiliated Corporate Groups*, 25 TAX L. REV. 171, 184 (1970).

The unitary business concept, therefore, recognizes that an interstate business may be so integrated that separate accounting by state would not make sense. For example, under a separate accounting system, a business that manufactures a product in a southern state and sells it in a northern state might report all its revenues in the latter and run at a loss in the former. Yet, the manufacturing activities are as much part of the business as are the sales. The southern state, therefore, should be permitted to tax a portion of the income generated by the out-of-state sales. See Keesling & Warren, *supra* note 13, at 46. Sometimes apportionment will benefit the business by allowing it to offset profits generated in the taxing state against losses incurred without the state. See, e.g., *Superior Oil Co. v. Franchise Tax Bd.*, 60 Cal. 2d 406, 386 P.2d 33, 34 Cal. Rptr. 545 (1963) (sustaining taxpayer's use of apportionment formula where out-of-state operations run at a loss). *But cf.* Webb Re-

activities within the jurisdiction are an inseparable portion of a business carried on within and without the jurisdiction."¹⁵ The unitary business concept enables states to establish the requisite minimum connection to a multistate integrated corporation, and hence to subject both its in-state and out-of-state income to taxation. To meet the second due process requirement—that a state may tax only income attributable to the in-state activities of a business¹⁶—state legislatures have devised apportionment

sources, Inc. v. McCoy, 194 Kan. 758, 401 P.2d 879 (1965) (enterprise held not to be a unitary business).

Two characteristics of a unitary business are operational and economic unity. There is operational unity when "[a]ll of the property and services involved in the manufacturing and selling operations [of the business] . . . contribute to the earning of the income resulting from the sale of the product." Keesling & Warren, *supra* note 13, at 50. See, e.g., Bass, Ratcliff & Gretton Ltd. v. State Tax Comm'n, 266 U.S. 271, 282 (1924) (English manufacturer with sales in New York held a unitary business). "Economic unity exists where there are two or more series of activities, which from an operational standpoint, are separate and distinct from one another, but which because of economic interrelationship, should be considered as constituting a single business." Keesling & Warren, *supra* note 13, at 51. See, e.g., Butler Bros. v. McColgan, 315 U.S. 501 (1942) (business operating separate wholesale outlets in seven states, but which purchased goods for entire business in bulk, held to be economically unitary); Household Fin. Corp. v. Franchise Tax Bd., 230 Cal. App. 2d 926, 929-30, 41 Cal. Rptr. 565, 567 (1965) (business's aggregate financing provided it with better interest rates); Keesling & Warren, *supra* note 13, at 51-52.

For discussions of the unitary business concept and related topics, see Dexter, *supra* note 3; Hellerstein, *Recent Developments in State Tax Apportionment and the Circumscription of Unitary Business*, 21 NAT'L TAX J. 487 (1968); Keesling & Warren, *supra* note 13; Rudolph, *supra*; Sabine, *supra* note 3; Comment, *State Taxation of Unitary Business*, 8 FORDHAM URB. L.J. 819 (1980).

¹⁵ Keesling & Warren, *supra* note 13, at 46. The Court first recognized the need for a unitary business concept in income taxation in *Underwood Typewriter Co. v. Chamberlain*, 254 U.S. 113 (1920). Justice Brandeis explained: "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." *Id.* at 120 (emphasis added). In Bass, Ratcliff & Gretton, Ltd. v. State Tax Comm'n, 266 U.S. 271 (1924), the Court first characterized this "series of transactions" as an indicator of a unitary business. There, a corporation in Great Britain manufactured ale that was sold in New York. The Court stated:

[I]n the present case we are of the opinion that, as the Company carried on the unitary business of manufacturing and selling ale, in which its profits were earned by a series of transactions beginning with the manufacture in England and ending in sales in New York and other places—the process of manufacturing resulting in no profits until it ends in sales—the State was justified in attributing to New York a just proportion of the profits earned by the Company from such unitary business.

Id. at 282 (emphasis added). Under the unitary business concept, therefore, the accounting practices of an enterprise will not prevent a nondomiciliary state from taxing that portion of the income of the entire business fairly attributable to that state. See *Exxon Corp. v. Wisconsin Dep't Rev.*, 447 U.S. 207 (1980) (rejecting taxpayer's separate accounting and holding petroleum empire a unitary business).

¹⁶ See *Hans Rees' Sons, Inc. v. North Carolina*, 283 U.S. 123, 135-36 (1931); note 13 *supra*.

formulas.¹⁷ When applied to a corporation's total income, the formulas determine the portion of income that is fairly related to in-state activities and hence taxable.

B. *The Commerce Clause*

The Supreme Court has proscribed state taxing schemes that unduly hinder interstate or foreign commerce.¹⁸ Thus, a state may not subject a business to multiple taxation¹⁹ or disproportionately tax an interstate business, if to do so would unduly burden the free flow of commerce, which the commerce clause seeks to protect.²⁰

II

MOBIL OIL CORP. v. COMMISSIONER OF TAXES

Mobil Oil Corporation, commercially domiciled in New York, engages in a multinational "integrated petroleum business."²¹ It derives a large portion of its income from foreign subsidiaries and

¹⁷ See note 13 *supra*.

¹⁸ See *Japan Line Ltd. v. County of Los Angeles*, 441 U.S. 434 (1980) (burden on foreign commerce resulting from multiple taxation); *Department of Rev. v. Association of Wash. Stevedoring Cos.*, 435 U.S. 734, 748 (1978) ("The Commerce Clause balance tips against the tax only when it unfairly burdens commerce by exacting more than a just share from the interstate activity."); *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274, 279 (1977); *Freeman v. Hewit*, 329 U.S. 249, 252-53 (1956).

In addition to prohibiting undue interference with interstate commerce, the commerce clause gives Congress power to preempt state taxing schemes. In *Northwestern Portland Cement Co. v. Minnesota*, 358 U.S. 450 (1959), the Supreme Court held that in-state solicitations constituted minimum contacts such that a tax on business operating in interstate commerce would be constitutional. Congress quickly altered such a result by statute. See 15 U.S.C. §§ 381-384 (1976). There have been recent moves in Congress to limit state taxation of foreign corporations. See H.R. REP. NO. 5076, 96th Cong., 1st Sess. (1976); *State Taxation of Foreign Source Income: Hearings on H.R. 5076 Before the House Comm. on Ways and Means*, 96th Cong., 2d Sess. (1980); Hellerstein, *State Income Taxation of Multijurisdictional Corporations: Reflections on Mobil, Exxon and H.R. 5076*, 79 MICH. L. REV. 113 (1980).

¹⁹ Multiple taxation results when two states tax the same income. See *Moorman Mfg. Co. v. Bair*, 437 U.S. 267, 283 (1978) (Powell, J., dissenting). See also *Gwin, White & Prince, Inc. v. Henneford*, 305 U.S. 434, 439 (1939) ("The present tax, though nominally local, thus in its practical operation discriminates against interstate commerce, since it imposes upon it, merely because interstate commerce is being done, the risk of a multiple burden to which local commerce is not exposed.") (citations omitted); Comment, *supra* note 14, at 823-24. Some overlap in taxation, however, is permissible. See *Moorman Mfg. Co. v. Bair*, 437 U.S. 267, 277-80 (1978).

²⁰ See *Moorman Mfg. Co. v. Bair*, 437 U.S. 267, 284 n.2 (1979) (Powell, J., dissenting) (multiple taxation resulting from apportionment formula that effectively discriminated against interstate business).

²¹ 445 U.S. at 428.

affiliates operating abroad.²² Mobil's activities in Vermont, however, are "confined to wholesale and retail marketing of petroleum and related products."²³

The Vermont statutory apportionment formula included dividends from foreign subsidiaries and affiliates in corporate taxable income.²⁴ For several years,²⁵ however, Mobil deducted from its Vermont taxable income dividends received from its foreign subsidiaries.²⁶ The Vermont Department of Taxes recalculated

²² *Id.* at 430. Three wholly owned foreign subsidiaries and one affiliate incorporated in Delaware provided the lion's share of Mobil's dividend income. *Id.* n.5.

²³ *Id.* at 428.

²⁴ The Vermont statute provides:

(a) If the income of a taxable corporation is derived from any trade, business, or activity conducted entirely within this state, the Vermont net income of the corporation shall be allocated to this state in full. If the income of a taxable corporation is derived from any trade, business or activity conducted both within and without this state, the amount of the corporation's Vermont net income which shall be apportioned to this state, so as to allocate to this state a fair and equitable portion of that income, shall be determined by multiplying that Vermont net income by the arithmetic average of the following factors:

(1) The average of the value of all the real and tangible property within this state (A) at the beginning of the taxable year and (B) at the end of the taxable year (but the commissioner may require the use of the average of such value on the fifteenth or other day of each month, in cases where he determines that such computation is necessary to more accurately reflect the average value of property within Vermont during the taxable year), expressed as a percentage of all such property both within and without this state;

(2) The total wages, salaries, and other personal service compensation paid during the taxable year to employees within this state, expressed as a percentage of all such compensation paid whether within or without this state;

(3) The gross sales, or charges for services performed, within this state, expressed as a percentage of such sales or charges whether within or without this state.

(b) If the application of the provisions of this section does not fairly represent the extent of the business activities of a corporation within this state, the corporation may petition for, or the commissioner may require, with respect to all or any part of the corporation's business activity, if reasonable:

(1) Separate accounting;

(2) The exclusion or modification of any or all of the factors;

(3) The inclusion of one or more additional factors which will fairly represent the corporation's business activity in this state; or

(4) The employment of any other method to effectuate an equitable allocation and apportionment of the corporation's income.

VT. STAT. ANN. tit. 32, § 5833 (1970 & Supp. 1980). The net taxable income under Vermont law is the corporation's income for federal tax purposes less the amount that the federal government exempts from state taxation. *Id.* § 5811(18) (Supp. 1980).

²⁵ The taxable years in issue were 1970, 1971, and 1972. 445 U.S. at 427.

²⁶ *Id.* at 430.

Mobil's income to include the foreign dividends.²⁷ Mobil objected and filed suit in Vermont Superior Court, which reversed the Department's decision.²⁸ The court reasoned that because New York, Mobil's legal and commercial domicile, could tax the dividends in full, Vermont's taxation of dividend income impermissibly subjected Mobil to the risk of double taxation.²⁹

The Supreme Court of Vermont reversed and sustained the tax.³⁰ The court found no undue burden on interstate commerce because New York did not tax foreign dividends³¹ and hence Mobil had not been subjected to actual multiple taxation.³² Moreover, it held that Mobil failed to demonstrate even a risk of multiple taxation,³³ and suggested that no risk existed because New York *could not* fully tax foreign dividends.³⁴ Mobil appealed to the Supreme Court.

In a six to one decision, the United States Supreme Court affirmed. Justice Blackmun, writing for the majority, framed the issue as "whether there is something about the character of income earned from investments in affiliates and subsidiaries operating abroad that precludes, as a constitutional matter, state taxation of that income by the apportionment method."³⁵ Mobil argued that the Vermont tax scheme violated the Constitution in three ways: first, the foreign dividends lacked a sufficient nexus to the state; second, the tax scheme subjected interstate businesses to a risk of multiple taxation; and third, the tax scheme created an unconstitutional risk of multiple taxation at the international level. The Court dismissed each of these arguments and approved the apportionment formula.

²⁷ *Id.* at 431. In its recalculation of Mobil's income, Vermont also included the interest income and foreign taxes that Mobil had deducted. Mobil did not challenge the inclusion of these amounts. *Id.* n.6.

²⁸ *Id.* at 433.

²⁹ *Id.*

³⁰ Mobil Oil Corp. v. Commissioner of Taxes, 136 Vt. 545, 394 A.2d 1147 (1978), *aff'd*, 445 U.S. 425 (1980).

³¹ *Id.* at 548, 394 A.2d at 1149.

³² *Id.* at 548-52, 394 A.2d at 1149-51. The Vermont Supreme Court did not focus on nexus. Rather, it took the view that once nexus between the taxpayer and the state existed, the state could tax a proportionate share of all investment income regardless of its connection to the unitary business. *See* 445 U.S. at 455-57 (Stevens, J., dissenting); notes 35-41 and accompanying text *infra*.

³³ 136 Vt. at 549, 394 A.2d at 1149-50.

³⁴ *Id.* at 548-52, at 394 A.2d at 1149-51. "An attempt on the part of New York to tax investment without apportionment would tip the balance by subjecting to taxation more than New York's just share." *Id.* at 551, 394 A.2d at 1151.

³⁵ 445 U.S. at 435.

The Court determined that Vermont had a sufficient nexus to Mobil's worldwide operations. It observed that the power of a state to tax the income of a unitary business does not depend solely on the geographical origin of the income: "separate accounting . . . may fail to account for contributions to income resulting from functional integration, centralization of management, and economies of scale."³⁶ The "linchpin of apportionability in the field of state income taxation," the Court emphasized, "is the unitary-business principle."³⁷ Furthermore, the Court held the *form* of the income—dividends in this case—irrelevant; although a unitary business may consist of more than one corporation, a state has the power to tax a portion of the entire income of the business.³⁸ Accordingly, the Court found no due process violation.

Justice Stevens, dissenting, argued that "Mobil's income from its investments and its income from the sale of petroleum in Vermont are not parts of the same 'unitary business . . .'"³⁹ Thus, in his view, Vermont had a constitutionally insufficient nexus with much of the foreign source income.⁴⁰ In addition, Justice Stevens

³⁶ *Id.* at 438 (citation omitted).

³⁷ *Id.* at 439 (footnote omitted). The Court presumed that Mobil and its subsidiaries constituted a unitary business, and noted that Mobil had offered no evidence to rebut that presumption. *Id.* at 435. *But see* note 40 *infra*.

³⁸ *Id.* at 440.

Nor do we find particularly persuasive Mobil's attempt to identify a separate business in its holding company function. So long as dividends from subsidiaries and affiliates reflect profits derived from a functionally integrated enterprise, those dividends are income to the parent earned in a unitary business. One must look principally at the underlying activity, not at the form of investment, to determine the propriety of apportionability.

Superficially, intercorporate division might appear to be a more attractive basis for limiting apportionability. But the form of business organization may have nothing to do with the underlying unity or diversity of business enterprise. Had appellant chosen to operate its foreign subsidiaries as separate divisions of a legally as well as a functionally integrated enterprise, there is little doubt that the income derived from those divisions would meet due process requirements for apportionability Transforming the same income into dividends from legally separate entities works no change in the underlying economic realities of a unitary business, and accordingly it ought not to affect the apportionability of income the parent receives.

Id. at 440-41 (footnote and citation omitted).

³⁹ *Id.* at 451. *See also id.* at 455-57. Justice Stevens argued that "it is readily apparent that a large number of corporations in which Mobil has small minority interests and from which it derived significant dividend income would seem neither to be engaged in the petroleum business nor to have any connection whatsoever with Mobil's marketing business. . . ." *Id.* at 460 (Stevens, J., dissenting).

⁴⁰ Justice Stevens disputed the majority's assertion that four oil-related corporations produced the major share of dividend income. He listed forty corporations from whom

maintained that Vermont's apportionment formula was unfair,⁴¹ an argument the majority dismissed on procedural grounds.⁴² He concluded, therefore, that the Vermont tax was unconstitutional.⁴³

Mobil also challenged the validity of the Vermont tax on commerce clause grounds. It argued that because New York, its commercial domicile, could tax the dividend income in full, Vermont's tax was potentially duplicative and thus impermissibly burdened interstate commerce.⁴⁴ The Court emphasized that the Vermont tax did not actually subject Mobil to multiple taxation,⁴⁵ but agreed that the "constitutionality of a Vermont tax should not depend on the vagaries of [another state's] tax policy."⁴⁶ The

Mobil received dividends (predominantly public utilities) to prove that Vermont apportioned dividend income from sources not part of the unitary business. *Id.* at 456 n.9, 460 n.17.

The majority controverted the importance of this list on two grounds. First, it argued that the list consisted of domestic corporations that operated principally in the United States—whose dividends were not at issue—and second, that the list was not part of the record. *Id.* at 434 n.11, 442 n.16. Although the latter reason makes sense, the former is contrived. If the list had been properly in the record, it would have helped determine whether Vermont included nonunitary income in the formula. Justice Stevens did agree that Vermont could tax the dividends received from subsidiaries and affiliates operating abroad if Mobil and its affiliates were a unitary business. *Id.* at 459-60. He also agreed with the Court that separation of the unitary business into different corporations made no difference.

⁴¹ Justice Stevens maintained that although Vermont included dividends in computing Mobil's total income, it excluded the wages, sales, and property of the subsidiaries and affiliates in determining Mobil's total size. The exclusions increased Mobil's tax:

But of greatest importance, the record contains no information about the payrolls, sales or property values of any of those corporations, and Vermont has made no attempt to incorporate them into the apportionment formula computations. Unless the sales, payroll and property values connected with the production of income by the payor corporations are added to the denominator of the apportionment formula, the inclusion of earnings attributable to those corporations in the apportionable tax base will inevitably cause Mobil's Vermont income to be overstated.

Either Mobil's worldwide "petroleum enterprise," . . . is all part of one unitary business, or it is not; if it is, Vermont must evaluate the entire enterprise in a consistent manner. As it is, it has indefensibly used its apportionment methodology artificially to multiply its share of Mobil's 1970 taxable income perhaps as much as tenfold. In my judgment, the record is clearly sufficient to establish the validity of Mobil's objections to what Vermont has done here.

Id. at 460-61.

⁴² The majority held that Mobil failed to adequately raise this "combined apportionment" issue. *Id.* at 441 n.15. See note 35 *supra*.

⁴³ *Id.* at 462.

⁴⁴ *Id.* at 443.

⁴⁵ *Id.* at 444.

⁴⁶ *Id.* The Court cautioned, however, that "the absence of any existing duplicative tax does alter the nature of appellant's claim." *Id.* (emphasis added).

Court implied that although the state of commercial domicile may tax dividend income,⁴⁷ the power to do so is not exclusive; the income of a unitary business "bears relation to benefits and privileges conferred by several States,"⁴⁸ and is subject to taxation by each.⁴⁹ Thus, the Court rejected the notion that the commerce clause requires intangible income to be taxed at a single situs.⁵⁰

In addition, the Court found that the Vermont statute did not impermissibly burden foreign commerce. Mobil claimed that even if dividends from domestic subsidiaries and affiliates are properly apportionable, the risk of taxation by foreign countries justified "allocation of *foreign-source* income to a single situs."⁵¹ It maintained that the possibility of foreign taxation exacerbated the potential adverse effect of apportionment formulas, which "necessarily entail[] some inaccuracy and duplication."⁵² The Court, however, was unpersuaded; in fact, Mobil's argument backfired. The majority remarked that "[b]y admitting the power of the State of commercial domicile to tax foreign-source dividends *in full*, Mobil necessarily forgoes any contention that local duplication of foreign taxes is proscribed."⁵³ Thus, the essence of Mobil's objection, the Court argued, was not the risk of multiple taxation arising from the overlap of foreign and domestic taxes, but multiple taxation aggravated by potentially overinclusive state apportionment formulas—an argument essentially no different from one the Court had already rejected.⁵⁴

⁴⁷ *Id.* at 445.

⁴⁸ *Id.* at 446.

⁴⁹ The majority distinguished property tax cases that treated intangible property as taxable only by the commercial domicile or the state where the property had its business situs. *Id.* at 444.

⁵⁰ *Id.* at 445.

⁵¹ *Id.* at 446 (emphasis added).

⁵² *Id.*

⁵³ *Id.* at 447 (emphasis in original).

Mobil should have argued in the alternative. On the one hand, if New York could fully tax the dividends, a Vermont tax on the same income would create a risk of duplicative taxation and impermissibly burden *interstate* commerce. See note 18 *supra*. On the other hand, even if New York could *not* fully tax the dividends, the Vermont tax might still result in duplicative taxation, and thus, impermissibly burden foreign commerce. See, e.g., *Japan Line Ltd. v. County of Los Angeles*, 441 U.S. 434 (1979). By straddling these arguments, the Court narrowed the constitutional inquiry to "whether taxation by apportionment at home produces significantly greater tax burdens than taxation by allocation." 445 U.S. at 447.

⁵⁴ The Court also extended Mobil's argument beyond its logical conclusion. It maintained that Mobil's objection to domestic apportioned taxation of foreign dividend income applied to *all* foreign source income. 445 U.S. at 447. This view is untenable. Mobil limited its commerce clause objections to the taxation of foreign source dividends. Clearly, New

III

STATE TAXATION OF FOREIGN-SOURCE INCOME AFTER *MOBIL*

In *Mobil*, the Court clearly validated the power of non-domiciliary states to tax dividends from subsidiaries and affiliates that are part of the unitary business operating abroad.⁵⁵ The underpinnings of the decision are logical; a unitary business's exposure to taxation should depend on corporate substance, not corporate form.⁵⁶ Nevertheless, the Court confounded this area of state taxation rather than clarifying it.

A. The Burden of Proof in a Multiple Taxation Claim

The *Mobil* Court did not specify whether a plaintiff may successfully challenge a state tax merely by showing that it creates a

York could not tax Mobil's entire operating income. See N.Y. TAX LAW § 210 (McKinney Supp. 1980). Therefore, there was a greater likelihood that multiple taxation would occur with dividend income. Moreover, assuming that New York and Vermont both apportioned ordinary income, there would be no domestic double taxation. The addition of a foreign tax on this operating income would, of course, amount to more than single taxation, and if New York taxed the dividends in full, as Mobil contended, then double taxation would result. An added foreign tax might treble taxation. The burden on dividend income, therefore, would be greater than on operating income.

⁵⁵ The decision assumes that the dividend payments necessarily reflected the profits of the subsidiaries. See note 38 and accompanying text *supra*. The dissent objected to the majority's assumption. 445 U.S. at 458 n.11 (Stevens, J.). Although dividends must come out of earnings and profits accounts, at least for the Internal Revenue Service to recognize them as distributions (see I.R.C. § 316), they do not reflect losses incurred by the subsidiary. For example, one foreign subsidiary might show a profit of \$20x and fully distribute it in dividends. A second subsidiary, however, might operate at a \$20x loss. Thus, the unitary business would yield no net income from these subsidiaries, but the Vermont tax scheme would tax the parent on \$20x income. A combined report that included both profits and losses would eliminate this anomaly. See note 56 *supra*.

⁵⁶ Three decades earlier, the Supreme Court of California reached the same result in *Edison Cal. Stores, Inc. v. McColgan*, 30 Cal. 2d 472, 183 P.2d 16 (1947). There the taxpayer was part of an operation comprised of fifteen wholly owned subsidiaries organized in different states. California used the income of the entire business (the parent and its subsidiaries) in its apportionment formula. The California Supreme Court found that the business was unitary and held the corporate divisions irrelevant: "In any event, since the business transacted by the parent and its subsidiaries in the present case was a unitary business, the accident of different labels which may have attached to the various subsidiaries does not change the result." *Id.* at 482, 183 P.2d at 22. The United States Supreme Court denied certiorari in a case similar to *Edison*. See *John Deere Plow v. Franchise Tax Bd.*, 38 Cal. 2d 214, 238 P.2d 569 (1951), *cert. denied*, 343 U.S. 939 (1952). See also *Keesling & Warren*, *supra* note 13, at 57; *Rudolph*, *supra* note 14, at 194-95. A combined report aggregates the net income of each corporation in the unitary business and eliminates intercompany sales, rents, and service charges. See *Keesling & Warren*, *supra* note 13, at 59. Some commentators point out that a combined report can result in double taxation, however, if it fails to eliminate intercorporate dividends. See *id.* at 59-62; *Rudolph*, *supra* note 14, at 200.

substantial risk of multiple taxation, or whether a showing of actual multiple taxation is required.⁵⁷ The strong implication from *Mobil*, bolstered by the Court's decisions in other recent cases,⁵⁸ is that a taxpayer must prove actual multiple taxation to sustain a challenge to a state tax.

B. Domiciliary State Taxation of Foreign-Source Dividend Income

Although the Court did not decide the constitutionality of a hypothetical New York tax on all of Mobil's dividend income,⁵⁹ it clearly implied that such a tax would be impermissible.⁶⁰ If the non-domiciliary state can tax dividends, full taxation by the domicile would necessarily result in multiple taxation. This conclusion threatens the tax schemes of many states associated with the Multistate Tax Compact.⁶¹ The Uniform Division of Income Tax Purposes Act,⁶² adopted by the compact, permits the state of com-

The Court also left open the question of the constitutionality of a state tax scheme that directly taxed the income of subsidiaries abroad by including their income, rather than dividends paid, in the parent's tax base. Use of a combined report would facilitate such direct taxation. For a more complete discussion of combined reports, see notes 55-56 *supra*.

⁵⁷ Mobil's failure to prove multiple taxation in fact, however, clearly weakened its case. See note 46 *supra*.

⁵⁸ Most recent cases require proof of actual multiple taxation. See, e.g., *Moorman Mfg. Co. v. Bair*, 437 U.S. 267, 276 (1978); *Department of Rev. v. Association of Wash. Stevedoring Cos.*, 435 U.S. 734, 746-47 (1978); *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274, 278 (1977); *Northwestern States Portland Cement Co. v. Minnesota*, 358 U.S. 450, 462-63 (1959). *But see* *Japan Line Ltd. v. County of Los Angeles*, 441 U.S. 434, 451 (1979) (proof of substantial risk sufficient) (dictum); *Standard Pressed Steel Co. v. Department of Rev.*, 419 U.S. 560, 563 (1975) (same); *General Motors Corp. v. Washington*, 377 U.S. 436, 439 (1964) (same).

⁵⁹ The Court's resolution of the burden of proof issue (see notes 57-58 and accompanying text *supra*) precluded it from reaching this issue.

⁶⁰ Cf. *Standard Oil Co. v. Peck*, 342 U.S. 382, 384-85 (1952) ("The rule which permits taxation by two or more states on an apportionment basis precludes taxation of all the property by the state of the domicile Otherwise there would be multiple taxation of interstate operations. . . .").

⁶¹ Nineteen states are members of the Multistate Tax Compact. Fourteen others are associate members. ALL STATES TAX GUIDE (P-H) ¶ 564 (1978).

⁶² UNIFORM DIVISION OF INCOME FOR TAX PURPOSES ACT § 7. The Act divides corporate income into business income and nonbusiness income, and allocates certain classes of non-business income, among them dividends, to the commercial domicile. "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." Dexter, *supra* note 3, at 411. The Multistate Tax Commission disfavored the business income/nonbusiness income distinction and adopted regulations that look to the relationship of the intangible investments to the taxpayer's overall business activities. MULTISTATE TAX COMM'N., SEVENTH ANNUAL REPORT, app. J, at 64-68 (1974). Professors Keesling and Warren accept this view. Keesling & Warren, *supra* note 13, at 42. See also Sabine, *supra* note 3, at 32.

mercial domicile to tax dividends in full.⁶³ After *Mobil*, these states may not tax fully the dividends of their corporate domiciliaries if these businesses are subject to taxation by a state not associated with the compact. Consequently, the vitality of the compact is threatened unless all states agree to tax dividends only of domiciliary corporations.

C. *Judicial Review of State Taxation of Foreign-Source Income*

The *Mobil* Court accorded considerably more deference to a state's taxation of foreign commerce than it had just one term earlier in *Japan Line Ltd. v. County of Los Angeles*.⁶⁴ In *Japan Line*, the Court held unconstitutional a state apportioned ad valorem property tax on foreign-owned cargo containers involved in international commerce. The *Japan Line* Court concluded that domestic taxation of foreign commerce required a "more extensive constitutional inquiry"⁶⁵ than domestic taxation of interstate commerce. The Court acknowledged that it could not insure "full apportionment when one of the taxing entities is a foreign sovereign,"⁶⁶ and feared that state taxation "on the instrumentalities of foreign commerce may impair federal uniformity in an area where federal uniformity is essential."⁶⁷ Although *Japan Line* involved tangible property actually subject to double taxation, whereas *Mobil* did not, these differences do not warrant different

A contrary view is that states should treat income from intangibles like any other corporate income.

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?

Dexter, *supra* note 3, at 415. The Vermont Supreme Court adopted this view in *Mobil. Mobile Oil Corp. v. Commissioner of Taxes*, 136 Vt. 545, 552, 394 A.2d 1147, 1151 (1978).

⁶³ Alabama, Alaska, Arkansas, California, Colorado, Hawaii, Idaho, Kansas, Kentucky, Maine, Michigan, Missouri, Montana, Nebraska, Nevada, New Mexico, North Dakota, Oregon, South Carolina, South Dakota, Texas, Utah, and Washington all adopted the uniform act. See 7A UNIFORM LAWS ANNOTATED 7 (West Supp. 1981). See, e.g., CAL. REV. TAX CODE § 25126 (West 1979); MICH. COMP. LAWS ANN. § 205.581 art. iv(7) (Supp. 1980); MO. REV. STAT. § 32.200 art. iv(7) (1978); TEX. REV. CIV. STAT. ANN. art. 7359(a) § 1, art. iv(7) (Vernon Supp. 1980).

⁶⁴ 441 U.S. 434 (1979).

⁶⁵ *Id.* at 446.

⁶⁶ *Id.* at 447. See generally *id.* at 446-48.

⁶⁷ *Id.* at 448.

standards of scrutiny. It is difficult to see how the Court's inability to control a foreign sovereign's taxing scheme and the interest in federal uniformity are any greater in a real property case than in a case involving taxation of income derived from intangible property. Nevertheless, the *Mobil* Court apparently perceived a distinction, for in deferring to Vermont's taxing scheme, the Court assumed that it could control multiple taxation on the international level⁶⁸ and dismissed the presence of a federal interest in uniformity.⁶⁹

CONCLUSION

In *Mobil Oil Corp. v. Commissioner of Taxes*, the Supreme Court correctly held that a state may constitutionally tax foreign-source dividend income of a unitary business operating within that state. By expanding the non-domiciliary state's taxing power, however, the Court implicitly denied domiciliary states the power to tax dividend income in full. The decision appears to reverse a recent trend towards strictly scrutinizing domestic taxation of foreign commerce, and to posit a new standard for challenging the constitutionality of a state taxation scheme.

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⁶⁸ 445 U.S. at 447.

⁶⁹ *Id.* at 449. *See id.* at 448-49.