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Federal Tax Concepts as a Guide for State Apportionment of Dividends

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FEDERAL TAX CONCEPTS AS A GUIDE FOR STATE APPORTIONMENT OF DIVIDENDS LIFE AFTER ASARCO.

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In this article, Pomp and Rudnick examine the recent Supreme Court decision in ASARCO, Inc. v. Idaho State Tax Commission, 102 S.Ct. 3103 (1982). They point out that apportionment questions similar to those presented in ASARCO are likely to arise again in the future. They also suggest that two federal tax doctrines--the "effectively connected" concept and the Corn Products doctrine--offer helpful guidelines for resolving dividend apportionment questions.

Introduction

In its recent decision in ASARCO, Inc. v. Idaho State Tax Commission, [1] the Supreme Court limited the apportionability of dividends, interest, and capital gains. The Court rejected Idaho's interpretation of its statutory definition of business income. Applying the principles enunciated in Mobil Oil Corp. v. Commissioner of Taxes of Vermont, [2] the Court held that a unitary business relationship did not exist between ASARCO and the dividend payors. Consequently, Idaho's taxation of ASARCO's dividends, interest, and capital gains violated the Due Process Clause.

Although hailed as a pro-taxpayer decision, ASARCO may actually increase the tax liabilities of some corporations. In states that have adopted the Uniform Division of Income for Tax Purposes Act (UDITPA), dividends are apportionable if they constitute business income; otherwise, they are allocable in full to the taxpayer's state of commercial domicile. A multijurisdictional corporation, commercially domiciled in a UDITPA state, or in a state having similar rules, usually achieves a tax savings if its dividends are treated as apportionable business income rather than as allocable nonbusiness income. [3] Because ASARCO limits the circumstances under which dividends are apportionable, the tax liabilities of these corporations may increase.

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The Court may yet find itself struggling with the taxation of dividends in the future. Although the Court viewed Mobil as dispositive of the issues in ASARCO, Mobil cannot serve as the exclusive test for the apportionability of dividends. Accordingly, our concern in this comment is not with the specific result in ASARCO that Idaho could not tax the contested income, but rather with the applicability of two federal tax doctrines that may provide an additional perspective into state taxation of dividends. The "effectively connected" and the Corn Products doctrines, drawn from different areas of federal taxation, offer some guidance and insight into the characterization of dividends as business income.

Facts in ASARCO

ASARCO, a New Jersey corporation commercially domiciled in New York, mines, smelts, and refines nonferrous metals in various states. In Idaho, ASARCO operates a silver mine, mines and sells other metals, and operates the administrative office of its northwest mining division. ASARCO received three types of intangible income that Idaho sought to tax. First, it received dividends from five corporations in which it owned major interests: M.I.M. Holdings, Ltd.; [4] General Cable Corp.; Revere Copper and Brass, Inc.; [5] ASARCO Mexicana, S.A.; [6] and Southern Peru Copper Corp. [7] Second, it received interest from convertible debentures of Revere, from a note received in connection with a prior sale of stock in Mexicana, and from a note attributable to its sale of General Cable stock. Third, it received capital gains from the sale of stock in M.I.M. and General Cable. [8]

Idaho adopted a version of UDITPA, which classifies corporate income from intangible property as either business or nonbusiness income. Business income means "income arising from transactions and activity in the regular course of the taxpayers' trade or business and includes income from the acquisition, management, or disposition of tangible and intangible property when such acquisition, management, or disposition constitute integral or necessary parts of the taxpayers' trade or business operations." [9] Nonbusiness income means "all income other than business income." [10] "Gains or losses and dividend and interest income from stock and securities ...shall be presumed to be income from intangible property, the acquisition, management, or disposition of which constitute an integral part of taxpayer's trade or business; [such] presumption may only be overcome by clear and convincing evidence to the contrary." [11]

The Idaho Tax Commission characterized ASARCO's dividends, interest, and capital gains as apportionable business income. The Commission's position was that all corporate investments could be regarded as assets that were integral or necessary parts of the taxpayer's trade or business, on the theory that all investments and investment income may benefit a corporation's business by supplying additional operating revenue and by improving its standing and financial posture. [12]

ASARCO appealed the Commission's findings and a state district court held in its favor. The district court was overruled by the Idaho Supreme Court, which disapproved of the Commission's position because it would treat nearly all income as business income. The court interpreted the phrase integral or necessary parts of the taxpayer's trade or business as "property which, though not absolutely essential to the conduct of the taxpayer's business, contributes to and is identifiable with the taxpayer's trade or business operations...," [13] and concluded that ASARCO had not rebutted the statutory presumption that its dividends, capital gains, and interest were business income. The court also held that Idaho's "statutory requirement that the acquisition, management or disposition of the underlying asset must be an integral or necessary part of the taxpayer's unitary business, a part of which is conducted in this state," satisfies due process requirements.

While the Idaho Supreme Court's decision was on appeal to the U.S. Supreme Court, Mobil was decided, holding that Vermont could apportion dividends received from the taxpayer's foreign subsidiaries and affiliates. The Court vacated the decision in ASARCO and remanded the case for further consideration in light of Mobil. [14] After **[P. 413]** reargument, the Idaho Supreme Court reinstated its original opinion. [15]

ASARCO's argument in the U.S. Supreme Court was based upon its interpretation of Mobil. ASARCO argued that its dividends could be taxed only if the business activities of the dividend-paying corporations were "so closely related, in a functional sense, to the [Idaho] activities of the recipient that all of those activities constitute a single 'unitary business.'" [16] ASARCO characterized its ownership of the dividend payors as a long-term investment in separately operated, independently managed, free-standing concerns whose profits had nothing to do with ASARCO's activities and whose dividends could therefore not be taxed by Idaho. [17]

Idaho contended that ASARCO's functional integration standard misstated the proper due process test. It argued that it could constitutionally tax the income from intangibles if the intangible assets were part of a unitary business partly conducted within Idaho. Intangibles were part of a unitary business if they were "acquired, managed, or disposed of for purposes relating or contributing to the taxpayer's business." [18] Idaho urged that this integration between the business use of the intangible asset (the shares of stock) and ASARCO's mining, smelting, and refining business made the income part of the unitary business and satisfied the "minimal connection" requirement of due process.

The Opinion

In rejecting Idaho's argument, the Court repeated the due process limitations on a state's assertion of tax jurisdiction that were set forth in Mobil. Idaho may assert tax jurisdiction if there is "a 'minimal connection' between the interstate activities and the taxing state, and a rational relationship between the income attributed to the state and the intrastate values of the enterprise." [19] Relying heavily upon Mobil, the Court stated that these due process limitations would be satisfied if a state apportioned and taxed income derived from activities in a different state so long as the intrastate and extra-state activities formed part of a single unitary business. The Court quoted its now de rigueur statement in Mobil that "the linchpin of apportionability in the field of state income taxation is the unitary-business principle." [20] The Court found that the five dividend-paying corporations were "'discrete business enterprises' that--in 'any business or economic sense'--have 'nothing to do with the activities' of ASARCO in Idaho." [21] Because the "'business activities of the dividend payor have nothing to do with the activities of the recipient in the taxing state..., '" [22] due process standards prohibited Idaho from taxing this income. [23]

The dissent stated three independent reasons in support of Idaho's taxation of ASARCO's dividends. First, the dissent argued that ASARCO's holdings in the five dividend payors were not passive investments but actively contributed to its nonferrous metals business. [24] Second, even assuming that ASARCO's holdings were passive, its "investment decisionmaking was part of an individual, unitary nonferrous metals business." [25] Third, ASARCO "failed to show that its holdings were divorced from its management of the financial requirements of its nonferrous metals business." [26] The dissent saw no distinction between income received from the short- term investment of working capital, which ASARCO conceded Idaho could tax, and the income received from its long-term investments in the dividend payors.

Commentary

Idaho's Broad Interpretation of Business Income

In its brief and during oral argument, Idaho stated the statutory definition of business income as whether the intangibles were "acquired, managed or disposed of for purposes relating or contributing to ASARCO's business."

[27] During oral argument, the Court expressed its concern over whether any logical limits existed on this broad interpretation of the statute, [28] a concern that was later reflected in its opinion:

The business of a corporation requires that it earn money to continue operations and to provide a return on its invested capital. Consequently, all of its operations, including any investment made, in some sense can be said to be 'for purposes related to or contributing to the [corporation's] business.' When pressed to its logical limit, this conception of the 'unitary business' limitation becomes no limitation at all. [29]

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The Court's concern extended to Idaho's application of the statute to ASARCO. [30]

The Court was clearly worried about eliminating any line between business and nonbusiness income and the "purposes relating to or contributing to" test was hardly reassuring. [31] Moreover, some of the cases cited by Idaho in support of its position could have only reinforced the Court's fears. Idaho cited Flint v. Stone Tracy Co., [32] a case upholding a federal excise tax levied on corporate income:

Nor can it be justly said that investments have no real relationship to the business transacted by a corporation. The possession of large assets is a business advantage of great value; it may give credit which will result in more economical business methods, it may give a standing which shall facilitate purchases, it may enable the corporation to enlarge the field of its activities and in many ways give it business standing and prestige. [33]

In the same vein, Idaho referred the Court to Ford Motor Co. v. Beauchamp /34/:

In a unitary enterprise, property outside of the state necessarily affects the worth of the privilege within the state. Financial power inherent in possession of assets may be applied, with flexibility, at whatever point within or without the state the managers of the business may determine. [35]

Carried to their logical conclusions, both cases would virtually eliminate the distinction between business and nonbusiness income.

The Application of Mobil

Idaho's broad interpretation of its statutory definition invited judicial rejection. [36] Unless Mobil is intended to be **[P. 415]** the only constitutional test for the apportionability of dividends, [37] ASARCO should not be read as affecting the apportionability of dividends received under other circumstances. Eventually, the Supreme Court will confront other situations involving the apportionability of dividends and Mobil, with its emphasis on the relationship between the business activities of the payor and those of the payee, cannot serve as the exclusive test. In these situations, a more narrow interpretation or formulation of Idaho's and similar definitions of business income might be acceptable to the Court in the future.

Limitations of the Mobil Test. A simple example can illustrate why Mobil cannot serve as the exclusive test for the apportionability of dividends. Consider a corporation engaged solely in the business of buying and selling securities that conducts its activities partially in the taxing state. Any dividends received by this corporation would be part of its operating or business income and properly apportionable by the taxing state, yet the business activities of the dividend payors might, as stated in Mobil, "have nothing to do with the activities of the recipient in the taxing State." While the straightforward conclusion to be drawn from this example is that the activities of the payors are irrelevant because dividends constitute business income in the case of a corporation buying and selling securities, that simply assumes away a determination of why it is business income.

As the taxpayer in ASARCO recognized, situations exist in which it is appropriate "to focus only on the taxpayer's own activities, without regard to the underlying activities of the company paying the dividends." [38] These situations include those in which dividends are received by a taxpayer in the business of buying and selling stocks, from the short-term investment of working capital, or from stock posted by a contractor "in order to bid and perform on jobs." [39] ASARCO characterized the ownership of stock in these situations as an "adjunct to the actual conduct of the taxpayer's own business, and in that type of situation ...the proper application of Mobil is to look at the functional relationship between the ownership of those securities and the conduct of the taxpayer's business, but nothing of that sort is involved here." [40]

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Analyzing Functional Relationships. An examination of the functional relationship between the income-generating activities--the ownership of securities in ASARCO--and the conduct of the taxpayer's business would always seem to be required for due process considerations, regardless of whether the income involved is dividends. For example, in Mobil the Court started with the premise that operating income of a multijurisdictional unitary business was properly apportionable and then asked the taxpayer to demonstrate why its dividends were distinguishable. The Court never asked why operating income is properly apportionable in the first place: because operating income is the quintessence of apportionable income, its nexus with the taxing state is rarely articulated. After all, "everybody knows" that the operating income of a unitary business can be apportioned. [41] The reason due process requirements are satisfied, however, has nothing necessarily to do with the activities of the payors of the income. It is the relationship between the income-generating activities and the taxpayer's own unitary business, part of which is conducted in the taxing state, which satisfies due process requirements. In examining this relationship, the activities of the payors may or may not be relevant.

The examination of this relationship should not be affected by the label placed on a category of income. Labels such as "business income," "intangible income," "dividends," "operating income," or "capital gains" might be convenient as a shorthand, but they cannot substitute for analyzing the relationship between the income-generating activities of the taxpayer and the conduct of its unitary business. For example, consider four corporations, one of which conducts part of its unitary business in Idaho. Assume that they all require a certain raw material as part of their production processes. Solely for the purpose of securing a reliable source of supply, each corporation agrees to buy 25 percent of the stock in a corporation that produces the raw material. Under the agreement, each shareholder purchases 25 percent of the output of the supplier. In deciding how to price these transactions, the shareholders can purchase the raw materials either at cost or at an arm's length price. They decide to purchase the raw materials at an arm's length price and at the end of the year the profits of the supplier are distributed equally to the shareholders as a dividend. The distribution of profits in this case actually represents a rebate on the purchase price of the raw materials. If this rebate had been granted initially through a lower purchase price, the taxpayer's cost of goods sold would have been lower, its business income would have been higher, and Idaho would have taxed an apportioned share of this increase. The result should not be different because the rebate was paid in the form of a dividend. [42]

Federal Tax Analogies: the Effectively Connected and Corn Products Doctrines

The Effectively Connected Doctrine. The issues raised by state taxation of dividends have parallels in federal taxation. Two federal tax doctrines, while not explicitly addressing the characterization of dividends as business income, deal with the same underlying issue. The first is the so-called "effectively connected" doctrine, applicable in the federal taxation of foreign corporations engaged in a United States trade or business. The effectively connected doctrine is European in origin and is contained in the 1963 OECD model tax treaty. The first U.S. adoption of the concept was in a 1965 protocol to the U.S.-Germany tax treaty. [43] The concept was added to the Internal Revenue Code in 1966 and has been incorporated into subsequent tax treaties.

A foreign corporation's income that is "effectively connected" with a U.S. trade or business is taxed at the regular corporate tax rates whereas its other income from U.S. sources is taxed at a 30 percent rate (or a lower rate if provided under an applicable tax treaty). In general, the effectively connected doctrine is used to distinguish between the active, operational, or business income of the corporation, including related "investment" income, and its "passive" income which, although sourced within the **[P. 417]** United States, is not attributable for tax purposes to its U.S. trade or business. [44]

Under the Code, dividends, interest, capital gains, royalties, rents, and so forth are taxed as business income if they are "effectively connected with the conduct of a trade or business within the United States." [45] An elaborate framework exists under the Internal Revenue Code and Treasury Department regulations for determining when such income is effectively connected. The Code generally applies two tests: an asset-use test and a business-activities test. Under the asset-use test, the question is whether the income, gain, or loss is "derived from assets used in, or held for use in, the conduct" of the U.S. trade or business. [46] Ordinarily, an asset is treated as used in, or held for use in, the conduct of a U.S. trade or business if it is (1) held for the principal purpose of promoting the present conduct of the U.S. trade or business, for example, stock acquired and held to assure a constant source of supply; [47] (2) acquired and held in the ordinary course of the U.S. trade or business, for example, a trade account receivable; or (3) otherwise held in a direct relationship to the U.S. trade or business. [48] In determining whether an asset is held in a direct relationship, [49] principal consideration is given to whether the asset is held to meet the present needs of the business, such as operating expenses. [50]

An asset held for anticipated future needs of the business does not satisfy the "direct relationship" requirement. These situations include an asset held for the purpose of providing for (1) future diversification into a new trade or business; (2) future plant replacement, or (3) future business contingencies. [51]

Under the business-activities test, the question is whether "the activities" of the U.S. trade or business "were a material factor in the realization of the income, gain, or loss." [52] The business- activities test is satisfied, for example, where dividends are derived by a dealer in stocks or securities. [53] Activities relating to the management of investment portfolios are not treated as activities of the U.S. trade or business unless the maintenance of the investments constitutes the principal activity of that trade or business. [54]

The effectively connected doctrine is directed at the relationship between the underlying assets or activities generating the income and the activities of the taxpayer's U.S. trade or business. Conceptually, the effectively connected test deals with an issue similar to that involved in state taxation: When do income- generating assets or activities have so close a relationship to the conduct of a business that the income should be taxed as business income? Indeed, the effectively connected legislation was originally drafted in terms of "business" and "nonbusiness" income. The business/nonbusiness language was later replaced with the effectively connected language after the protocol to the U.S.-Germany tax treaty was signed, presumably to conform with European usage. [55]

Examples of the Effectively Connected Doctrine. A few examples based on the regulations illustrate the underlying similarity between the federal approach and Idaho's statutory definition of business income. Consider a foreign corporation that manufactures abroad and distributes its merchandise in the United States through an Idaho **[P. 418]** branch. [56] The branch is required to hold a large current cash balance for business purposes, but the amount needed varies because of seasonal fluctuations. During the current taxable year when large cash balances are not required, the branch invests its cash surplus in stocks and receives dividends.

Federally, the taxation of the dividends as business income turns on whether the asset generating the dividends --the stock--was used in or held for use in the conduct of the branch's business. From Idaho's perspective, the question turns on whether the acquisition of the stock was an integral or necessary part of the taxpayer's trade or business. While the phrasing of the statutory tests are different, the fundamental inquiry into the relationship between the asset and the taxpayer's business is the same and, in this case, the resulting determination is also the same: the United States, Idaho (and ASARCO) would treat these dividends as business income. [57]

Suppose, however, that instead of investing its short-term working capital, the foreign corporation bought stock with funds from its general surplus reserves. If the funds were not necessary to provide for the present needs of its U.S. trade or business, the dividends would not be effectively connected with the conduct of the business. [58] The regulations thus draw a line between income received from the short-term investment of working capital and other income, a distinction that has also been drawn in the context of state taxation. [59]

The references in the regulations to stock acquired and held to assure a constant source of supply, the distinction drawn between the short-term investment of working capital and the investment of general surplus funds, and the treatment of the management of investment portfolios all deal with issues raised in ASARCO. [60] The relevance of the effectively connected doctrine is further underscored when the regulations are read replacing the references to the taxpayer's "U.S. trade or business" with, for example, the taxpayer's "Idaho trade or business."

The Corn Products Doctrine. The second of the two federal doctrines is known as the Corn Products doctrine. [61] This doctrine is used to determine when gain or loss arising from the sale of a capital asset is treated as ordinary rather than as capital gain or loss. Usually the sale of a capital asset generates capital gain or loss. Some capital assets, however, are so "essential to and an integral part of" [62] the taxpayer's business (language strikingly similar to Idaho's statutory definition of business income) that any gains or losses generated by their sale are treated as arising from the everyday operation of the business and produce ordinary income or loss. Typical Corn Products situations include gains or losses attributable to the sale of a performance or security bond, [63] to hedging transactions related to a business's production or supply needs, [64] to the sale of stock purchased to protect a commission, [65] and to the sale of stock purchased to obtain a source of supply. [66]

The relevance of the Corn Products doctrine was acknowledged by ASARCO during its oral argument. In response to a question from the Court, counsel for ASARCO replied that if the stock "investment was made purely and simply for the purposes of obtaining needed supplies or providing a customer outlook [sic], if that were the only purpose of the investment, I think it might be relevant [in determining whether the dividends were part of the unitary business]. It might be one of the cases that you were suggesting earlier where ownership of the stock was so integrally involved in the taxpayer's own business activities that it would be a part of the unitary business." [67] ASARCO referred the Court to W.W. Windle Co. v. Commissioner, [68] a Corn Products case holding that stock purchased with a substantial investment purpose is a capital asset, even if there is a more substantial business motive for the purchase. Since ASARCO asserted that the stock in its dividend payors was purchased as a long-term **[P. 419]** investment, Windle would treat such stock as a capital asset even if substantial business motives also existed. [69] Characterization of the stock as an investment asset suggests that the dividends are not business income.

Examples of the Corn Products Doctine. As Windle illustrates, gain or loss attributable to the sale of stock in a supplier is not necessarily treated as ordinary income or loss under Corn Products. In cases where the stock in a supplier was purchased initially only for business purposes, continued ownership of the stock after the source of supply became unnecessary may indicate a subsequent investment motive that converted the stock into an investment asset. [70] If the stock was purchased initially for business and investment purposes, a substantial investment motive will characterize the stock as an investment asset even if at the time of sale the investment motive had been abandoned. [71] Lack of any investment motive at the time of purchase and sale results in ordinary gain or loss. [72]

The Corn Products doctrine is directed at answering a question similar to that asked by the effectively connected doctrine: When should an asset be treated as having a sufficiently close relationship to the conduct of a business that income arising from its sale should be taxed as business income? [73] The treatment of stock purchased in a corporation solely to obtain a source of supply illustrates one area where the doctrines overlap. Capital gains attributable to the sale of such stock is treated as ordinary income under the Corn Products doctrine and also as "effectively connected" income. In both cases, the result is the same: the income is taxed as business income.

Conclusion

Our purpose in discussing the Corn Products and the effectively connected doctrines is not to argue that they are coterminous with the due process standards that apply for purposes of state taxation or to suggest that, on the record, the result in ASARCO should have been different. Our purpose is to show that the treatment of dividends, capital gains, and so forth as business income is not unique to state taxation. Similar issues are addressed by the Corn Products doctrine, which has been widely discussed and analyzed, and by the effectively connected doctrine, which is embodied in a detailed statutory and regulatory framework replete with examples. A considerable body of learning is therefore available to provide criteria and analogies that should be helpful in formulating a definition of business income for state purposes.

Admittedly, the Corn Products and the effectively connected doctrines do not provide "bright line" tests. The Court would no doubt prefer a bright line test that would clearly demarcate the taxing boundaries of the states. The Court is aware that commentators have argued that the distinction between business and nonbusiness income should be eliminated and that all of a corporation's taxable income should be apportionable. While this argument has some logical appeal, especially if directed at the Congress, it violates the Court's view of the Due Process Clause and may have encouraged the Court to formulate basic ground rules.

In searching for a meaningful line to draw, the Court had a readily available alternative in Mobil. It is unlikely, however, that Mobil will provide much clarity or certainty. However phrased, Mobil, as applied in ASARCO , requires the existence of a unitary business relationship between the dividend payors and payee. The determination of a unitary business relationship, often an elusive matter, has taken on new dimensions after ASARCO and Woolworth. The emphasis in these cases on actual control rather than potential control as one of the relevant factors creates further uncertainty. Because of the subtle ways in which control can be exercised, the opportunities for tax planning, as well as litigation, are obvious.

Inevitably, the Court will still have to refine the rules governing the apportionability of dividends, interest, and capital gains. Mobil cannot be the exclusive test, as the situations involving the securities dealer, the investment of short-term working capital, and so forth suggest. The Court will eventually be forced to distinguish between those situations in which the proper focus is on the activities of the payor and those in which the proper focus is on the relationship of the income-generating assets to the activities of the payee. Whether these situations will ultimately be viewed as a question involving the definition of business income, or, in ASARCO's terms, as a question of what is an "adjunct to the taxpayer's business," the basic issue is the same. Line drawing problems will remain, and perhaps more certainty cannot be expected in the area of state taxation than exists in other areas of taxation.

FOOTNOTES

[1] 102 S. Ct. 3103 (1982). In a companion case, the Court held that New Mexico could not tax dividends received by Woolworth from its foreign subsidiaries. F.W. Woolworth Co. Inc. v. Taxation & Revenue Dep't of New Mexico, 102 S. Ct. 3128 (1982). A petition for rehearing filed by the appellees in both ASARCO and Woolworth has been denied. ASARCO, Inc. v. Idaho State Tax Comm'n, No. 80-2015 (U.S. Oct. 18, 1982) (order denying petition for rehearing); F.W. Woolworth, Co. Inc. v. Taxation & Revenue Dep't of New Mexico, No. 80-1745 (U.S. Oct. 18, 1982) (order denying petition for rehearing).

[2] 445 U.S. 425 (1980). Mobil is discussed in Lathrop, Due Process Considerations and the Apportionment of Dividend Income: A Dissent From the ASARCO and Woolworth Decisions, 16 Tax Notes 3 (July 5, 1982). For other articles, see id. 6 n.26. For a general discussion of business income, see Dexter, Business versus Nonbusiness Distinction Under the Uniform Division of Income for Tax Purposes Act, 10 Urban Law. 243 (1978); Peters, The Distinction Between Business and Nonbusiness Income, 25 U.S.C. Tax Inst. 251 (1973).

[3] If the dividends are business income, only a portion will be taxable by the state of commercial domicile; that portion will depend on the corporation's apportionment factor. If the dividends are nonbusiness income, they will be allocable in full to the state of commercial domicile. If the state of commercial domicile taxes dividends, the corporation's taxes will be lower if its dividends are apportioned rather than allocated. Presumably, these tax savings motivated Standard Oil of California, commercially domiciled in California, to file an amicus brief in Mobil opposing the principle that dividends could only be specifically allocated and not apportioned. See Lathrop, supra

note 2, at 6-7; see also Appeal of Occidental Petroleum Corp., slip op. (Calif. Bd. of Equalization, Mar. 31, 1982) (taxpayer, commercially domiciled in California, characterized its capital gains and losses as apportionable business income rather than as allocable nonbusiness income) (petition for rehearing pending). Mobil, however, has raised doubts regarding the constitutionality of specifically allocating all of a corporation's dividends to the state of commercial domicile. See 445 U.S. at 445- 46.

[4] M.I.M. mines, mills, smelts, and refines copper, lead, zinc, and silver in Australia, and refines lead and zinc in England; one percent of its output was sold to ASARCO, which owned 52 percent of its stock. 102 S. Ct. at 3112-13.

[5] ASARCO owned approximately 34 percent of General Cable and 34 percent of Revere, both of which fabricate metal products. The Idaho Supreme Court described General Cable and Revere as major customers of ASARCO, American Smelting & Mining Co. v. Idaho State Tax Comm'n, 99 Idaho 924, 929, 592 P.2d 39, 44 (1979), although the majority did not adopt this characterization, see 102 S. Ct. at 3113; but see 102 S. Ct. at 3123 n.10 (O'Connor, J., dissenting).

[6] Mexicana mines and smelts lead and copper in Mexico. ASARCO owned 49 percent of Mexicana and acted as its contract sales agent in the United States. 102 S. Ct. at 3113.

[7] ASARCO owned 51.5 percent of Southern Peru, which produces smelted but unrefined blister copper in Peru. Approximately 35 percent of Southern Peru's output was sold to ASARCO. 102 S. Ct. at 3111-12. ASARCO provided certain services to Southern Peru. See id. at 3112 n.17.

[8] ASARCO and Idaho agreed that the interest and capital gains should be taxed in the same manner as the dividends. Consequently, the Court's analysis concentrated on the taxation of the dividends. 102 S. Ct. at 3116.

[9] Idaho Code Section 63-3027(a)(1) (Supp. 1981); UDITPA Section 1(a), 7A Uniform Laws Annotated 93 (1978). The words "or necessary" in the Idaho definition are not contained in UDITPA's definition.

[10] Idaho Code Section 63-3027(a)(4) (Supp. 1981); UDITPA Section 1(a), 7A Uniform Laws Annotated 93 (1978).

[11] Idaho Code Section 63-3027(a)(1) (Supp. 1981); this presumption is not contained in UDITPA.

[12] American Smelting & Refining Co. v. Idaho State Tax Comm'n, 99 Idaho at 932, 592 P.2d at 47.

[13] Id.

[14] ASARCO, Inc. v. Idaho State Tax Comm'n, 445 U.S. 939 (1980).

[15] American Smelting & Mining Co. v. Idaho State Tax Comm'n, 102 Idaho 38, 624 P.2d 946 (1981).

[16] Brief for Appellant at 8.

[17] Id. ASARCO also argued that if its dividends were taxable by Idaho, the apportionment formula must be adjusted to reflect the out-of-state property, payroll, and sales of the payors.

[18] Brief for Appellee at 4. See also Tr. of Oral Arg. at 25.

[19] 102 S.Ct. at 3109 (quoting Mobil, 445 U.S. at 436-37).

[20] Id. at 3109 (quoting Mobil, 445 U.S. at 439-40).

[21] Id. at 3115 (quoting Mobil, 445 U.S. at 439-42).

[22] Id. at 3115 (quoting Mobil, 445 U.S. at 442).

[23] State courts have applied similar reasoning. See, e.g., Square D Co. v. Kentucky Bd. of Tax Appeals, 415 S.W.2d 594, 599-602 (Ky. App. 1967).

[24] 102 S.Ct. at 3121.

[25] Id. at 3120.

[26] Id.

[27] Brief for Appellee at 4 (emphasis added); Tr. of Oral Arg. at 25.

[28] Tr. of Oral Arg. at 25-29, 33-34, 37-38.

[29] 102 S. Ct. at 3114 (emphasis in original). These same concerns were expressed in Woolworth. See 102 S.Ct. at 3134-35.

The Court stated that Idaho " urges that we expand the concept of a 'unitary business' to cover the facts of this case." 102 S.Ct. at 3114. The Court apparently viewed Idaho as agreeing with the proposition that a unitary business relationship between ASARCO and the dividend-paying subsidiaries was a necessary prerequisite to its taxation of the dividends. See 102 S.Ct. at 3114. Idaho, however, was not challenging the definition of a unitary business, but only the relationship between the management, disposition, and ownership of its stock and the conduct of its unitary business. Idaho characterized ASARCO's unitary business as the mining, smelting, and refining business, part of which was conducted in Idaho, and never argued that the subsidiaries were part of this unitary business. See Brief for Appellee at 2-5, 8-9, 29; Tr. of Oral Arg. at 31-36.

[30] 102 S.Ct. at 3114-15 & n.22. The Court was concerned with the apparent inconsistencies in Idaho's (1) "unitizing" six of ASARCO's other subsidiaries and requiring them to file a combined report--an issue not before the Court; (2) not unitizing a wholly owned Canadian subsidiary engaged in the asbestos business, which the Court described as appearing "in many respects to be more likely to qualify as part of ASARCO's unitary business than does any of the five corporations involved in this case...," id. at 3114 n.22; (3) taxing the dividends at issue; and (4) not taxing the dividends received from Kennecott Copper and Phelps-Dodge, corporations in which ASARCO owned a very small percentage of the stock, see American Smelting & Mining Co. v. Idaho State Tax Comm'n, 99 Idaho at 929, 592 P.2d at 44. The Court did not perceive any difference between ASARCO's purpose in acquiring the Kennecott Copper and Phelps-Dodge stock and its purpose in acquiring the stock in those corporations whose dividends were taxed. See 102 S. Ct. at 3114-15 n.22.

The allowance of combined reporting in Idaho highlights a difference between ASARCO and Mobil. Vermont does not allow combined reporting; taxing the dividends received from corporations not doing business in Vermont is the only way for the state to reach these out- of-state activities. In Idaho, however, these out-of-state activities can be reached through a combined report, which was required in the case of six subsidiaries of ASARCO. The Court may have viewed Idaho's attempt to tax ASARCO's dividends from five other corporations as an end-run around its inability to unitize three of these five dividend payors. Idaho requires more than 50 percent ownership before corporations can be unitized. Idaho Code Section 63-3027(s) (Supp. 1981). Of the five dividend payors, ASARCO's ownership exceeded 50 percent in the cases of Southern Peru and M.I.M.

The Idaho Supreme Court did not view Idaho's treatment of ASARCO as inconsistent:

Simply because the management, operation and activity of a corporation in which the taxpayer owns stock is not so closely connected with the management, operation, and activities of the taxpayer to warrant a combined tax return, does not ipso facto mean that the dividends the taxpayer received from that stock cannot be 'income arising from transactions and activity in the regular course of the taxpayer's trade or business' and that the 'acquisition, management or disposition' of the stock does not 'constitute integral or necessary parts of the taxpayers' trade or business operation. [Citation omitted.] The combined reporting provision and the business income definition serve different purposes, ask different questions, and apply different standards. The answer to one does not necessarily imply the same answer to the other.

American Smelting & Refining Co. v. Idaho State Tax Comm'n, 99 Idaho at 935, 592 P.2d at 50. The difference in result between (1) unitizing the payor and payees and requiring a combined report, and (2) not unitizing them but taxing the payee's dividends, cannot be evaluated without determining, in the second situation, whether the factors of the payors should be taken into account, and if so, to what extent. This issue, which was one of the questions on appeal, was never reached in ASARCO because the Court held that the dividends could not be taxed. In Mobil, the Court avoided this issue on the grounds that "[i]n keeping with its litigation strategy, appellant has disclaimed any dispute with the accuracy or fairness of Vermont's apportionment formula." 445 U.S. at 434.

[31] The Idaho Supreme Court was also concerned about eliminating the distinction between business and nonbusiness income but thought that its interpretation distinguished between incidental benefits from investments in general, such as enhanced credit standing, and income incidental to and connected with the taxpayer's business. 99 Idaho at 932-33, 592 P.2d at 47-48.

[32] 220 U.S. 107 (1911), cited in Brief for Appellee at 13.

[33] 220 U.S. at 166. Cf. Cleveland-Cliffs Iron Co. v. Michigan Corp. & Securities Comm'n, 351 Mich. 652, 679, 88 N.W.2d 564, 572 (1958) (income from investment portfolio of steel stocks owned by company that operated a multifaceted iron business held apportionable).

[34] 308 U.S. 331 (1939), cited in Brief for Appellee at xxx.

[35] 308 U.S. at 336.

[36] Idaho's broad interpretation may have been compelled by the poorly developed record in ASARCO. The state of the record probably reflected the Tax Commission's litigating posture that all investment assets and investment income benefit a corporation's business by supplying additional operating revenue and by improving its financial standing. This proposition does not require an overly detailed record for support. For example, ASARCO's purpose in acquiring its M.I.M. stock was not in the record, a fact that the Court noted during oral argument. See Tr. of Oral Arg. at 11. In addition, the record was not developed in view of Mobil, which was decided after the trial in ASARCO.

In Mobil, part of Vermont's argument was based on the relationship between the ownership and income from Mobil's stock and its Vermont business activities. The argument was stated very broadly:

Mobil has not disassociated such income from use to finance
daily operations in Vermont, to purchase Vermont property, to
pay Vermont wages, to purchase or finance the petroleum products
marketed in Vermont or to otherwise, directly or indirectly,
benefit its business activities in Vermont. Nor has Mobil
revealed the source of the funds with which it purchased the
stocks in its operating subsidiaries and affiliates.

Brief for Appellee at 17-18, Mobil Oil Corp. v. Commissioner of Taxes of Vermont, 445 U.S. 425 (1980). The Court did not have to address this argument because Vermont also argued that the stockholdings were not separate from and unrelated to Mobils worldwide, integrated petroleum business, conducted in part, in Vermont. The dividends were:

derived from stockholdings in operating businesses integrally
related to Mobil's petroleum business....The fact that Mobil has
chosen to conduct certain of its integrated business activities
through subsidiaries and affiliates, rather than through
operating divisions, should not limit Vermont's right to impose
a tax on Mobil's net income fairly apportioned to business
activities in Vermont.

Id. Since Mobil had treated as irrelevant the question of whether its dividend payors were "integrally related" to its petroleum business, based on the record the Court had little difficulty responding to Vermont's argument by viewing the payors as incorporated divisions of Mobil.

Had [Mobil] 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 apportionablility. [Citation omitted.] 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.

445 U.S. at 440-41. The dividends were thus viewed by the Court as operating income: "[Mobil] must demonstrate something about the nature of this income that distinguishes it from operating income, a proper portion of which the State concededly may tax." Id. at 437-38. Idaho never made a similar argument in ASARCO.

Because the Court in ASARCO rejected Idaho's broad interpretation of the statutory definition of business income, it did not have to distinguish between cases in which the nexus with the taxing state that satisfies the minimal connection requirement of due process is provided by the activities of the dividend payors--the Mobil situation--or by the activities of the dividend payee--the ASARCO situation. Once it rejected Idaho's argument, the Court's application of Mobil was understandable. Both cases involved taxpayers that were conducting part of their businesses in the taxing states. In both cases, the dividends at issue were received from subsidiaries that conducted none of their business in the taxing states. In both cases, the taxpayers' activities regarding their ownership of stock were also conducted outside of the taxing states.

[37] Mobil never held that due process standards are necessarily violated "where the business activities of the dividend payor have to do with the activities of the recipient in the taxing State," but only that if this condition were not satisfied, due process considerations "might well preclude apportionability, because there would be no underlying unitary business." 445 U.S. at 442 (emphasis in original).

For economic rather than legal reasons, Charles McLure argues that dividends received from nonunitary firms should not be included in the apportionable income of the payee. See McLure, Toward Uniformity in Interstate Taxation: A Further Analysis, 13 Tax Notes 51 (July 13, 1981).

[38] Brief for Appellant at 18. See also Tr. of Oral Arg. at 10.

[39] Tr. of Oral Arg. at 9. See also Brief for Appellant at 17- 18. Cf. Multistate Tax Comm'n Reg. Section IV.1(c)(4), ex. iv, 1 All States Tax Guide (CCH) para. 352 (1980).

[40] Tr. of Oral Arg. at 10 (emphasis added). Idaho's statutory definition of business income, as distinct from the manner in which it was interpreted, would appear to focus on the functional relationship between the ownership of the securities and the conduct of the taxpayer's business. Although ASARCO would disregard the payor's activities when the ownership of stock was an "adjunct to the actual conduct of the taxpayer's own business...," Tr. of Oral Arg. at 10, that condition assumes away the underlying question: When is the relationship between the income-generating activities--the ownership of stock--and the taxpayer's unitary business close enough so that the dividends can be apportioned without violating the Due Process Clause?

[41] Cf. Ture, Taxation and Distribution of Income, in Wealth Redistribution and the Income Tax 3 (Leibowitz, ed. 1978):

All of us concerned with tax theory and policy rely heavily

on 'everybody knows' propositions, often without being conscious
of the fact. When we go out of our way to identify and to
analyze these basic assumptions, challenging and exciting
conclusions often emerge. And even when we come away from such
exercises without having reached solid conclusions, the
questions that we have raised are themselves fascinating.

[42] For Professor Hellerstein's approach in this situation, see Hellerstein, Allocation and Apportionment of Dividends and the Delineation of the Unitary Business, 14 Tax Notes 155, 160 (Jan. 25, 1982).

The example in the text suggests a tax planning opportunity presented by ASARCO. In any situation in which the apportionability of a corporation's dividends is controlled by whether a unitary business relationship exists between itself and the payors, a negative determination provides an additional incentive to shift profits through intercorporate transactions from a parent corporation doing business in high-tax jurisdictions to related corporations doing business in low-tax jurisdictions. The shifted profits can then be distributed back to the parent as non-apportionable dividends. If these dividends are to be taxed, it will be by the taxpayer's state of commercial domicile. See note 3 supra.

[43] In general, see Jones, Foreign Investors Tax Act: The "Effectively Connected" Concept and Taxation of Domestic Source Income, 26 N.Y.U. Inst. Fed. Tax. 389 (1968).

[44] See I.R.C. Section 864(c). For federal purposes, the source of income--U.S. or foreign--is a critical distinction in the taxation of foreign corporations. Such corporations are taxable by the United States on most of their U. S. source income but only on limited categories of their foreign source income. See I.R.C. Sections 864, 882. The effectively connected rules for U. S. source income are different from those for foreign source income, which are narrowly circumscribed. Compare I.R.C. Sections 864(c)(1)-(3); Treas. Reg. Section 1.864-4, with I.R.C. Section 864(c)(4); Treas. Reg. Section 1.864-5. At present, state taxation is not constrained by whether an item of income is from U. S. sources or from foreign sources as determined under the Internal Revenue Code. In Mobil the Court refused to grant foreign source dividends any special constitutional protection. A state can tax income that would be considered from foreign sources under federal rules even if the United States would not tax that income. Accordingly, the text discusses the more generally applicable effectively connected rules for U.S. source income as an appropriate analog in state taxation and deletes references to source. The issue of state taxation of foreign income is implicated in two cases presently before the Court. See Caterpillar Tractor Co. v. Lenckos, 84 Ill. 2d 102, 417 N.E.2d 1343 (1981), prob. juris. noted, sub nom. Chicago Bridge & Iron Co. v. Caterpillar Tractor Co., 454 U.S. 1029 (1981); Container Corp. of America v. Franchise Tax Bd., 117 Cal. App. 3d 988, 173 Cal. Rptr. 121 (1st Dist. 1982), prob. juris. noted, 102 S. Ct. 2034 (1982).

[45] I.R.C. Section 864(c)(1)-(3). Other types of income, not relevant to the present discussion, can also be effectively connected. See I.R.C. Section 864(c)(4).

[46] I.R.C. Section 864(c)(2)(A) (emphasis added). See Treas. Reg. Section 1.864-4(c).

[47] Cf. Multistate Tax Comm'n Reg. Section IV.1(c)(4), ex. iii, 1 All States Tax Guide (CCH) para. 352 (1980).

[48] Treas. Reg. Section 1.864-4(c)(2)(ii).

[49] The Treasury regulations set forth a presumption of a direct relationship if "(1) the asset was acquired with funds generated by that trade or business, (2) the income from the asset is retained or reinvested in that trade or business, and (3) personnel who are present in the United States and actively involved in the conduct of that trade or business exercise significant management and control over the investment of such asset." Treas. Reg. Section 1.864-4(c)(1)(iii)(b).

[50] Cf. Multistate Tax Comm'n Reg. Section IV.1(c)(4), ex.ii, 1 All States Tax Guide (CCH) para. 352 (1980).

[51] Treas. Reg. Section 1.864-4(c)(2)(iii). Cf.Montgomery Ward & Co. v. Commissioner of Taxation, 276 Minn. 479, 483, 151 N.W.2d 294, 296 (1967) ("We recognize the possibility that at some point funds accumulated, held, and invested in anticipation of expansion of a business at a future, but indefinite, date have but a minimal relationship to the successful day-to-day operation of a general merchandising business.") (remanding to Board of Tax Appeals).

[52] I.R.C. Section 864(c)(2)(B) (emphasis added).

[53] Cf. Multistate Tax Comm'n Reg. Section IV.1(c)(4), ex. i, 1 All States Tax Guide (CCH) para. 352 (1980).

[54] Treas. Reg. Section 1.864-4(c)(3). In applying either the asset-use test or the business-activities test, the regulations provide that "due regard shall be given to whether or not the asset or the income, gain, or loss, is accounted for through the trade or business conducted in the United States, that is, whether or not the asset, or the income, gain, or loss, is carried on the books of account separately kept for that trade or business, but this accounting test shall not by itself be controlling." Treas. Reg. Section 1.864-4(c)(4). In the federal context, where separate accounting is the rule rather than the exception, "due regard" can be given to the taxpayer's U.S. books and records. For state purposes, however, where separate accounting is the exception rather than the rule, the taxpayer's books and records are not given much weight. But cf. Montgomery Ward & Co. v. Commissioner of Taxation, supra note 51. The Government Accounting Office has recently criticized the use of separate accounting for federal purposes. See General Accounting Office Rep., IRS Could Better Protect U.S. Tax Interests in Determining the Income of Multinational Corporations, GAO Doc. No. GGD-81-81 (Sept. 30, 1981).

[55] Jones, supra note 43, at 394.

[56] See Treas. Reg. Section 1.864-4(c)(2)(iv), ex. 1.

[57] Id., 102 S. Ct. at 3120 n.5. The United States would tax these dividends only if they were from domestic sources. See note 44 supra.

[58] Treas. Reg. Section 1.864-4(c)(2)(iv), ex. 2.

[59] See Sperry & Hutchinson Co. v. Dep't of Revenue, 270 Or. 329, 332-33, 527 P.2d 729, 731 (1974) (interest on short-term securities held for liquid capital in stamp business is apportionable but interest on short-term securities held pending long-term investment not apportionable). Accord, Champion Int'l Corp. v. Bureau of Revenue, 88 N.M. 411, 414-15, 540 P.2d 1300, 1303-04 (1975) (interest from short-term investments needed for future business activity held apportionable); Great Lakes Pipe Line Co. v. Commissioner of Taxation, 272 Minn.

403, 138 N.W.2d 612 (1965), appeal dismissed, 384 U.S. 718 (1966) (interest from short-term securities purchased with operating income and used for operating expenses held apportionable).

The dissent agreed that "an appropriate amount of liquid working capital is necessary to the day-to-day operation of a business, and any return earned from its temporary investment is a byproduct of the operation of the business..." but would not distinguish between short-term investments and long-term investments. 102 S.Ct. at 3120.

[60] See Brief for Appellee at 18-19; 102 S. Ct. at 3120-21, 3122-23, 3125-26. See also Multistate Tax Comm'n Reg. Section IV.1(c)(4), exs. (i)-(vi), 1 All States Tax Guide (CCH) para. 352 (1980).

[61] In Corn Products Refining Co. v. Commissioner, 350 U.S. 46 (1955), the Court held that gains and losses arising from the sale of corn futures were taxable as ordinary gains and losses, even though the futures satisfied the statutory definition of a capital asset. The Court found that the taxpayer had a business purpose in purchasing the futures, which played an "integral part" in the taxpayer's business by protecting it against price increases of its raw material--corn. Profits and losses arising from the "everyday operation of the business" should be treated as ordinary income. Id. at 52.

Readers familiar with other areas of taxation will no doubt be able to suggest other analogies.

[62] Norton v. United States, 551 F.2d 821, 826 (Ct. Cl.), cert. denied, 434 U.S. 831 (1977).

[63] See, e.g., Bagley & Sewall Co. v. Commissioner, 20 T.C. 983 (1953), aff'd, 221 F.2d 944 (2d Cir. 1955).

[64] See, e.g., Corn Products Refining Co. v. Commissioner, supra note 61; Rev. Rul. 72-179, 1972-1 C.B. 57; but see United States v. Rogers, 286 F.2d 277 (6th Cir.), cert. denied, 386 U.S. 951 (1961); Meade v. Commissioner, 32 T.C.M. (CCH) 200 (1973).

[65] See, e.g., Waterman, Largen & Co. v. United States, 419 F.2d 845 (Ct. Cl. 1969), cert. denied, 400 U.S. 869 (1970); Hegan v. United States, 221 F. Supp. 248 (W.D. Ark. 1963).

[66] See, e.g., Booth Newspapers, Inc. v. United States, 303 F.2d 916, 921 (Ct. Cl. 1960).

[67] Tr. of Oral Arg. at 54. State courts in characterizing income as business income have recognized the relevance of the Corn Products doctrine. See, e.g., W.R. Grace & Co. v. Commissioner of Revenue, 378 Mass. 577, 583, 393 N.E.2d 330, 334 (1979).

[68] 65 T.C. 694 (1976), appeal dismissed, 550 F.2d 43 (1st Cir.), cert. denied, 431 U.S. 966 (1977).

[69] For cases following Windle, see Continental Illinois Nat'l Bank & Trust Co. of Chicago v. Commissioner, 69 T.C. 357 (1977); Bell Fibre Products Corp. v. Commissioner, 36 T.C.M. (CCH) 182 (1977). Accord, Rev. Rul. 78-94, 1978-1 C.B. 58 (predominant business motive does not preclude capital asset treatment if substantial investment motive present). See also Agway, Inc. v. United States, 524 F.2d 1194 (Ct. Cl. 1975); Dearborn Co. v. United States, 444 F.2d 1145 (Ct. Cl. 1971).

ASARCO's reference to Windle with its emphasis on "purpose" is somewhat ironic. The Court criticized Idaho's argument that ASARCO's purpose in acquiring the stock in the payors was relevant in defining business income, yet Windle and other Corn Products cases emphasize the taxpayer's purpose in acquiring the assets.

[70] See, e.g., Missisquoi Corp. v. Commissioner, 37 T.C. 791 (1962); Gulftex Drug Co., Inc. v. Commissioner, 29 T.C. 118 (1957).

[71] See W. W. Windle Co. v. Commissioner, supra note 68.

[72] See, e.g., Electrical Fillings Corp. v. Commissioner, 33 T.C. 1026 (1960); see also Rev. Rul. 58-40, 1958-1 C.B. 275.

[73] Professor Hellerstein agrees with the applicability of the Corn Products doctrine in defining business income, though not necessarily for the reasons stated in the text. See Hellerstein, supra note 42, at 159.

DOCUMENT ATTRIBUTES

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