STATE TAX LIABILITY AND COMPLIANCE MANUAL

1983 SUPPLEMENT
(INCLUDES 1982 CHANGES)

LLOYD S. HALE
RUTH GORAN

A RONALD PRESS PUBLICATION

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Preface

The *State Tax Liability and Compliance Manual* provides an overview of state taxation to minimize and/or avoid, as well as comply with, various state tax structures that face the interstate taxpayer. The book covers income based, capital based, sales and use, gross receipts, and value-added classes of tax, as well as the effect of the Multistate Tax Compact.

This Supplement is designed to provide a commulative update for all this tax information. It is organized in the same manner as the basic volume and features significant new information about combined reporting Additionally, it includes:

illuminating notes

current case updates

a table of cases

a completely new index

all revised to be current through the end of 1982.

March 1983

1982 SUPPLEMENT

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CHAPTER ONE

Jurisdiction—Taxes Based on Income

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VALIDITY OF APPORTIONMENT

In the recent Supreme Court case of *Exxon Corporation v. Wisconsin Department of Revenue*,[52] the Court upheld the use of the apportionment formula applied by the state of Wisconsin. Exxon was determined to be a unitary business, and as such had to subject substantially all of its corporate income to the apportionment formula. It could not rely on the Wisconsin statute that allows the allocation of income and separate accounting for business activities which are not integral parts of a unitary business.[53] The use of separate accounting is not compatible with the implementation of accounting for a unitary business.

As compared with earlier case history, the *Exxon* case was unlike the *Bass, Ratcliff, and Gretton* case,[54] where there were insufficient data in the records to determine any profit or loss from the firm's business when considered separately from its manufacturing activities in Great Britain. Bass, Ratcliff, and Gretton, however, was also considered to be engaged in a unitary business, thereby justifying the state of New York to attribute a portion of its profits to the state through the use of formulary apportionment.[55]

[52] *Exxon Corp. v. Wisconsin Department of Revenue* 100 S. Ct. 2109, 65 L.Ed. 66 (1980).

[53] Wisconsin Stats. 71.01 (2).

[54] *Bass, Ratcliff, and Gretton, Limited, v. State Tax Commission* 266 U.S. 271 (1924).

[55] Brief of Appellant, *Exxon Corp. v. Wisconsin Department of Revenue*, in the Supreme Court of the United States, October Term, 1979, No. 79-509.

The lack of sufficient evidence had also occurred in the *Butler Brothers* case,[56] and in the *Moorman Manufacturing* case.[57] Butler Brothers could not substantiate that the use of an apportionment formula caused income to be taxed in California that was not part of its unitary income. Moorman Manufacturing also could not substantiate that the single factor apportionment formula applied by the state of Iowa produced an arbitrary result.

The *Exxon* case was also unlike the *Hans Rees' Sons* case,[58] where the use of apportionment by the state of North Carolina caused a proven overassessment of their income. Although the unitary concept was also applied here, the application of the apportionment formula by the state was proven unreasonable by the evidence submitted by Hans Rees' Sons. The use of an apportionment formula was not overruled; additional evidence was considered so that an apportionment formula would not "operate so as to reach profits which are in no just sense attributable to transactions within its jurisdiction."[59]

All of these earlier cases dealt with businesses engaged in manufacturing and selling or, for *Butler Brothers*, purchasing and selling. The *Exxon* case deals with a vertically integrated petroleum company. A more complete history and explanation of this case is found at the supplement to Chapter Three.

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ADDITIONAL JURISDICTIONAL STANDARDS—JAPAN LINE, LIMITED

The possibility that the two new jurisdictional standards enumerated in *Japan Line*—namely whether the tax creates a substantial risk of international multiple taxation, and whether the tax prevents the Federal government from speaking with one voice when regulating commercial relations with foreign governments—might have implications with respect to state income taxation has been dismissed in the *Mobil*[60] decision. As a consequence of *Mobil* the criteria in

[56] *Butler Brothers v. McColgan* 315 U.S. 501 (1941).
[57] *Moorman Manufacturing Co. v. Bair* 437 U.S. 267 (1978).
[58] *Hans Rees' Sons, Inc., v. North Carolina* 283 U.S. 123 (1931).
[59] *Ibid.*
[60] *Mobil Oil Corp. v. Commissioner of Taxes of Vermont* 445 U.S. 425 (1980).

Japan Line are restricted to ad valorem taxes imposed on property used in foreign commerce. The risk of multiple taxation is not to be applied to state income taxes which include foreign source income, and the principles of taxation of foreign instrumentalities are not applicable to state income taxation. (See page 135 of text for further detail.)

Woolworth,[61] outlined in this Supplement, had also relied on *Japan Line* in its attempt to prevent apportionment under the Commerce Clause of foreign sourced dividends. The New Mexico Supreme Court reiterated the *Mobil* principles in its finding that the dividends were apportionable.

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SUMMARY OF U.S. CONSTITUTIONAL CONSIDERATIONS

The constitutionality of the concept of formulary apportionment under both the due process and commerce clauses is now well established. See *Moorman Manufacturing Co. v. Bair*, 437 U.S. 267.

The burden is upon the taxpayer to show that an apportionment formula places a burden on interstate commerce in a constitutional sense. *Northwestern States Portland Cement Co. v. Minnesota*, 358 U.S. 450 (1959). See also, *Norfolk & Western Railway Co. v. Missouri State Tax Commission*, 390 U.S. 317 (1968). *Hans Rees' Sons, Inc. v. North Carolina*, 283 U.S. 123 (1930).

One who attacks such a formula must show by clear and cogent evidence that its use results in extraterritorial value being taxed. *Butler Bros. v. McColgan*, 315 U.S. 501 (1941); *General Motors Corp. v. State*, 509 P. 2d 1260 (Colo. 1973). See also, *Fleming v. Oklahoma Tax Commission*, 157 F.2d 888 (10 Cir., 1946).

The taxpayer also bears the burden of showing that application of a formula violates due process. *Hans Rees' Sons, Inc. v. North Carolina, supra.* See also, *Cook v. Kansas City Southern Ry. Co.*, 205 S.W.2d 441 (Ark.), *cert. den.* 333 U.S. 873 (1948).

The limitation on a state's power to tax a foreign corporation is that the measure of the tax must bear some reasonable relation to its doing business in the state. *Southern Pacific Co. v. McColgan, supra; Wisconsin v. J. C. Penney Co., supra; Hans Rees' Sons, Inc. v.*

[61] *Taxation and Revenue Department of New Mexico v. F. W. Woolworth Co.* 624 P. 2d 28 (1981).

North Carolina, supra. There must be minimal connection between the activities and the taxing state. *Moorman Manufacturing Co. v. Bair, supra.*

A state may violate the commerce clause when it discriminates against interstate commerce by subjecting it to the burden of multiple taxation to which local commerce is not exposed. *Northwestern States Portland Cement Co. v. Minnesota, supra. Gwin, White & Prince, Inc. v. Henneford*, 305 U.S. 434 (1939); *Gulf Oil Corp. v. Joseph* 121 N.E.2d 360 (N.Y.)

A tax levied by a state may run afoul of the due process and interstate commerce clauses, if it is not laid on property, business done, or transactions carried on within the state. *Connecticut General Life Ins. Co. v. Johnson*, 303 U.S. 77 (1938); *Gwin, White & Prince, Inc. v. Henneford, supra.*

A state does not violate the Fourteenth Amendment when its legislature, faced with the practical impossibility of allocating specifically the profits earned by a corporation engaged in interstate commerce through processes conducted within the borders of that state, adopts a method of apportionment that reaches, and was meant to reach, only the profits earned within the state. *Underwood Typewriter Co. v. Chamberlain*, 254 U.S. 113. See also, *Gwin, White & Prince, Inc. v. Henneford, supra.*

The entire net income of a corporation generated by interstate, as well as intrastate, activities may be fairly apportioned among the states for tax purposes by a formula utilizing in-state aspects of interstate affairs without violating either the due process or commerce clauses of the United States Constitution. *Northwestern States Portland Cement Co. v. Minnesota, supra; Butler Bros. v. McColgan, supra.* See also, *Gwin, White & Prince Inc. v. Henneford, supra.*

Net income from the interstate operations of a foreign corporation may be subjected to state taxation, provided the levy is not discriminatory and is properly apportioned to local activities within the taxing state, forming sufficient nexus to support the same, without violating either the due process or commerce clauses of the United States Constitution. *Northwestern States Portland Cement Co. v. Minnesota, supra; Wisconsin v. J. C. Penney Co., supra; Gulf Oil Corp. v. Clayton* 147 S.E.2d 522 (N.C. 1966); *American Smelting & Refining Co. v. Idaho State Tax Commission* 592 P.2d 39 (1979). See also, *Cook v. Kansas City Southern Railway Co., supra; Roadway Express, Inc. v. Director, Division of Taxation* 236 A.2d 577 (N.J. 1967), *appeal dismissed*, 390 U.S. 745 (1968); *Complete Auto Transits, Inc. v. Brady* 430 U.S. 274 (1977). Cf. *Hans Rees' Sons, Inc. v. North Carolina, supra.*

Not only must there be some minimal connection between the business activities generating the income and the taxing state, but the income attributed to the state for taxing purposes must be rationally related to values connected with the taxing state. *Moorman Manufacturing Co. v. Bair* 437 U.S. 267 (1978). The mere fact that the demand of the tax exaction is contingent upon events brought to pass outside the state does not destroy the nexus between the tax and transactions within the state for which the tax is an exaction. *Wisconsin v. J. C. Penney Co., supra.*

The three-factor formula has been held to be constitutional in that it does not violate either the due process clause or commerce clause of the Constitution of the United States. *Oklahoma Tax Commission v. Southwestern Bell Telephone Co.* 396 P.2d 500 (Okla. 1964); *Great Lakes Pipe Line Co. v. Commissioner of Taxation, supra; Walgreen Co. v. Commissioner of Taxation* 104 N.W.2d 714 (Minn. 1960). See also, *Butler Bros. v. McColgan, supra.*

The mere fact that application of the formula may result in some overlapping measures of net income among states is not fatal. *Great Lakes Pipe Line Co. v. Commissioner of Taxation, supra; General Motors Corp. v. State* 509 P.2d 1260 (Colo. 1973); *Moorman Manufacturing Co. v. Bair, supra; American Smelting & Refining Co. v. Idaho State Tax Commission, supra; Walgreen Co. v. Commissioner of Taxation, supra.* See also, *Southern Pacific Co. v. McClogan* 156 P.2d 81 (Cal. 1945). It is not necessary that a state demonstrate that an apportionment formula results in an exact measure in order to avoid transgression of the due process and commerce clauses. *Norfolk & Western Railway Co. v. Missouri Tax Commission* 390 U.S. 317 (1968). See also, *Hans Rees' Sons, Inc. v. North Carolina, supra.* Mathematical exactness is impossible and any method of apportionment will contain imperfections. *Fleming v. Oklahoma Tax Commission*, 157 F.2d 888 (10th Cir., 1946).

In considering the validity of a state's apportionment formula in the light of the prohibition against a state's burdening interstate commerce, the United States Supreme Court has recognized the practical impossibility of a state's achieving a perfect apportionment of expansive, complex, multistate business activities, and finds a rough approximation, rather than precision, sufficient. Unless it is demonstrated that an apportionment formula which includes consideration of interstate and out-of-state transactions in relation to the intrastate privilege of doing business produces a palpably disproportionate result, making it patent that the tax is levied upon interstate commerce, the state's tax law will not be nullified. *International Harvester Co. v. Evatt* 329 U.S. 416 (1947); *Moorman Manu-*

facturing Co. v. Bair, supra; Gulf Oil Corp. v. Joseph 121 N.E.2d 360 (N.Y. 1954); *General Motors Corp. v. State* 509 P.2d 1260 (Colo. 1973). Cf. *Hans Rees' Sons, Inc. v. North Carolina* 283 U.S. 123 (1930).

CHAPTER TWO

Determination of State Taxable Income

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The question of the applicability of separate accounting was also demonstrated in the *Exxon* case.[29] This case followed previous rulings supporting the concept that income of a unitary business carried on partly within and partly without a taxing jurisdiction are constitutionally subject to a reasonable method of apportionment, regardless of separate accounting results.

The separate accounting records maintained by a taxpayer have not invalidated the apportionment results of the taxing states. The efforts to do so have been consistently rejected by the courts. In the *Exxon* case, the separate accounting procedures were a product of Exxon's internal accounting procedures and policies. There were no objective standards available to test the validity of Exxon's separate accounting results, which were in fact a product of theoretical transactions with unrelated third parties.[30]

The *Exxon* decision is consistent with previous holdings by the Supreme Court. The income or values of a unitary operation which is conducted partly within and partly without a taxing state will be subject to a reasonable rule of apportionment, regardless of separate accounting results. Separate accounting was considered irrelevant in the context of an income tax [*Bass, Ratcliff, and Gretton, Limited v. New York Tax Commission* 266 U.S. 271 (1924), *Hans Rees' Sons, Incorporated v. North Carolina* 283 U.S. 123 (1931), and *Moorman*

[29] *Exxon Corp. v. Wisconsin Department of Revenue* 100 S. Ct. 2109, 65 L. Ed. 66 (1960).

[30] Motion for Leave to File Brief *Amicus Curiae* and Brief *Amicus Curiae* of the Multistate Tax Commission and Participating States, *Exxon Corp. v. Wisconsin Department of Revenue*, in the Supreme Court of the United States, October Term, 1979, No. 79-509, p. 41.

Manufacturing Company v. Bair 437 U.S. 267 (1978)], an ad valorem property tax [*Adams Express Co. v. Ohio State Auditor* 165 U.S. 194 (1896)], and a franchise tax based on net worth [*Ford Motor Co. v. Beauchamp*, 308 U.S. 313 (1939)].[31]

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CONTROVERSIES INVOLVING BUSINESS VS. NONBUSINESS INCOME

The decision in *Mobil Oil Corp. v. Commissioner of Taxation of Vermont* 445 U.S. 425 (1980) fairly well closed the door to the classification of income as non-business in the case of a unitary business. (See pages 131–135 of text.) If not completely closing the door, a difficult burden was placed on a taxpayer to show the non-business nature of such income. Other decisions by various state courts have reinforced the concept that most income should be business income. These decisions basically follow the same principles, with the exception of the *Wisconsin* case in which the interpretation of the applicable Wisconsin statute lines up with the traditional and historical view, as outlined on page 36. These case are:

W. R. Grace & Co. v. Commissioner of Revenue
393 N.E. 2d 330 (Massachusetts Supreme Judicial Court, 1979)

R. L. Qualls v. Montgomery Ward & Co., Inc.
585 S.W. 2d 18 (Arkansas Supreme Court, 1979)

Atlantic Richfield Co. v. State of Colorado
601 P.2d 628 (Colorado Supreme Court, 1979)

Kearney & Trecker Corp. v. Wisconsin Department of Revenue
284 N.W. 2d 61 (Wisconsin Supreme Court, 1979)

American Smelting and Refining Co. v. Idaho State Tax Commission
592 P.2d 39 (1979)

[31] *Ibid.*, pp. 39–40.

Taxation and Revenue Department of New Mexico v. F. W. Woolworth Co.
624 P. 2d 28 (1981)

The taxpayer in this case owned a stock interest in the Miller Brewing Company as well as stock interests in other companies, all of which were sold in 1969. A net gain of some $93 million was realized. The issue was whether this gain was properly apportionable to Massachusetts for purposes of the Massachusetts Corporation excise tax. W. R. Grace had petitioned the Commissioner of Revenue to calculate the Massachusetts tax so as to exclude the gain from the tax base, i.e., regard it as allocable rather than apportionable income. The taxpayer's treatment of the gain would have resulted in a tax of $58,684. Inclusion of the gain as apportionable income increased the tax by $75,658.68 and this amount was assessed against the taxpayer. Grace acknowledged that its operations in Massachusetts and throughout the United States constituted a unitary business for purposes of state taxation. However, it maintained that the Miller stock was a separate investment outside the ordinary course of business, and if the gain was business income, it was not income derived from business carried on within the Commonwealth. The Court's conclusion from the evidence presented was that Grace intended that the Miller operation be combined with other company operations as part of the overall company performance; that the Miller ownership contributed to such overall performance; and that the organization was depending on Miller's contribution. This evidence was nonsupportive to Grace's contention, and supportive to the unitary principle.

The unitary nature in itself was viewed as sufficient to attribute a portion to Massachusetts and it was not shown that the amount taxable did not bear a rational relationship to values connected with the taxing state of Massachusetts. Grace also raised the same Commerce Clause argument that Mobil had raised.[32] (See page 131 of text.)

This being the contention that New York, as the state of commercial domicile of the stock transactions, had the power to tax the entire gain, exposed Grace to the danger of multiple taxation. This argument was rejected in the *Mobil* decision, and was rejected by the Massachusetts Court. (See page 132 where the resolution to multiple taxation is suggested in the *Mobil* opinion.)

[32] *Mobil Oil Corp. v. Commissioner of Taxes of Vermont* 445 U.S. 425 (1980).

R. L. Qualls v. Montgomery Ward & Company, Inc. 585 S.W. 2d 18 (Arkansas Supreme Court 1979)

For the fiscal periods ending in 1972, 1973, and 1974, Montgomery Ward deducted interest income from its total taxable income before applying the Arkansas apportionment formula, contending that such income was non-business income under the formula specified by the state. (Arkansas is a member of the Multi-State Tax Compact and had adopted the UDITPA as part of its statutes.) The interest income in question was derived from loans made to various affiliated companies. These were:

1. The parent holding company
2. Real estate subsidiaries holding title to real property used by Montgomery Ward in retail operations
3. Subsidiaries selling products to Montgomery Ward
4. Subsidiaries having no transactions with Montgomery Ward other than the loans and advances
5. A credit corporation which financed the accounts receivable of Montgomery Ward

Most of the above companies were not doing business in Arkansas. The total interest income derived from these loans was nominal compared to total income.

Montgomery Ward's argument was that the interest was allocable entirely to Illinois, the state in which its principal office was located, because the income was not an integral part of its regular trade or business operations. Reviewing the circumstances surrounding the income in question, the Arkansas Supreme Court concluded otherwise. The interest on the loans and advances to corporate affiliates was income from intangible property belonging to Montgomery Ward. Due to the regularity and consistency of these loans and advances, the income arose from transactions and activity in the regular course of Montgomery Ward's business, of which the court adopted the following definition:

> Business deals and the performance of a specific function in the normal, typical, customary or accustomed policy or procedure of the taxpayer's trade or business. [*Champion International Corp. v. Bureau of Revenue* 540 P. 2d 1300 (N.M. 1975)].

The acquisition, management, and disposition of the working capital in the court's view constituted an integral part of Mont-