Special Report / Viewpoint

UDITPA and Combined Unitary Reporting: Suggestions for Improving Louisiana Income Taxation of Multistate Businesses — Part II

by Susan Kalinka

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The footnotes began in Part I, and consecutive numbering of footnotes and sections here continues from that point.

III. The Unitary Business Principle

As used in this article, the term "unitary business principle" will mean the inclusion in a corporation's income of an affiliate's income that is derived from a unitary business conducted by both the corporation and the affiliate.

The Louisiana Corporation Income Tax Act does not provide a rule for taxing a corporation and its affiliates as a unitary business. Thus, a corporation transacting business in Louisiana that owns a controlling interest in a corporation, partnership, or limited liability company that transacts a business outside of Louisiana pays no Louisiana income tax on its share of the affiliate's income, even if the affiliate's income is derived from a business that is functionally related to the business of the corporation and there is a direct economic relationship between the Louisiana income earned by the corporation and the income earned by the affiliate. In such a case, the activities of a corporation in Louisiana may enhance the income earned by the affiliate because the operation of the business transacted by the corporation within Louisiana contributes to the operation of the business transacted by the affiliate outside Louisiana or because the affiliate's operation of the business outside Louisiana is dependent on the corporation's Louisiana activities.

The Louisiana Corporation Income Tax Act prohibits affiliated corporations from filing consolidated returns, even if they file consolidated returns for federal income tax purposes.[143] Dividends from affiliated corporations also cannot be apportioned to Louisiana. While the Louisiana Corporation Income Tax Act provides that dividends and interest paid by an affiliated corporation may be included in the a corporate payee's Louisiana income under certain circumstances,[144] the provison is not effective. In 1997, the Louisiana Supreme Court declared the provision unconstitutional because it was added by Act 690.[145] Instead, former law remains effective, allowing a nondomiciliary corporation to exclude from Louisiana income any dividends it receives from a subsidiary, as long as the subsidiary earns all of its income outside Louisiana.[146]

If Louisiana adopted the unitary business principle for a corporation and its affiliates, the income earned by both the corporation and its affiliates from a unitary business conducted in Louisiana and in other states would be apportioned among the states using the applicable apportionment rules. For this purpose, a unitary business generally is a business in which the activities of each member of the unitary group contribute to or are dependent on the activities of the other members in producing income from the business. The U.S. Supreme Court has described a unitary business as a discrete business enterprise in which the activities are functionally integrated, are coordinated through a centralized management, and enjoy economies of scale.[147] The unitary business concept is discussed in greater detail later in this article.[148]

A. Diversion of Income From Louisiana Under the Separate Return Method

Because the Louisiana Corporation Income Tax Act does not apply the unitary business principle, Louisiana is not collecting revenues to which it should be entitled. Louisiana utilizes the separate-return method, requiring a corporation that transacts business in Louisiana to file a separate return from its affiliates, even if the corporation and its affiliates are engaged in a unitary business. Thus, a corporation that conducts a unitary business

[143] La. Rev. Stat. Ann. section 47:287.733.

[144] La. Rev. Stat. Ann. section 47:287 94(I).

[145] *Dow Hydrocarbon & Resources v Kennedy*, No. 96-CA-2471 (La. May 20, 1997) (La. Rev. Stat. Ann. section 47.287.94(I), as well as all amendments enacted in 1993 Act No. 690, unconstitutional because Act No. 690 was enacted in violation of the Louisiana constitutional provision prohibiting the enactment of tax statutes in odd-numbered years). (*See* note 7, in Part I)

[146] La. Rev. Stat. Ann. section 47:287.93(A)(4).

[147] *See, e.g., Mobil Oil Corp. v. Commissioner of Taxes of Vermont*, 445 U.S. 425, 438 (1980), discussed *infra*, notes 209-212 and accompanying text.

[148] *See infra*, notes 204-237 and accompanying text.

with an affiliated company can divert income from Louisiana's taxing jurisdiction to another state that taxes corporations at a lower income tax rate by transfer-pricing manipulation. For example, by paying more than fair market value for goods purchased from an out-of-state affiliate or by charging less than fair market value on a sale of goods to an out-of-state affiliate, a corporation transacting business in Louisiana can reduce the amount of its Louisiana income.

The Louisiana Revenue Department can challenge the price charged by the affiliate by arguing that the price of the goods was either more or less than the amount of an arm's-length price that would have been charged by an unrelated party.[149] However, there is no guarantee that a court will support the Revenue Department's determination of an appropriate arm's-length price in such cases.

Because the Louisiana Corporation Income Tax Act does not apply the unitary business principle, Louisiana is not collecting revenues to which it should be entitled.

Taxpayers have developed other techniques for diverting income from Louisiana. The following example, presented by the Revenue Department at a meeting of the Louisiana Senate's Select Committee on Tax Structures, illustrates one of the methods used to reduce Louisiana income tax liability without creating additional tax liability at the federal level:

> This multinational oil production company (Oil Co.) is composed of a parent (Parent Co.), that is the 100 percent owner of a holding company (Holding Co.) that in turn owns 100 percent of a production company (Production Co.) that includes all the company's United States production including Louisiana production, and several foreign production companies. Production Co. is a Louisiana taxpayer.
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> Oil Co. was told by its accounting firm that it was paying too much state income tax and that if it increased its debt to create an interest expense deduction for Production Co. it could save state income tax with no federal income tax consequences. Oil Co. was told that a four to one debt to equity ratio would not be questioned by the IRS or the SEC. Prior to 1992, Production Co. had over $8 billion in retained earnings. In 1992, Production Co. declared an $8 billion dividend to Holding Co. No funds were actually transferred among the companies to pay the dividend. Instead, the transaction was accomplished using book entries that created an $8 billion note payable by Production Co. to Parent Co. The interest on the note payable is $800 million per year. This created an annual interest expense deduction in Louisiana of $22 million and an annual tax savings in Louisiana of $1.75 million.
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> When questioned by Louisiana auditors about the nature of the 1992 transaction, Oil Co. replied that the transaction was a "financial recapitalization." However, Oil Co. did not subject its foreign production companies to the same financial recapitalization. The recapitalization of Production Co. did not have any federal tax consequences because Parent Co., Holding Co., and Production Co. filed a federal consolidated return that ignores intercompany transactions among members of United States consolidated groups. If a similar recapitalization had taken place for the foreign production companies, Parent Co. would have been required to report interest income on the notes owed to it by its foreign subsidiaries.[150]

The Revenue Department may challenge the recapitalization of Production Co. as a sham transaction, arguing that the recapitalization had no business purpose and therefore should be ignored. It is not certain, however, whether a court will uphold the Revenue Department's position. The U.S. Supreme Court has stated, at least for federal tax purposes, that a taxpayer may arrange its affairs to avoid tax by any means that the law permits.[151] However, if a transaction has no purpose other than avoidance of taxes and does not accomplish a result that the statute intended, a court may disregard the transaction or recast it.[152]

Production Co. may be able to show a legitimate business purpose for the recapitalization. Alternatively, a court may find that the recapitalization should be respected because it was accomplished in accordance with the law. Under both federal and state income tax law, a corporation may claim a deduction for interest payments[153] but may not claim a deduction for dividends paid to shareholders. While both dividends[154] and interest payments[155] constitute income to the shareholders, the deduction allowed to the corporation for interest payments ensures that the earnings paid to a shareholder as interest will be subject to a single level of tax, at the shareholder level. In contrast, corporate earnings distributed as dividends are taxed once at the corporate level,[156] and a second time when they are distributed to shareholders.

Because Louisiana tax law permits a taxpayer to deduct interest expenses, it is not uncommon for shareholders to finance their closely held corporations with a certain amount of debt to avoid a double tax on corporate distributions to shareholders. In the foregoing example, Oil Co.'s accounting firm indicated that a four-to-one debt-to-equity ratio would not be questioned by the Internal Revenue Service or the Securities and Exchange Commission. If the recapitalization is accepted by both federal agencies, it may be difficult for the Revenue Department to convince a court that it should be ignored for state income tax purposes.

[149] *See* La. Rev. Stat. Ann. section 47:287.480(2) (authorizing the Revenue Department to distribute, apportion, or allocate gross income or deductions among related businesses to prevent evasion of taxes or to clearly reflect income).

[150] Briefing Report prepared by the Louisiana Department of Revenue, submitted at the November 30, 2000, Tax Study Meeting of the Senate Select Committee on Tax Structures, p. 5.

[151] *Cf. Gregory v. Helvering*, 293 U.S. 465 (1935).

[152] *Id.*

[153] IRC section 162(a). Louisiana generally adopts the same rules as apply under the Internal Revenue Code in computing the amount of income of a corporation and the amount of deductions allowed to the corporation. *See* La. Rev. Stat. Ann. sections 47:287.61 (gross income), 47:287.63 (allowable deductions).

[154] IRC section 61(a)(7).

[155] IRC section 61(a)(4).

[156] IRC section 11.

Nevertheless, the amount of Production Co.'s income that is apportioned to Louisiana after the recapitalization probably does not accurately reflect the extent to which the entire unitary business operated by Production Co. and its affiliates is conducted in Louisiana. If Louisiana were to require combined unitary business income reporting,[157] intercompany loans, interest payments, and dividends would be ignored. In that case, Production Co. would pay the same amount of income tax to Louisiana regardless of whether the $8 billion of retained earnings were distributed and recharacterized as a loan from Parent Co.

In other cases, corporations have contributed intangibles to passive holding companies in order to divert income to a state that imposes a corporate tax at a lower rate or has no corporate income tax. For example, in *Geoffrey Inc. v. South Carolina Tax Commission*,[158] Geoffrey Inc., a wholly owned, second-tier subsidiary of Toys R Us Inc., was incorporated in Delaware, a state that does not tax a corporation's passive income.

Geoffrey became the owner of several valuable trademarks and trade names, including "Toys R Us," a trade name that it licensed to Toys R Us for use in all but five states. As part of the same licensing agreement, Geoffrey also granted to Toys R Us the right to use Geoffrey's marketing skills, techniques, and "know-how" in connection with the marketing, promotion, advertising, and sale of products covered by the agreement. In consideration for the licenses granted under the agreement, Geoffrey received a royalty of 1 percent of the net sales by Toys R Us or any of its affiliated companies of the licensed products or services covered by the licensing agreement.

In *Geoffrey*, the South Carolina Tax Commission took the position that Toys R Us was entitled to a deduction for royalties it paid to Geoffrey pursuant to the licensing agreement, but that Geoffrey was required to pay South Carolina income tax on the royalty fee. Geoffrey argued that it did not have sufficient nexus with South Carolina to be taxable in that state because it did not have a physical presence in South Carolina.

The nexus requirements of the Due Process Clause prohibit a state from imposing a tax on a corporation unless there is "some definite link, some minimum connection, between [the] state and the person property or transaction it seeks to tax" and the "income attributed to the state for tax purposes [is] rationally related to values connected with the taxing state."[159] The Supreme Court of South Carolina held that Geoffrey had sufficient nexus to statisfy due process requirements.

Relying on *Quill Corp. v. North Dakota*,[160] the *Geoffrey* court explained that the Due Process Clause can be satisfied even if a corporation does not have physical presence in the taxing state, if the corporation has purposefully directed its activity at the state's economic forum.[161] The court concluded that Geoffrey had purposefully sought and obtained the benefit of economic contact with South Carolina by electing to license its trademarks and trade names in that state. The court also found that the "minimum connection" required by the Due Process Clause also was satisfied by the presence of Geoffrey's intangible property in South Carolina.[162]

The *Geoffrey* court held that the second prong of the due process test also had been met because South Carolina had conferred benefits on Geoffrey to which the tax was rationally related. The court determined that the real source of Geoffrey's income was South Carolina's Toys R Us customers. By providing an orderly society in which Toys R Us conducted its business, South Carolina made it possible for Geoffrey to earn income pursuant to the royalty agreement. Moreover, the court concluded that because South Carolina sought only to tax the portion of Geoffrey's income that it earned in the state, the tax was rationally related to the protection, benefits, and opportunities South Carolina provided to the corporation.[163]

In other cases, corporations have contributed intangibles to passive holding companies in order to divert income to a state that imposes a corporate tax at a lower rate or has no corporate income tax.

While Geoffrey did not argue that the challenged tax discriminated against interstate commerce, the South Carolina Supreme Court determined that the requirements of the Commerce Clause were met. To survive a challenge under the Commerce Clause, a tax: (1) must be applied to an activity with a substantial nexus with the taxing state; (2) must be fairly apportioned; (3) must not discriminate against interstate commerce; and (4) must be fairly related to the services provided in the state.

Geoffrey argued that it did not have sufficient nexus with South Carolina because it was not physically present in the state. The *Geoffrey* court, however, held that a state may tax income even if the taxpayer does not have a tangible physical presence in the state. In the court's opinion, the presence of Geoffrey's intangibles in South Carolina was sufficient to establish nexus for Commerce Clause purposes.

While the South Carolina Supreme Court upheld the tax in the *Geoffrey* case, it is not certain whether a Louisiana court would reach the same result. Moreover, it is not certain whether the U.S. Supreme Court would sustain such a tax. As explained above, both the requirements of the Due Process Clause and the requirements of the Commerce Clause must be satisfied for a state to impose a tax on the income of a corporation. Courts in other states have required a closer connection to a state to satisfy Commerce Clause requirements than did the *Geoffrey* court.

In *J.C. Penney National Bank v. Johnson*,[164] the J.C. Penney National Bank (JCPNB), a federally chartered national banking association incorporated in Delaware, challenged a tax imposed by the Tennessee revenue commissioner on the income JCPNB derived from credit card activities in Tennessee. The

[157] For a description of the combined unitary method of reporting corporate income, *see infra*, section III B.
[158] 313 S.C. 15, 437 S.E.2d 13 (1993).
[159] *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992).
[160] *Geoffrey*, 313 S.C., at 19, 437 S.E.2d, at 16.
[161] *Id.*
[162] 313 S.C., at 19-20, 437 S.E.2d, at 16-17.
[163] 313 S.C., at 21, 437 S.E.2d, at 18.
[164] 19 S.W.3d 831 (Tenn. App.), *application for permission to appeal denied* (May 8, 2000), *cert. denied*, 121 S. Ct. 305 (2000). (For the full text of the Tennessee Court of Appeals' decision, *see Doc 1999-39731 (20 original pages)* or *1999 STT 248-17*.)

Tennessee Court of Appeals held that while the tax satisfied the nexus requirements of the Due Process Clause, it failed the nexus requirements of the Commerce Clause. The Tennessee Supreme Court denied the commissioner's application to appeal,[165] and the U.S. Supreme Court denied *certiorari*.[166]

The *JCPNB* court held that the nexus requirements under the Commerce Clause are more stringent than the nexus requirements under the Due Process Clause. While due process considerations require a taxpayer to have minimum contacts with the state for a tax to be upheld, the court determined that the first prong of the Commerce Clause test requires "substantial nexus."

The court did not determine whether Commerce Clause nexus was the same as actual physical presence, but it noted that the commissioner had not pointed to any case in which the U.S. Supreme Court upheld a state tax in which the out-of-state taxpayer had absolutely no physical presence in the taxing state. Not only did JCPNB lack physical presence in Tennessee either through its own operations or the operations of its affiliates, but the banking company did not have independent agents conducting its business in Tennessee. Instead, JCPNB solicited customers for its credit card operations through the U.S. mail. Thus, the court held that Tennessee could not constitutionally impose a tax on the income derived from JCPNB's credit card activities in Tennessee.

If, as the* JCPNB *court implied, physical presence is necessary to satisfy the nexus requirement of the Commerce Clause, the result in* Geoffrey *might have been incorrect.

It is possible to distinguish *JCPNB* from *Geoffrey*. Unlike JCPNB, Geoffrey arguably had established a presence in the taxing state through its Toys R Us affiliate. While JCPNB's parent, the J.C. Penney Co., owned and operated the J.C. Penney retail stores in Tennessee, none of the stores were affiliated with JCPNB's credit card operations. In contrast, the intangibles that were the subject of the license agreement between Geoffrey and Toys R Us were directly related to the production of income in South Carolina. Thus, Geoffrey had a closer connection with the taxing state than did JCPNB.

Nevertheless, if, as the *JCPNB* court implied, physical presence is necessary to satisfy the nexus requirement of the Commerce Clause, the result in *Geoffrey* might have been incorrect. Unless and until the U.S. Supreme Court provides further guidance, questions will remain as to whether the Commerce Clause permits a state to impose a tax on income earned by a person that is not physically present in the state.

On the other hand, the licensing income in the *Geoffrey* case would never have raised an issue if South Carolina had required Toys R Us to report the combined unitary income earned by the corporation and its affiliates in the state. In that case, the license fees would have been ignored, and the unitary business income of Toys R Us, Geoffrey, and other affiliates would have been apportioned to South Carolina, based on the extent to which the entire business operated in South Carolina, as compared with business operations in all states.

Auditing and litigating such controversies drains the Revenue Department of resources that could be used for collecting taxes from other delinquent taxpayers and for providing services to other taxpayers. Adoption of the unitary business principle in Louisiana would eliminate transfer pricing controversies and controversies like the one described above.

B. Reporting Income in Accordance With the Unitary Business Principle

Under the unitary business principle, income of a corporation and its affiliates is apportioned to a state using the formulary apportionment method adopted by the state, even if the corporation's affiliates are not present in the state and are not directly subject to the state's taxing jurisdiction. The application of the unitary business principle is appropriate in cases where the operation of the business within a state either is dependent on or contributes to the operation of the business outside the state.[167] In other words, the activities of the taxpayer and its affiliates engaged in the same business outside the state contribute to the production of income produced within the state, or the activities of the taxpayer and its affiliates within the state contribute to the income produced without the state.

As explained earlier, the apportionment statutes measure the degree of a corporation's business activity in a state. To the extent that a corporation conducts its business activity in a state, the corporation enjoys benefits and services that the state provides. Thus, the apportionment statutes provide a measurement of the degree to which a corporation enjoys benefits provided by each of the states in which the corporation transacts business. It is appropriate to apportion a greater portion of a corporation's income to a state in which it enjoys a greater portion of state benefits and services. The corporate income tax should reimburse states proportionately for the costs they incur in providing such benefits and services.

Where a corporation conducts a unitary business in one state with affiliated business organizations that do not conduct business in that state, the out-of state business organizations benefit indirectly from the benefits and services that the state provides to the corporation. Thus, a portion of the unitary business income earned by the entire affiliated group is enhanced by the services provided by the state in which the corporation transacts business. Accordingly, it is appropriate to apportion all of the unitary business income to that state, based on the property, payroll, and sales factors of the entire affiliated group.

The application of the unitary business principle varies from state to state.[168] A number of states permit or require a corporation to file a separate return, even if the corporation is part of a multicorporate group that conducts a unitary business. In some states in which separate returns are filed, a corporation must include in its apportionable net income dividends paid by nondomiciliary subsidiaries that are engaged with the corporation in a unitary business.[169]

[165] *J.C. Penney National Bank*, 19 S.W.2d, at 831.
[166] 121 S. Ct. 305 (2000).

[167] *Edison Cal. Stores Inc. v. McColgan*, 30 Cal.2d 472, 183 P.2d 16, 21 (1947).
[168] For a description of the different ways in which states apply the unitary business principle, *see* Franklin C. Latcham, 1110 Tax Mgmt., *Income Taxes: Definition of a Unitary Business* 0002, 0028-0037.
[169] *Id.*

Including unitary business income in the apportionable tax base only when dividends are paid presents a number of problems. If a corporation transacts business in a state that subjects unitary business income of an affiliate to taxation only when such income is realized, the corporation can manipulate the amount of its apportionable income (and therefore income subject to state tax) by controlling the timing of distributions made by its subsidiaries. On the other hand, the inclusion of dividends received from affiliates in apportionable income may be detrimental to a corporate taxpayer because the taxpayer may not use the property, payroll, and sales of the subsidiary to reduce the portion of its tax base that is apportionable to the state imposing the tax.

Some states require affiliated corporations to file consolidated returns.[170] Still other states require a corporation to file a combined income tax return with its affiliates.[171] The definitions of "consolidated return" and "combined return" vary from state to state.

If the Louisiana Legislature decides to adopt the unitary business principle for taxing corporations, it should require the combined return method, with separate return limitation rules, for reporting income.

For purposes of this article, the term "consolidated return" will be used to refer to a tax return in which all members of a group of affiliated corporations report their income on the same income tax return, and the apportionment factors are applied by reference to the property, payroll, and sales of the entire affiliated group.[172] On the other hand, if affiliated members of a unitary business file a combined report, each corporation that has nexus with the state determines its state taxable income by apportioning the group's combined business income to the state on the basis of combined apportionment factors.[173]

The group's combined business income is apportioned to the state using the three apportionment factors. Any nonbusiness income that is specifically allocated to the state then is added to the amount of unitary business income that is apportioned to the state.

A state that requires combined unitary business income reporting may have a separate return limitation rule for specific items such as nonbusiness losses, net operating loss carryforwards, and tax credits. In such a case, an individual corporation in the group will report its share of the unitary business income and use its own losses and credits to offset its share of the unitary business income. Other members of the affiliated group may not use any of another member's losses or credits.

In contrast, taxpayers that file a consolidated return may reduce income of the entire group by utilizing net operating losses of each of the members carried forward from earlier years. Regardless of whether a corporation files a consolidated return or a combined return with affiliates that are engaged in a unitary business, all of the income of the affiliated group that is earned in the unitary business and all of the property, payroll, and sales of the members of the group that are connected with the unitary business are taken into account in determining the amount of the group's income that is attributable to the state. The following example illustrates the difference between the use of a consolidated return and the use of a combined return for reporting unitary business income:

> **EXAMPLE:** Assume that Corporation A and Corporation B are affiliated corporations that transact a unitary business. Corporation A transacts business in Louisiana and, therefore, is subject to the state's taxing jurisdiction. Corporation B transacts business outside Louisiana. Assume that for each of the years 1998, 1999, 2000, and 2001, Corporation A has had a net profit of $100, and Corporation B has incurred a net loss of $50. Louisiana did not require corporations to report or pay tax on its unitary income for 1998-2000. Assume that in 2000, the Louisiana Legislature approves a statute requiring affiliated corporations to report and pay Louisiana corporate income tax on unitary business income for the year 2001 and thereafter.
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> If the Louisiana Legislature approves legislation requiring affiliated corporations to file consolidated returns on their unitary business income, the consolidated return including Corporation A and Corporation B will show net income of $50 for 2001 and a net operating loss carryover of $150, attributable to Corporation B's net losses incurred from 1998-2000. Thus, the affiliated group consisting of Corporation A and Corporation B will have no unitary business income allocable to Louisiana and will have a remaining net operating loss of $100 to be carried forward to 2002.
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> If the Louisiana Legislature approves legislation requiring corporations to file combined returns with respect to their unitary business income, Corporation A and Corporation B will report $50 of net unitary income for 2001. Assume that after applying the three-factor test (property, payroll, and sales), one-half of the $50, or $25, of the unitary business income attributable to Louisiana is allocated to Corporation A and the other half, or $25, is allocated to Corporation B. Corporation B then will use $25 of Corporation B's $150 net operating loss to offset the $25 of unitary income allocated to Corporation B. In that case, Corporation A will report and pay Louisiana corporate income tax on $25 of unitary income, and Corporation B will have

[170] For statutes requiring taxpayers to file consolidated reports under certain circumstances, *see, e.g.*, Ga. Code Ann. section 48-7-21(b)(7)(A)(i); Ga. Regs. 560-7-3-.06(4); Neb. Rev. Stat. section 77-2734.04(6); Okla. Stat. section 2367. For a description of the consolidated return and combined return methods of reporting unitary income, *see* William L. Goldman, et al., 1130 Tax Mgmt., *Income Taxes: Consolidated Returns and Combined Reporting.*

[171] *See, e.g.*, *Alaska Stat. section 43.20.073*(a); *Ariz. Regs. R15-2-113.E.1*; Cal. Rev. & Tax. Code section 25110 *et seq.*; Me. Rev. Stat. Ann. section 5220.5; N.D. Regs. section 81-03-05.3-02; Utah Code Ann. section 59-7-402. In some states, the tax administrator may require combined unitary reporting if it is necessary to accurately reflect income. *See, e.g.*, Colo. Rev. Stat. section 39-22-303(ii); Idaho Code section 63-3027(t); Mich. Comp. Laws section 208.77; N.Y. Regs. section 6-2. Tennessee requires financial institutions that form a unitary business to file combined unitary reports Tenn. Code Ann. section 67-4-2006(a). However, other corporations transacting business in Tennessee are not required to file combined reports.

[172] Goldman, et al., *supra*, note 170, at 1130.003.

[173] *Id.*, at 1130.002.

remaining a $125 net operating loss to carry forward to offset Corporation B's share of the unitary income subject to tax in Louisiana in future years.[174]

If the Louisiana Legislature decides to adopt the unitary business principle for taxing corporations, it should require the combined return method, with separate return limitation rules, for reporting income, rather than either of the other methods. As explained above, requiring a corporation to include in income only dividends, interest, and capital gain on the sale of stock attributable to a subsidiary conducting a unitary business with the parent can cause distortions in attributing the affiliated group's unitary income to the state. If consolidated returns are permitted, Louisiana will lose significant revenues during the first few years in which the statute is effective as corporations use carryovers of their affiliates' net operating losses to offset the entire unitary business income for the year. If Louisiana adopts a combined return reporting system, an affiliated corporation's carryover net operating losses will eventually offset the group's unitary business income that is allocable to Louisiana, but not all in the first few years in which unitary business income reporting is adopted for Louisiana.

The adoption of the unitary business principle in Louisiana would eliminate transfer pricing controversies between taxpayers and the Louisiana Revenue Department.

Combined unitary reporting also may provide a more accurate reflection of the group's economic activity in Louisiana than consolidated return reporting because the ownership threshold is lower for combined reporting. Under most state statutes, two or more corporations must be connected through an ownership of at least 80 percent of a member's voting stock before consolidated returns will be permitted or required.[175] Noncorporate members of an affiliated group conducting a unitary business do not join in a consolidated report.

In contrast, combined unitary reporting may be permitted or required where one or more corporations own more than 50 percent of the voting stock of another corporation[176] or own a controlling interest in an unincorporated business organization such as a partnership, LLC, or trust.[177] If a state requires only corporate members of a unitary group to file consolidated or combined returns, corporations may find methods of diverting income to unincorporated affiliates that do not have nexus with the taxing state.

Under either the consolidated return method or the combined unitary return method of reporting income, intercompany transactions,[178] such as the sale of property to members of the affiliated group, intercompany loans, and dividends received from an affiliate, generally are ignored, at least to the extent that the intercompany transactions are entered into in connection with the unitary business or, in the case of dividends, the dividends are from earnings and profits of the unitary business.[179] Thus, the cost at which property is transferred from one member to another is irrelevant. The adoption of the unitary business principle in Louisiana would eliminate transfer pricing controversies between taxpayers and the Louisiana Revenue Department.

A number of states permit a corporation either to file a separate return or to file a consolidated[180] or combined return with other members of a unitary business.[181] Louisiana should require corporations to report unitary business income, and not permit corporations to elect to use consolidated or combined unitary income reporting. Elective unitary business reporting would result in a significant loss in Louisiana revenue. If Louisiana permitted corporations to choose whether to report their Louisiana income using separate returns, combined returns, or consolidated returns, corporations would minimize their Louisiana income tax liability by selecting the method for reporting their income that would produce the least amount of Louisiana income.

C. Statutory Adoption Of the Unitary Business Principle

Like the Louisiana Corporation Income Tax Act, UDITPA does not contain a specific provision authorizing the use of the unitary business principle. Nevertheless, section 18 of UDITPA, authorizing alternative methods for allocating and apportion-

[174] The example was provided to the author by Michael D. Pearson, Senior Policy Consultant for Corporate, Income, and Franchise Tax Policy, Louisiana Department of Revenue and Taxation, telephone conversation (Nov 13, 2000). *See also* Goldman, et al., *Income Taxes: Consolidated Returns and Combined Reporting*, 1130 Tax Mgmt. 1130:0002-0003.

[175] *See, e.g.*, Ala. Code section 40-16-3(d); Alaska Admin. Code tit. 15, section 20.100; Ark. Code Ann. section 26-51-805; Ark. Reg. 1977-2; Colo. Rev. Stat. section 39-22-305(1); Fla. Stat. Ann. section 220.131(1); Ga. Code Ann. section 48-7-21(b)(7)(A)(i); Haw. Stat. section 235.92; Mont. Code Ann. section 15-31-141(1), (2); Ind. Code section 6-3-4-14; Iowa Code section 422.37; Iowa Regs. section 53.15(422); Kan. Stat. Ann. section 79-32,142; Ky. Rev. Stat. Ann. section 141.200(2), (3)(a); Me. Rev. Stat. Ann. section 5220.6; Miss Code Ann. section 27-7-37(2)(a)(i); Neb. Rev. Stat. section 77-2734.04(6); N.M. Stat. Ann. section 7-2A-8.4.A; Okla. Stat. section 2367; Or. Rev. Stat. section 317.710; Or. Admin. R. 150-317.710(5)(a)-(b); S.C. Code Ann. section 12-7-1570; Va. Code section 58.1-442; W.Va. Code section 11-24-13a(a). Rhode Island requires a 95-percent ownership interest for corporations to file consolidated returns. R.I. Gen. Laws section 44-11-4; R.I. Regs. section CT 88-7(1).

[176] *See, e.g.*, Idaho Code section 63-3027(t); Neb. Rev. Stat. section 77-2734.04(13); Ohio Regs. section 5703.5.06.

[177] *See, e.g.*, Minn. Stat. section 290.17. Subd.4(b).

[178] *See, e.g.*, Colo. Rev. Stat. section 39-22-303(11); Ill. Admin. Code section 100.3320(d); N.M. Stat. Ann. section 7-2A-8.3.

[179] If a state requires combined unitary reporting, dividends generally are ignored to the extent the dividends are paid from earnings and profits that have been included in the combined report. *See, e.g.*, Alaska Admin. Code tit. 15, section 20.300; Cal. Rev. & Tax. Code section 25106; Colo. Regs. section 39-22-303.9; Conn. Gen. Stat. section 12-223a.(3).

[180] *See, e.g.*, Ala. Code section 40-16-3(d); Alaska Admin. Code tit.15, section 20.100; Ark. Code Ann. section 26-51-805; Ark. Reg. 1977-2; Colo. Rev. Stat. section 39-22-305(1); Fla. Stat. Ann. section 220.131(1); Haw. Rev. Stat. section 235.92; Ind. Code section 6-3-4-14; Iowa Code section 433.37; Iowa Regs. section 53.15(422); Me. Rev. Stat. Ann. section 5220.6; Miss. Code Ann. section 27-7-37(2)(a)(i); Mont. Code Ann. section 15-31-141(1), (2); N.M. Stat. Ann. section 7-2A-8.4.A; Or. Rev. Stat. section 317.710; Or. Admin. R. 150-317.710(5)(a)-(B); R.I. Gen. Laws section 44-11-4; R.I. Regs. section CT88-7(1); Va. Code section 58.1-442; W.Va. Code section 11-24-13a(a).

[181] Colo. Rev. Stat. section 39-22-303(II); Conn. Gen. Stat. section 12-223a; Ill. Rev. Stat. section 502(e); Ind. Code section 6-3-2-2(p), (q); 103 Ky. Admin. Regs. section 16:200 Section 1; Miss. Code Ann. section 27-7-37(2)(a)(i); N.M. Stat. Ann. section 7-2A-8.3; Ohio Rev. Code Ann. section 5733.052; Ohio Regs. section 5703-5-06; Va. Code section 58.1-442.

ing income if the methods under UDITPA do not "fairly represent the extent of the taxpayer's business activity in this state," has been interpreted as authorizing the use of the unitary business principle.

If the Louisiana Legislature adopts UDITPA, however, it should not rely on section 18 to ensure that combined unitary reporting will be required in Louisiana. Instead, the Legislature should approve a provision specifically authorizing the use of the unitary business principle, requiring combined unitary reporting, and defining the term "unitary business."

The Louisiana Supreme Court has taken a narrow view of what constitutes a unitary business. In *Texas Co. v. Cooper*,[182] the taxpayer Texas Co. sought to compute its Louisiana income using the apportionment method prescribed by statute. During the years in issue, the Louisiana statutes concerning the allocation and apportionment of a corporation's income to Louisiana were similar to the current statutes. Like the current rule, the statute in effect at the time of *Texas Co.* permitted the Louisiana Revenue Department to require a taxpayer to use the separate accounting method "when the collector finds that the use of the apportionment method used by a taxpayer produces a manifestly unfair result and that the separate accounting method would more equitably determine the amount of net income from sources in Louisiana."[183]

The Revenue Department sought to allocate Texas Co.'s income to Louisiana using the separate accounting method. The Louisiana Supreme Court held that even though the statute, as construed both by the Louisiana Department of Revenue and the taxpayer, authorized the use of the formulary method for apportioning income if the business was unitary, the court held that the business of Texaco, an integrated oil company, was not unitary.

In *Texas Co.*, the taxpayer argued that:

> the business of the Texas Company of gathering raw materials, refining, manufacturing and selling is strictly a unitary operation so that each step is so linked with every other step wherever taken that the whole is a single unit to the extent that it is impossible to make a separate accounting of the Louisiana transactions to determine the net income attributable to sources arising within the state.[184]

The Louisiana Supreme Court disagreed, stating:

> There is nothing done to the crude oil in Louisiana that benefits the business or operations done elsewhere, and therefore, the production and purchase of crude oil in Louisiana is a complete step and not necessarily linked with the refining, distribution and sales elsewhere. . . .[185]

It is not certain whether the Louisiana Supreme Court would reach the same conclusion if *Texas Co.* were decided today. At the time of the decision, the unitary business principle was not as widely used as it is today. It was difficult for the Texas Co. to show that the separate accounting method was inappropriate because it used that method for reporting its income in Arkansas, Mississippi, Kansas, and New Mexico.[186] Moreover, *Texas Co.* was decided in 1958, 22 years before the U.S. Supreme Court approved application of the unitary business principle to the operations of an integrated oil company in *Exxon Corp. v. Wisconsin Department of Revenue*[187] and *Mobil Oil Corp. v. Commissioner of Taxes of Vermont*.[188]

In *Texas Co.*, it was the Revenue Department, and not the taxpayer, that sought use of the separate-accounting method. Even though the statute, like the current rule, placed the burden of establishing the manifest unfairness of the apportionment method on the party seeking separate accounting,[189] the court interpreted the Louisiana statute to give the Revenue Department broad discretion in requiring the use of the separate accounting method.

The Legislature should approve a provision specifically authorizing the use of the unitary business principle, requiring combined unitary reporting, and defining the term 'unitary business.'

It is not certain whether the *Texas Co.* court would have required the use of the separate accounting method if the taxpayer, rather than the Revenue Department, had sought to use that method of reporting its Louisiana income. At the time of the decision the statute, like the current rules, imposed a more stringent standard on a taxpayer than applied to the Revenue Department in seeking to use the separate accounting method. If a taxpayer desires to depart from the statutory apportionment rules, not only does the taxpayer have to show that the apportionment method produces a manifestly unfair result, but the taxpayer also has to show that:

> [T]he unit of the taxpayer's business operating in this state could be successfully operated independently of the units in other states, and makes all of its sales in this state or derives all of its gross revenues from sources in this state, and any merchandise sold by the unit in this state is either:
>
> (1) Produced by the taxpayer in Louisiana;
>
> (2) Purchased by the taxpayer from nonaffiliated sources within or without this state;
>
> (3) Purchased from an affiliated source at not more than the price at which similar merchandise or products in similar quantities could be purchased from nonaffiliated sources; or
>
> (4) Transferred from another department of the taxpayer's business at no more than the actual cost to the taxpayer; or where it is otherwise shown to the satisfaction of the collector that the apportionment produces a manifestly unfair result and that the separate accounting method

[182] 236 La. 380, 107 So.2d 676 (1958).

[183] La. Rev. Stat. Ann. section 47:244, 5th para., 1948 Louisiana Acts No. 354. *See also* La. Rev. Stat. Ann. section 47:287.94(E).

[184] *Texas Co.*, 236 La. 380, 107 So.2d 676, 681 (1958).

[185] *Texas Co.*, 236 La. 380, 170 So.2d 676, 683 (1958).

[186] *Texas Co.*, 236 La. 380, at 397, 107 So.2d, at 682.

[187] 447 U.S. 207 (1980), discussed *infra* at, note 204-208 and accompanying text.

[188] 445 U.S. 425 (1980), discussed *infra*, at notes 209-212 and accompanying text.

[189] La. Rev. Stat. Ann. section 47:244, 6th para., 1948 La. Acts No. 354. *See also* La. Rev. Stat. Ann. section 47:287.94(F).

produces a fair and equitable determination of the amount of net income taxable in this state.[190]

In *Texas Co.*, the court deferred to the Revenue Department's decision to determine the method by which the taxpayer's income should be attributed to Louisiana.[191] The court required the taxpayer to prove that it would be impossible to make a separate accounting of its income in Louisiana.

Section 18 of UDITPA imposes the same standard on the taxpayer and the tax administrator for departing from the statutory apportionment rules.

In contrast, section 18 of UDITPA imposes the same standard on the taxpayer and the tax administrator for departing from the statutory apportionment rules, that "the allocation and apportionment provisions of this Act do not fairly represent the extent of the taxpayer's business activity in this state." Unlike the Louisiana Corporation Income Tax Act, UDITPA focuses on business activity in a state, rather than the amount of net income taxable in the state. Moreover, section 18 of UDITPA allows the tax administrator to seek the use of methods other than the statutory apportionment method or the separate accounting method in attributing a taxpayer's income to the state. If the Louisiana Legislature adopted UDITPA, it is not certain whether the Louisiana Supreme Court would interpret section 18 of UDITPA to require combined unitary reporting. Like other courts, the Louisiana Supreme Court could interpret the language of UDITPA to allow the Revenue Department to require the use of combined unitary reporting.

The Louisiana Supreme Court may also defer to the Revenue Department's decision to require combined unitary reporting under the authority granted to the Revenue Department under section 47:287.480 of the Revised Statutes to apportion or allocate items of income, deduction, or credit between or among related business organizations if it determines that the allocation or apportionment is necessary in order to prevent evasion of taxes or clearly reflect income of any of the business organizations.[192] Section 47:287.480 specifically authorizes the Revenue Department to require corporations to file consolidated returns[193] and implies that it may require combined returns.[194] Courts in other states have interpreted similar provisions to authorize the tax administrator to require combined unitary income returns.[195]

Nevertheless, if the Legislature wants to ensure that the unitary business principle will apply in Louisiana, it should adopt the principle by statute. In that case, there will be no question concerning legislative intent.

D. Definition of 'Unitary Business'

Income of an affiliated entity may be included in a corporation's apportionable business income only if the corporation and its affiliate are engaged in a unitary business. The definition of what constitutes a unitary business varies from state to state. In most cases, the definition is vague. While the lack of uniformity and the uncertain standards are likely to cause confusion and controversy, the unitary business principle provides a more accurate method for attributing a corporation's business to a state in cases in which the corporation operates its business in other states through affiliates.

Moreover, the U.S. Supreme Court has provided some guidance concerning the limitations on a state's ability to define the term "unitary business." If the Louisiana Legislature approves a statute requiring corporations to report and pay tax on the unitary business income of their affiliates and provides a definition of the term "unitary business" that falls within the Supreme Court's guidelines, the use of the unitary business principle in Louisiana should not result in much litigation.

The U.S. Supreme Court has identified three criteria that indicate that a business should be considered unitary: (1) functional integration; (2) centralization of management; and (3) economies of scale.[196] Thus, where a corporation and its affiliates engage in the same line of business, business decisions are made for the group by the same persons, and goods and/or services are transferred among the group, the affiliated group may be treated as a unitary business.

E. Constitutional Considerations

As explained earlier, there are two potential limitations on a state's ability to impose a tax on the income of any taxpayer: (1) the Due Process Clause of the 14th Amendment;[197] and (2) the Commerce Clause[198] of the U.S. Constitution. Under the Due Process Clause, a state may not deprive a taxpayer of property without due process of law. Under the Commerce Clause, a state may not impose a tax that places an undue burden on interstate or foreign commerce. Due Process Clause considerations focus on the fairness of imposing a tax on the taxpayer, whereas Commerce Clause considerations focus on the effect of the tax on interstate and foreign commerce.

The Supreme Court has stated that the exercise of a state's taxing power over a taxpayer or its activities is justified if the state provides the taxpayer "protection, opportunities and benefits."[199] If the state lacks some minimum connection or nexus with the taxpayer or its activities, "it has not given anything for which it can ask return."[200]

Thus, when a state seeks to include a corporation's income from interstate activities in the state tax base, there must be some link, or at least "a 'minimal connection' between the interstate activities and the taxing state, and a rational relation-

[190] La. Rev. Stat. Ann. section 47:242(2), 1948 La. Acts No. 354. *See also* La Rev. Stat. Ann. section 47:287.94(C).

[191] *See Texas Co.*, 236 La. 380, 394-395, 107 So.2d, 676, 681-682:

"It is my opinion Louisiana, having the right to collect a tax imposed on net income, has the right to determine what that income is in relation to the business transacted within the state if that can be done fairly and equitably even though the net income by that separate accounting method is more than what would be the state's aliquot portion of the earnings based on the statutory formula of the earnings based on the statutory formula of apportionment of the nationwide operations."

[192] La. Rev. Stat. Ann. section 47:287.480(2).

[193] La. Rev. Stat. Ann. section 47:287.480(3).

[194] La. Rev. Stat. Ann. section 47:287.480(3)(a).

[195] *See, e.g., Pioneer Container Corp v Director of Taxation*, 684 P.2d 1286 (Kan. 1989).

[196] *See, e.g., Mobil Oil Corp. v Commissioner of Taxes of Vermont*, 445 U.S. 425, 438 (1980).

[197] U.S. Const. Amd. XIV section 1.

[198] U.S. Const. Art. I, section 8.

[199] *Wisconsin v J.C. Penney Co.*, 311 U.S. 435, 444 (1940).

[200] *J.C. Penney*, 311 U.S. 435, 444.

ship between the income attributed to the state and the intrastate values of the enterprise" for the tax to satisfy constitutional limitations.[201] In general, a state may not tax value earned outside its borders.[202] However, the Supreme Court has held in numerous cases that constitutional limitations do not prevent a state from apportioning and taxing income that under geographic accounting is earned outside the state "so long as the intrastate and interstate activities [form] part of a single unitary business."[203]

This section discusses six cases in which the U.S. Supreme Court has determined whether a state's application of the unitary business principle was constitutional. While the cases are somewhat confusing, they set some important guidelines regarding certain types of business operations that may be considered unitary. Reviewing the factual settings of each of the cases may provide a better understanding of the application of the unitary business principle.

1. Exxon

In *Exxon Corp. v. Wisconsin Department of Revenue*,[204] Exxon used a functional accounting system that divided the corporation's income among three separate types of activities, two of which were conducted outside Wisconsin. Exxon sought to segregate the income it attributed to the Wisconsin activity from the income it attributed to its out-of-state activities under its accounting method. The issue in *Exxon* was whether constitutional limitations prohibited Wisconsin from including all of Exxon's net income generated by interstate, as well as intrastate, activities in its apportionable income, notwithstanding the corporation's use of a separate functional accounting system. While *Exxon* concerned the apportionment of only one corporation's income, *Exxon* is helpful in defining the parameters of a unitary business. The *Exxon* court held that a state may include in apportionable income, from all activities of a unitary business, even though the taxpayer accounts separately for activities that do not occur within the state.

Exxon was a vertically integrated petroleum company organized under the laws of Delaware, with its corporate headquarters in Houston, Texas. For accounting purposes, Exxon divided its activities among the following functional departments: Exploration and Production; Refining; Marketing; Marine; Coal and Shale Oil; Minerals; and Land Management. Each department had its own separate management, and each department was treated as a separate investment center. The company determined a profit for each department. Intracompany sales of products and raw materials among the three major functional departments — Exploration and Production, Refining, and Marketing — were theoretically based on competitive wholesale market prices.

Exxon's only business activity in Wisconsin was marketing and selling gasoline, tires, batteries, and accessories. The gasoline sold in Wisconsin was not produced by Exxon, but instead was obtained from Pure Oil Co. in Illinois, under an exchange agreement permitting Exxon to reduce the cost of transporting the gasoline to Wisconsin. Additives were put into the Pure Oil gasoline to make the final product conform to uniform Exxon standards.

If the state lacks some minimum connection or nexus with the taxpayer or its activities, 'it has not given anything for which it can ask return.'

The separate management for each of Exxon's functional departments constituted one of three levels of management within the company. Two higher levels of management, Corporate Management (including the board of directors, the chief executive officer, and the president of the company) and Coordination and Services Management (providing specialized services including long-range planning, development of financial policy, public relations, labor relations, purchase and sale of raw crude oil and raw materials, and coordination between refining and other functions) provided a centralized management for the company.

Exxon also used a nationwide uniform credit card system, uniform packaging, and brand names. The overall plan for distribution of products was developed by the Houston office. Promotional display equipment was designed by the engineering staff at the marketing headquarters.

In reporting its income subject to Wisconsin tax, Exxon included all of its income attributable to its marketing activities both within and without the state of Wisconsin. However, Exxon excluded its income from its other functions, such as exploration and production and refining. Wisconsin sought to include in Exxon's apportionable income all of the corporation's net income, regardless of the function to which the income was attributable under Exxon's method of accounting.

In *Exxon*, the Supreme Court explained that a company's internal accounting techniques are not binding on a state for tax purposes and held that if a company is a unitary business, a state may apply an apportionment formula to the taxpayer's total income.[205] The Court determined that Exxon's exploration, production, marketing, and other activities constituted a unitary business because Exxon operated "a highly integrated business which benefit[ted] from an umbrella of centralized management and controlled interaction."[206]

Many of the items sold by Exxon in Wisconsin were obtained through a centralized purchasing office in Houston. Thus, Exxon enjoyed economies of scale by purchasing such items in bulk. The gasoline sold in Wisconsin was available because of the exchange agreement with Pure Oil that was arranged by the Supply Department, part of Exxon's Coordination and Services Management, and the Refining Department. Moreover, sales were facilitated by the use of a uniform credit card system, uniform packaging, brand names, and promotion-

[201] *Mobil Oil Corp. v. Commissioner of Taxes of Vermont*, 445 U.S. 425, 436-437 (1980), *citing Moorman Mfg. Co. v. Bair*, 437 U.S. 267, 272-273 (1978); *National Bellas Hess Inc. v. Illinois Dept. of Revenue* 386 U.S. 753, 756 (1967); *Norfolk &Western R. Co. v. Missouri Tax Comm'n*, 390 U.S. 317, 325 (1967).

[202] *See, e.g., Connecticut General Life Ins. Co. v. Johnson*, 303 U.S. 77, 80-81 (1938).

[203] *Mobil Oil*, 445 U.S., at 438. Under *Mobil Oil*, "the linchpin of apportionability in the field of state income taxation is the unitary-business principle." *Id.*, at 439-440.

[204] 447 U.S. 207 (1980).

[205] *Exxon*, 447 U.S., at 220.

[206] *Exxon* 447 U.S., at 224.

al displays, all run from the corporation's national headquarters.

In the Court's opinion, the following testimony of an Exxon senior vice president illustrated the link among Exxon's three main operating departments:

> [I]n any industry which is highly capital intensive, such as the petroleum industry, the fixed operating costs are highly relative to total operating costs, and for this reason the profitability of such an industry is very sensitive and directly related to the full utilization of the full capacities of the facilities.
>
> So, in the case of the petroleum industry it is — where you have high capital investments in refineries, the existence of an assured supply of raw materials and crude is important and the assured and stable outlet for products is important, and therefore when there are — when these segments are under a single corporate entity, it provides for some assurance that the risk of disruptions in refining operations are minimized due to supply and demand imbalances that may occur from time to time. . . .[207]

Thus, the Court concluded that Exxon's marketing activity in Wisconsin was an integral part of a unitary business. Wisconsin was not required to treat Exxon's income derived from exploration and production as attributable to the situs in which such activities occurred. The Court explained:

> An effective marketing operation is important to assure full or nearly full use of the refining capacities. Obviously the quality of the refined product affects the marketing operation. And the success of the Exploration and Production Department helps to keep the refineries operating at a capacity which is cost efficient. There is indeed a unitary stream of income, of which the income derived from internal transfers of raw material from exploration and production to refining is a part. There is sufficient nexus to satisfy the Due Process Clause.[208]

Under *Exxon*, a unitary business may be present where each of the separate functions of the business contribute to the generation of the income from the sale of a product. However, all three factors should be present before a state treats a group of related corporations as a unitary business. In *Exxon*, all three factors were present. The corporation's exploration and production, refining, and marketing departments were functionally integrated because each department depended on another or contributed to the operation of another department. A centralized management coordinated the activities of all of the corporation's departments. Economies of scale were realized through the corporation's centralized purchasing system and its ability to negotiate an exchange agreement with Pure Oil.

2. Mobil Oil

In *Mobil Oil Corp. v. Commissioner of Taxes of Vermont*,[209] Mobil Oil Corp., a corporation formed under the laws of New York and whose principal place of business was in New York, engaged in the business of wholesale and retail marketing of petroleum products in Vermont. The commissioner of taxes of Vermont sought to include in Mobil's apportionment tax base dividends that Mobil received from affiliates and subsidiaries primarily doing business in foreign countries.

Mobil's petroleum business included activities such as exploration for petroleum reserves and production, refining, transportation, distribution, and sale of petroleum and petroleum products. Because the petroleum activities were functionally integrated, they constituted a unitary business. While Mobil's business activities in Vermont were significant, they only comprised a small part of the corporation's worldwide enterprise.

Because Mobil failed to provide evidence that would undermine the conclusion that most, if not all, of the subsidiaries and affiliates were part of Mobil's worldwide petroleum business, the Supreme Court assumed that the subsidiaries and affiliates were part of Mobil's unitary petroleum business. Accordingly, the Court held that there was no constitutional limitation on Vermont's including income from part of the unitary business in its apportionable tax base. However, if the dividends had been attributable to activities of the dividend payers that had nothing to do with Mobil's activities in Vermont, the Court noted that "due process considerations might well preclude apportionability, because there would be no underlying unitary business."[210]

In *Mobil Oil*, the Court also dismissed the taxpayer's argument that the inclusion of such dividend income in a taxpayer's apportionable tax base imposed a burden on interstate commerce by subjecting the taxpayer's dividend income to a substantial risk of double taxation. New York, Mobil's state of commercial domicile, had the power to tax all dividend income received by Mobil. While New York did not tax the dividends at issue, the Court agreed that "the constitutionality of the Vermont tax should not depend on the vagaries of New York tax policy."[211] Even assuming that a state of commercial domicile has the power to impose a tax on dividends, however, the Court observed:

> [T]here is no reason in theory why that power should be exclusive when the dividends reflect income from a unitary business, part of which is conducted in other States. In that situation, the income bears relation to benefits and privileges conferred by several States. These are the circumstances in which apportionment is ordinarily the accepted method. Since Vermont seeks to tax income, not ownership, we hold that its interest in taxing a proportionate share of [Mobil's] dividend income is not overridden by any interest of the State of commercial domicile.[212]

Mobil also argued that the Vermont tax imposed a burden on foreign commerce because it subjected foreign-source income to a potential double tax, once by New York, the state of commercial domicile, and a second time by Vermont. The Supreme Court dismissed the argument, in part, because the dividend income was potentially subject to a double domestic tax, not a double tax at the international level. Thus, under *Mobil Oil*, a state may include in a corporation's apportionable income tax base dividends received from domestic or foreign subsidiaries that are engaged in a unitary business with the taxpayer.

[207] 447 U.S., at 225.
[208] 447 U.S., at 226 (footnotes omitted).
[209] 445 U.S. 425 (1980).
[210] *Mobil Oil*, 445 U.S., at 442.
[211] 445 U.S., at 444.
[212] 445 U.S., at 445-446.

3. ASARCO and Woolworth

As in Mobil Oil, the issue in *ASARCO Inc. v. Idaho State Tax Commission*[213] and *F.W. Woolworth Co. v. Taxation and Revenue Department of New Mexico*[214] was whether a nondomiciliary state's inclusion in apportionable business income of dividends received from the taxpayer's subsidiaries met constitutional standards. In both *ASARCO* and *Woolworth*, the Court held that inclusion of such income in the apportionable tax base violated constitutional constraints because the taxpayer was not conducting a unitary business with the subsidiaries in question. In both cases, the Court found that centralized management was lacking. Each case will be discussed in turn.

In *ASARCO*, Idaho sought to include in ASARCO's apportionable business income of dividends, interest, and capital gains attributable to five of ASARCO's foreign subsidiaries. ASARCO was incorporated in New Jersey and had its business headquarters in New York. During the years in issue ASARCO mined, smelted, and refined in various states nonferrous metals such as copper, gold, silver, lead, and zinc. ASARCO's primary business in Idaho was the operation of a silver mine. It also mined and sold other metals and operated the administrative office of its Northwest mining division in Idaho.

The Supreme Court considered each subsidiary separately to determine whether the subsidiary was engaged in a unitary business with ASARCO. The closest question was presented by Southern Peru Copper Corp. ASARCO was one of Southern Peru's four shareholders, owning 51.5 percent of its stock. Southern Peru produced smelted "blister copper" in Peru and sold about 35 percent of its output to ASARCO.

It would seem that ASARCO's 51.5-percent ownership interest in Southern Peru would be sufficient to control the management of the subsidiary. ASARCO, however, could not take advantage of its voting stake in Southern Peru to control the subsidiary. The other three shareholders had refused to participate in Southern Peru unless they received assurance that ASARCO would not completely dominate the subsidiary. Consequently, ASARCO entered into a management agreement under which it shared management and control of Southern Peru equally with the other three shareholders.

The trial court in *ASARCO* found that Southern Peru operated independently of ASARCO and did not seek direction or approval from ASARCO on major decisions. Based on the foregoing facts, the Supreme Court concluded that ASARCO and Southern Peru could not be classified as a unitary business.[215]

Another subsidiary, M.I.M. General Holdings Ltd., engaged in the mining, milling, smelting, and refining of copper, lead, zinc, and silver in Australia and operated a lead and zinc refinery in England. During the years in issue, M.I.M. sold approximately 1 percent of its output to ASARCO ($200,000 to $2 million per year). The sales were on the open market. M.I.M. also used an ASARCO melting furnace patent, but M.I.M. paid ASARCO a price for the use of the patent that was "the same that would be paid by any other company using it."[216]

ASARCO owned 52.7 percent of M.I.M.'s stock; the rest was widely held. While ASARCO had the voting power to control M.I.M.'s management, it appeared that ASARCO had not asserted it. ASARCO did not even elect a member of M.I.M.'s board or take part in the selection of M.I.M.'s officers. ASARCO and M.I.M. did not have any common directors or officers. The Supreme Court concluded that because the business relation between the two companies also was nominal, M.I.M. was merely an investment for ASARCO.[217]

Two other subsidiaries, General Cable Corp. and Revere Copper and Brass Inc., were large publicly traded companies that fabricated metal products. Both were ASARCO customers. ASARCO owned approximately 34 percent of the stock of each. The remaining shares were widely held. Because the two companies occupied parallel positions with respect to ASARCO, the Justice Department had brought an antitrust suit against ASARCO. In 1967, ASARCO entered into a consent decree that prohibited it from maintaining common officers in the companies, voting its stock in them, or selling the companies copper at prices below the prices it quoted their competition. Neither company's management sought direction or approval from ASARCO.

The last subsidiary under consideration was Mexicana, S.A., a corporation that mined and smelted copper in Mexico. Mexicana originally had been a wholly owned subsidiary of ASARCO, but a change in Mexican law required ASARCO to divest itself of 51 percent of Mexicana's stock. During the years in issue, ASARCO owned 49 percent of the Mexicana stock, and the remaining shares were publicly held. The Idaho Supreme Court found that Mexicana operated independently of ASARCO.

There were some business relations between Mexicana and ASARCO. While Mexicana sold insignificant amounts of its output to ASARCO, ASARCO acted as a contract sales agent for Mexicana in the United States and provided technical services to Mexicana for a fee. Nevertheless, the Supreme Court did not consider these business relations sufficient to result in a unitary business.

In *ASARCO*, Idaho argued that intangible income should be considered part of a unitary business if the intangible property (the shares of stock) is "acquired, managed or disposed of for purposes relating or contributing to the taxpayer's unitary business."[218] The Supreme Court disagreed, opining that Idaho's definition of a unitary business would destroy the concept of a "unitary business" because all of a corporation's operations, including investments, can be said to be for purposes related to or contributing to the corporation's business. The Court refused to adopt a definition of a unitary business that would permit nondomiciliary states to apportion and tax dividends "[w]here the business activities of the dividend payor have nothing to do with the activities of the recipient in the taxing State."[219]

Under *ASARCO*, a taxpayer is not engaged in a unitary business with another company if there is no centralization of management. Even though Southern Peru sold 35 percent of its output to ASARCO, the Supreme Court held that the two

[213] 458 U.S. 307 (1982).
[214] 458 U.S. 354 (1982).
[215] *ASARCO*, 458 U.S., at 321.
[216] *ASARCO*, 458 U.S., at 321, n. 18.
[217] 458 U.S., at 323.
[218] 458 U.S., at 326.
[219] 458 U.S., at 327, *quoting Mobil Oil Corp. v. Commissioner of Taxes of Vermont*, 445 U.S., at 442.

corporations were not engaged in a unitary business because ASARCO did not exercise its controlling interest in Southern Peru to dominate Southern Peru's management. Stock ownership is not sufficient to establish centralization of management unless the taxpayer actually exercised its power to make business decisions on behalf of a subsidiary. Moreover, even if a taxpayer and its subsidiaries are engaged in the same line of business, a unitary business will not be present if the taxpayer's business operations are not sufficiently related to those of the subsidiaries. While the other factors may be necessary to establish the existence of a unitary business, it seems that one of the most important factors is the actual existence of a centralized management.

While the other factors may be necessary to establish the existence of a unitary business, it seems that one of the most important factors is the actual existence of a centralized management.

The Supreme Court used a similar analysis in *Woolworth* to deny the existence of a unitary business. The taxpayer in *Woolworth*, the F.W. Woolworth Co., had its principal place of business and commercial domicile in New York. Woolworth engaged in retail businesses through chains of stores located in the United States, Puerto Rico, and the U.S. Virgin Islands. Woolworth had four foreign subsidiaries that also engaged in chain store retailing.

New Mexico sought to include in Woolworth's apportionable income approximately $39.9 million in dividends Woolworth received from the four foreign subsidiaries, as well as the "gross-up" in the dividend income that Woolworth reported on its federal income tax return because Woolworth claimed a foreign tax credit for the dividends in question.[220] Woolworth owned all of the stock of three of the foreign corporations and 52 percent of the stock of the fourth. As a result, at least with respect to the wholly owned companies, Woolworth elected all of the subsidiaries' directors. Even though Woolworth had the potential to operate the subsidiaries as integrated divisions of a unitary business, the Supreme Court concluded that it did not.

The Court determined that there was little functional integration between Woolworth and its subsidiaries. Each subsidiary made its own decisions concerning merchandise, store location, advertising, and accounting. Woolworth did not engage in any centralized purchasing, manufacturing, or warehousing of merchandise. It had no central personnel training school for its foreign subsidiaries. Each subsidiary was responsible for obtaining its own financing from sources other than the parent.

The Court also concluded that there was no centralization of management or achievement of other economies of scale. In general, none of the subsidiaries' officers was a current or former employee of the parent. Woolworth did not rotate personnel or train personnel to operate stores in the countries in which the subsidiaries operated.

The New Mexico Taxation and Revenue Department's hearing examiner found:

> Each of the four subsidiaries are [sic] responsible for determining the size and location of retail stores, the market conditions in their own territory and the mix of items to be sold. The German subsidiary emphasizes soft goods such as dresses and coats. The English subsidiary operates restaurants in its stores and also operates supermarkets. Each subsidiary attempts to cater to local tastes and needs. The inventory of each subsidiary consists, in large part, of home country produced items. This purchase-at-home practice is consistent with the policy of the taxpayer. A number of inventory items are purchased from the Orient or other places but there is no evidence that the subsidiaries purchase, or are required to purchase, inventory items from any particular source.[221]

The Supreme Court considered it important that the hearing examiner found that Woolworth "had no department or section, as such, devoted to overseeing the foreign subsidiary operations."[222] While there were some management links, the Court did not consider them sufficient to treat Woolworth and its subsidiaries as a unitary business.

Woolworth maintained one or several common directors with some of the subsidiaries. There also was "frequent" mail, telephone, and teletype communication between the upper echelons of management of the parent and the subsidiaries. Major financial decisions, such as the amount of dividends to be paid by the subsidiaries and the creation of substantial debt, had to be approved by the parent. Woolworth's published financial statements, such as annual reports, were prepared on a consolidated basis.

The Court determined that the occasional oversight that Woolworth gave its subsidiaries was no more substantial than the type of oversight that any parent gives to an investment in a subsidiary.[223] Accordingly, the Court concluded that there was little or no functional integration of business activities or centralization of management of Woolworth and the four foreign subsidiaries.[224]

The fact that Woolworth and its subsidiaries were engaged in the same line of business, of itself, was not sufficient to establish the existence of a unitary business. Under *Woolworth*, it seems that corporate management must coordinate the business operations of affiliated corporations and the business operations of each affiliate must depend on one another for the

[220] The Internal Revenue Code allows a United States corporation to claim a tax credit (the "deemed paid" credit) against its United States tax liability for foreign taxes paid by a foreign subsidiary on the earnings that the subsidiary distributes as dividends to its United States parent. IRC section 902(a). To be eligible to claim the "deemed paid" foreign tax credit, the United States corporation must own at least 10 percent of the distributing corporation's voting stock. *Id.* If a parent corporation claims the deemed-paid credit, the transaction is treated as if the subsidiary distributed to the parent corporation both the amount that actually was distributed and the amount of the foreign taxes that the subsidiary paid on the distributed earnings. IRC section 78. Because the parent then is treated as if the parent paid the foreign taxes, the parent is entitled to claim a foreign tax credit in the amount that its income is "grossed-up."

[221] *Woolworth*, 458 U.S., at 367.
[222] *Id.*
[223] 458 U.S., at 369.
[224] *Id.*

corporation and its affiliates to be considered a unitary business. If Woolworth had had a centralized purchasing system for its chain stores and the chain stores of its subsidiaries, if management had made purchasing decisions for the subsidiaries, and if Woolworth had provided training to personnel of the subsidiaries, the Court might have held that it was operating a unitary business with its subsidiaries.

Because the Court concluded that there was no unitary business, New Mexico could not include in Woolworth's apportionable income either the dividends or the gross-up amount in question. Thus, the Supreme Court did not address the issue of whether a nondomiciliary state may include in a corporate taxpayer's apportionable income the gross-up amount included on the taxpayer's federal tax return as a result of claiming a deemed-paid foreign tax credit for dividends received from a subsidiary with which the taxpayer conducts a unitary business.

The Supreme Court may find it appropriate to include the gross-up amount in apportionable income where the actual amount of a dividend from a foreign subsidiary is included in a taxpayer's unitary business income.

In other cases where the dividend payer and the corporate taxpayer were engaged in a unitary business, state courts have held that the gross-up amount is apportionable.[225] It is not certain whether such a conclusion would be supported by the Supreme Court. While the Court permits a state to apportion capital gain from the sale of stock in a subsidiary that is engaged in a unitary business with the corporate taxpayer, such income may be considered different from the gross-up amount included in the income of a taxpayer that claims a deemed paid foreign tax credit. Dividends and capital gain income are represented by a receipt of money or other property, whereas the gross-up amount is an accounting entry utilized to support a foreign tax credit.

On the other hand, the gross-up amount may enrich the taxpayer as much or more than the receipt of dividends or capital gain income. The inclusion of the gross-up amount in income may entitle the taxpayer to claim a tax credit in an amount equal to the gross-up amount, thereby increasing the amount of cash in corporate coffers. Consequently, the Supreme Court may find it appropriate to include the gross-up amount in apportionable income where the actual amount of a dividend from a foreign subsidiary is included in a taxpayer's unitary business income.

4. Container Corp.

The controversy in *Container Corp. of America v. Franchise Tax Board*[226] concerned the application of a California franchise tax (calculated with respect to income) that included in a nondomiciliary corporation's income a portion of the undistributed income earned by the corporation's foreign subsidiaries. In many respects, the facts of *Container* were similar to the facts in *Woolworth*, and Container's relations with its subsidiaries were similar to ASARCO's relations with its subsidiaries. Container was in the business of manufacturing custom-ordered paperboard packaging. Its operation was vertically integrated, including the production of paperboard from raw timber and wastepaper as well as its composition into the finished products ordered by customers.

Container owned (either directly or through other subsidiaries) 66.7 to 100 percent of the stock of 20 foreign subsidiaries. One of the subsidiaries was a holding company and another was inactive. All of the others were engaged — in their respective local markets — in the same business as Container.

Most of the subsidiaries were fully integrated. Sales from Container to its subsidiaries constituted about 1 percent of the subsidiaries' total purchases. Like Woolworth, Container did not participate in the subsidiaries' personnel matters or the day-to-day management of their businesses. Transfers of personnel from Container to its subsidiaries were rare. There was no formal United States training program for the subsidiaries' employees. However, groups of foreign employees occasionally visited the United States for two to six weeks to familiarize themselves with Container's methods of operation. Five of Container's officers, charged with the task of overseeing the subsidiaries' operations, established general standards of professionalism, profitability, and ethical practices and dealt with long-term decisions. While local decisions regarding capital expenditures were subject to Container's review, problems generally were worked out by consensus, rather than by outright domination. A number of Container's directors and officers served on the subsidiaries' boards of directors, but they generally did not play an active role in management decisions.

Nevertheless, the Supreme Court concluded that Container was engaged in a unitary business with its subsidiaries. The Court's conclusion was based on the following facts:

> [A]pproximately half of the subsidiaries' long-term debt was either held directly, or guaranteed, by [Container]. [Container] also provided advice and consultation regarding manufacturing techniques, engineering design, architecture, insurance, and cost accounting to a number of its subsidiaries, either by entering into technical service agreements with them or by informal arrangement. Finally, [Container] occasionally assisted its subsidiaries in their procurement of equipment, either by selling them used equipment of its own or by employing its own purchasing department to act as an agent for the subsidiaries.[227]

In *Container*, the Supreme Court expressed a hesitancy to review *de novo* the facts of every case in which a taxpayer challenges application of the unitary business principle. Instead, the Court defined its role in such cases as determining "whether the state court applied the correct standards to the case; and if it did, whether its judgment 'was within the realm of permissible judgment.'"[228]

The Court declined to decide whether any one of the foregoing factors would be sufficient to establish the existence of a unitary business. Nevertheless, the Court determined that, taken in combination, the factors clearly demonstrated that the

[225] *See, e.g., NCR Corp. v. Comptroller of the Treasury*, 544 A.2d 764 (Md. 1988); *International Minerals and Chemical Corp. v. Heitkamp*, 417 N.W.2d 791 (N.D. 1987).

[226] 463 U.S. 159 (1983).

[227] *Container*, 463 U.S., at 172 (footnote omitted).

[228] 463 U.S., at 176 (footnote omitted).

state court reached a conclusion "within the realm of permissible judgment."[229]

The Court considered the flow of capital resources from Container to its subsidiaries through loans and loan guarantees and the managerial roles played by Container in the subsidiaries' affairs as particularly important factors.[230] There was no indication that the loan transactions were conducted at arm's length. Furthermore, the loan transactions resulted in a flow of value from Container to its subsidiaries.

The Court also distinguished Container's oversight of its subsidiaries from Woolworth's occasional oversight — with respect to capital structure, major debt, and dividends — that was of the type typically given by any parent corporation to an investment in a subsidiary. The Court explained that a unitary business is more likely to be found where the parent's management role is grounded on its own operational expertise and its overall operational strategy.[231] In the Court's opinion, "the business 'guidelines' established by [Container] for its subsidiaries, the 'consensus' process by which [Container's] management was involved in the subsidiaries' business decisions, and the sometimes uncompensated technical assistance provided by [Container], all point to the precisely the sort of operational role we found lacking in F.W. Woolworth."[232]

Container has created some confusion over the limits of the unitary business principle. While the Court distinguished the facts in *Container* from the facts in *ASARCO* and *Woolworth*, the facts of the three cases are not so significantly different.

Container *has created some confusion over the limits of the unitary business principle.*

For example, in *ASARCO*, the parent owned 51.5 percent of the stock of its Southern Peru subsidiary; the subsidiary sold 30 percent of its production to the parent; the parent acted as a selling agent for another 20 percent of the subsidiary's output; and the parent provided substantial services to the subsidiary. The *ASARCO* Court, however, focused on the parent's lack of actual control over the subsidiary as a result of the parent's entering into a shareholder agreement that curtailed its rights to dominate Southern Peru. It seems that a unitary business will not be present if the taxpayer does not exercise its power to direct important management decisions of the subsidiary, regardless of whether the business relationship between the taxpayer and its subsidiary is substantial.

Woolworth, however, presents a closer case. Woolworth, like Container, was engaged in the same business as its subsidiaries. Like Container, Woolworth exercised little control over the day-to-day affairs of its subsidiaries. Woolworth also influenced major business decisions of the subsidiaries through frequent mail, telephone, and teletype communication between the upper echelons of management. It is difficult to distinguish the type of managerial control over the subsidiaries exercised by Woolworth from that exercised by Container. The *Container* Court did not provide a workable method for distinguishing cases like *Woolworth* from cases like *Container*.

The Louisiana Legislature should limit the definition of a unitary business to a business in which there is a flow of goods and services between a corporation and its affiliates.

The Court's opinions in *ASARCO*, *Woolworth*, and *Container* were based on a careful analysis of all of the facts and circumstances, a method of analysis that sometimes results in conflicting or seemingly conflicting opinions. In *Container*, the Court expressed an unwillingness to review the facts of every case *de novo*. Therefore, it is likely that many of the unitary business cases will be determined at the trial level by the finder-of-fact.

Container also creates confusion because the *Container* Court adopted a somewhat imprecise standard for defining the term "unitary business." In *Container*, the taxpayer urged the Supreme Court to adopt a bright-line rule requiring a finding that an enterprise constitutes a unitary business only if it is characterized by a substantial flow of goods. The Supreme Court declined, explaining that the prerequisite to finding the existence of a unitary business that meets constitutional standards is a flow of value, not of goods.

While a test requiring a flow of value between a corporation and its affiliates gives flexibility to states in applying the unitary business principle, the determination of whether there has been a sufficient flow of value may be controversial. If the Louisiana Legislature desires to adopt the unitary business principle but wants to limit the amount of potential litigation in determining the boundaries of the application of the principle, it should limit the definition of a unitary business to a business in which there is a flow of goods and services between a corporation and its affiliates.

5. Allied-Signal

While the Court did not overrule *ASARCO* or *Woolworth* in *Container*, it seemed to relax the limitations on a state's ability to tax the income of a nondomiciliary corporation. Indeed, in *Allied-Signal Inc. v. Director, Division of Taxation*,[233] New Jersey argued that the unitary business concept was so unworkable that the existence of a unitary business should not be required for a state to include in the apportionable income of a nondomiciliary corporation dividends and other intangible income received from investments.

Allied-Signal was the successor-in-interest to the Bendix Corp. The controversy in *Allied-Signal* concerned whether New Jersey could include in Bendix's apportionable tax base \$211.5 million of capital gain realized by Bendix on the sale of its 20.6 percent interest in ASARCO Inc., the same corporation that had been the petitioner in the *ASARCO* case.

During the years in issue, Bendix was a Delaware corporation with its commercial domicile and headquarters in Michigan. Bendix was organized into four major operating

[229] *Id.*, at 180.
[230] *Id.*, at 180, n. 19
[231] *Id.*
[232] *Id.*

[233] 504 U.S. 768 (1992).

groups: automotive; aerospace/electronics; industrial/energy; and forest products. Bendix's primary operations in New Jersey were the development and manufacture of aerospace products.

ASARCO was a New Jersey corporation with its principal offices in New York. ASARCO was a producer of nonferrous metals. From December 1977 through November 1978, Bendix acquired 20.6 percent of ASARCO's stock by purchase on the open market. In 1981, Bendix sold its stock back to ASARCO, realizing the capital gain that was the subject of the controversy in *Allied-Signal*.

In *Allied-Signal*, the parties stipulated that Bendix and ASARCO were "unrelated business enterprises, each of whose activities had nothing to do with the other."[234] The parties also stipulated that Bendix and ASARCO operated independently of one another. At the initial oral argument, New Jersey argued that all income earned by a nondomiciliary corporation should be apportioned by any state in which the corporation does business. The Supreme Court requested a rebriefing and a reargument, asking the parties to address the issue of whether the Court should overrule *ASARCO* and *Woolworth*.

After the rebriefing and reargument, the *Allied-Signal* Court declined to overrule its former cases and reaffirmed its conclusion that the Due Process and Commerce clauses prohibit a state from taxing value earned outside its borders. While the Court held that constitutional constraints prohibited New Jersey from taxing the income in question, it stated that the unitary business principle was not the only prerequisite for apportionment in all cases.[235] According to the Court, what is required is that the taxpayer treat the particular intangible asset as serving an operational function, rather than an investment function.[236] Thus, for example, income from short-term investments of working capital is apportionable, notwithstanding the absence of a relationship between the corporation and the entity in which the working capital is invested.[237]

While the *Allied-Signal* Court stated that relationships other than a unitary business may justify taxation, the Court provided only one example in which apportionment of nonunitary business income from intangibles was permissible, i.e., income from short-term investments to raise working capital. The Court provided no method for determining whether an investment is operationally related to the taxpayer.

F. Suggestion for a Definition of a Unitary Business For Louisiana Income Tax Purposes

The Supreme Court's failure to provide a meaningful definition of the term "unitary business" and the circumstances, other than investing to increase working capital, in which income other than unitary business income may be included in apportionable income, is likely to lead to litigation in borderline unitary business cases. Nevertheless, there are a number of situations in which there should be no question as to the existence of a unitary business. If the Louisiana Legislature decides to adopt the unitary business principle, it should define the term "unitary business" by statute to provide certainty to taxpayers and to ease the administrative burden on the Revenue Department.

The Legislature can reduce the potential for litigation by defining a unitary business in accordance with some of the Court's clearer guidance. *ASARCO* and *Woolworth* established that functional integration, centralization of management, and economies of scale are three criteria that will establish the existence of a unitary business. All three criteria are likely to be found in the case of a vertically integrated business in which goods are manufactured or produced in one state and sold in another. In such cases, there is a "flow of value" between or among members of an affiliated group that cannot be precisely identified or measured.[238]

The Legislature can reduce the potential for litigation by defining a unitary business in accordance with some of the Court's clearer guidance.

Woolworth indicates that a unitary business also may be present where an affiliated group is engaged in a business involving the centralized purchase and multistate sale of inventory. In *Butler Brothers v. McColgan*,[239] the Supreme Court affirmed the existence of a unitary business where the taxpayer, a corporation with its headquarters in Illinois and stores in California and other states, was engaged in a wholesale dry goods business. Because inventory was purchased centrally for all the stores on a volume basis, the business enjoyed economies of scale. In *Butler Brothers*, centralized management and other services, such as accounting and advertisement, were provided to each of the separate branches. If inventory is purchased centrally, it is likely that centralization of management also will be present to coordinate the purchase and distribution of the inventory to the affiliates or branches of the corporation.

As explained above, the *Container* Court held that a flow of goods was not a necessary element for establishing the existence of a unitary business. Instead, a unitary business may exist if there is a "flow of values" between or among members of an affiliated group. The flow of values in *Container* consisted of loans from the parent corporation to its subsidiaries and guarantees of the subsidiaries' debt. In addition, the subsidiaries benefited from the establishment by Container's officers of general standards of professionalism, profitability, and ethical practices and their involvement in major problems and long-term decisions.

A flow of values also could be established in the case of a service-oriented business in which the taxpayer provides training to its affiliates' employees and technical knowledge and expertise. A number of state courts have assumed that multistate general contractors are unitary.[240] Similarly, a multistate services-oriented business such as a telecommunications busi-

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[234] *Allied-Signal*, 504 U.S. 768, 774.

[235] 504 U.S., at 787.

[236] *Id*

[237] *Id.*, at 787-788.

[238] *Container Corp. of America v. Franchise Tax Bd.*, 463 U.S. 159, 166 (1983).

[239] 315 U.S. 501 (1942), *aff'g* 111 P.2d 334 (Cal. 1941)

[240] *See, e.g., Pentzien Inc. v. Department of Revenue*, 418 N.W.2d 546 (Neb. 1988); *Donald M Drake v. Department of Revenue*, 500 P.2d 1041 (Ore. 1972); *Donovan Construction Co. v. Department of Treasury*, 337 N.W.2d 297 (Mich. 1983); *Bank Building and Equipment Corp. v. Director of Revenue*, 687

(Footnote 240 continued on next page.)

ness, architectural firm, securities firm, underwriting business, or restaurant chain, could be found to be unitary. Indeed, Louisiana currently has rules for apportioning the income of certain service enterprises.[241]

The Arizona regulations provide that a flow of know-how and expertise may establish the existence of a unitary business for a service enterprise as follows:

> In a unitary business, the operations of the various component parts or entities of the business are integrated and interrelated by their involvement with the central office of the parent in delivering the same service. The day-to-day operations of these components use the same procedures and technologies which are developed, organized, purchased, and/or prescribed by the central office of the parent. There usually is an exchange of employees among the component parts and centralized training of employees.[242]

There is no Supreme Court guidance on the circumstances under which a services-oriented business may be considered unitary. Nevertheless, as the service sector has become a more important component of the economy than heavy industry, the state of Louisiana should consider developing standards for including service businesses in the definition of a unitary business. Where a centralized management makes policy and major business decisions for the group, sets standards, and provides training and expertise to the other members of the group, a group of affiliated business organizations, all engaged in offering the same type of services, should be considered a unitary business.

IV. Conclusion

The confusion caused by the invalidation of Act 690 provides an excellent opportunity for the Louisiana Legislature to reconsider the manner in which the income of a multistate corporation is attributed to Louisiana. In reviewing the Louisiana allocation and apportionment rules, the Legislature should give careful consideration to adopting UDITPA. Not only does UDITPA offer a simpler approach to the division of income than the current Louisiana rules, but uniform rules would provide benefits both to taxpayers and to the Revenue Department by easing the costs of compliance and administration. The adoption of UDITPA would add certainty because the parties would have the advantage of the experience of other states in interpreting the act. In addition, the adoption of UDITPA would reduce the risk that a multistate corporation's income could be subject to double taxation.

Regardless of whether Louisiana adopts UDITPA, the Legislature should approve a law incorporating the unitary business principle into the apportionment rules. Treating each member of an affiliated group as a separate entity under Louisiana law provides incentive to multistate affiliates to divert income from Louisiana by selling each other goods and services. The separate-return method places at a competitive disadvantage taxpayers that cannot divert income from Louisiana because their entire operation is located in Louisiana. In this respect, the Louisiana Corporation Income Tax Act arbitrarily discriminates against local businesses.

Some have suggested that the adoption of the unitary business principle would hasten the departure of businesses from Louisiana by creating an unfavorable tax environment to corporations.[243] Currently, Louisiana does not require a corporation to file combined unitary income tax returns with its nondomiciliary affiliates. Nevertheless, the state has not been able to stem the flow of businesses to other states. It is likely that other factors, such as the lack of trained and trainable workers as a result of the deficient Louisiana education system, are more influential in repelling businesses from Louisiana than the adoption of the unitary business principle would be. Indeed, California, a state that employs perhaps the most aggressive interpretation of the unitary business principle, attracts many more businesses than Louisiana.

The Louisiana Corporation Income Tax Act arbitrarily discriminates against local businesses.

Businesses have expressed disfavor for Louisiana's tax laws. In a survey conducted in 1998 by *CFO The Magazine for Senior Financial Executives*, tax executives ranked Louisiana's tax department as their sixth least favorite among all of the states.[244] The central problem identified by the tax executives in the survey, however, had nothing to do with state income taxation. Practitioners and corporations said that the ability of Louisiana's 64 parishes to assess and collect sales taxes on all manner of goods creates significant problems for businesses.[245] Complicating the law are numerous and inconsistent exemptions in sales and use taxes.[246]

In addition, the oil and gas industry, which conducts much of its activity out of state, expressed concern that taxes fall more heavily on in-state oil and gas activities than on other industries that conduct more of their activities within the state.[247] The adoption of UDITPA and combined unitary business income reporting in Louisiana would likely resolve some of the problems by bringing clarity to the Louisiana rules that apply in taxing multistate businesses such as the oil and gas industry. While UDITPA would include all of the income of affiliates of an oil and gas corporation in the apportionable tax base, the property, payroll, and sales of the affiliates in other states would remove a significant portion of the income from Louisiana taxation. It is interesting to note that an integrated oil and gas company conducting business in Louisiana has sought to apply the unitary business principle in determining its Louisiana income.[248] ✩

(Footnote 240 continued.)

S.W.2d 168 (Mo. 1985); *Western Contracting Corp. v. State Tax Comm'n*, 414 P.2d 579 (Utah 1966). Louisiana has taken the opposite view. *See* La. Rev. Stat. Ann. section 47:287.93(A)(3) (allocating income from construction, repair, or other services to the state in which the work is done).

[241] La. Rev. Stat. Ann. section 47:287.95(D).

[242] Ariz. Regs. R15-2-1131 E.1.

[243] Dan Juneau, "Why are good jobs leaving?" Louisiana Association of Business and Industry (Oct 2, 2000).

[244] Ian Springsteel, "State Tax Audit 1998: Part 1 of 2," *CFO The Magazine for Senior Financial Executives* (June 1998).

[245] *Id.*

[246] *Id.*

[247] *Id.*

[248] *Texas Co. v. Cooper*, 107 So.2d 676 (La. 1958), discussed *supra*, at notes 182-191 and accompanying text.