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COMMENTS

FACTOR REPRESENTATION IN THE APPORTIONMENT OF INCOME FROM INTANGIBLES

I. INTRODUCTION

Taxation has been a source of heated conflict between the citizen and state throughout our nation's history. Government control in the form of taxation is often repugnant to a nation whose principles historically center around notions of individualism and free market economics. Although taxation is a necessity that provides the revenues required for public goods, the Constitution restrains government overreaching in the form of taxation.

As the nation grew, the tax system evolved into a large, complicated structure. The tax system touched all citizens, from the welfare recipient to the corporate entity. Business also expanded: small family businesses developed into corporations that grew beyond home-state borders. In America, this post-Industrial Revolution expansion of corporate enterprises was evidenced by companies like Ford Motor Co. and Standard Oil.

As a result of this expansion, many corporations created numerous subsidiaries to handle separate but related activities. Related corporations that interacted with one another in areas of ownership, use, and management became what are known as unitary businesses.¹ Unitary, multistate (or multinational) businesses posed a dilemma for state governments. The states needed a method for measuring a corporation's intrastate activities (and taxing those activities) when the corporation's activities extended beyond their borders.

¹. BLACK'S LAW DICTIONARY 1533 (6th ed. 1990). Unitary business is a term used to describe highly interdependent or interrelated multistate or international corporations where income arises from operation of the business as a whole. Id. For example, parent and subsidiary corporations, together, may be considered a single unitary business for tax purposes.
Generally, it was not until the 1940's that states began considering different methods of taxation or testing those methods against constitutional restraints. Three primary methods were considered: separate geographical accounting, allocation, and apportionment. This comment will focus on apportionment, and correspondingly, a three-factor apportionment formula. This taxation method was approved by the United States Supreme Court as a constitutional mechanism that enabled states to tax unitary business income in a way that reasonably reflects a unitary business' in-state activities.

Presently, an issue exists as to the appropriate method of apportioning intangible business income. The focus of this comment is on state taxation of a unitary business, and the need for factor representation of income from intangibles in the apportionment formula. This comment is not meant to be

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3. See Exxon Corp. v. Wisconsin Dep't of Revenue, 447 U.S. 207, 219-20 (1980); Mobil Oil Corp. v. Commissioner of Taxes, 445 U.S. 425, 438 (1980). Separate geographical accounting purports to isolate portions of income earned within the different states. Id. Certain economic benefits are derived from operating on the larger scale of a unitary business. Id. Geographical accounting does not account for these economic benefits, nor the resulting increase in income earned. Id.

4. JEROME R. HELLERSTEIN & WALTER HELLERSTEIN, STATE TAXATION: CORPORATE INCOME AND FRANCHISE TAXES, ¶ 9.02, at 9-6 (2d ed. 1993). Allocation for taxation purposes assigns income to the corporation's state of commercial domicile. Allocation leaves nothing to tax for the remaining states where the corporation conducts business. Id.

5. Id. ¶ 9.01, at 9-5 & n.1. Allocation is to be distinguished from apportionment, which mathematically divides income among several jurisdictions, enabling the states to tax the portion of income derived from the corporation's in-state activities. Id.

6. Mobil Oil Corp. v. Commissioner of Taxes, 445 U.S. 425, 436-42 (1980). Essentially, the three-factor formula uses the property, payroll, and sales factors of the corporations that comprise the unitary business to determine how much of the unitary income should be apportioned to individual states. The fact that the Court did not consider whether the application of the formula was constitutional is noteworthy, because it is the fulcrum upon which the apportionment controversy balances.

7. See infra notes 60-62 and accompanying text.

8. Factor representation reflects in the denominators of the three-factor apportionment formula a portion of the subsidiaries' property, payroll, and sales factors that contributed to the individual amounts of intangible income received by the parent company. This addition to the denominators results in a decrease of the net income taxable by the state, because the value of the property, payroll, and sales of the unitary business everywhere would increase. See infra text accompanying note 62.
an exhaustive study of the three-factor formula, nor of factor representation. It is merely an attempt to give the reader a basic understanding of formula apportionment, and to offer a proposal to end the controversy surrounding the proper apportionment of intangibles.

First, the background section will explain the constitutional implications of the apportionment formula, and trace the evolution of applicable constitutional tests of apportionment formulas. Second, the analysis will explain the current controversy regarding the application of the formula to intangible income, as depicted through a line of circuit court and state supreme court cases. A solution to the controversy will be discussed in the proposal section. This comment will suggest that factor representation in the taxation of intangible income is necessary for the proper application of the apportionment formula.

II. BACKGROUND

The states' power to tax corporate income stemming from out-of-state activities is subject to federal constitutional constraints. These constraints stem from the Due Process Clause, which prohibits states from attributing income derived extraterritorially to the state, and the Commerce Clause of the Constitution, which proscribes discrimination against interstate commerce. A tax will survive constitutional challenge if it is "applied to an activity with a substantial nexus with the taxing State, is fairly apportioned, does not discriminate against interstate commerce, and is fairly related to the services provided by the State."

9. See infra part II.
10. See infra part III.
11. See infra part IV.
12. In reference to state taxation, the Commerce Clause and the Due Process Clause have been interpreted as prohibiting states from regulating beyond their borders. See generally Hellerstein & Hellerstein, supra note 4, ¶ 8.07, at 8-44. The Commerce Clause gives Congress the power "to regulate Commerce with foreign Nations, and among the several States." U.S. Const. art. I, § 8, cl. 3. The Due Process Clause prohibits the states from "depriving any person of life, liberty, or property, without due process of law." U.S. Const. amend. XIV, § 1.
13. Hellerstein & Hellerstein, supra note 4, ¶ 8.07, at 8-44.
14. Id. ¶ 4.08, at 4-36 (quoting Complete Auto Transit, Inc. v. Brady, 430 U.S. 274, 279 (1977)); see also Exxon Corp. v. Wisconsin Dep't of Revenue, 447 U.S. 207 (1980) (upholding the Wisconsin Department of Revenue's tax assess-
In order for a state to tax an entity's out-of-state activities, those activities must in some way be connected to the in-state activities.\(^ {15} \) Also, the corporation must avail itself of some of the benefits of carrying on business in the state in order to justify the state's power to tax its income.\(^ {16} \) To reach this result, three issues must be considered. First, is the entity operating as a unitary business?\(^ {17} \) Second, when deciding which tax method to apply, allocation or apportionment, is the corporate income to be taxed characterized as business or nonbusiness income?\(^ {18} \) Third, is the state's corporate income tax formula fair and nondiscriminatory?\(^ {19} \)

A. Is the Entity a Unitary Business?

Since this discussion centers around multistate corporations, a court reviewing a tax apportionment challenge must first ask whether or not the multistate operations are part of a unitary business.\(^ {20} \) This inquiry is necessary since the income sought to be taxed must be related to the operations carried on in the state that seeks to tax the corporation.\(^ {21} \) If the corporation's in-state operations are not part of the multistate unitary business, generally, the state has no right to tax the multistate income. Apportionment will not be used because the state only has the power to tax within its own borders.\(^ {22} \) Basically, a unitary business exists when there are interrelations or interdependence of one corporation, generally a parent corporation, and one or more subsidiaries in multistate or international locations.\(^ {23} \)

\(^ {16} \) Id.
\(^ {17} \) See infra part II.A.
\(^ {18} \) See infra part II.B.
\(^ {19} \) See infra part II.C.
\(^ {20} \) Container Corp. v. Franchise Tax Bd., 463 U.S. 159 (1983); see also Asarco Inc. v. Idaho State Tax Comm'n, 458 U.S. 307 (1982) (holding that Asarco's payor subsidiaries were discrete enterprises and not part of Asarco's unitary business); Mobil Oil Corp. v. Commissioner of Taxes, 445 U.S. 425 (1980) (holding that Mobil and its subsidiaries comprised a unitary business).
\(^ {22} \) Exxon Corp., 447 U.S. at 219-20.
1. Butler Bros. v. McColgan

In Butler Bros. v. McColgan, the United States Supreme Court explained why the unitary principle entitles a state to tax a portion of the income generated by the unitary business' in-state activities. The Court discussed the three unities that arise from a unitary business: unity of use, unity of ownership, and unity of management. If the manufacturing process of a product is scattered throughout several states, there is unity of use, and the manufacturing factors are primary in the realization of profits. Unity of ownership and unity of management result in increased efficiency in operations and savings in production, which would not occur if each branch operated separately. Thus, the three unities affect the income generated by the unitary business in a multistate framework.

In Butler, the Court agreed with the California Supreme Court that the property, payroll, and sales factors properly reflect the contributions to the total unitary income from the related in-state business activities. The factors enable a fair apportionment of the benefits realized and the income earned from the unitary business to the state. The Court noted that there had been no showing that the income used in the apportionment formula was not connected to or generated from the unitary business.

25. Butler Bros., 315 U.S. at 508-09.
26. Id. Unity of ownership and management is best exemplified by the parent/subsidiary relationship, where the parent owns a large portion of the subsidiary and is involved with the management decisions. For example, Butler Brothers is a wholesale dry goods and general merchandising company with its home office in Chicago, Illinois. Butler Brothers owns seven wholesale distributing houses, even though each house maintains its own stock of inventory, sales, and accounting. The home office is also involved with the buying and purchasing divisions of Butler Brothers' seven wholesale distributing houses. Id.
27. Id. (quoting Hans Rees' Sons, Inc. v. North Carolina, 283 U.S. 123, 133 (1931)).
28. Id.
29. Id. at 509.
31. Id. This additional note indicates that the property, payroll, and sales factors may not properly reflect the activities that generate the income. This is true, for example, if intangible income from dividend payments by a subsidiary are included in the total unitary income of the payee company, while the payor subsidiary is not considered a part of the unitary business. Id.
The presence of the unitary business within the state provides the nexus, or minimum connection, necessary to justify a state's taxation of a corporation's income generated by interstate activities. In deciding if a business is unitary, a court will consider whether the corporation has vertical integration, central management, intercorporate training, or related business activities. These aspects of the multi-state or international relationship must contribute in some way to the intrastate values of the business enterprise.

If there is no such contribution, then the state cannot reach that income. A state also cannot reach income that is unrelated to the in-state operations. Such income is classified as nonbusiness income, which, because it does not arise from the unitary operations, is not subject to apportionment. Rather, the income is allocated in total to the corporation's commercial domicile.

A corporation can avoid state income tax on income generated by out-of-state activities if the entity can prove that the activity or income is nonbusiness related, constituting a discrete business enterprise.

2. Asarco Inc. v. Idaho State Tax Commission

In Asarco Inc. v. Idaho State Tax Commission, the constitutionality of including intangible income in the total taxable income was challenged. The intangible income that comprised the subject of the challenge included dividend and

33. See Bass, Ratcliff & Gretton, Ltd. v. State Tax Comm'n, 266 U.S. 271, 280-83 (1924). Bass, Ratcliff & Gretton, Ltd.'s vertical integration involved the ownership and control over the stages of production in the brewing and selling of Bass Ale. Id. at 278.
34. See supra note 26. Centralization of management is synonymous with unity of management.
35. F.W. Woolworth Co. v. Taxation & Revenue Dep't, 458 U.S. 354, 365 (1982). Intercorporate training of personnel is used to transmit the parent's operational and managerial methods to the subsidiaries, or to enable the free exchange of personnel among the subsidiaries. Id.
interest payments from certain subsidiaries, and capital gains from the sale of stock.\textsuperscript{41}

Asarco is incorporated in New Jersey and is commercially domiciled in New York.\textsuperscript{42} It mines, smelts, and refines metals in various states, including Idaho.\textsuperscript{43} Idaho adopted its own version of the Uniform Division of Income for Tax Purposes Act\textsuperscript{44} (UDITPA) in 1965, apportioning business income by the three-factor formula and allocating nonbusiness income to the state of commercial domicile.\textsuperscript{45}

The Court considered whether Asarco and the payor subsidiaries operated as a unitary business. It found that, although Asarco owns majority shares in those subsidiaries, the subsidiaries are discrete from Asarco's activity in Idaho because Asarco neither controls the management of the companies, nor asserts control over the boards of directors.\textsuperscript{46}

3. F.W. Woolworth v. Taxation & Revenue Department

In a companion case, \textit{F.W. Woolworth v. Taxation & Revenue Department},\textsuperscript{47} the Court again considered the constitutionality of taxing dividend income from payor subsidiaries that do not conduct business in the taxing state.\textsuperscript{48} Woolworth engages in the retail sale of various merchandise and is commercially domiciled in New York.\textsuperscript{49} Similar to Idaho and many other states, New Mexico has its own version of UDITPA, which apportions business income and allocates nonbusiness income.\textsuperscript{50}

The Court focused on three factors to decide whether Woolworth and its subsidiaries operate as a unitary business: functional integration, centralization of management, and

\begin{itemize}
  \item \textsuperscript{41} \textit{Id.}
  \item \textsuperscript{42} \textit{Id.} at 309.
  \item \textsuperscript{43} \textit{Id.}
  \item \textsuperscript{44} \textit{See infra} note 55.
  \item \textsuperscript{45} \textit{Asarco Inc.}, 458 U.S. at 311 (quoting \textit{IDAHO CODE} § 63-3027(a)(4) (Supp. 1981)).
  \item \textsuperscript{46} \textit{Id.} at 322-28.
  \item \textsuperscript{47} 458 U.S. 354 (1982).
  \item \textsuperscript{48} \textit{F.W. Woolworth Co.}, 458 U.S. at 354.
  \item \textsuperscript{49} \textit{Id.} at 356.
  \item \textsuperscript{50} \textit{N.M. STAT. ANN.} §§ 7-4-1 to -21 (Michie 1981).
\end{itemize}
economies of scale. The Court found that Woolworth was not functionally integrated with the subsidiaries because it dealt exclusively with the retail sale of goods, unlike the subsidiaries which dealt with each of the individual stages of production and marketing.

The Court reasoned that there was no centralization of management, since none of the subsidiaries' management had been trained or employed by the parent company, and retail policies were independent. Without functional integration or centralized management, the Court could not find the requisite connection between New Mexico and the dividend income, thereby holding New Mexico's taxation of Woolworth's dividend income unconstitutional under the Due Process Clause.

In the Asarco and Woolworth cases, the Court did not specifically consider the constitutionality of including intangible income in the apportionment formula. This consideration was precluded by the Court's determination that the subsidiaries were not part of the parent company's activities within the respective states, and they could not be considered part of a unitary system for tax purposes.

B. Business v. Nonbusiness Income: Which Formula Should Be Applied?

The Uniform Division of Income for Tax Purposes Act provides for two methods for taxing income from intangibles: allocation or apportionment. Income from intangibles includes dividends, interest, capital gains from stock sales, and royalties from patents or copyrights. The question of whether intangible income, or any type of income, is allocated

52. F.W. Woolworth Co., 458 U.S. at 364.
53. Id. at 366-67.
54. Id. at 372-73.
55. UNIF. DIV. OF INCOME TAX PURPOSES ACT, 7A U.L.A. 331 (1985) [hereinafter UDITPA]. In 1957 UDITPA was approved by the National Conference of Commissioners on Uniform State Laws and by the American Bar Association. It is a uniform tax allocation system, and a majority of states have adopted substantial portions of it.
56. HELLERSTEIN & HELLERSTEIN, supra note 4, ¶ 9.02, at 9-6.
57. Id. ¶ 9.01, at 9-5 & n.1.
58. See id. ¶ 9.08, at 9-35.
or apportioned depends on whether it is business income or nonbusiness income.\(^5\)

Business income arises "from transactions and activity in the regular course of the taxpayer's trade or business," and includes intangible income "if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations."\(^6\) To determine a state's share of business income, a three-factor apportionment formula is generally applied to all business income.\(^6\) A mathematical representation of the formula is:

\[
\frac{(\text{Property Receipts Payroll})}{(\text{in-state + in-state + in-state})} \times \frac{(\text{everywhere everywhere everywhere})}{3} \times \text{Total} = \text{Net y taxable by state}\]

The formula determines the net income taxable by the state.

First, the average of the ratios of payroll, property and sales factors of the unitary business within the state to those factors of the unitary business everywhere within the United States is determined.\(^6\) Second, the average is multiplied by the entity's apportionable base. The result is the amount of business income to be apportioned to the state.\(^6\)

The only other type of income is nonbusiness income, which is "all income other than business income."\(^6\) Nonbusiness income is either allocated to the enterprise's commercial domicile or to the business situs of the source of the income.\(^6\)

A leading case on the classification of intangible income as either business or nonbusiness income was \textit{Mobil Oil Corp.}\(^6\)

\(^{5}\) Id. ¶ 9.07[2], at 9-29.
\(^{6}\) UDITPA, supra note 55, ¶ 1(a).
\(^{6}\) Id. ¶ 9. See supra note 6.
\(^{6}\) This assumes a "water's edge" method of taxation. Most states now limit their taxation to domestic (water's edge) income. Previously, many states attempted to tax worldwide income. See generally Nicholas S. Freud & Walter M. Kolligs, \textit{U.S. Supreme Court Upholds Worldwide Reporting and Unitary Taxation}, J. INT'L TAX'N, August 1994, at 340.
\(^{6}\) See generally Butler Bros. v. McColgan, 315 U.S. 501 (1942) (approving California's three-factor apportionment formula). "[T]hese factors may properly be deemed to reflect 'the relative contribution of the activities in the various states to the production to the total unitary income,' so as to allocate to California its just proportion of the profits earned by appellant from this unitary business." \textit{Id.} at 509.
\(^{6}\) UDITPA, supra note 55, ¶ 1(e).
\(^{6}\) Id.
v. Commissioner of Taxes. The Court considered whether there was something in the nature of intangible income that precluded a state from apportioning it.

Mobil Oil Corporation is an integrated petroleum business, but it also has mining and chemical operations. Its commercial domicile is New York, and it has subsidiaries and affiliates worldwide. Mobil's Vermont operation deals in the wholesale and retail marketing of its petroleum products and, Mobil contends, does not conduct business with Mobil's other affiliates. Mobil, the parent, received dividend income from its subsidiaries and affiliates worldwide. The issue in the case was whether or not the dividend income should be classified as business income, which would allow Vermont to tax its share of income.

Vermont uses the UDITPA three-factor apportionment formula for taxing corporate business income. Mobil treated the intangible business income on its Vermont returns as "nonapportionable," thereby lowering its Vermont tax liability significantly. The Vermont Department of Taxes recalculated Mobil's apportionable income, including the intangible income Mobil had deemed "nonapportionable," and assessed Mobil accordingly. Mobil brought action against the state. Mobil claimed that the taxation of the income was unconstitutional under the Commerce and Due Process Clauses because the result was not a fair apportionment. Upon reaching the Supreme Court, the adjudication of the claim had been narrowed to solely considering whether dividend income was apportionable.

The Court rejected Mobil's contention that there was no minimum connection between Vermont and the managing of

69. Id.
70. Id. at 427-28.
71. Id. at 428. Mobil contends that the worldwide subsidiaries are discrete from Mobil's operations in Vermont. Id.
72. Id. at 425.
73. Mobil Oil Corp., 445 U.S. at 429. See also supra text accompanying notes 61-62.
74. See Mobil Oil Corp., 445 U.S. at 430.
75. Id. at 430-32.
76. Id. at 432.
77. Id. at 435-36.
investments or business activities of the payor corporations.\textsuperscript{78} Mobil argued that separate accounting could be used when measuring Mobil's Vermont activities and the payor corporations' activities, and that apportionment was not necessary.\textsuperscript{79} The Court, citing Butler Bros. \textit{v.} McColgan,\textsuperscript{80} noted that separate accounting failed "to account for contributions to income resulting from functional integration, centralization of management, and economies of scale."\textsuperscript{81} The Court reasoned that these factors of profitability arose from business operations as a whole and, therefore, could not be attributed to a single source.\textsuperscript{82} The Court concluded that "the linchpin of apportionability in the field of state income taxation is the unitary-business principle," and the taxpayer must show that the income was generated by a nonbusiness related activity or by a discrete business enterprise.\textsuperscript{83} In the absence of such proof, there is an incontestable presumption of the requisite nexus.\textsuperscript{84} The Court held that if the underlying activities generating the dividend income are derived from the operating activities of the functionally integrated whole, the income is constitutionally apportionable.\textsuperscript{85} The Butler Bros., Asarco, Woolworth, and Mobil line of cases provides some guidance on apportioning the income of multistate corporations. First, the corporation challenging the tax must be part of a unitary business.\textsuperscript{86} Second, the income at issue must be business income.\textsuperscript{87} In other words, the income must have arisen out of the regular course of operations of the business. Finally, the apportionment formula must not give the taxing state more than its appropriate

\textsuperscript{78} Id. at 436, 442.
\textsuperscript{79} Mobil Oil Corp., 445 U.S. at 438.
\textsuperscript{80} 315 U.S. 501 (1942).
\textsuperscript{81} Id.
\textsuperscript{82} Id. at 439.
\textsuperscript{83} See id. at 439-40.
\textsuperscript{84} See id. at 440.
\textsuperscript{85} See id. at 440.
share of unitary income. This final step in the analysis considers whether the apportionment is fair.

C. *Is the Three-Factor Apportionment Formula Fair?*

A constitutional requisite for apportionment formulas is that they be "fair" and nondiscriminatory. This fairness requirement measures the internal and external consistency of the formula. An apportionment formula is internally consistent if, applied in every jurisdiction, it would result in no greater than 100% of the unitary business income being taxed. External consistency exists when the factors reasonably reflect how the income was generated. The Court "will strike down the . . . apportionment formula if the taxpayer can prove 'by 'clear and cogent evidence' that the income attributed to the State is in fact "out of all appropriate proportions to the business transacted . . . in that State," or has "led to a grossly distorted result."

In addition to being fair, the apportionment formula must not discriminate against interstate or foreign commerce. The threat of double taxation exists when jurisdictions differ in their approach to taxation, for instance, when allocation or apportionment is used inconsistently across jurisdictions. However, the complete elimination of overlapping taxation among jurisdictions would require the Court to decide on a constitutionally uniform method and application

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90. *Id.* Internal and external consistency were parameters established by the Court as a guide to determining the fairness of an apportionment formula. *Id.*
91. *Id.*
92. *Id. See also* AT&T v. Wisconsin Dep't of Revenue, 422 N.W.2d 469 (Wis. Ct. App. 1988). The Wisconsin Court of Appeals found that the Department's apportionment formula violated the external consistency requirement because too much was apportioned to Wisconsin and other jurisdictions where AT&T operated, and too little was apportioned to other jurisdictions where AT&T functioned. *Id.*
94. *Id.* (quoting Hans Rees' Sons, Inc. v. North Carolina, 283 U.S. 123, 135 (1931)).
96. *Container Corp.,* 463 U.S. at 169.
97. *Id.* at 170-71.
of corporate tax. The Court is reluctant to get involved in this sort of judicial legislation.

The Court has accepted the three-factor formula as being constitutionally fair because it sorts out accounting distortions caused by the multiple inputs in a unitary system. The Court has noted that apportionment methods would be held to a higher scrutiny in cases involving international subsidiaries and the threat of double taxation.

Accordingly, the California apportionment formula was held to a higher scrutiny in Container Corp. v. Franchise Tax Board, because of its potential effect on international commerce. The Court scrutinized the formula in two ways. First, the Court asked if there was a substantial risk of international multiple taxation. The Court distinguished California's apportionment method from the alternative "arm's length approach," which is a general rule not to tax any income specifically resulting from foreign commerce. Although most countries apply the "arm's length approach" to taxation of international commerce, their applications of the approach differ. Inconsistent approaches among different jurisdictions create the possibility of double taxation on a corporation. Generally, if an apportionment formula meets the internal and external consistency standards established in Container Corp., the tax will be deemed constitutionally fair.

98. Id. at 171.
99. Id.
100. Id. at 183.
102. Id. at 159. Container Corporation challenged California's corporate franchise tax of income from foreign subsidiaries. Id.
103. Id.
104. Id. at 185-86. See also Japan Line Ltd. v. County of Los Angeles, 441 U.S. 434 (1979). The Court struck down the tax at issue due to the existence of double taxation, noting that the scrutiny applied must consider the context of the tax. Id. at 451.
106. Id. at 191.
107. Id.
108. See id. at 185; see also NCR Corp. v. Taxation & Revenue Dep't, 856 P.2d 982 (N.M. Ct. App. 1993); Tambrands, Inc. v. State Tax Assessor, 595 A.2d 1039 (Me. 1991); NCR Corp. v. South Carolina Tax Comm'n, 402 S.E.2d 666 (S.C. 1991); NCR Corp. v. Commissioner of Revenue, 438 N.W.2d 86 (Minn. 1989); NCR Corp. v. Comptroller of the Treasury, Income Tax Div., 544 A.2d 764 (Md. 1988); AT&T v. Wisconsin Dep't of Revenue, 422 N.W.2d 629 (Wis. Ct. App. 1988).
Second, the Court asked whether California was permitted to adopt formula apportionment where it “may impair federal uniformity . . . [and] prevents the Federal Government from ‘speaking with one voice’ in international trade.”\(^{109}\) The Court concluded that the California apportionment method did not interfere with the government’s foreign trade policies.\(^{110}\)

The issue of discrimination in violation of the Commerce Clause\(^{111}\) was again raised in *Kraft General Foods v. Iowa Department of Revenue*.\(^{112}\) *Kraft General Foods* is a unitary business with operations in the United States and foreign countries.\(^{113}\) At issue in the case was Iowa’s inclusion of subsidiary dividends in *Kraft’s* tax base.\(^{114}\)

Each of *Kraft’s* six subsidiaries was incorporated abroad, and their operations in foreign commerce were supported by legitimate business reasons.\(^{115}\) Iowa’s tax code follows the federal tax scheme by allowing corporations to take a deduction for dividends received from domestic, but not foreign, subsidiaries.\(^{116}\) Unlike the federal tax scheme, however, Iowa does not allow a credit for taxes paid to foreign countries to offset the tax paid on the subsidiary's dividend income.\(^{117}\)

*Kraft* was assessed a tax only on its dividend income from foreign subsidiaries, and was not allowed a credit for the taxes paid to the six foreign countries. The Supreme Court held that the Iowa statute facially discriminates against foreign commerce in violation of the Foreign Commerce Clause.\(^{118}\) Once again, the use of an apportionment formula without factor representation, although not specifically mentioned, lead to a discriminate tax.

Presently, case law suggests that a challenge against an apportioned state tax assessment will undergo a three-tiered analysis. The source of the income subject to taxation must


\(^{111}\) U.S. Const. art. I, § 8, cl. 3.


\(^{113}\) *Kraft Gen. Foods, Inc.*, 505 U.S. at 72.

\(^{114}\) Id.

\(^{115}\) Id. at 76.

\(^{116}\) Id. at 73.

\(^{117}\) Id. at 75.

\(^{118}\) *Kraft Gen. Foods, Inc.*, 505 U.S. at 82.
be from companies that are part of a unitary business. The unitary business principle justifies a state's taxation of income that is partly derived from out-of-state activities. The unitary income subject to taxation must be business income. The rationale behind the business income requirement is that if the income is the product of business activities, a state is constitutionally empowered to tax companies for benefits received from operating within the state. Finally, the apportionment method applied to the unitary business income must be fair. However, at least one question remains to be decided, namely whether or not the present application of the three-factor formula to income from intangibles is constitutionally valid.

III. ANALYSIS

The Supreme Court has found that the three-factor formula offers a balance between the state's revenue raising tax power and the individual's right to be protected from extraterritorial taxation. The Butler Bros., Asarco, Woolworth, Mobil, Container Corp., and Kraft line of cases establishes the constitutionality of the three-factor apportionment formula. Inclusion of the property, payroll, and sales factors enables the state to tax values earned within its borders.

The constitutionality of the apportionment formula derives from the assertion that states may only tax income earned from activities performed within their borders. The formula multiplies the apportionable base by the arithmetic mean of the payroll, property, and sales factors. Taking

120. See supra part II.A.
121. See Hellerstein & Hellerstein, supra note 4, ¶ 9.07[2], at 9-29.
122. See supra notes 12-16, 59-62 and accompanying text.
123. See supra part II.C.
125. See supra part II.
126. See supra note 62.
128. See UDITPA, supra note 55, § 9; see also Mobil Oil Corp. v. Commissioner of Taxes, 445 U.S. 425, 429 n.4 (1980); Butler Bros. v. McColgan, 315
the precept that states may only tax income earned within their borders and that the apportionment formula obtains that result, it logically follows that intangible business income from out-of-state, payor subsidiaries should not be included in the total income of the payee when the payroll, property, and sales factors of the payor companies are not included in the apportionment formula. Otherwise, the state unfairly overtaxes the corporation.

This factor representation issue arises when the payor subsidiary is excluded from the unitary return, and therefore, its factors are omitted. Payors can be omitted when they are unitary, but, because of a state statute requirement (usually an ownership threshold), they are not included in the tax return.

Justice Stevens' final remarks, in his now famous Mobil dissent, are the most widely cited with respect to the factor representation issue.\(^{129}\) He argued that the application of Vermont's apportionment formula to Mobil's net income was arbitrary and unconstitutional.\(^{130}\) Stevens remonstrated that no attempt was made to incorporate the property, payroll, and sales factors of the payor subsidiaries into the apportionment formula.\(^{131}\) "Unless the sales, payroll, and property values connected with the production of income by the payor corporations are added to the denominator of the apportionment formula, the inclusion of earnings attributable to those corporations in the apportionable tax base will inevitably cause Mobil's Vermont income to be overstated."\(^{132}\) This remark embodies the factor representation controversy.\(^{133}\)


130. Id.

131. Id. If the majority considered the subsidiaries to be part of the unitary business, and not discrete, then the subsidiaries' factors should have been included in the apportionable base to be in conformity with the unitary business principle.

132. Id. at 461.

133. Id. at 460-61. Stevens also argued that the Court narrowed its holding in avoidance of this constitutional issue. Id. at 461. Stevens first argued that the dividend income was improperly included in the apportionable unitary income because it was generated from discrete subsidiaries. Id. at 460. The subsidiaries were neither involved with the petroleum business, nor connected to the marketing business in Vermont. Id. Second, he argued that the Court
States nationwide apply the three-factor apportionment formula without factor representation to corporate income, and include the dividend, interest income, royalties, and other forms of intangible business income from nonunitary subsidiaries in the tax base.134 State taxing authorities and corporate taxpayers alike are left with little guidance from formula apportionment jurisprudence.

The three-tier analysis used when determining the constitutional validity of an apportionment formula is well established.135 However, the constitutional analysis would be more absolute if factor representation were included as a necessary step to ensure the equitable and constitutional application of the apportionment formula.136

Part A of the analysis section discusses the decisions of state courts that agree with this hypothesis. Part B illustrates one company's fight in state courts across the country against the present application of the three-factor formula. The company was a recent advocate of factor representation before the Supreme Court. Part C articulates the need for factor representation as the solution to constitutional application of the apportionment formula in the taxation of income from intangibles.


135. See supra part II.

136. Analysis of additional cases is necessary to fully explore issues within the apportionment controversy. The cases introduced in part III are specifically on point in regard to the present controversy involving apportionment of income from intangibles. In addition, they fully incorporate the concepts previously introduced in part II. They will offer the best evidence in support of factor representation.
A. Case Support for Factor Representation if Intangible Business Income Is Included in the Apportionable Tax Base

1. Partnership Profits: Homart Development Co. v. Norberg

The application of the three-factor apportionment formula was challenged in Homart Development Co. v. Norberg. Homart, a Delaware corporation with its commercial domicile in Chicago, Illinois, develops and operates shopping centers. Its business activity within the state of Rhode Island was limited to ownership and operation of a mall in Warwick, Rhode Island. Homart also owned general partnership interests in several partnerships engaged in the same line of business, and was entitled to a percentage of the distributive shares of these partnerships.

Rhode Island applied its three-factor apportionment formula for the ostensible purpose of fairly taxing Homart's income arising from its in-state activities. The dispute centered on whether Rhode Island could include the distributive shares of the total net income from Homart's status as a general partner, without including the partnerships' property, payroll, and sales factors.

Homart argued that if the total net income is increased by the distributive shares, but the apportionment factors are not adjusted, then the amount of net income taxable by Rhode Island will be overstated. Homart illustrated this position with an example giving Homart ninety percent ownership of a general partnership interest. The particular partnership did no business in the state of Rhode Island. Homart asserted that if ninety percent of that partnership's distributive shares were included in Homart's net income, then ninety percent of the partnership's property, payroll, and sales factors should be included in the denominators of

139. Id.
140. Id.
141. Id. at 119. See supra text accompanying notes 61-62.
142. Homart Dev. Co., 529 A.2d at 118.
143. Id.
144. Id.
145. Id.
the fractions.\textsuperscript{146} If applied to the mathematical formula, this would result in a lower “in-state” activity over “everywhere” activity ratio, and the amount of net income taxable by Rhode Island would be lower.\textsuperscript{147}

The court rejected the state’s argument that partnerships were separate entities whose income was properly taxed as a portion of corporate income.\textsuperscript{148} However, the court agreed with Homart’s reasoning. It noted that the formula required that the property, payroll, and sales factors be the “taxpayer’s.”\textsuperscript{149} Since Homart was a “tenant of the partnership,” the partnership’s apportionment factors were considered to be those of Homart’s.\textsuperscript{150}

Otherwise, the net income is subject to an apportionment ratio that reflects only Homart’s in-state and everywhere business activity when, in fact, this income did not arise from Homart’s corporate business activity but instead arose out of the partnerships’ business activities that were not reflected in the apportionment ratio . . . . [Such a calculation results in] an inherent and manifest distortion.\textsuperscript{151}

In the factor representation debate, Homart was a step toward supporting the inclusion of the property, payroll, and sales factors of companies that provide the intangible business income, if such income is also a part of the apportionable income base.

2. \textit{Dividend and Interest Income:} American Telephone & Telegraph Co. v. Wisconsin Department of Revenue

Although Homart advocated factor representation, other courts did not. Corporations in other states continued to ar-

\textsuperscript{146} Id.
\textsuperscript{147} Homart Dev. Co., 529 A.2d at 118. The following is the mathematical formula referred to in Homart:

\[ \frac{\text{(Property Payroll Sales)}_{\text{in R.I.}} + \text{(in R.I.)}}{\text{(everywhere everywhere everywhere)}} \times \frac{\text{Total } = \text{ Net } y \text{ taxable by R.I.}}{3} \]

\textsuperscript{148} Id.
\textsuperscript{149} Id. at 120.
\textsuperscript{150} Id.
\textsuperscript{151} Id. at 121.
gue in support of factor representation. In AT&T Co. v. Wisconsin Department of Revenue, AT&T's claim for redetermination of taxes against the Wisconsin Department of Revenue arose from the inclusion of intangible income from subsidiaries in the total unitary income, while omitting from the denominators of the apportionment ratios the factors that contributed to that income. AT&T is an interstate public utility whose business income requires apportionment, according to the Wisconsin Administrative Code, section Tax 2.50(1). The court used an analysis comparable to that used by the Rhode Island court in Homart, and found that factor representation is necessary if the unitary principle is to be given any credibility.

The court in AT&T declared the application of the apportionment formula unconstitutional because it did not meet the external consistency test developed in Container Corp. The factors did not reasonably reflect how the income was generated. Noting that the Supreme Court had not developed a "bright line" rule as to what ingredients a constitutional formula must contain," the formula did not reflect a reasonable sense of how the income was generated, and thus violated the Due Process and Commerce Clauses of the Constitution.

AT&T demonstrates that while the apportionment formula may be the appropriate method of taxation, the application of the formula may not meet constitutional standards. Specifically, the actual numbers Wisconsin used as representative factors in the apportionment formula were underinclusive, thus overstating the percentage of income at-

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152. 422 N.W.2d 629 (Wis. Ct. App. 1988).
153. AT&T Co., 422 N.W.2d at 629.
154. Id. at 630.
155. Id. at 632. The court decided that the subsidiaries' real property, which contributed to the parent's intangible income, should be recognized as a property factor. Id. The court additionally noted that if the tax department can recognize intangible income stemming from the subsidiaries in a unitary business and consider them "taxpayers" for that purpose, then the department should entirely recognize the unitary principle and include the subsidiaries factors in the apportion ratios. Id.
156. Id. at 634. See supra notes 92-95 and accompanying text.
158. AT&T Co. v. Wisconsin Dep't of Revenue, 422 N.W.2d 629, 636 (Wis. Ct. App. 1988).
tributable to AT&T's activities in Wisconsin. The apportionment formula should have included the subsidiaries' factors.


In Tambrands, Inc. v. State Tax Assessor, the constitutionality of a 1984 tax assessment resulting from the application of the three-factor apportionment formula was challenged before the Supreme Judicial Court of Maine. Tambrands is a Delaware corporation with its commercial domicile in New York. It operates as an integrated, unitary business, having both domestic and foreign subsidiaries.

Tambrands conceded that it was a unitary business, and that the intangible business income received from the dividends of its foreign affiliates was properly included in the business income to be apportioned by Maine. However, Tambrands claimed that Maine was apportioning more than was appropriate, because Maine included the affiliates' intangible business income and did not include some portion of the foreign affiliates' property, payroll, and sales factors.

The court applied the internal consistency test developed in Container Corp., and found that if the apportionment formula was hypothetically applied in all the jurisdictions in which Tambrands and its subsidiaries operated, more than 100% of its income would be subject to tax. In this hypothetical, the apportionment method would not serve its purpose: to tax the portion of income attributable to in-state activities. The court held that Maine's failure to include some portion of the foreign subsidiaries' factors in the apportionment formula was inconsistent with the unitary business principle, because the inclusion of income allowed Maine to tax income earned outside of its borders.

159. 595 A.2d 1039 (Me. 1991).
161. Id. at 1040.
162. Id.
163. Id. at 1042.
164. Id.
166. Id. at 1042. This overreaching was in violation of the Due Process and Commerce Clauses of the Constitution.
Property, payroll, and sales factors are considered an objective measure of in-state activities.\textsuperscript{167} The Supreme Judicial Court of Maine held that the apportionment formula does not satisfy the very principle used to justify it as a constitutional method of taxation — the unitary business principle. \textit{Tambrands} is clear authority favoring factor representation.

B. \textit{Factor Representation Is Not Constitutionally Required Without Proof of "Gross Distortion"}

NCR, a manufacturer and retailer of business products, has been a party to several tax disputes over the apportionment of intangible business income. Although NCR is meeting opposition in its battle concerning the equitable application of apportionment formulas, it continues to advocate factor representation.

1. \textit{Dividends, Royalties and Interest: The NCR Trilogy}

In 1988, NCR challenged Maryland's apportionment formula on constitutional theories in \textit{NCR Corp. v. Comptroller of the Treasury, Income Tax Division}.\textsuperscript{168} NCR is incorporated in Maryland and commercially domiciled in Ohio.\textsuperscript{169} Maryland's inclusion of dividend and royalty payments from foreign subsidiaries as taxable net income, without including the property, payroll, and sales factors of these subsidiaries, was the basis for NCR's challenge.\textsuperscript{170}

The court held that a tax would be struck down if the income attributed to the state was out of proportion to the activities performed in Maryland.\textsuperscript{171} The case was remanded to modify the formula.\textsuperscript{172} The comptroller was required to include the property, payroll, and sales factors of the foreign

\textsuperscript{167} See supra part II.A.
\textsuperscript{168} 544 A.2d 764 (Md. 1988).
\textsuperscript{169} \textit{NCR Corp.}, 544 A.2d at 765.
\textsuperscript{170} \textit{Id.}
\textsuperscript{171} \textit{Id.} at 779-80. Proving that the apportionable base was out of proportion would require a showing of gross distortion. NCR found a distortion in the denominator of 75%, whereas the comptroller found only an 11% variation. The Court of Appeals rejected NCR's argument that Justice Steven's dissent in \textit{Mobil} had been adopted by the Supreme Court in \textit{Container Corp.}, but conceded that the Maryland formula could lead to an unconstitutional distortion with respect to the dividend income. \textit{Id.} See supra notes 93-95 and accompanying text.
\textsuperscript{172} \textit{NCR Corp.}, 544 A.2d at 781.
subsidiaries that generate NCR's dividend income, and test for unconstitutional levels of distortion.173

The following year, the Minnesota Supreme Court rejected NCR's argument that the apportionment formula should include the foreign subsidiaries' factors that generated dividend and royalty income.174 It followed the analysis in the Maryland NCR case and decided that a distortion of twenty-three percent was not significant enough to require modification of the formula.175

In a 1991 South Carolina case, NCR raised the same argument it had raised in the previous two cases: either do not include interest or royalty income in the apportionable base, or include in the apportionment ratios the factors of the subsidiaries generating such income.176 The court remanded the case, instructing the lower court to modify the formula and compare the tax result with the tax assessment. If a constitutional distortion was found between the two amounts, a refund was to be granted.177

2. Capital Gains: NCR's Final Controversy

The Supreme Court denied NCR's petition concerning the constitutional application of the three-factor formula.178 In NCR v. Taxation and Revenue Department,179 the New Mexico State Court rejected NCR's claims that the New Mexico apportionment formula was unconstitutional.180

173. Id.
174. NCR Corp. v. Commissioner of Revenue, 438 N.W.2d 86 (Minn. 1989).
175. Id. at 93.
179. Id.
180. Id. at 986-89. The court first rejected NCR's argument that the inclusion of intangible income in the apportionment formula violates the Foreign Commerce Clause. Id. at 987-88. The two-part test for Foreign Commerce Clause violations, established in Container Corp., was applied. Id. The court found that the tax neither imposed multiple, inevitable taxation, nor did it violate the "one voice" standard. Id. at 988. See also text accompanying notes 102-10. NCR's second challenge asserted that their Subpart F income — intangible income not yet distributed — could not be taxed without violating the Due Process Clause. NCR Corp., 856 P.2d at 988. Under § 951(a)(2)(A) of the IRS code, Subpart F income must be reported as a pro rata share, even if the income has not been distributed. 26 U.S.C. § 951(a)(2)(A) (1988). The court rejected this
NCR argued that the New Mexico tax statute required inclusion of all or some of their foreign subsidiaries' factors in computing the proper apportionment percentage.\textsuperscript{181} NCR unsuccessfully urged the court to follow Justice Stevens' dissent in \textit{Mobil}.\textsuperscript{182} NCR argued that the formula did not meet \textit{Container Corp.}'s test for fairness — internal and external consistency.\textsuperscript{183} However, the court followed the Maryland and South Carolina NCR cases, declaring that it was NCR's duty to prove that a gross distortion had occurred before a modification of the apportionment formula would be required.\textsuperscript{184} The court concluded that the formula met the test of fairness and was constitutional under the Due Process and Commerce Clauses.\textsuperscript{185} Writ of certiorari was denied by both the New Mexico Supreme Court and the United States Supreme Court.\textsuperscript{186}

In an amicus curiae brief to the United States Supreme Court, the Committee on State Taxation asserted that where the formula has been agreed upon, but the formula's underlying principles have not been followed, requiring proof of gross distortion is of no use.\textsuperscript{187} The payroll, property, and sales that generate the income should be used to apportion that same income.\textsuperscript{188} The apportionment formula is widely used because it gives an accurate reflection of income generated by in-state activities. However, if the formula does not recognize the factors that generate that income, an accurate reflection of in-state activities is not given.\textsuperscript{189}

Another amicus curiae brief, submitted by the Tax Executive Institute, noted that "an apportionment formula that fails by design to take into account the factors that generated the apportioned income is constitutionally flawed because argument, concluding that under the unitary business principle the state required inclusion of the Subpart F income, and New Mexico had a right to tax their apportioned share. \textit{NCR Corp.}, 856 P.2d at 988-90.

\textsuperscript{181} \textit{NCR Corp.}, 856 P.2d at 990.

\textsuperscript{182} \textit{Id.; see also supra text accompanying notes 129-33.}

\textsuperscript{183} \textit{See supra text accompanying notes 89-95.}


\textsuperscript{185} \textit{Id.} at 991.

\textsuperscript{186} \textit{Id.} at 982.

\textsuperscript{187} \textit{Amicus Brief of Committee on State Taxation at 3, NCR Corp. v. Taxation & Revenue Dep't}, 856 P.2d 982 (N.M. Ct. App. 1993) (No. 93-541), \textit{cert. denied}, 114 S. Ct. 2763 (1994).

\textsuperscript{188} \textit{Id.}

\textsuperscript{189} \textit{Id.} at 8.
there can never be a ‘rational relationship between the income attributed to the State and the intrastate values of the enterprise.’”¹⁹⁰ Throughout all of these cases, NCR merely sought the proper application of the three-factor apportionment formula through the use of factor representation.

C. A Synthesis of the Present Controversy

Factor representation is a young concept in the field of corporate income tax. Its parameters are not clearly defined. Some states such as Rhode Island,¹⁹¹ Wisconsin,¹⁹² and Maine¹⁹³ have embraced the concept. Still others, as exemplified by the NCR cases,¹⁹⁴ continue to challenge the idea. These latter states impose ambiguous requirements, such as proof of gross distortion, before allowing factor representation, or they allow factor representation for certain types of intangible income but not others.

The need for factor representation is evident; the Due Process and Commerce Clause restraints of the Constitution require it.¹⁹⁵ Understandably, the Supreme Court has approved the three-factor apportionment formula as a mechanism for limiting state tax to the portion of income attributable to business activities within the state.¹⁹⁶ Although the formula does not produce perfectly accurate taxable income figures, “it has become . . . something of a benchmark against

¹⁹². See AT&T Co. v. Wisconsin Dep't of Revenue, 422 N.W.2d 629 (Wis. Ct. App. 1988).
¹⁹⁵. See supra notes 12-14 and accompanying text.
which other apportionment formulas are judged.” However, Justice Stevens correctly stated that unless factor representation is allowed, corporate income will be overstated. Companies will incur an unjustly high corporate tax liability. The theory of factor representation should become a reality. Therefore, states nationwide should adopt factor representation as a means of validating the application of the three-factor apportionment formula under the Due Process and Commerce Clauses.

The theory upon which factor representation is based was set forth in Container Corp. v. Franchise Tax Board. The Court stated that the factors used in the formula must “actually reflect a reasonable sense of how income is generated.” Factor representation, although simple in theory, will not be simple in its application. Different methods of factor representation pose different problems. For example, New York’s method uses factor representation in the apportionment of the taxpayer’s “investment income,” which is based on a percentage that objectively measures the subsidiaries’ investment activities within the state. In addition, New York applies the traditional three-factor apportionment formula to “business income.” Unfortunately, New York’s method does not define all forms of intangible income as “investment income,” leaving the enigma of finding the appropriate application of factor representation unresolved.

201. Walter Hellerstein, State Taxation of Corporate Income from Intangibles: Allied Signal and Beyond, 48 Tax L. Rev. 739, 816 (1993) (quoting N.Y. TAX LAW § 210(3)(b) (McKinney Supp. 1993)). The appropriate measure of the subsidiaries investment activities within the state is obtained by the incorporation of a portion of the subsidiaries property, payroll, and sales factors.
202. Id. at 816 (quoting N.Y. TAX LAW § 208(8)-(9) (McKinney 1986 & Supp. 1993)). Hellerstein notes that business income is federal taxable income less investment income and income from subsidiary capital.
203. Id. at 815 n.408 (quoting N.Y. TAX LAW § 208(5)-(6) (McKinney Supp. 1993)). “Investment income . . . consists of income, including capital gains, from investments in stocks, bonds, and other securities not held for sale in the regular course of business, except for income from investment in the stock of subsidiaries and from indebtedness from subsidiaries.” Id.
Intangibles take many forms, and the income from each appears to require a different method of factor representation. Dividends, one form of intangible income, illustrate why different methods of factoring may be required. Dividends may come from the earnings and profits of a subsidiary, or from the subsidiary's operating income. Regardless of their source, if dividends are based on the subsidiary's gross income, inclusion of 100% of the subsidiary's property, payroll, and sales factors in the apportionment formula will not create an accurate measure of the amount of income to be apportioned. This is because the income tax paid by the subsidiary causes the subsidiary's current earnings and, subsequently, the dividends to be less than one hundred percent. In this scenario, the subsidiary's factors would be overrepresented. However, requiring different applications of factor representation for each type of intangible income would increase administration costs and offset the benefits of factor representation.

Other intangibles that are also a reflection of earnings and profits include distributive shares of partnerships and income in the form of capital gains from the sale of assets. In contrast, there are forms of intangible income that are not derived from the subsidiaries' earnings and profits. Instead, they are expense payments that reduce the subsidiaries' earnings. Such forms include interest payments, patent and copyright royalties, and license and franchise fees.

These different types of intangible income share a common trait. They are included in the apportionable base, but the subsidiaries' property, payroll, and sales factors, from which they derive are not reflected in the apportionment formula. The various types of intangible income presented above offer a glimpse into the complex nature of intangibles and the difficulty of finding an all-encompassing method of factor representation.

Regardless of the type of intangible income, the purpose of the three-factor apportionment formula is to enable states

204. See id. at 832-33.
205. Id. at 833.
206. Id. at 858-76. Hellerstein discusses the economic elements involved with various types of intangible income and the complications that potentially could arise from the use of factor representation.
207. Id. at 835.
208. Id. at 837.
to tax the "portion" of the corporate earnings attributable to activities in their state.\textsuperscript{209} The purpose of the formula is based on the unitary business principle, which recognizes that the operational integration of parents and subsidiaries in a multicorporate structure lends itself to efficient and improved productivity and earnings. The property, payroll, and sales factors are the basic ingredients of a fully functioning company, and they should represent the whole unitary enterprise.

IV. PROPOSAL

Intangible income, like tangible income, is created through the property, payroll, and sales activities in a unitary corporate system. Therefore, the percentage of the subsidiaries' property, payroll, and sales factors that contributed to the individual amounts of intangible income received by the parent (i.e. dividends, capital gains, interest payments) should be included in the denominators of the apportionment factors. A simple example of this theory can be shown by using the mathematical representation of the formula:

\[
\frac{(\text{Property} \ + \text{Payroll} \ + \text{Sales})}{(\text{in-state} \ + \text{in-state} \ + \text{in-state})} \times \frac{(\text{everywhere})}{3} = \frac{\text{Total}}{\text{Net \ y \ taxable \ by \ state}}
\]

The following steps are required to calculate the net income taxable by the state. The value of the property used by the unitary business in the state is divided by the value of the property used by the unitary business everywhere. The same calculation is done for the payroll and the sales factors. The three factors are then averaged by adding them together and dividing by three. The resulting number is the "apportionment factor." The apportionment factor is then multiplied by the total unitary income, or the apportionable base, to determine the amount of net income taxable by the state.

The following is a simplified hypothetical example to demonstrate the need for factor representation. FactorRep Co. is a holding company for providers of financial services. The parent company is domiciled in New York and operates as a unitary business, having both domestic and interna-
tional subsidiaries. FactorRep Co.'s primary services include banking, real estate, and insurance. Its business activity within the state of Rhode Island is limited to a small chain of banks. FactorRep Co. also receives dividends from a subsidiary in England that is involved with the buying and selling of financial instruments. FactorRep Co. maintains that Rhode Island has over-assessed it by using an apportionment formula that includes the intangible business income from the English subsidiary, but excludes the factors of that subsidiary.

In this hypothetical, FactorRep Co.'s chain of banks in Rhode Island hold property, payroll, and sales in the amount of $14.2 million, $800 thousand, and $10 million, respectively. The value of the unitary group's property, payroll, and sales everywhere are, without the English subsidiary's factor representation, $71 million, $8 million, and $200 million, respectively. The unitary group's income is $150 million, which includes $25 million of the English subsidiary's subincome. Under this scenario, Rhode Island's tax assessment would be $17.5 million. If Rhode Island used factor representation to include the factors of the English subsidiary, the property, payroll, and sales factors would increase to $85.2 million, $8.8 million, and $400 million, respectively. The tax assessment would properly decrease to $14.1 million — a significant reduction of $3.4 million. Factor representation ensures the equitable state income tax apportionment of unitary business income and reduces the potential for a state to tax income earned outside its borders.

This hypothetical represents factor representation in its most primitive form. Without delving into a complex analysis, it demonstrates how factor representation leads to a more equitable apportionment of corporate income. The proposal offers a new direction at the crossroads of income apportionment.

V. CONCLUSION

At first glance, factor representation may appear to be a callow idea in the cultivated field of corporate taxation. The concept grew late in the season of apportionment exploration. Theories surrounding the constitutionality of the three-factor apportionment formula were tested and consummated. The application of an internally and externally consistent three-
factor formula to the business income of a unitary business is the parameter designed to satisfy constitutional restraints on apportionment. However, the unitary business principle, upon which the constitutional parameters are based, is violated when intangible income from corporate subsidiaries of the unitary business is included in the unitary income to be apportioned, while the factors of the subsidiaries are not. The seeds of factor representation have been planted. Their survival and further development is cardinal to the fair taxation of corporations.

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