STATE OF MAINE
KENNEBEC, SS.

MAINE SUPREME JUDICIAL COURT
SITTING AS THE LAW COURT
LAW DOCKET NO. KEN-95-206

E.I. DU PONT DE NEMOURS & CO.,

Appellee,

v.

STATE TAX ASSESSOR,

Appellant.

ON REPORT FROM THE KENNEBEC COUNTY SUPERIOR COURT

BRIEF *AMICUS CURIAE* OF MULTISTATE TAX COMMISSION IN SUPPORT OF STATE TAX ASSESSOR

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INTEREST OF *AMICUS CURIAE*

Amicus curiae, Multistate Tax Commission, respectfully files this Brief in support of the State Tax Assessor to defend state tax sovereignty over multijurisdictional commerce, which the United States Supreme Court has indicated should pay its fair share of the cost of state government. *Barclays Bank PLC* v. *Franchise Tax Bd.*, 512 U.S. ___, 114 S.Ct. 2268, 2276 (1994) (Commerce Clause does not shield interstate or foreign commerce from its "fair share of the state tax burden"); *Northwestern States Portland Cement Co.* v. *Minnesota*, 358 U.S. 450 (1959). The Multistate Tax Commission assumes this role by virtue of its status as the official administrative agency of the Multistate Tax Compact ("COMPACT").

Twenty States (including the District of Columbia) have adopted the COMPACT through the enactment of legislation that makes the COMPACT an integral part of their respective state statutory law. Fourteen additional States, including the State of Maine, have expressed commitment to the goals of the Multistate Tax Commission by joining as associate member States.[1] The U.S. Supreme Court upheld the validity of the COMPACT in *United States Steel Corp.* v. *Multistate Tax Comm'n*, 434 U.S. 452 (1978).

Historically, the COMPACT was developed through the cooperative efforts of the States and multistate taxpayers in response to the criticisms, findings and recommendations of the Willis Committee. *See* Corrigan, *A Final Review*, 1989 MULTISTATE TAX COMM'N REV. 1, 1 and 23; Hellerstein and Hellerstein, STATE AND LOCAL TAXATION 653 (5TH ED. 1988). The Willis Committee, a congressional study of state taxation of interstate commerce

[1] The current full members are the States of Alabama, Alaska, Arkansas, California, Colorado, District of Columbia, Hawaii, Idaho, Kansas, Minnesota, Missouri, Michigan, Montana, New Mexico, North Dakota, Oregon, South Dakota, Texas, Utah, and Washington. The associate members are the States of Arizona, Connecticut, Georgia, Louisiana, Maine, Maryland, Massachusetts, New Hampshire, New Jersey, Ohio, Pennsylvania, Tennessee, West Virginia, and Wisconsin.

sanctioned by TITLE II of PUB. L. NO. 86-272, 73 STAT. 555, 556 (1959), made extensive recommendations as to how Congress could regulate state taxation of interstate commerce.[2]

The COMPACT and the Commission's defense of state tax sovereignty over multijurisdictional commerce reflect a goal to resolve reasonably the issues inherent in having a federal form of government that presupposes States with the separate sovereign power to impose taxes on multijurisdictional commerce. These issues arise, because, on the one hand, our Nation has a single economy and, on the other, Federalism recognizes separate and independent state taxing authority with regard to slices of interstate and foreign commerce as a source of revenue for the States to discharge their own spheres of governmental responsibility.

The Multistate Tax Commission is specifically concerned about the Superior Court's decision in this case, and indeed this Court's decision in *Tambrands, Inc.* v. *State Tax Assessor*, 595 A.2d 1039 (Me. 1991), upon which the Superior Court relied for its ruling. Both cases uniquely apply constitutional doctrine in a manner that has the potential to thwart reasonable and, more importantly from the Commission's perspective, constitutional state tax systems designed to ensure that multijurisdictional commerce does pay its fair share of the cost of state government from which it benefits. Maine's unilateral understanding of the U.S. constitutional restrictions reflected in this case and *Tambrands* strikes at the core of a State's sovereign right to elect through legislative action a system of state taxation of multijurisdictional commerce (domestic water's edge, combined reporting) that the United States Supreme Court has otherwise indicated meets constitutional standards. Recent proselytizing of the alleged virtues of *Tambrands* and this case that is

[2]The Willis Committee's recommendations for regulating state taxation of interstate commerce which have not been enacted as federal law at their best were interesting, theoretical exercises and at their worse intrusive usurpation's of state power by a supreme sovereign (the Federal Government) not responsible for delivery of the governmental services for which the support of the regulated revenues are needed.

now occurring among state tax practitioners[3] motivates the Commission to offer its perspective on the issues here being raised, because this case and *Tambrands* have become more visible. By its participation, the Multistate Tax Commission desires to do no more than preserve state sovereignty to choose constitutional state tax systems. Hopefully, the Court welcomes the participation of the Multistate Tax Commission as being useful to resolving this matter appropriately.

In the Commission's view, the Superior Court's decision in this case undermines the ability of States to tax multijurisdictional commerce, because *amicus* knows of no way for the State of Maine, if it is to be true to the Superior Court's rationale which the Commission views as erroneous, to meet the Superior Court's requirement other than to eliminate completely state taxation of dividends from foreign affiliates[4] that are derived from the same unitary business being conducted in Maine. Complete elimination of taxation of dividends from foreign affiliates provides foreign commerce a discriminatory *benefit* not otherwise available to domestic commerce, to say nothing of economically skewering business location decision-making in favor of foreign, as opposed to domestic, commerce. Properly understood, state taxation of unitary dividends from foreign affiliates involves state taxation of income properly attributable to the taxing State through the application of the receiving corporation's own apportionment factors. *See Barclays Bank*, 512 U.S. at ___ n.10, 114 S.Ct. at 2276 n.10 (1994). The Commission submits that a result allowing a unitary business a discriminatory *benefit* to escape its fair share of state taxes is a clear warning that something is amiss.

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[3] Beard, *Factor Relief for Foreign Source Dividends*, 18TH ANNUAL GEORGETOWN STATE & LOCAL TAX INSTITUTE 12, 13 (1995) ("This article briefly describes [the *Tambrands* and *du Pont*] cases, then outlines the successful "internal consistency" arguments used by Tambrands and Du Pont. These arguments may be useful to taxpayers from other States.")

[4] Although the argument is stated in terms of "dividends from foreign affiliates", the deficiency of the rationale would equally apply to a state tax system that was based upon separate entity accounting combined with inclusion of dividends from domestic affiliates. *See* Argument II.B., below.

CONTEXT OF CASE PERTAINING TO MULTIJURISDICTIONAL TAXATION

The State Tax Assessor on audit has adjusted the income base of the taxpayer, E. I. du Pont de Nemours ("du Pont"), which is subject to apportionment, to include dividends received from various foreign affiliates. In addition, the Assessor in response to this Court's decision in *Tambrands, Inc.* v. *State Tax Assessor*, 595 A.2d 1039 (Me. 1991), has adopted a policy, the "Augusta formula," which ensures in this case that the tax assessed based upon including these dividends in the apportionable base will be no higher than if the entire earnings and apportionment factors of the dividend payors were included in the apportionable base.

The Superior Court of the County of Kennebec, under its interpretation of *Tambrands* and the United States Supreme Court's decision in *Kraft General Foods, Inc.* v. *Iowa*, 505 U.S. ___, 112 S.Ct. 2365 (1992), found the Maine Tax Assessor's action violated the Foreign Commerce Clause of the United States Constitution *by discriminating against foreign commerce.*

Amicus understands all parties concede the dividends at issue were received from foreign affiliates which are properly considered part of the "unitary business" carried on by du Pont in the State of Maine. This agreement among the parties means that the dividends constitute "business income" within the meaning of the Maine statute for the years in issue. It follows from the classification of the dividends as business income that the dividends are properly apportionable under the Maine statute then in force and also under the United States Constitution. *See Allied-Signal, Inc.* v. *Director, Div. of Taxation*, 504 U.S. 768, 786 (1992). Under the Maine statute, the formula used to apportion the business income base to determine the amount of income properly attributable to Maine includes only the factors[5] of the corporate entities included in "water's-edge combined report group." Because the entities which paid the dividends to du Pont do not fall within the water's-edge group, none of their factors is included in the apportionment formula except under relief of the Augusta

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[5]These factors are property, payroll, and sales.

formula. No issue of proper statutory construction is presented. There is no Due Process issue either. The question is whether the Tax Assessor has violated the Commerce Clause of the United States Constitution.

SUMMARY OF POSITION OF *AMICUS*

Amicus respectfully submits that the Superior Court's decision is in error and that, in part, this error arose from its efforts to apply faithfully the *Tambrands* decision of this Court. *Amicus* submits that the errors in the lower court's decision arise from its (i) misreading of this Court's *Tambrands* decision,[6] (ii) failure to keep separate issues involving the determination of what items are properly includible in the tax base of a multijurisdictional taxpayer from determination of whether the apportionment formula is fair, (iii) failure to keep distinct the analysis required by the dormant Commerce Clause and by the Due Process Clause, (iv) confusion of two of the four prongs of the "dormant Commerce Clause" standard enunciated by the United States Supreme Court,[7] and (v) conceptual mistreatment of the unitary business concept.

The decision of the Superior Court should be reversed based upon a proper application of the distinct legal principles that apply to determination of the tax base and the determination of the apportionment formula and the dormant Commerce Clause principles of "fair apportionment" and "nondiscrimination," as articulated by the United States Supreme Court. *Amicus* also respectfully submits that, following new precedent of the United States Supreme Court, this case affords the opportunity for this Court to reconsider

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[6]The Superior Court's confusion regarding the internal consistency test is revealed by a number of misstatements of this Court's holding in *Tambrands*. For example, the Superior Court viewed this Court as holding "that the water's edge combined reporting tax calculation [applied therein] discriminates against foreign commerce because it violates the internal consistency test of the Due Process and Commerce Clauses." (Slip Opinion, p. 7.) This Court correctly recognized in *Tambrands* the separateness of Due Process Clause and Commerce Clause analysis and did not view internal consistency as being an element of Due Process Clause analysis.

[7]These standards were formally established in *Complete Auto Transit, Inc.* v. *Brady*, 430 U.S. 274 (1977), and later explained in *Container Corporation of America* v. *Franchise Tax Bd.*, 463 U.S. 159 (1983), and subsequent cases.

its decision in *Tambrands*, in accord with the dissent filed by then Justice Wathen in that case.

ARGUMENT

I. INTRODUCTION TO ARGUMENT.

A. A Proper Constitutional Analysis Of State Taxes Is One Of Limitation, Not Mandate.

Consistent with the needs of Federalism, United States constitutional analysis of state taxes does not mandate the application of one method of state taxation or one method of apportionment. The U.S. Constitution establishes limits on what States can do. It does not direct what they must do. *See generally Moorman Mfg. Co.* v. *Bair*, 437 U.S. 267, 278-80 (1978) (United Supreme Court will not under the guise of the Commerce Clause undertake to make state apportionment formulas uniform). As the Court said in *Container Corp. of America* v. *Franchise Tax Bd.*, 463 U.S. 159, 168-169 (1983):

> A final point that needs to be made about the unitary business concept is that it is not, so to speak, unitary: there are variations on the theme, and any number of them are logically consistent with the underlying principles motivating the approach. For example, a State might decide to respect formal corporate lines and treat the ownership of a corporate subsidiary as *per se* a passive investment. In *Mobil Oil Corp.*, [citations omitted], however, we made clear that, as a general matter, such a *per se* rule is not constitutionally required:
>
> * * *
>
> Even among States that take [the approach of combined reporting], however, only some apply it in taxing American corporations with subsidiaries located in foreign countries. The difficult question we address in [another portion] of this opinion is whether, for reasons not implicated in *Mobil*, that particular variation on the theme [worldwide combined reporting] is constitutionally barred. [notes omitted].

The learning from *Container*, whose value as a valid precedent was most recently reaffirmed in *Barclays Bank*, is that a State may use variations on the combined report approach, as Maine does, or a State may use a separate entity approach. Under any of these approaches, the income base includes all of the income of the defined corporation or group. If a combined report or group approach is used, intergroup transactions are invariably

disregarded, and the group is treated as a single entity in many respects. The total income of the group is then normally divided, as Maine does for the years in issue, between business and nonbusiness income. The former is apportioned [assigned by formula among the States] and the latter is allocated [specifically assigned to a location]. The foregoing is qualified by the requirement that in all events a State may only consider the income of nondomiciliaries which is related to the State through the unitary business principle. *Allied-Signal, Inc.* v. *Director, Div. of Taxation*, 504 U.S. 768 (1992).

B. To Reach The Correct Result In This Case, The Court Must Correctly Apply The Fair Apportionment Prong And The Non-Discrimination Prong Of The Dormant Commerce Clause.

In *Complete Auto Transit* the United States Supreme Court explained the four-prong test which is the basis for modern dormant Commerce Clause analysis. Under this standard, a state tax to be constitutional must (1) be applied to an activity with a substantial nexus with the taxing State, (2) be fairly apportioned, (3) not discriminate, and (4) be fairly related to the services provided by the State. 430 U.S. at 279. The present case potentially raises only questions under the second and third prongs of this standard. The second and third prongs of the *Complete Auto* standard address distinct issues.

The second prong of *Complete Auto* addresses the question of whether the method used to divide up the base is fair. The United States Supreme Court explained the fair apportionment prong in *Container*, 463 U.S. at 169 (1983), an income tax case,[8] thusly:

> The first, and again obvious, component of fairness in an apportionment formula is what might be called internal consistency—that is, the *formula* must be such that, if applied by every jurisdiction, it would result in no more than all of the unitary business income being taxed. The second and more difficult requirement is what might be called external consistency—the factor or factors used in the *apportionment formula* must actually reflect a reasonable sense of how income is generated. [emphasis supplied].

In *Goldberg* v. *Sweet*, 488 U.S. 252, 261 (1989), the United States Supreme Court stated ". . . the internal consistency test [the first part of the fair apportionment prong of

[8] To be precise, the tax at issue in *Container* was a franchise tax based upon net income.

Complete Auto] focuses on the text of the challenged statute and hypothesizes a situation where other States have passed an *identical* statute." [emphasis supplied]. Internal consistency is an examination of the taxing State's formula in theory and does not involve testing the taxing State's formula against other jurisdictions' different formulas. Recently the Court in *Oklahoma Tax Comm'n* v. *Jefferson Lines, Inc.*, 63 L.W. 4233, 4236 (April 3, 1995) stated:

> Internal consistency is preserved when the imposition of a tax *identical* to the one in question by every other State would add no burden to interstate commerce that intrastate commerce did not bear. [emphasis supplied].

External consistency, the second part of the fair apportionment prong of *Complete Auto*, attempts to determine whether the proper items have been included in the establishment of the formula. In the context of a state income tax, the question is whether the factors which are included in the formula reflect a general sense of how the income being apportioned is earned. Again, the formula is judged not as compared to another formula or calculation, but against itself.

The third prong of *Complete Auto*, as distinguished from the second prong, prohibits discrimination. Discrimination being a concept of comparison necessarily involves testing one method against another. Under the Commerce Clause, the presence of discrimination depends upon tax distinctions that are made based upon different types of commerce. Determination of the presence of discrimination focuses on what is subject to tax, or the rates of taxation, or the credits allowed by a tax. Discrimination requires reference to something beyond the formula itself. A classic example of a tax which was found to discriminate under the Commerce Clause is presented in *Boston Stock Exchange* v. *State Tax Comm'n,* 429 U.S. 318 (1977) (unconstitutional preferential treatment accorded to stock transactions undertaken on particular exchanges located in the taxing State to the detriment of transactions undertaken on exchanges located in other States).

This understanding of the fundamentals of properly analyzing the fair apportionment and non-discrimination prongs of the dormant Commerce Clause highlight the important differences that the Superior Court failed to recognized. In the context of an income tax,[9] fair apportionment, the second prong of *Complete Auto* that was the basis of the Superior Court's decision, is largely a mechanical test based upon an examination of the formula and the elements of the formula. The internal consistency standard is basically a mathematical exercise. It judges a tax by hypothesizing imposition of the *identical* system by every jurisdiction in which the taxpayer is taxable by application of the statutory apportionment formula. It does not involve a comparison with alternative methods, or other taxes, or even States where the taxpayer in the *testing* State under the operation of the *taxing* State's *identical* system would not be taxable. Under the fair apportionment prong, to hypothesize a different taxing approach in the *testing* jurisdiction is to do precisely what the United States Supreme Court has warned against. If the internal consistency test involved analysis of other taxing jurisdictions' distinct taxing approaches, "the constitutionality of [a state tax] would depend on the shifting complexities of the tax codes of 49 other States, and . . . the validity of the taxes imposed on each taxpayer would depend on the particular other States is which it operated." *Armco, Inc.* v. *Hardesty*, 467 U.S. 638, 644-645. [emphasis added].

Questions involving the *apportionment formula* are properly subject to scrutiny on the basis of the fair apportionment test; questions involving the *tax base*, the rate, or the availability of credits are subject to the discrimination test.[10]

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[9]In the context of a sales tax, which is an allocated, as distinguished from an apportioned, tax, *see Jefferson Lines*, 63 L.W. at 4236, the focus of the fair apportionment prong is on the tax itself, because the tax applying to 100% of the sale subject to the tax, is in fact the formula.

[10]Questions of what should be included in the tax base may also give rise to questions involving the first prong of the *Complete Auto* standard, nexus. No questions regarding nexus have been raised in this case and none exist. du Pont is present in Maine and the dividends received are from affiliates that are in the same unitary business being conducted in Maine, which in the end means the dividends statutorily and constitutionally constitute apportionable income in Maine.

Finally, because of a misstatement by the Superior Court of this Court's decision in *Tambrands*, it should be noted that "internal consistency" is an element of the fair apportionment test of the *Complete Auto* standard for reviewing the constitutionality of state taxes under a dormant Commerce Clause analysis. It is not an element of the "discrimination" test and it is not part of the United States Supreme Court's Due Process analysis.

Argument II discusses why the fair apportionment prong is met in this case. Argument III discusses why there is no unconstitutional discrimination in this case.

II. THERE IS NO UNFAIR APPORTIONMENT IN THIS CASE.

A. External Consistency Test Is Not At Issue And, In Any Event, Is Satisfied.

The only potentially proper *formula* question to be asked in this case, which *amicus* understands is not before the Court, is whether the Maine formula fails the external consistency standard, that is, does the formula "reflect a reasonable sense of how the income was earned." *Container*, 463 U.S. at 169. *Amicus* believes that the formula does reflect a reasonable sense of how the income of du Pont was earned.

States are allowed great latitude in determining the basis of their taxes. They may tax on a separate entity basis, they may tax on a water's-edge combined report group basis, and they may tax on a worldwide combined report basis. See Argument I.A., above. The actual values included in the apportionment formula to be used in each of these different systems will differ, even though the same apportionment factors of property, payroll and sales are used. The values plugged into the apportionment factors will differ because these different systems of taxation potentially involve different entities. The values plugged into the apportionment factors follow the identity of the entities whose income is subject to apportionment under each different system.

In the case of the single entity return, only the values of the activities of that single entity should be reflected in the formula, because only the single entity's income is subject

to tax. For the water's edge group, the values plugged into the formula should reflect the activities of each member of that group, because it is the income of the defined group which is subject to tax. For the worldwide group, it is proper to include the values of the worldwide activities, because worldwide income of the worldwide affiliates is being considered. But in a separate entity regime, a State should not be required to include the factors of any of the entity's affiliates, even if they are unitary, because the single entity system does not consider the income of the affiliates. Similarly, a State employing a domestic water's edge system should not be required to include the factors of any of the entity's foreign affiliates, even if they are unitary, because the water's edge system does not consider the income of the affiliates.

Under United States income tax theory, to which state income taxation generally conforms, the distinction between corporation and shareholder is honored, respected and enforced, *Miller* v. *Milwaukee*, 272 U.S. 713 (1926), unless, pursuant to specific statutory authorization, it is allowed to be disregarded, as in the case of consolidated return filings or Subchapter S elections. Dividends paid from a corporation to its shareholders are taxable to the shareholder unless a statutory deduction is provided.[11] The inclusion of unitary dividends from foreign affiliates in the apportionable tax base of the water's edge group is not taxation of the entity declaring the dividend; it is taxation of the income of the entity receiving the income that should be assigned based upon the values of the activities of the recipient. du Pont's income includes the dividends paid to it by the foreign affiliates. But the dividend income arises from *du Pont's* activities, *du Pont's* investment in the affiliates and the activities of *du Pont's* employees in supervising and managing those affiliates. The

[11]For example, *see* Section 243, Internal Revenue Code, with varying levels of deductibility based upon the percentage of stock owned and filing status for dividends between corporations. No deduction is provided for dividends paid by corporations to their shareholders, who are individuals, except when the income has already been reported by the individual as, for example, in the case of Subchapter S corporations.

dividend income, therefore, arises from the conduct of du Pont's own unitary business, not from the conduct of the business of the foreign affiliates.

There is no constitutional principle in state taxation which requires the abandonment of the rule that recognizes dividends as the separate income of the dividend recipient. External consistency requires nothing different. Taxpayer's failure to assert any challenge based on the external consistency test suggests that it understands this fundamental principle.

To the extent a corporation receives dividends, there is no constitutional mandate as to their taxability by States.[12] A State may choose to tax dividends, it may choose to allow a deduction with respect to dividends, or it may exclude them completely from its tax base. Whatever the approach used, there is no constitutional requirement that a State forgo the taxation of dividend income *per se*. One State's treatment of dividends does not mandate that other States provide similar or identical treatment. All that is required for dividends to be included within the apportionable tax base, as it is for all other types of income, is that the dividends be rationally related to the activities of the corporation in the State. This rational relationship may be established either through the act of incorporation or the maintenance of the principal offices of the corporation in the State or through the application of the "unitary business principle." If a State chooses to exempt dividends in whole or part, it only must consider the warning that it may not choose to exempt some dividends in a manner which discriminates against interstate or foreign commerce. *Kraft Gen'l Foods*. (*Amicus* explains in Argument III, below, why taxpayer has established no existence of discrimination within the meaning on the Commerce Clause.)

There are four United States Supreme Court cases which have considered constitutional concerns regarding the taxation by States of foreign dividends in the last 15

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[12]There is nothing unique about dividends. Dividends are income. This is a matter of statutory definition under federal income tax law to which State income taxes largely conform. Dividends are not specifically mentioned in the United States Constitution and there is nothing in their character which constitutionally mandates particular treatment for income tax purposes. Furthermore, dividends are income in the hands of the recipient. They are not income to the dividend payor. They are, by definition, a distribution of the payor's earnings and profits.

years. There are no cases which have arisen with respect to the States' ability to tax dividends generally. The four cases are:

Mobil Oil Corp. v. *Vermont*, 445 U.S. 425 (1980): The Supreme Court concluded that dividends from foreign subsidiaries could be subject to apportionment in the non-domiciliary State. No suggestion was made that the dividends were exempt from State taxation even though full taxability by the State of commercial domicile was conceded.

ASARCO, Inc. v. *Idaho*, 458 U.S. 307 (1982), and *F.W. Woolworth Co.* v. *Taxation & Revenue Dept. of New Mexico*, 458 U.S. 354 (1982): These cases were argued at the same time with separate decisions released in tandem. The Supreme Court held in each case that the dividends received by non-domiciliary companies were not apportionable (business) income and could not be taxed by the States. No argument was made, and there was no suggestion, that the dividends could not constitutionally be considered and taxed by some State.

Kraft Gen'l Foods, Inc. v. *Iowa Dept. of Revenue & Finance*, 505 U.S. ___ (1992): The Supreme Court held that dividends from foreign entities could not be taxed because dividends from domestic entities were not taxed. (This non-discrimination holding is discussed in Argument III, below.) There was no suggestion that if domestic dividends had been taxed that foreign dividends would be exempt.

In none of these cases is there any suggestion that dividends are *per se* exempt from state taxation as a separate class of income: Constitutional exemptions arose for two reasons: First, the dividends were not related to the unitary business carried on by the recipient in the taxing State or, second, the State discriminated by providing a statutory deduction for one type of dividend and not another type of dividend.

B. <u>The Internal Consistency Test Has Been Improperly Applied In This Case And In *Tambrands*.</u>

As noted above, Argument I.B., the "internal consistency" test cannot be violated where the taxpayer under the hypothetical application of the taxing State's *identical* system would not be subject to tax in the testing jurisdiction. The Superior Court in this case, and this Court in *Tambrands*, has conceptually misapplied the mechanical nature of the internal consistency test by hypothesizing application of the Maine statute by jurisdictions in which the *taxpayer* (*e.g.*, Tambrands and/or the other members of the Maine's water's edge group)

would not be taxable under Maine's law This invocation of the internal consistency test could only be accomplished by changing the identity of the taxpayer in the testing jurisdiction. Changing the identity of the taxpayer means that application of the identical system is not being hypothesized in the testing jurisdiction.

The illogic of the Superior Court's test is demonstrated by the observation that if its view were correct, no state tax system of separately including dividends of a non-included member of the unitary group could ever satisfy the internal consistency test. That result would deny to the taxing State the ability to ensure that a multijurisdictional *taxpayer* pays its fair share of state taxes, taxes determined by apportioning the unitary income of the *taxpayer*. The inability to satisfy the internal consistency test would be present regardless of whether the dividends in issue involved foreign commerce. The error of the Superior Court is demonstrated by the following hypothetical.

> Corporation A is present only in State X. State X includes all dividends in its tax base and taxes all of A's income. Corporation A owns stock in Corporation B, a member of the same unitary business as Corporation A. B does business only in State Y. State Y taxes all of B's income.

Under a proper application of internal consistency, State X taxes 100% of Corporation A's income and State Y, using State X's rule, taxes none of A's income. Under a hypothetical application of State X's rule, State Y taxes Corporation B's income. State X does not tax Corporation B's income, it taxes Corporation A's income. Internal consistency exists. Under the Superior Court's misapplication of internal consistency, the State X tax fails internal consistency. The failure would occur because the Superior Court would change the identity of the taxpayer, contrary to State X's law, by treating the entire unitary business of Corporation A and Corporation B as the taxpayer to which State X's formula is hypothetically applied in State Y, even though State X's actual formula only applies to Corporation A. Under the Superior Court's analysis, a State regardless of its law may not constitutionally tax dividend income, because to do so would violate its interpretation of

internal consistency. This is not the law. *See Mobil*, *ASARCO*, *Woolworth*, and *Kraft*. No factor relief formula can cure this so-called violation of the internal consistency test.

The Superior Court's misstep in application of internal consistency occurs, because the Superior Court phrased internal consistency as requiring that "no multiple taxation would result." (Slip opinion, p. 7.) The United States Supreme Court in *Container*, 463 U.S. at 169, however, described internal consistency in the context of an income tax as "the *formula* must be such that, if applied by every jurisdiction, it would result in no more than all of the unitary business income being taxed." [emphasis supplied]. The "unitary business" described in *Container* is the taxing State's definition of the unitary business—*not* the most expansive concept of the unitary business that is constitutionally permitted, but which the taxing State has not adopted as a part of its formula.

The Superior Court committed two errors in applying the internal consistency test: (i) it changed the identity of the taxpayer so that the formula being applied hypothetically in the testing jurisdiction was no longer identical to the taxing jurisdiction's formula; and (ii) it then looked at the results of application of the formula, the formula times the base, to judge the tax. The Supreme Court, under a fair apportionment analysis, does not change the identity of the taxpayer and only looks at the formula.

The water's-edge combined report group required by the State of Maine, and used by du Pont in this case, did not operate in the countries where the foreign subsidiaries were located, because Maine did not include these foreign subsidiaries within the Maine taxpayer group. du Pont, and the water's-edge combined report group, were not taxable in those jurisdictions under Maine's statute.[13] A proper internal consistency analysis looks only to the formula as described by the taxing State. In this case, the Maine formula only includes activities where the water's-edge group is present. The formula used by Maine,

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[13]Some foreign countries assert withholding taxes on dividends paid to non-resident shareholders. *Amicus* has no knowledge of whether such taxes were asserted by the foreign countries in this case. Whether they were or not is irrelevant, however, because they represent a different tax which would not be included in an internal consistency analysis.

that required by the Uniform Division of Income for Tax Purposes Act, is the same formula used by California and approved by the United States Supreme Court. The Supreme Court has determined that the formula meets the internal consistency standard. A proper internal consistency analysis cannot consider the activities arising in a jurisdiction where the *formula* would not operate without changing the identity of the taxpayer in the testing jurisdiction. It is a definitional question, and it is a mathematical certainty that the Maine formula does not violate internal consistency.

In *Container*, in contrast to this case, it was proper to apply the internal consistency test in a manner which hypothesized the application of the California methodology by foreign jurisdictions, because the activities in those jurisdictions were included within the California formula. Maine and California use different combined report approaches which therefore require different internal consistency analyses. Maine, employing a water's edge concept of combined reporting, has defined the elements included within its formula as limited to corporations in that domestic group. California in *Container*, employing a worldwide concept, defines the elements in terms of that worldwide group. Maine's different theme is clearly permissible. (*See* the discussion, above, "A final point that needs to be made about the unitary business concept is that it is not, so to speak, unitary: there are variations on the theme, and any number of them are logically consistent with the underlying principles motivating the approach." *Container*, 463 U.S at 168-169.

C. The "Multiple Taxation" The Superior Court Was Concerned With Is Not Constitutionally Impermissible.

The Superior Court found multiple taxation to exist, because the dividends included in Maine's apportionable income were paid from earnings taxed in the hands of the payor by the foreign country. This multiple taxation is not constitutionally impermissible. It is analytically identical to the circumstance considered in *Jefferson Lines* by the United States Supreme Court when it examined the assessment of an apportioned use tax by Texas on the

Texas portion of the travel from Oklahoma City to Dallas on a ticket purchased, paid, and taxed in full in Oklahoma. The Supreme Court said that travel in this circumstance,

> would not be exposed to multiple taxation in any sense different from coal for which the producer may be taxed first at point of severance by Montana and the customer may later be taxed upon its purchase in New York. The multiple taxation placed upon interstate commerce by such a confluence of taxes is not a structural evil that flows from either tax individually, but it is rather the "accidental incidence of interstate commerce being subject to two different taxing jurisdictions." Lockhart 75; See *Moorman Mfg. Co.*, 437 U.S., at 277. [note omitted]. [63 L.W. at 4238].

III. THERE IS NO DISCRIMINATION AGAINST FOREIGN COMMERCE IN THIS CASE.

A. Discrimination Under *Kraft Gen'l Foods* Is Not Present.

In this case, the question of discrimination arises because of Maine's definition of the tax base. Maine limits its combined group to water's edge unitary subsidiaries. It is clear that there would be no claim of constitutional discrimination if Maine were to include foreign unitary subsidiaries in their entirety in its tax base. *Container*; *Barclays Bank*. It also goes without challenge that a State may limit its combined report group to only water's-edge entities as Maine has done. The claim of discrimination arises because Maine includes the dividends received from the excluded foreign, unitary subsidiaries in its tax base, subject to the "Augusta formula" which limits the amount of tax assessed to du Pont to an amount no greater than it could constitutionally assess under worldwide combined reporting. Maine does no more than it is clearly constitutionally permitted to do and still is faced with a claim of discrimination.

The claim of discrimination arises from the United Supreme Court's decision in *Kraft Gen'l Foods*. In that case, Iowa, a single entity State which did not use combined reporting, either water's edge or worldwide, was held to discriminate against foreign commerce, because it included foreign unitary dividends in its tax base while giving no consideration to the earnings of the unitary water's edge affiliates of the taxpayer. The United States Supreme Court in its *Kraft Gen'l Foods* analysis recognized that that case has no

application in the instant situation where Maine gives consideration to the earnings of du Pont's unitary domestic affiliates by including them in full in its water's edge combined reporting group. The Supreme Court in footnote 23 to its decision stated,

> If one were to compare the aggregate tax imposed by Iowa on a unitary business which included a subsidiary doing business throughout the United States (including Iowa) with the aggregate tax imposed by Iowa on a unitary business which included a foreign subsidiary business abroad, it would be difficult to say that Iowa discriminates against the business with the foreign subsidiary. Iowa would tax an apportioned share of the domestic subsidiary's entire earnings, but would tax only the amount of the foreign subsidiary's earnings paid as a dividend to the parent. 112 S.Ct. at 2371.

This footnote describes the effect of Maine's application of water's edge combined reporting. Maine imposes a tax upon the aggregate income of all of du Pont's unitary domestic business, including subsidiaries doing business throughout the United States. Whether the domestic unitary subsidiaries of du Pont are doing business in Maine has no effect on whether their earnings are included in the domestic water's edge base which Maine subjects to an apportioned tax.

Furthermore, in *Kraft* the United States Supreme Court accepted the assertion of the *amicus* United States that "in evaluating the alleged facial discrimination effected by the Iowa tax, it is not proper to ignore the operation of other provisions of the *same* statute." 112 S.Ct. at 2371. It is that standard which this Court should apply in evaluating Maine's statute in this case. The use of domestic water's edge combined reporting by Maine equates directly to footnote 23 of the *Kraft Gen'l Foods* decision and leads directly to the conclusion that Maine's consideration of foreign dividends violates no constitutional prohibitions.

This is not a case like *Kraft Gen'l Foods* where Iowa sought to justify its tax upon the basis of taxes asserted by other States. 112 S.Ct. at 2371. Maine justifies its tax on the basis of what Maine taxes. It is what is appropriately described as an internally consistent tax, both in the sense of fair apportionment, and in the sense that it is judged only by what it does, not by what others do.

It is important to recognize that *Kraft Gen'l Foods* did not overrule *Container*. This was confirmed by the United States Supreme Court's decision in *Barclays Bank*, which was joined with *Colgate-Palmolive Co.* v. *Franchise Tax Bd.*, a case involving a domestic-based, unitary business. Therefore, it is clear that Maine could have applied worldwide combined reporting to du Pont and there would be no valid constitutional objection. Maine has chosen to do something less than is constitutionally permitted. By adoption of the "Augusta formula" Maine has ensured that it will do nothing more than is constitutionally permitted. There is no discrimination. The discussion of dividends and the *Kraft Gen'l Foods* case is irrelevant. For purposes of a discrimination analysis, *Container* and *Barclays Bank* establish the benchmark for measurement. The "Augusta formula" ensures that that benchmark will not be exceeded.

B. <u>The Superior Court's "Inevitability" Analysis Is Fatally Flawed</u>.

The Superior Court committed two fatal flaws when it employed its mixed *discrimination-internal consistency-multiple taxation analysis*, which led to its erroneous conclusion regarding inevitability. One flaw was the Superior Court's departure from *Container*, when it erroneously hypothesized alleged facts to create three possible classes of taxpayers, one class of which posited a circumstance suggesting the possibility of multiple taxation.[14] The other flaw was its insistence, contrary to the fundamental concept of the unitary business principle, that it was even possible to know within a unitary business which of the domestic subsidiaries or the foreign subsidiaries was the most profitable. The particulars on these two fatal flaws follows.

The Superior Court divided the class of taxpayers with foreign affiliates into three classes, and with respect to one of those three classes found that there was inevitable

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[14]The classes devised by the Superior Court were (i) those with foreign subsidiaries that are more profitable than domestic operations; (2) those with foreign subsidiaries that are less profitable than domestic operations; and (3) those with foreign subsidiaries that are equally profitable as domestic operations. (Slip opinion, p.7). Note 7 accompanying this classification indicates that the Superior Court would devise these classes based upon the taxpayer's own separate accounting.

multiple taxation. The Superior Court used this speculative hypothesis, whose legitimacy is questioned in the description of the second flaw, below, to hold Maine's action unconstitutional under *Container*. In taking this step, the Superior Court undertook an analysis *Container* had rejected. This Court as the enforcer of a federal constitutional right must reject this erroneous interpretation of the applicable standard as established by the United States Supreme Court.

In *Container*, under the multiple tax element of dormant foreign commerce clause analysis, 463 U.S. at 186-193, the *Container* Court assumed actual multiple taxation in the facts of that case, 463 U.S. at 187, but concluded that "the double taxation in this case, although real [was] not the 'inevitable' result of the California taxing scheme. 462 U.S. at 188. In rejecting that these facts could establish an unconstitutional taxing approach, the Court continued, "Whether the combination of the two methods results in the same income being taxed twice or in some portion of income not being taxed at all is dependent solely on the facts of the individual case." It is these facts of the individual case which the Superior Court uses to create its three categories (Slip opinion, p. 7). If such an analysis were appropriate, the Supreme Court would have used it in *Container*. It did not. The United States Supreme Court's language and application demonstrates that such an analysis is inappropriate. This kind of analysis is thus inappropriate for a State court as well.

The second fatal flaw involves the Superior Court's assumption that it could determine the separate profitability of each of the unitary business' subsidiaries, domestic or foreign. The only basis upon which the Superior Court could make this comparison was the separately stated incomes of the subsidiaries. Slip opinion, p. 7 n.5. This surprising reliance upon separate accounting in the face of the United States Supreme Court's most recent identification of the risks of separate accounting in *Barclays Bank*, 114 S.Ct. at 2272, to justify a finding of discrimination flies in the face of a fundamental precept of a unitary business. That fundamental precept of the constitutionality of formula apportionment of a unitary business is the inability to account separately for all the contributing elements that

generate the income of a unitary business. Identifying the more profitable subsidiaries on the basis of separately stated income and invalidating a state tax system based upon an alleged discrimination that has been so identified leaves the States at risk for precisely the kinds of machinations that promoted the unitary business concept in the first place. States are free to utilize formula apportionment of a unitary business, because in the view of the United States Supreme Court that approach does a better job than separate accounting in dividing the income among taxing jurisdictions in which the unitary business operates. There is simply no justification this late in the day following the United States Supreme Court's repeated defense of state formula apportionment of a unitary business for a state court to hamstring its own state tax system based upon an accounting model that has been repeatedly rejected as being constitutionally mandated. States, including the State of Maine, have the freedom to ensure multijurisdictional commerce pays its fair share by employing domestic's water's edge combined reporting coupled with the inclusion of declared dividends of foreign subsidiaries that are not members of the combined group.

CONCLUSION

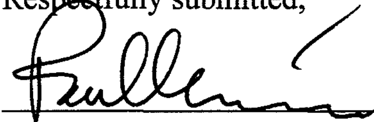
The decision of the Superior Court should be reversed in this matter. Its analysis is confused and fatally flawed in many respects and has led to an incorrect result.

In addition, it is respectfully submitted that this Court should use this case as an opportunity to revisit its decision in *Tambrands* and clear up the confusion which has been created by it. The discussion of the Superior Court in this case regarding the remedy, Slip Opinion pp. 10-12, while based upon a confused understanding of the opinions of the United States Supreme Court, is insightful in one aspect. That Court recognized that "establishing a formula is really a matter of tax policy making and expertise of the legislative and executive branches of government." Slip Opinion, p. 11. The Tax Assessor has undertaken that duty and this Court should

honor his efforts as long as they meets the requirements of the United States Constitution which *amicus* submits that they do.

DATED: July 26, 1995

Respectfully submitted,



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CERTIFICATE OF SERVICE

I, Crombie J. D. Garrett, Assistant Attorney General, hereby certify that I have this day caused two copies of the foregoing Brief *Amicus Curiae* of Multistate Tax Commission in Support of State Tax Assessor to be served upon Attorney of Record, Daniel M. Snow, Esq., by having the same deposited in the United States Mail, postage prepaid, addressed as follows:

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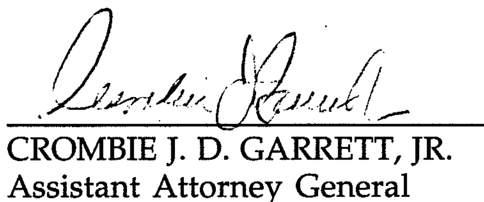

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