

Constitutionality of New Hampshire Taxation of Foreign-Source Dividends Upheld Despite Apparent Discrimination

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A recent New Hampshire Supreme Court decision misconstrues several U.S. Supreme Court decisions and muddles a number of state court opinions in holding that New Hampshire tax law does not discriminate against foreign commerce in not allowing a parent company to deduct dividends it receives from a foreign subsidiary, even though it would allow a deduction for dividends from subsidiaries with operations in New Hampshire (*General Electric Co., Inc. v. Commissioner*, No. 2005-668 (N.H. Dec. 5, 2006)). While the court spent much of its opinion searching for “taxing symmetry” in New Hampshire tax law, it somehow misses the fact that the state’s dividends received deduction (DRD) violates the Commerce Clause of the U.S. Constitution by favoring investments in companies doing business in New Hampshire over investments in non-New Hampshire entities.

The New Hampshire Tax System

The New Hampshire business profits tax (BPT) is imposed on the net income of entities doing business in the state (N.H. RSA 77-A:1). New Hampshire requires unitary businesses to file a combined BPT return on a water’s-edge basis — that is, only U.S. domestic entities are included in the combined report. Intragroup activity such as the payment of dividends and royalties from one member of the water’s-edge group to another is eliminated in the combined report (N.H. RSA 77-A:1, XII, XV, and XVI). Dividends received from foreign — that is, non-U.S. — affiliates that cannot be included in the water’s-edge combined report are not eliminated.

In addition, under N.H. RSA 77-A:4, IV, a parent company is allowed a DRD for dividends received

from foreign subsidiaries only to the extent that the foreign subsidiary has activity in New Hampshire and pays New Hampshire BPT. Thus, a parent company with a foreign subsidiary with no activity in New Hampshire would get no DRD on dividends it received from the foreign subsidiary. However, a parent company with a foreign subsidiary that does business in New Hampshire would get a DRD for “such amounts of gross business profits as are derived from dividends paid to the parent by a subsidiary . . . whose gross business profits have already been subject to taxation . . . during the same taxable period” (N.H. RSA 77-A:4, IV). Also, N.H. RSA 77-A:3, II(b) provides a modified apportionment method for determining the amount of foreign dividends that are to be included in the BPT base. That method allows for some of the foreign-dividend-paying subsidiaries’ factors to be taken into account in taxing the foreign-source dividend income. This is intended to provide a partial exemption for foreign dividends.¹

The New Hampshire Court’s Decision

The case at issue involved General Electric Co. Inc. (GE), the parent company of a large number of foreign and domestic subsidiaries. GE has a place of business in New Hampshire, as did some of its domestic subsidiaries; however, none of its foreign subsidiaries did business in New Hampshire during the tax years in issue. GE and its unitary domestic affiliates were included in a water’s-edge BPT return in New Hampshire. None of GE’s unitary foreign subsidiaries were included in the water’s-edge report. Based on the New Hampshire statute, GE was denied a deduction for the dividends it received from its foreign unitary subsidiaries, while

¹Opinion of the Justices, 509 A.2d 734 (N.H. 1986).

the dividends from domestic subsidiaries were eliminated in the water's-edge report. Further, GE alleged that it would have been allowed a DRD for dividends from a foreign subsidiary if it had a foreign subsidiary that was doing business in New Hampshire.² Based on New Hampshire's more favorable treatment of dividends from either domestic subsidiaries or foreign subsidiaries doing business in New Hampshire, GE challenged the DRD provision, asserting that it discriminated against foreign subsidiaries that do not do business in New Hampshire, thus violating the Commerce Clause of the U.S. Constitution. (For the New Hampshire Supreme Court's decision in *General Electric*, see *Doc 2006-24450* or *2006 STT 236-12*.)

The U.S. Supreme Court held in *Complete Auto Transit v. Brady*, 430 U.S. 274 (1977), that for a state to impose a tax affecting interstate commerce without violating the Commerce Clause, the tax must: (1) be applied to an activity with a substantial nexus with the taxing state; (2) be nondiscriminatory; (3) be fairly apportioned; and (4) be fairly related to the services provided by the state. When foreign commerce is involved, an even higher level of scrutiny is applied. See *Japan Line, Ltd. v. County of Los Angeles*, 441 U.S. 434 (1979). At issue in *General Electric* was whether the DRD provision violated the second requirement of *Complete Auto* by discriminating against dividends received from foreign subsidiaries that did not do business in New Hampshire.

The court in *General Electric* held that the New Hampshire DRD provision, when reviewed within the context of the entire New Hampshire taxing scheme, did not violate the Commerce Clause because the earnings of a subsidiary with operations in New Hampshire and a foreign subsidiary with no operations in New Hampshire are each taxed only once by New Hampshire. Thus, according to the court, there was taxing symmetry and no differential treatment that benefited intrastate commerce over interstate or foreign commerce.

The court's conclusion is flawed for several reasons. The court mistakenly focuses on the wrong aspect of the New Hampshire taxing scheme. The court looks only at the DRD provision's role in preventing any double tax on income earned by a subsidiary that is taxed in New Hampshire. However, regardless of the taxing scheme's intended purpose, it cannot be accomplished in a manner that

discriminates against interstate or foreign commerce. The court should have instead focused on the fact that the New Hampshire BPT included dividend income from foreign subsidiaries not doing business in the state in the parent's apportionable tax base while eliminating dividend income from subsidiaries included in the water's-edge group and providing a DRD for dividends from foreign subsidiaries that did do business in the state. Clearly, such a scheme discriminates against foreign-dividend-paying subsidiaries by favoring investments in companies that do business in New Hampshire.

The U.S. Supreme Court Cases

The U.S. Supreme Court has addressed similar issues more than once. In *Kraft General Foods, Inc. v. Iowa Department of Revenue*, 505 U.S. 71 (1992), the Court addressed the inclusion of dividends from foreign subsidiaries in the tax base in a separate return state. Iowa's taxing scheme did not tax the dividends received from a domestic subsidiary that had no nexus with Iowa but did tax the dividends received from a foreign subsidiary that had no operations in Iowa. That was because a parent corporation was allowed a DRD for the dividends received from the domestic subsidiary but no similar deduction was allowed for the dividends received from the foreign subsidiary.

Essentially, that mirrored the federal treatment of dividends, which Iowa adopted by using federal taxable income as the starting point for its tax. For federal purposes, a DRD is allowed for dividends from domestic subsidiaries but not from foreign subsidiaries except to the extent that the subsidiary is subject to U.S. tax. However, even though federal law does not allow a DRD for the foreign dividends, it does allow either a credit or a deduction for foreign taxes paid on the income out of which the dividend is paid. Iowa did not adopt the foreign tax credit or deduction portions of federal law.³

In defending its tax structure, Iowa argued that its DRD provision did not favor local interests because a domestic subsidiary with operations in Iowa would pay Iowa tax while the foreign subsidiary would pay no Iowa tax, even though the dividends it paid to the domestic parent company were taxed in Iowa. Iowa asserted that the tax paid by the Iowa subsidiary would be more than the Iowa tax paid by the parent company on the dividends received from the foreign subsidiary and thus there was no discrimination against foreign commerce. The Court disagreed with that argument, holding that "the fact remains that Iowa imposes a burden on foreign subsidiaries that it does not impose on domestic subsidiaries" because "the only subsidiary dividend

²There appears to have been some disagreement as to whether a 100 percent DRD would have been allowed if the foreign subsidiary had done business in New Hampshire or if the DRD would have been based on the percentage of the foreign subsidiary's income taxed in New Hampshire. The court determined that the latter was the correct answer and that the other alternative would have allowed a "hyperdeduction" not allowed by the statute.

³See IRC sections 164 and 901.

payments taxed by Iowa are those reflecting the foreign business activity of foreign subsidiaries.”

In Footnote 23 of the decision, the Court stated that if the “aggregate tax imposed by Iowa on a unitary business which included a subsidiary doing business through the United States (including Iowa)” were compared with “the aggregate tax imposed by Iowa on a unitary business which included a foreign subsidiary doing business abroad, it would be difficult to say that Iowa discriminates against the business with the foreign subsidiary.” In that case, the Court wrote, “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.”

The state court decisions that have relied on a footnote in *Kraft* to uphold discriminatory state taxing schemes have done so by ignoring important questions.

After *Kraft*, several state court decisions have focused on the language of Footnote 23 to hold that it was constitutional to allow a DRD to a domestic subsidiary included in a water’s-edge combined report, even though no DRD was allowed for dividends from foreign subsidiaries that were not included in the combined report. Putting aside the fact that the statement in Footnote 23 amounts only to *dictum* that should not rise to the level of deciding constitutional questions, the state court decisions that have relied on that footnote to uphold discriminatory state taxing schemes have done so by ignoring important questions raised by the disallowance of a DRD to companies that are not included in a water’s-edge group.

For example, the Kansas Supreme Court in *Appeal of Morton Thiokol*, 864 P.2d 1175 (Kan. 1993), addressed a tax structure in which dividends from foreign subsidiaries were included in the tax base of the domestic combined report while a DRD was allowed for dividends from domestic subsidiaries included in the combined group. According to the court, that taxing scheme was constitutional because the “aggregate tax imposed by Kansas on a unitary business with a domestic subsidiary would not be less burdensome than that imposed by Kansas on a unitary business with a foreign subsidiary because the income of the domestic subsidiary would be combined, apportioned and taxed while only the dividend of the foreign subsidiary would be taxed.”

Similarly, in *E.I. du Pont de Nemours v. State Tax Assessor*, 675 A.2d 82 (Maine 1996), the Maine Supreme Judicial Court, addressing the disallowance of a DRD for dividends from foreign subsidiar-

ies, held that because the combined reporting method “includes within the amount apportioned to Maine, part of the income earned by the unitary business’s domestic subsidiaries” and thus “captures some of the value of the business activities of the domestic subsidiaries,” it is necessary to add to the tax base “the dividends paid by the foreign subsidiaries to the domestic parent because these dividends represent value earned by the parent that is not otherwise captured” and thus, according to the court, there was a “taxing symmetry” that was not present under a separate reporting regime.

The New Hampshire court in *General Electric* relied heavily on the decisions in *Morton Thiokol* and *Dupont*, and their interpretation of *Kraft*, in determining that there was a taxing symmetry to the New Hampshire DRD provisions and that when viewing the state’s taxing regime as a whole, there was no discrimination against foreign commerce. According to the court, the New Hampshire tax system is structured so that the income of the business entity is taxed only once and the foreign subsidiary with no New Hampshire activity is not taxed more heavily than a domestic subsidiary or a foreign subsidiary that pays the BPT. Thus, there was no differential treatment that benefited one more than the other.

In reaching that conclusion, the Kansas court focused on Footnote 23 while ignoring the holding in the *Kraft* decision, which said that the fact that the domestic subsidiary might be subject to the state’s tax, while the foreign subsidiary was not, was *not* determinative of whether the investment in the foreign subsidiary was subject to a greater burden than the investment in the domestic subsidiary. Also, the taxing symmetry the court found in the Kansas tax system in *Morton Thiokol* is an illusion. It may be true that the Kansas-tax-paying subsidiary’s earnings were taxed once in Kansas and the earnings of the foreign subsidiary with no Kansas activity was also taxed once in the state, through the dividend income. But the Footnote 23 argument breaks down because not only was the dividend income received from a subsidiary doing business in the state not taxed, but the domestic subsidiary’s factors were also included in the water’s-edge combined report while the foreign subsidiary’s factors were not included. What cases like *Dupont* and *Morton Thiokol* miss is that the absence of “factor representation” for the foreign subsidiary’s apportionment factors results in a higher burden being placed on the earnings of the foreign subsidiary and thus in a Commerce Clause violation.⁴

⁴The New Hampshire Supreme Court previously rejected the idea that factor representation was constitutionally required in the taxing of interest and royalties received from a
(Footnote continued on next page.)

When the effect of the apportionment factor treatment of the foreign and domestic subsidiaries is taken into consideration, the Footnote 23 argument championed by *Dupont* and *Morton Thiokol*, on which the New Hampshire court heavily relies, falls apart. Although New Hampshire does have a separate apportionment calculation for income from foreign-dividend-paying subsidiaries, the discriminatory effect of its DRD is not eliminated.⁵ In fact, a similar provision regarding apportionment of foreign dividend income was held not to cure a state's discriminatory DRD in *Conoco Inc. and Intel Corp. v. Taxation and Revenue Department of New Mexico*, 931 P.2d 730 (1996), *cert. denied*, 117 S.Ct. 2497 (1997). In that case, the New Mexico Supreme Court addressed a taxing scheme similar to New Hampshire's that added a portion of the property, payroll, and sales of foreign-dividend-paying subsidiaries into the property, payroll, and sales of its domestic parent. Although the *Conoco/Intel* case did not involve a water's-edge report, the apportionment provision regarding dividends from foreign subsidiaries acted similarly to New Hampshire's: Both provided potential factor relief for dividends from foreign subsidiaries in an attempt to cure the discrimination caused by allowing a DRD for dividends received from domestic but not foreign subsidiaries.

When the effect of the apportionment factor treatment of the foreign and domestic subsidiaries is taken into consideration, the Footnote 23 argument falls apart.

The court in *Conoco/Intel* determined that the New Mexico apportionment scheme did not remove all of the dividends paid by foreign subsidiaries from the tax bases of the taxpayers and that it did not neutralize the discriminatory effect of the DRD provision "because the extent to which it eliminates this discriminatory effect depends on the relative efficiencies of a corporation's foreign and domestic subsidiaries." The court found that the apportionment formula for foreign dividends did not cure the discriminatory effect of the DRD provision because

foreign affiliate by a New Hampshire water's-edge group. *Caterpillar, Inc. v. New Hampshire*, 741 A.2d 56 (N.H. 1999). (For the New Hampshire Supreme Court's decision in *Caterpillar*, see *Doc 1999-34660* or *1999 STT 209-17*.)

⁵See Michael W. McLoughlin, "Is Water's Edge Constitutional Without Factor Representation," *State Tax Notes*, July 6, 1998, p. 29, *98 STN 128-19*, or *Doc 98-21190*, for a discussion of the constitutional issues raised by the absence of factor representation regarding dividends, interest, and royalties received from foreign affiliates.

"it does not eliminate dividends paid by foreign subsidiaries from the tax base in every case." The same holds true for the New Hampshire apportionment scheme for foreign dividend income; thus, it does not neutralize the discriminatory effect of the New Hampshire DRD provision.

If the New Hampshire DRD provision is facially discriminatory, the only way it could survive a Commerce Clause challenge would be under the compensatory tax doctrine. That doctrine has been examined by the Supreme Court on several occasions regarding discriminatory state taxes.⁶ For example, in *Fulton Corp. v. Faulkner*, 516 U.S. 325 (1996), the Supreme Court addressed a North Carolina intangibles tax that was imposed on the value of corporate stock owned by North Carolina residents. A deduction was allowed from the tax based on the level of activity the issuing company had in North Carolina. Thus, an investment in the stock of a company that did 100 percent of its business in North Carolina received a 100 percent deduction, while an investment in a company that did 0 percent of its business in North Carolina received no deduction. As a result, like with the New Hampshire BPT, an investment in an in-state subsidiary was much more tax beneficial than an investment in an out-of-state company. North Carolina argued that even if the tax was facially discriminatory, the differential treatment was justified because the North Carolina company was subject to North Carolina tax. In other words, the deduction for the investor compensated for the tax that was paid by the investee company and thus the compensatory tax doctrine was satisfied.

The Court found that the North Carolina taxing scheme favored domestic corporations over their foreign competitors in raising capital in the state and discouraged domestic companies from participating in interstate commerce. The Court also rejected the state's compensatory tax argument. The Court held that the state must meet three requirements to demonstrate that a discriminatory tax should be upheld as compensatory:

- the state must identify the intrastate tax burden for which the state is attempting to compensate;
- the tax on interstate commerce must be shown to be roughly approximate to, but not to exceed, the amount of tax on interstate commerce; and
- the events on which the interstate and intrastate taxes are imposed must be substantially equivalent.

⁶The New Hampshire Supreme Court in *General Electric* did not address the compensatory tax doctrine because it determined that the New Hampshire DRD provision was not discriminatory.

The Court held that the North Carolina tax satisfied none of those requirements. The state argued that the intangibles tax met the first requirement because it compensated for the burden of the corporate income tax paid by the companies doing business in North Carolina. The Court disagreed, holding that allowing a discriminatory tax on interstate commerce “to compensate for charges purportedly included in general forms of intrastate taxation would allow a state to tax interstate commerce more heavily anytime the entities involved in interstate commerce happened to use the facilities supported by general state tax funds.”

The Court also found that North Carolina could not demonstrate that the tax on interstate commerce was roughly approximate to the tax on intrastate commerce because the “corporate income tax is a general form of taxation, not assessed according to the taxpayer’s use of particular services, and before its revenues are earmarked for particular purposes they have been commingled with funds from other sources.” Thus, it was not possible to demonstrate that the discriminatory intangibles tax deduction was roughly equivalent to the corporate income tax paid. Finally, the Court found that North Carolina could not prove that the corporate income tax was substantially equivalent to the burden on shareholding imposed by the intangibles tax, and the Court doubted that such an equivalence could ever be proven outside the sales and use tax area, the only area that the Court has allowed a discriminatory tax to be upheld as compensatory.⁷

The court in *General Electric* appears to be holding that the New Hampshire scheme is “compensatory” by saying that the tax-free treatment of dividends from subsidiaries doing business in New Hampshire compensates for the New Hampshire tax paid by those subsidiaries. But it would seem that that holding would be necessary only if the taxing scheme were facially discriminatory, with the compensatory nature of the taxing structure curing the discrimination. However, because the court held that New Hampshire’s treatment of dividends from foreign subsidiaries with no New Hampshire activity was not discriminatory, there would seem to be no need to assert that the dividend treatment compensated for the tax paid by the domestic subsidiaries.

The New Hampshire Supreme Court dismissed the applicability of *Fulton* without further analysis because that case involved a different type of tax. However, *Fulton* is more relevant than the court admits. The New Hampshire court is blinded by its finding that the purpose of the dividends received deduction is to prevent double taxation, and it incorrectly concludes that there can thus be no

discriminatory purpose. However, the U.S. Supreme Court has held that the purpose behind a law has no bearing on whether it is facially discriminatory and that if it is discriminatory it is per se invalid unless it serves a legitimate local purpose that cannot be adequately served by reasonable nondiscriminatory alternatives. See *Oregon Waste Systems, Inc. v. Department of Environmental Quality*, 511 U.S. 93 (1994).

If the New Hampshire DRD provision is facially discriminatory, the only way it could survive a Commerce Clause challenge would be under the compensatory tax doctrine.

The New Hampshire court would have been more correct if it had focused not on the purpose behind the DRD provision but instead, like the Court in *Fulton*, on the incentives that the New Hampshire DRD provides to in-state companies in raising capital at the expense of foreign subsidiaries with no activity in the state. A company that is looking to expand its business would most likely receive a greater New Hampshire tax benefit by investing in a subsidiary doing business in New Hampshire than by investing in a non-New Hampshire subsidiary.

Thus, the New Hampshire DRD “favors domestic corporations over their foreign competitors in raising capital.”⁸ Had the court focused on that aspect of the DRD provision, it would have been more difficult for it to so easily dismiss the applicability of the Supreme Court’s holding in *Fulton* to the New Hampshire DRD. The right approach for the court to have taken would have been to recognize that the New Hampshire DRD provision was facially discriminatory, based on *Fulton*, and then to examine whether the taxing scheme was valid under the compensatory tax doctrine.

Had the court done that, it would have been difficult for it to conclude that the New Hampshire treatment of dividend income qualified as compensatory. The U.S. Supreme Court rejected a similar compensatory tax argument in striking down a tax as discriminatory in *South Central Bell v. Alabama*, 526 U.S. 160 (1999). In *South Central Bell*, the Alabama franchise tax was imposed on the par value of the stock of domestic entities but imposed on “the actual amount of capital employed” of non-Alabama entities doing business in the state. The tax structure provided a substantial benefit to domestic entities because an entity can set its stock’s par value

⁷See *Henneford v. Silas Mason Co.*, 300 U.S. 577 (1937).

⁸*Fulton Corp. v. Faulkner*, 516 U.S. 325 (1996).

at a level below book or market value while non-Alabama entities could not similarly control their tax base. The result was that domestic entities paid a much lower franchise tax.

Alabama tried to defend that discriminatory tax system by asserting that the favorable treatment afforded to domestic entities was intended to compensate for the Alabama domestic shares tax. The Court found that the burdens of the two taxes were not roughly approximate, nor were the taxes similar in substance, and thus the domestic shares tax was not a compensatory tax and did not cure the discrimination against interstate commerce that resulted from the differing franchise tax base calculations. Similarly, the discriminatory nature of the New Hampshire DRD cannot be excused as a compensatory tax, as can be seen from a review of several state court decisions evaluating compensatory tax arguments regarding DRD provisions similar to New Hampshire's.

Other States' Decisions Regarding Discriminatory DRD Provisions

Several recent state court cases have addressed compensatory tax arguments regarding taxes that are imposed on dividends from foreign subsidiaries. Most recently, a Mississippi court, in *AT&T Corp. v. State Tax Commission*, Dkt. No G-2000-31 (May 26, 2006), struck down the state's DRD provision as unconstitutional. Mississippi Code section 27-7-15(4)(i) provided a deduction for dividends received from domestic affiliates doing business and filing returns in Mississippi. However, no deduction was allowed for dividends from affiliates that did not do business in the state. The court held that the DRD provision "disallows a valuable tax exemption based solely upon an interstate element" and that such a taxing scheme "clearly favors domestic corporations over foreign competitors and discourages corporations from choosing to locate their operations outside Mississippi."

The court rejected the state's argument that the DRD provision was a compensatory tax because the taxing scheme failed to satisfy any of the three tests set out in *Fulton*. The court held that it was clear that the "subject statute is not an avoidance of double taxation . . . as the statute is not linked to the amount of tax the distributing corporation paid and actually results in double taxation to certain distributing corporations."

Similarly, in a North Dakota case, *D.D.I. Inc. v. North Dakota*, 657 N.W.2d 228 (N.D. 2003), the court held that North Dakota's DRD provision, which allowed a DRD only to the extent that the company paying the dividend was subject to North Dakota tax, was unconstitutional. The North Dakota tax commissioner conceded that the DRD provision facially discriminated against the taxpayers who did business in North Dakota and had investments in

subsidiaries either wholly or primarily located outside the state. However, the commissioner argued that despite the discriminatory impact of the DRD, it should survive Commerce Clause scrutiny because it was a compensatory tax — that is, it compensated for the North Dakota tax paid by the subsidiaries that distributed corporate profits that had already been taxed by North Dakota. Thus, only one level of tax was imposed on North Dakota income.

The court disagreed, holding that while "avoiding double taxation of North Dakota income is a permissible goal, the Commissioner has not identified any specific in-state activity or benefit received by the taxpayers to justify the compensatory levy on their dividends received from out-of-state corporations" and that the fact that the tax has a legitimate legislative goal "has no bearing on whether it is facially discriminatory." Relying on *Fulton*, the court found that allowing a discriminatory tax as a compensation for charges purportedly included in general forms of interstate taxation "would allow a state to tax interstate commerce more heavily than in-state commerce anytime the entities involved in interstate commerce happened to use facilities supported by general tax funds."

Regardless of the taxing scheme's intended purpose, it cannot be accomplished in a manner that discriminates against interstate or foreign commerce.

In a California case, *Farmer Brothers Co. v. Franchise Tax Board*, 108 Cal. App. 4th 976 (2003), a court of appeal held that the DRD allowed under Revenue and Taxation Code section 24402 (section 24402) violated the Commerce Clause by discriminating against corporations engaged in interstate commerce.⁹ That section allowed a DRD for dividends received from another corporation to the extent that the dividends were paid from income that had been subject to California tax. The court held section 24402 to be discriminatory on its face "because it affords to taxpayers a deduction for dividends received from corporations subject to tax in California, while no deduction is afforded for dividends received from corporations not subject to tax in California."

The court rejected the Franchise Tax Board's argument that the tax was a compensatory tax intended to compensate for the California tax burden on the dividend payer. The court, based on

⁹See also *Ceridian Corp. v. Franchise Tax Board*, 85 Cal. App. 4th 875 (2000) (holding that a similar DRD provision for insurance companies was unconstitutional).

Fulton and the North Dakota Supreme Court's decision in *D.D.I.*, found that section 24402 failed to meet any of the three requirements for it to be a valid compensatory tax. The court rejected the board's argument that the purpose of section 24402 was to prevent double taxation because that argument ignored the taxes that the payer corporation might have been required to pay outside California. The court found that section 24402 and the corporate income tax were not substantially equivalent events because the burden of the former is on the taxpayer receiving the dividend, while the burden of the latter is on the company paying the dividend.

The New Hampshire court in *General Electric* rejected the holding in *Farmer Brothers* because of the possibility that section 24402 "may" lack taxing symmetry; instead the court focused on a subsequent decision of a California court of appeal in *Amdahl Corp./Fujitsu IT v. Franchise Tax Board*, 15 Cal. Rptr.3d 473 (2004), in which the court also looked to Footnote 23 of *Kraft* to hold that a DRD provision was constitutional. *Amdahl* involved a different California DRD provision found in California Revenue and Tax Code section 24441 (section 24441), which provides a 100 percent DRD for dividends received from a member of a water's-edge combined group but allows only a 75 percent DRD for dividends from foreign subsidiaries not included in the water's-edge group.

The appeals court agreed with the Franchise Tax Board's claim that "*Kraft* should have no application within a combined unitary group because each member's income and *apportionment factors* are included in the return equally" (emphasis added) while only the dividend payment of the foreign subsidiary is included. However, as discussed above, the inclusion of only the dividend income of the foreign subsidiary but not its apportionment factors results in discriminatory treatment of the foreign subsidiary. The only way that discriminatory treatment can be cured in a water's-edge group is possibly by including all of the foreign subsidiaries' factors, or by allowing a DRD for dividends received from both foreign and domestic subsidiaries.

Indeed, a state's water's-edge taxing scheme that taxes the earnings of a foreign subsidiary by including the dividends it pays in the combined group's income can essentially result in a de facto worldwide combined report that is a best-case scenario for the state. For example, if the foreign subsidiary's income is paid out every year in dividends, interest, and/or royalties to the parent, which might all be includable in the parent's apportionable tax base, the state would be allowed to essentially tax the income of the foreign subsidiary without the factor dilution that would result from including all of the foreign company's property, payroll, and sales in the combined report. In a true worldwide combined report, the foreign subsidiaries apportionment fac-

tors, when included in the combined group's apportionment factor, could greatly reduce the tax that the combined group pays on the foreign entity's earnings.

Conclusion

The court in *General Electric* would have been more likely to reach the right conclusion about the constitutionality of the DRD provision if it had focused on the actual decision in *Kraft* and on other relevant U.S. Supreme Court cases regarding discriminatory taxes, and not on the *dictum* found in Footnote 23. A careful analysis of the federal and state cases regarding that issue makes clear that the New Hampshire DRD provision discriminates against foreign commerce by providing favorable treatment to entities that do business in the state.¹⁰ Thus, the only way it can be sustained is by demonstrating that there is a legitimate local purpose to the DRD provision that cannot be adequately served by reasonable nondiscriminatory alternatives. One way to do that would be to demonstrate that the provision is a valid compensatory tax, which would likely be difficult to do in this case. However, the New Hampshire court declines to even attempt that route and instead supports its taxing symmetry argument on the flimsy basis of a footnote in a Supreme Court decision.

The inclusion of only the dividend income of the foreign subsidiary but not its apportionment factors results in discriminatory treatment of the foreign subsidiary.

The gloss that some state courts have put on the language in Footnote 23 ignores what the Supreme Court has actually held in cases addressing discriminatory taxes and misconstrues the unitary business principle. Interestingly, the attempt by some state courts to ignore the holding of *Kraft* while focusing on the *dictum* in a footnote is similar to state court nexus decisions regarding corporate income taxes, which essentially ignore the holding of *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992), to

¹⁰The absurdity of discriminatory DRD provisions such as New Hampshire's was demonstrated in *Ex Parte Sonat, Inc.*, 752 So.2d 1211 (Ala. 1999), in which the Alabama Supreme Court looked to the plain language of the Alabama DRD to hold that the taxpayer was eligible for the deduction even though its subsidiary had entered into a \$145-per-month lease of office equipment in Alabama solely for the purpose of achieving a substantial Alabama deduction. (For the Alabama Supreme Court's decision in *Sonat*, see *Doc 1999-28409* or *1999 STT 170-2*.)

instead focus on a single sentence¹¹ of *dictum* in the opinion that is not meant to be, and could not be, cited as law. It is hoped that the Supreme Court will agree to take both of those issues up again soon and clear up the confusion caused by state courts' ignoring the relevant portions of the Court's holdings. ☆

¹¹The Court's decision in *Quill* includes the sentence, "Although we have not, in our review of other types of taxes, articulated the same physical presence requirement that *Bellas Hess* established for sales and use taxes, that silence does not imply repudiation of the *Bellas Hess* rule." Even though it is not clear how the Court's admitted "silence" regarding other taxes can represent a holding, several state courts have cited that language to justify holding that physical presence is not required for corporate income taxes. See, for example, *Lanco, Inc. v. Division of Taxation*, No. A-89 (N.J. 2006), and *Tax Commissioner v. MBNA America Bank N.A.*, No. 33049 (W.Va. 2006). (For the New Jersey Supreme Court's decision in *Lanco*, see *Doc 2006-21177* or *2006 STT 199-22*; for the West Virginia Supreme Court's decision in *MBNA*, see *Doc 2006-23668* or *2006 STT 228-18*.)