South Carolina Law Review

Volume 44
Issue 1 *ANNUAL SURVEY OF SOUTH CAROLINA LAW*

Article 18

Fall 1992

Tax Law

Rochelle L. Romosca

TAX LAW

I. COURT REVIEWS UNITARY BUSINESS TAX APPORTIONMENT STATUTE

In *NCR Corp. v. South Carolina Tax Commission*[1] the South Carolina Supreme Court held that under the state's apportionment taxing scheme[2] a taxpayer corporation generally cannot include in the apportionment formula its foreign subsidiaries' property, payroll, and sales.[3] However, the court recognized that due process may require partial consideration of these factors in the apportionment calculation to yield a tax that is reasonably proportionate to the actual amount of business the taxpayer transacts in the state.[4]

The plaintiff, NCR, is a multinational corporation operating partly within South Carolina. NCR conducts much of its overseas business through subsidiary corporations; however, none of these subsidiaries conducts any business in South Carolina. These foreign subsidiaries pay royalty fees to NCR for use of NCR's licenses and patents. In addition, the subsidiaries pay interest on loans made to them by NCR.[5]

NCR brought this action to challenge its apportioned tax liability for the royalty and interest payments from NCR's foreign subsidiaries. The South Carolina Tax Commission included this revenue in NCR's unitary business income, but refused to include the property, payroll, and sales

---

1. 304 S.C. 1, 402 S.E.2d 666 (1991).

2. S.C. CODE ANN. §§ 12-7-1100 to -1200 (Law. Co-op. 1976 & Supp. 1991).

3. *NCR Corp.*, 304 S.C. at 6, 402 S.E.2d at 669. The purpose of the apportionment formula is to tax an interstate company based roughly on the percentage of business it conducts in the state. *See id.* at 4, 402 S.E.2d at 668. The apportionment formula uses three objective factors, property, payroll, and sales, to determine the company's South Carolina tax liability. The first step in the apportionment scheme is to calculate ratios of in-state amount to total amount for each of the taxpayer's three factors. S.C. CODE ANN. §§ 12-7-1150 to -1170 (Law. Co-op. 1976 & Supp. 1991). Then, to calculate the apportioned taxable income, the average of these three ratios is multiplied by the taxpayer's unitary business income. *Id.* § 12-7-1140.

4. *NCR Corp.*, 304 S.C. at 13-14, 402 S.E.2d at 673-74. The court also held that the apportionment taxing scheme does not violate the Foreign Commerce Clause, U.S. CONST. art. I, § 8, cl. 3 ("Congress shall have power . . . to regulate commerce with foreign nations, and among the several states . . . ."). *NCR Corp.*, 304 S.C. at 11, 402 S.E.2d at 672.

5. *NCR Corp.*, 304 S.C. at 3, 402 S.E.2d at 667-68.

of the foreign subsidiaries in NCR's apportionment formula.[6] The trial court ruled that NCR was not entitled to a refund.[7]

On appeal, NCR first argued that the plain meaning of the apportionment statute requires the property, payroll, and sales of NCR's foreign subsidiaries to be included in the denominator of the apportionment formula.[8] However, the supreme court held that the statute, read in context, does not allow NCR to include the factors of its foreign subsidiaries. The court determined that the apportionment scheme contemplates treating subsidiaries and parents as separate entities because the statutory sections that define the property, payroll, and sales ratios use the singular term "taxpayer."[9] The court further reasoned that, because South Carolina was taxing the income of NCR, not that of its subsidiaries, the apportionment formula should not include the subsidiaries' property, payroll, and sales.[10]

NCR also argued on appeal that the apportionment taxing scheme denied it due process because the apportionment formula unfairly taxed more income than NCR actually earned in this state. The interest and royalty payments were undoubtedly part of NCR's unitary business income; however, NCR contended that, because its subsidiaries generated part of this income, the apportionment calculation should include its subsidiaries' property, payroll, and sales.[11]

Generally, a state may not tax a company's interstate activities unless there is "a 'minimal connection' between the interstate activities and the taxing State, and a rational relationship between the income attributed to the State and the intrastate values of the enterprise."[12]

---

6. *Id.* at 4, 402 S.E.2d at 668.

7. *Id.* at 3, 402 S.E.2d at 667.

8. *Id.* at 5, 402 S.E.2d at 668-69.

9. *Id.* at 5-6, 402 S.E.2d at 669; *cf.* Emerson Elec. Co. v. Wasson, 287 S.C. 394, 339 S.E.2d 118 (1986) (holding that parent and subsidiary corporations are not a single entity for purposes of the taxing statute), *cited in NCR Corp.*, 304 S.C. at 5-6, 402 S.E.2d 669.

10. *NCR Corp.*, 304 S.C. at 5-6, 402 S.E.2d at 669 (citing NCR Corp. v. Comptroller of the Treasury, 544 A.2d 764 (Md. 1988); NCR Corp. v. Commissioner of Revenue, 438 N.W.2d 86 (Minn.), *cert. denied*, 493 U.S. 484 (1989)). *But see* Kellogg Co. v. Herrington, 343 N.W.2d 326 (Neb. 1984).

11. *NCR Corp.*, 304 S.C. at 12, 402 S.E.2d at 672.

12. Mobil Oil Corp. v. Commissioner of Taxes, 445 U.S. 425, 436-37 (1980) (citing Moorman Mfg. Co. v. Bair, 437 U.S. 267, 272-73 (1978)). A taxing scheme satisfies the "minimal connection" requirement if the taxed income is generated by a unitary business, part of which is carried on in the taxing state. NCR Corp. v. Comptroller of the Treasury, 544 A.2d at 771. In general, a unitary business has unity of ownership, management, and operations among its several parts such that the integrated activities afford to the entire enterprise advantages that would otherwise

However, an apportionment formula is not constitutionally invalid merely because "'it *may* result in taxation of some income that did not have its source in the taxing State.'"[13] To prove that an apportionment formula violates due process, a taxpayer must prove "clearly and cogently" that the apportionment calculation is entirely disproportionate to the amount of business the taxpayer actually transacted in the state.[14]

The supreme court acknowledged that South Carolina's "taxing scheme is not ideally fair."[15] The court adopted the reasoning of the Court of Appeals of Maryland in *NCR Corp. v. Comptroller of the Treasury*[16] and remanded the case for a recalculation of NCR's tax

---

be unavailable. *See* Butler Bros. v. McColgan, 315 U.S. 501, 508-09 (1942).

Under the rational relationship requirement a state cannot tax income that a taxpayer earns outside of the state. Container Corp. of America v. Franchise Tax Bd., 463 U.S. 159, 164 (1983) (citing ASARCO, Inc. v. Idaho State Tax Comm'n, 458 U.S. 307, 315 (1982)).

13. *Container Corp.*, 463 U.S. at 169-70 (quoting *Moorman Mfg. Co.*, 437 U.S. at 272).

14. *NCR Corp.*, 304 S.C. at 11-12, 402 S.E.2d at 672 (citing NCR Corp. v. Comptroller of the Treasury, 544 A.2d at 779 (citing *Container Corp.*, 463 U.S. at 170)). The United States Supreme Court has recognized the problems created by the unique characteristics of a "unitary business":

> [S]eparate accounting, while it purports to isolate portions of income received in various States, may fail to account for contributions to income resulting from functional integration, centralization of management, and economies of scale. Because these factors of profitability arise from the operation of the business as a whole, it becomes misleading to characterize the income of the business as having a single identifiable "source."

Mobil Oil Corp., 445 U.S. at 438 (citation omitted). In response to these inadequacies, the Court approved the use of the apportionment method because "[i]t rejects geographical or transactional accounting, and instead . . . apportion[s] the total income of that 'unitary business' between the taxing jurisdiction and the rest of the world on the basis of a formula taking into account objective measures of the corporation's activities within and without the jurisdiction." *Container Corp.*, 463 U.S. at 165.

The "unitary business" is the underlying principle of the apportionment method; only if a unitary business exists will problems arise in defining the "source" of income. Although the use of objective factors to determine the amount of income generated in a particular state may result in some taxation of value earned outside the state, the Court has determined that the utility of the apportionment formula far outweighs any minor inaccuracies in taxing unitary business income. The taxpayer, therefore, has an extremely heavy burden of proving that an inaccuracy is a violation of due process. *See, e.g., id.* at 164, 175-76; Exxon Corp. v. Department of Revenue, 447 U.S. 207, 221-22 (1980); *Butler Bros.*, 315 U.S. at 507.

15. *NCR Corp.*, 304 S.C. at 14, 402 S.E.2d at 673.

16. 544 A.2d 764 (Md. 1988).

liability.[17] The South Carolina court stated that on remand only the portion of the subsidiaries' sales, property, and payroll that generated income to NCR is to be included in the denominator of the apportionment formula. The court instructed the lower court to compare the disputed tax liability with the new result to determine if the disparity violates due process. The court ordered a permanent adjustment only if the difference was of constitutional proportions.[18]

The court's reliance on the Maryland case is unsound. The Maryland court allowed a possible adjustment with respect to dividend income, but explicitly rejected NCR's claim that royalty income required the same treatment.[19] The Maryland court characterized royalty income, the sale of the right to use patents, as similar to the sale of any NCR product. In contrast, the court found that the dividend income was generated by the subsidiaries' operations as part of NCR's unitary business.[20] Because of this distinction, the court held that inclusion of the subsidiary's property, payroll, and sales, to the extent these factors actually generated the dividend income, was reasonable to prevent the state from taxing value earned outside its borders.[21]

The South Carolina court ordered the apportionment recalculation to include "in the formula denominator the proportionate measure . . . of the foreign subsidiaries' property, payroll, and sales which generated the NCR income."[22] However, it is impossible to determine accurately the amount of subsidiary factors that reflects how the income was generated because the royalty income was generated by NCR's sale of a right, not by the subsidiaries' activities. Any calculation that focuses on the source of the payments, instead of on the objective measures upon which the apportionment formula is based, would be artificial and

17. *NCR Corp.*, 304 S.C. at 14-15, 402 S.E.2d at 674.

18. *Id.* Unfortunately, decisions of other courts give little guidance for determining what amount of distortion is a violation of due process. *See, e.g., Container Corp.*, 463 U.S. at 184 (upholding a 14% increase in tax liability); *Butler Bros.*, 315 U.S. 501 (upholding a 1500% increase in tax liability); Hans Rees' Sons, Inc. v. North Carolina *ex rel.* Maxwell, 283 U.S. 123 (1931) (holding a 250% distortion resulting from a single factor formula improper); NCR Corp. v. Commissioner of Revenue, 438 N.W.2d 86 (Minn.) (holding a 23% increase within the acceptable margin of error), *cert. denied*, 493 U.S. 848 (1989).

19. NCR Corp. v. Comptroller of the Treasury, 544 A.2d at 781.

20. *Id.*

21. *Id. But see* Frank M. Kessling, *The Impact of the* Mobil *Case on Apportionment of Income*, 1981 B.Y.U. L. REV. 87, 101-04 (1981) (arguing that the difficulties in determining a proportionate measure of property, payroll, and sales also apply in the case of dividends).

22. *NCR Corp.*, 304 S.C. at 14, 402 S.E.2d at 674.

arbitrary. This source-oriented "numbers game" is the very result that the Supreme Court intended to avoid when it adopted the apportionment method.[23]

The South Carolina decision has another flaw. The court failed to analyze whether a minimal connection actually existed between NCR's taxable income and the taxing state. Although NCR conceded that it carried on a unitary business with its subsidiaries, the court applied the unitary principle incorrectly.[24] The court recognized the subsidiaries as part of NCR's unitary business in order to justify including the royalty and interest payments in NCR's apportionable income. However, the court refused to recognize the same subsidiaries as unitary for calculating the property, payroll, and sales ratios. The court's reasoning lacks a rational basis.

When a state taxes certain income because the parent and subsidiary businesses are so integrated that the source of the income is indeterminable, trying to identify the source of the income by using the factors that produced the income is not only illogical, but impossible. If the business is in fact so integrated that the source of income cannot be identified, the state must include either all or none of the subsidiaries' factors and income in the apportionment formula to determine the corporation's taxable income.[25] To hold otherwise would create administrative problems that are impossible to solve and a tax that is not rationally related to the income the taxpayer generated in the state. However, this is the very situation created by this court's decision.

Rochelle L. Romosca

---

23. *See* discussion *supra* note 14; *cf.* Container Corp. of America v. Franchise Tax Bd., 463 U.S. 159, 181 (1983) (rejecting appellant's argument that the three-factor formula distorts true income because the argument is based on formal separate accounting methods "whose basic theoretical weaknesses justify resort to formula apportionment in the first place").

24. The primary justification for applying the apportionment formula is that the existence of the unitary business makes it impossible to determine the exact source of the unitary income. *See supra* note 14; *see also* Mobil Oil Corp. v. Commissioner of Taxes, 445 U.S. 425, 439 (1980) ("[T]he linchpin of apportionability in the field of state income taxation is the unitary-business principle."). Although states have wide latitude in determining the scope of a unitary business, they must apply the principle consistently in order to meet due process requirements because the artificial lines drawn between a corporation and its subsidiaries or divisions have "nothing to do with the underlying unity or diversity of [the] business enterprise." *Id.* at 440.

25. "Either [the taxpayer's] . . . enterprise[ ] . . . is all part of one unitary business, or it is not." *Mobil Oil Corp.*, 445 U.S. at 461 (Stevens, J., dissenting).