

Unitary Taxation in New Jersey

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INTRODUCTION

Any person attempting to start a business or work in a business soon comes to realize the difference between the organization and the business enterprise itself. Other words and terms describing this distinction include the entity and the activity, the form and the substance, the juridical side and the economic side. Lawyers face this question frequently in advising clients about the choice of legal entity to use in selecting a formal legal structure for a particular business enterprise.

A further dimension comes into play when attempting to tax a multi-state business organization on its income. This further distinction is a reflection of the difference between a business's organizational structure and its money making activities. A figure of speech used in taxation is contained in the opinion, *Container Corporation of America v. Franchise Tax Board*,¹ where Justice Brennan observed that dividing income among taxing jurisdictions in which a taxpayer may be doing business "bears some resemblance . . . to slicing a shadow."² This article attempts to describe and analyze these constitutional distinctions with reference to their impact upon the administration of the New Jersey Corporation Business Tax Act (CBT).³

It is the thesis of this article that the subject court decisions (as well as changes in modern technology and newly available alternative legal entities that are beyond the scope of this article) have caused the structure of the CBT to become obsolete. Statutory changes are called for that would expand the scope of the tax based upon income of a single corporate entity and include, in the case of corporate groups, the income of the entire uni-

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¹ 463 U.S. 159 (1983).

² *Id.* at 192.

³ N.J. STAT. ANN. §§ 54:10A-1 to 10A-40 (West 1986 & Supp. 1997).

tary business across corporate lines through a combined or consolidated filing. It was the *F.W. Woolworth Co. v. Director of Division of Taxation*⁴ case, decided 32 years ago, that pointed the direction toward this new regime.

When the CBT was originally enacted as a tax on net worth, it was relatively easy to measure the proportionate share of the net worth that could be taxed in exchange for the corporation's right to do business in New Jersey. Today, however, the net worth base has been eliminated, and legislation has replaced it with a net income base. In addition, the courts have carved out of the net income base certain "investment" or "non-operational income" not connected with the state. This income falls into two classifications: (1) income that is derived from a discrete line of business and (2) intangible income such as interest, dividends, and capital gains. The current situation presents both conceptual and administrative difficulties for a so-called franchise tax. It is this new class of excludible income that is the focus of this article and that illustrates a major difficulty with the current tax regime.

Seven New Jersey cases decided since 1980 have considered the inclusion of intangible income in the tax base. Taxpayers have claimed that "investment" income is not sufficiently connected with business operations in New Jersey to be constitutionally includible in the New Jersey tax base. These examples of so called "non-operational income" have included portfolio income as well as gains from the sale of stock in enterprises that were not connected with the taxing district.

There has also been an instance of New Jersey upholding the exclusion of the first class of income, namely, income from a discrete line of business—a division—operated as part of the same franchise within the same corporate entity and not connected with New Jersey. In the most recent case to be considered, the court held that a forest products division and an investment division of a single corporation were separate, unrelated business enterprises. The portion of the taxpayer's income derived from the investment division was held not subject to taxation by New Jersey.

Some further comments on the structure of the CBT are useful in examining the issue. The underlying premise of the tax currently is that the value of the corporate franchise for a corporate taxpayer is calculated based upon a tax rate multiplied by the taxpayer's entire net income, which is a statutorily defined term.⁵ In the case of a corporation doing business inside and outside New Jersey and having an office outside the state, the entire net income is reduced before it is taxed because all its income is not

⁴ 45 N.J. 466, 213 A.2d 1 (1965).

⁵ See N.J. STAT. ANN. § 54:10A-4(k) (West 1986 & Supp. 1997).

attributable to New Jersey. This reduction is done by multiplying the entire net income by an "allocation factor" whose numerator represents values (corporate property, payroll, and sales) in New Jersey and whose denominator represents such values everywhere.⁶ Such an "allocation factor" or "apportionment formula" is commonly used in the tax systems of many states.

An alternate approach, not used in New Jersey and different from "formula apportionment," is "separate accounting." Unlike formula apportionment where the total income is divided, under separate geographical accounting the income from one geographical location (for example, a state) is defined independently of the total income, and tax is paid using that local amount as the tax base. This was a method advocated by *F. W. Woolworth*.⁷

Separate accounting has been consistently disallowed in New Jersey, most recently in *Kettler Realty Corp. v. Director, Division of Taxation*,⁸ a case in which taxpayers were afforded relief under New Jersey Administrative Code Section 18:7-8.3, a tax credit provision. Separate accounting has obvious shortcomings in a mobile society where income can be shifted from one state or location to another quite easily; thus, administrators must grapple with formula apportionment in a unitary context and environment.

The particular issue for New Jersey arises when principles of the United States Constitution are overlaid upon the formal corporate structure of a multistate business enterprise. Courts and tax administrators have attempted to describe or give guidance to taxpayers to determine what amounts must be included in the income tax base of a particular taxpayer when the Commerce Clause and the Due Process Clause of the Constitution are taken into account. The term and concept that has developed to give constitutional meaning to this aspect of interstate taxation is the concept of the "Unitary Business." In a nutshell, a state cannot tax values that are not part of the operations of a unitary business having a connection with the state; otherwise expressed, there must first be a minimal connec-

⁶ See *id.* § 54:10A-6.

⁷ See *F.W. Woolworth Co. v. Director of Div. of Taxation*, 45 N.J. 466, 213 A.2d 1 (1965). Interestingly, footnote nine of the case states that "[a]ll agreed that complete consolidation of the parent and subsidiaries, not only as to net worth and income, but also with respect to the tangible property, sales and payroll in the allocation formula, would be the fairest and best method." *Id.* at 500 n.9, 213 A.2d at 20. This was not, however, requested by Woolworth because, by reason of British corporation law, it did not have available and could not furnish the amount of gross sales of the English company.

The regulations under the corporation business tax now contain provisions disallowing consolidated returns except for licensees under the Casino Control Act, who are required to file that way by statute. See N.J. STAT. ANN. § 5:12-148b (West 1988 & Supp. 1997); N.J. ADMIN. CODE tit. 18, §§ 7-1.17, 7-11.15 (1997).

⁸ 12 N.J. Tax 470 (N.J. Tax Ct. 1992), *aff'd*, 14 N.J. Tax 165 (App. Div. 1993).

tion between the interstate activities and the taxing state, as well as a rational relationship between income attributed to the state for tax purposes and the instate values of the corporate business.

The Multistate Tax Commission (MTC), an organization that serves several purposes and represents a number of member states, works toward uniformity in state tax laws and has developed a definition of the term "Unitary Business" that provides a helpful starting point.⁹ As the MTC has written at the beginning of its draft definition of Unitary Business: "The decisions of the United States Supreme Court require all States to determine the scope of a unitary business for purposes of determining whether specific items of income or loss are properly subject to apportionment by the taxing State."¹⁰ The pertinent parts of the MTC definition continue:

A unitary business is an enterprise comprised of one or more business segments that are sufficiently related to one another for their business income to be aggregated and apportioned by a common apportionment formula. Where an enterprise consists of more than one business segment, it is necessary to determine whether the different business segments constitute a single unitary business, or whether the enterprise has more than one unitary business.¹¹

....

... The formal business organization of an enterprise does not affect the determination of the scope of a unitary business. A unitary business may exist within a single business entity or among commonly owned or controlled business entities.¹²

Thus, a unitary business can be composed of operations that include but transcend one legal corporate entity, or, more rarely, a single corporation can contain more than one unitary business or have income that is not constitutionally part of the unitary business of the corporation.

Unitary issues arise nationally in different forms depending upon the type of tax structure of the particular state. The unitary principle can be illustrated in concrete form at two different extremes. One extreme, which involves filing one tax return for the income of a group of corporations, is the so-called California unitary method, worldwide combined reporting. This has resulted in litigation over the years; for example, the recent opin-

⁹ The existence of the Multistate Tax Commission itself had been unsuccessfully challenged by taxpayers as an improper delegation of state sovereignty. See *United States Steel Corp. v. Multistate Tax Comm'n*, 434 U.S. 452, 479 (1978).

¹⁰ Multistate Tax Commission, Draft Definition of a Unitary Business, lines 7-10 (Nov. 1996) [hereinafter Tax Commission Draft] (on file with the *Seton Hall Law Review*) (available from the Multistate Tax Commission, 444 North Capitol Street, NW, Suite 425, Washington, DC 20001); see also <<http://www.mtc.gov/uniform/projlist.htm>>.

¹¹ Tax Commission Draft, *supra* note 10, at lines 27-33.

¹² *Id.* at lines 81-84.

ion (issued after statutory changes were enacted) *Barclays Bank PLC v. Franchise Tax Board of California*¹³ involved the inclusion of income of a foreign parent corporation in a state return. The other extreme is illustrated by *Exxon Corp. v. Department of Revenue of Wisconsin*,¹⁴ in which Wisconsin was permitted to apply its apportionment formula to corporate income from exploration and production departments of a unitary business from outside the state because the marketing function was inside the state. The Court held that marketing, exploration, and production were part of a unitary business.

The situation—in which a discrete line of business may be carved out within a single corporation and where some income of that corporation is considered constitutionally separate from the taxable, operational income of the corporation—now confronts taxpayers in New Jersey. New Jersey is historically a separate entity state where each subject corporate legal entity is required to file its own corporation tax return.

THE NEW JERSEY CASES: A “CONSTITUTIONAL EXCLUSION” COMES TO FULL BLOOM

A survey of seven cases in New Jersey dealing with unitary issues, and the shift in approach and applicable legal standards from *Silent Hoist & Crane Co. v. Director, Division of Taxation*,¹⁵ the first, to *Central National-Gottesman Inc. v. Director, Division of Taxation*,¹⁶ the seventh, (both single privately held corporations) illustrates the difficulty faced by tax administrators, those responsible for budgeting projected state revenues, and taxpayers themselves. Close attention will be given to the factual patterns to which the law is applied because, paradoxically, the unitary business concept “is not, so to speak, unitary”¹⁷ and such cases are intensely fact-sensitive.

The first case, and the benchmark, was *Silent Hoist*. It attempted to clarify for New Jersey “the precise distinguishing characteristics between ‘unitary’ and ‘nonunitary’ businesses . . . in New Jersey.”¹⁸ In that case, the taxpayer objected to a New Jersey tax on what it claimed was extrajurisdictional income from its manufacturing/sales business and from its invest-

¹³ 512 U.S. 298 (1994).

¹⁴ 447 U.S. 207 (1980). Unlike New Jersey law, Wisconsin law permits allocation and separate accounting. *See id.* at 214 n.3.

¹⁵ 5 N.J. Tax 242 (N.J. Tax Ct. 1983), *aff’d*, 6 N.J. Tax 348 (App. Div. 1984), *rev’d*, 100 N.J. 1, 494 A.2d 775 (1985), *cert. denied*, 474 U.S. 995 (1985).

¹⁶ 14 N.J. Tax 545 (N.J. Tax Ct. 1995), *aff’d*, 291 N.J. Super. 277, 677 A.2d 265 (App. Div. 1996), *cert. denied*, 146 N.J. 569, 683 A.2d 1164 (1996).

¹⁷ *Container Corp. of America v. Franchise Tax Bd.*, 463 U.S. 159, 167 (1983) (implying that there is no single test to determine whether a business is unitary).

¹⁸ *Silent Hoist*, 5 N.J. Tax at 245.

ment portfolio. Silent Hoist was a privately held New York corporation with a heavy equipment manufacturing plant and principal place of business in Brooklyn, New York, where it also maintained a diversified securities portfolio. It owned two parcels of industrially zoned land in Clifton and Bloomfield, New Jersey, neither of which was used in the taxpayer's manufacturing business; both were rented to others. Its business activity was heavy equipment manufacturing and sales and security investments. It used a New York broker and had no office, employees, agents, or investments in New Jersey. It had large sales in New Jersey where the salesmen gave advice to customers.

With respect to a fair apportionment fraction, it is well established that a state cannot impose a tax on profits that are in no just sense attributable to transactions within its borders.¹⁹ Initially, however, as noted above, there is the threshold question of nexus 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. The basic question was whether the scope and nature of the taxpayer's various business activities was "unitary," such that taxation would not be violative of the Due Process and Commerce Clauses of the United States Constitution; in other words, did the taxpayer's activities in New Jersey permit New Jersey to exercise jurisdiction over the out-of-state income?

The taxpayer took the position that its New York business was non-unitary, and as such the income from it could not be taxed in New Jersey. In accordance with this position, the taxpayer used separate geographic accounting, separating its income from New York and New Jersey. The Director of the Division of Taxation rejected this approach. The Director viewed the manufacturing and investment activities as a unitary business having functional integration, centralization of management, and economies of scale. All major corporate decisions on manufacturing, real estate, and investment were made by the president. There was one bank account into which all receipts were deposited and expenses paid. There was a direct monetary flow of value from one segment of the business to another. Sources and application of funds established the integration of the business.

In the course of affirming the imposition of tax on both the taxpayer's portfolio income and its sales income, the New Jersey Supreme Court presented a helpful overview of the United States Supreme Court's unitary jurisprudence to that time. The court focused on economic reality. It held that "under any test that has been approved, the taxpayer meets the meas-

¹⁹ See *Hans Rees' Sons, Inc. v. North Carolina ex rel. Maxwell*, 283 U.S. 123, 133 (1931).

ure of a unitary business.”²⁰ The proper tests to be applied established centralized management and transfers of value among the components of the single enterprise. Furthermore, the three unities of ownership, operation, and use were met. In addition, the “dependent upon or contributory tests” used in certain other states were also met.²¹

The United States Supreme Court tests in *Mobil Oil Corp. v. Commissioner of Taxes of Vermont*,²² *Exxon Corp. v. Department of Revenue of Wisconsin*,²³ *ASARCO, Inc. v. Idaho State Tax Commission*,²⁴ *F.W. Woolworth Co. v. Taxation and Revenue Department of New Mexico*,²⁵ and *Container Corp. of America v. Franchise Tax Board*,²⁶ were held not applicable because only one corporation was involved in the case under review and it was not a multinational corporation with subsidiaries.²⁷

As stated by the court in *Silent Hoist*:

Our job is not to rewrite the State’s Corporation Business Tax but to apply it as intended. New Jersey’s tax policy is quite distinct from the majority of states. We do not seek to allocate non-business income to the place of commercial or legal domicile. On the other hand, we accommodate our tax policy to the modern business complex by specifically excluding all dividends from subsidiaries (at least 80% owned) and 50% of other dividend income.²⁸

In light of later cases, these words have been rendered obsolete. Having found that the business was unitary, the court ultimately remanded the matter to the tax court for final disposition. On remand, the tax court held that (1) the application of the allocation formula to taxpayer’s business was constitutionally valid and (2) the resulting apportionment was fair.²⁹

Soon other cases arose where unitary claims were central to the taxpayer’s position. The second case for purposes of this survey was *International Paper Co. v. Taxation Division Director*.³⁰ Normally, tax court

²⁰ See *Silent Hoist & Crane Co. v. Director, Div. of Taxation*, 100 N.J. 1, 18, 494 A.2d 775, 784 (1985).

²¹ See *id.* at 19, 494 A.2d at 785.

²² 445 U.S. 425 (1980).

²³ 447 U.S. 207 (1980).

²⁴ 458 U.S. 307 (1982).

²⁵ 458 U.S. 354 (1982).

²⁶ 463 U.S. 159 (1983).

²⁷ See *Silent Hoist & Crane Co. v. Director, Div. of Taxation*, 100 N.J. 1, 19-20, 494 A.2d 775, 784-85 (1985).

²⁸ *Id.* at 22, 494 A.2d at 788.

²⁹ See *Silent Hoist & Crane Co. v. Taxation Div. Dir.*, 9 N.J. Tax 178, 195 (N.J. Tax Ct. 1987).

³⁰ 11 N.J. Tax 147 (N.J. Tax Ct. 1990), *aff’d*, 12 N.J. Tax 253 (App. Div. 1991), *cert. denied*, 127 N.J. 549, 606 A.2d 363 (1991).

cases are heard by one judge, but an interesting feature of this case was that the tax court sat en banc pursuant to New Jersey Court Rule 8:8-6.³¹ This allowed for the rare occurrence of (1) majority and (2) concurring and dissenting opinions in a tax court case.

This case involved the taxation of International Paper Company (IP), a New York corporation with headquarters in Purchase, New York. It transacted business in more than thirty-five states, including New Jersey. It owned, maintained, and operated a computer center in Denville, New Jersey, and a sales office for its container division in Cedar Knolls. The taxpayer was engaged principally in the manufacture and sale of products in three industry segments (shown with percentages of total sales for the years 1977-1981): (i) pulp and paper (31-34%); (ii) packaging and packaging materials (45-50%); and (iii) wood products and resources (18-21%). Through the use of approximately one hundred subsidiary corporations, the taxpayer also engaged in other diverse businesses, including "the development of mineral properties, the operation of a contract oil and gas drilling business, and the management of agricultural operations."³²

Bearing in mind the constitutional principle that New Jersey cannot tax value earned outside its borders, the issue was whether the gain on the sale of Canadian International Paper Company (CIP) and the gain on the sale of C.R. Bard stock could be included in the New Jersey tax base that was subject to formula apportionment. CIP was a wholly owned subsidiary incorporated in Quebec and headquartered in Montreal, Canada. In 1981 it was the largest newsprint producer in the world. CIP and its subsidiaries were engaged in a number of industry segments, as was IP, but did not transact any business in New Jersey. The sale of CIP resulted in a pre-tax gain to IP of \$534,884,565. It also received \$24,250,570 in interest on the second installment-sale payment.

The C.R. Bard shares had been owned by Davol Corporation, which had been acquired by IP in 1968. As the result of a stock split, IP owned 1,404,000 Bard shares, which represented 14.4% of the outstanding shares. Bard was a New Jersey corporation headquartered in Murray Hill, New Jersey, and its stock was traded on the New York Stock Exchange. Its business involved the design, packaging, distribution, and sale of hospital and surgical specialties. IP's relationship with Bard was consistently that of a shareholder. In 1971, IP issued debentures that were convertible for Bard shares. IP later purchased the debentures and reacquired the Bard shares from an escrow agent. IP sold 148,078 of the reacquired Bard

³¹ N.J. Ct. R. 8:8-6.

³² *Id.* at 151-52.

shares and realized a pretax gain of \$2,276,502. IP retained roughly 12.8% of the issued and outstanding common stock of Bard after the sale.³³

The Director won the money in this case, so to speak, but the taxpayer won the principle. The court held that CIP gain and interest received by IP were unitary. IP had active, continuous, and substantial involvement with CIP. IP argued that the sales between the companies were de minimis, but the majority opinion did not accept this, finding that the flow of value test was met even though the sales were at market values. The two companies were functionally integrated. The court also held, over the dissents of two tax court judges, that the gain from C.R. Bard stock was non-unitary as a passive investment and that the companies were not in the same line of business. The dissenting judges would have held the amounts from the Bard shares includible in the tax base and noted that the difference between Silent Hoist, a one man corporation, and IP, a corporation with professional centralized management, was a distinction without a difference. There was an "exchange of value" that made the investment in Bard unitary.

The third New Jersey case, one resulting in a United States Supreme Court opinion and receiving the greatest national attention, was *Bendix Corp. v. Taxation Division Director*.³⁴ Bendix was a Delaware corporation with principal office and commercial domicile in Michigan, doing business in fifty states and twenty-two foreign countries. It merged into Allied in 1985. A division of Bendix developed and manufactured aerospace flight control systems in New Jersey.³⁵ Its chairman, William Agee, began a policy of growth through acquisition as evidenced by memorandum of March 31, 1978. Diversification and expansion had become the by-word of corporate policy. The memorandum went on to focus on copper, a product of ASARCO. Bendix acquired two seats on its board and used the equity method of accounting (in other words, put a percentage of ASARCO's total earnings in its income statement). There was an interdependence of Bendix existing business and long term strategic planning. The facts demonstrating this linkage were discussed at length in the New Jersey Supreme Court opinion.

In the tax case, three items of income were in dispute: (1) an approximately \$211.5 million capital gain realized on Bendix's sale of its stock interest in ASARCO; (2) an approximately \$41.9 million capital gain realized on Bendix's sale of stock in its subsidiary, United Geophysical

³³ See *id.* at 155.

³⁴ 10 N.J. Tax 46 (N.J. Tax Ct. 1988), *aff'd*, 237 N.J. Super. 328, 568 A.2d 59 (App. Div. 1989), *aff'd*, 125 N.J. 20, 592 A.2d 536 (1991), *rev'd sub nom.*, *Allied-Signal, Inc. v. Director, Div. of Taxation*, 504 U.S. 768 (1992).

³⁵ See *id.* at 49.

Corporation; and (3) \$3.4 million in interest earned on the proceeds of the two sales.³⁶ As noted by the New Jersey Supreme Court, the assessment resulted in an additional tax liability of \$1,845,000.³⁷

The legal significance of this opinion to tax administration in New Jersey was that it authoritatively and decisively rewrote the State's Corporation Business Tax Act, which the New Jersey Supreme Court had been loath to do seven years before in *Silent Hoist*. The contention of New Jersey that was specifically rejected by the Supreme Court in this case was that "all income of a corporation doing any business in a State is, by virtue of common ownership, part of the corporation's unitary business and apportionable," that "multistate corporations like Bendix regard all of their holdings as pools of assets, used for maximum long-term profitability, and that any distinction between operational and investment assets is artificial."³⁸

The nine Justices rejected this argument, believing that this "theory cannot be reconciled with the concept that the Constitution places limits on a State's power to tax value earned outside of its borders."³⁹ In its opinion, the United States Supreme Court reaffirmed formulary apportionment and the right of a state to use a formula to tax intrastate income, but it also placed limits on the state's authority to tax value or income that in fairness could not be attributed to the taxpayer's activities within the state.⁴⁰ While the Court was unanimous as to the guiding principles, it was divided on a five to four vote as to the applicability of the principles to the case at hand. Justice O'Connor believed that "the link between the ASARCO investment . . . and the in-state business" was closer than the majority of the Court suggested.⁴¹ Other implications of the holding in this case will be discussed further in the conclusion of this study.

The fourth case, *American Home Products Corp. v. Director, Division of Taxation*,⁴² also occurred in this same time frame. In that case, the taxpayer (AHPC) was a Delaware corporation whose principal office was in New York City. Its business operations "were multi-state and multinational in scope, encompassing over . . . [twenty-five] states, including New Jersey and numerous foreign countries."⁴³ AHPC and its subsidiaries principally engaged in the manufacture and marketing of medical supplies,

³⁶ See *id.* at 47-48.

³⁷ See *Bendix*, 125 N.J. at 22, 592 A.2d at 537.

³⁸ *Allied-Signal*, 504 U.S. at 784.

³⁹ *Id.*

⁴⁰ See *id.* at 780-81.

⁴¹ See *id.* at 794 (O'Connor, J., dissenting).

⁴² 11 N.J. Tax 287 (N.J. Tax Ct. 1990), *aff'd*, 13 N.J. Tax 120 (App. Div. 1992).

⁴³ *Id.* at 290.

prescription drugs, packaged medicines, household products, food, and housewares. Its New Jersey activities consisted of “manufacturing and distribution from plants in Cranford and Hammonton, and distribution from warehouses in South Plainfield, Secaucus, and Linden.”⁴⁴ It also maintained administrative and accounting offices and sales offices in New Jersey. During the years at issue it had securities, interest, dividends, and capital gain income earned thereon “managed and controlled by AHPC from its New York corporate headquarters”; it was managed from New York, and all corporate funds were commingled in New York.⁴⁵

At issue were dividends and capital gain from public equity investments in B.F. Goodrich Company, William Wrigley Jr. Company, Becton Dickinson & Company, and Holt Lloyd International Limited. Also at issue were public interest-bearing investment securities that included the following: commercial paper, certificates of deposit, United States Treasury Securities, corporate repos, and municipal bonds. Amounts were commingled in one bank account. The court found no transfers of personnel, goods, services, or other property between AHPC and the four public companies paying dividends, no functional integration between operations or centralization of management, no sharing of administrative services, and no loans. The defendant Director argued that equity investments were not discrete business activities, but that argument did not prevail. The corporate treasury investments of working capital, however, were held to be part of the unitary business.⁴⁶

A fifth case presenting unitary issues was *Mobil Oil Corp. v. Director, Division of Taxation*.⁴⁷ Mobil was a New York Corporation with its principal office in New York. It had a refinery, corporate office, and 210 gas stations in New Jersey. At issue in the case was an ownership interest of 17.9% of Belridge Oil Company. The taxpayer excluded \$647,905,091 on its 1980 Corporation Business Tax return, representing its gain on the sale of 178,111 shares of Belridge. In 1979, Belridge had merged with Shellridge, a subsidiary of Shell, primarily engaged in producing crude oil and natural gas from properties in the South Belridge oil field of Kera County, California. Mobil argued that its investment was passive, lacking a sufficiently unitary relationship to be included in the return. It argued that it had no overall acquisition strategy, its acquisition was not part of a plan, and the shares were not used as security. The Director referred to the fact that Mobil and Belridge were in the same business and their oil fields

⁴⁴ *Id.*

⁴⁵ *See id.* at 290-91.

⁴⁶ These includible percentage amounts were 17.6611% in 1979, 16.9144% in 1980, and 12.7626% in 1981 (net worth—12.7626% in 1981).

⁴⁷ 11 N.J. Tax 344 (N.J. Tax Ct. 1990), *aff'd*, 13 N.J. Tax 111 (App. Div. 1992).

shared a common boundary. Mobil managed its investment by attendance at Belridge board meetings and its retention of Belridge shares was part of an overall corporate strategy. The facts were distinguished from the situation of Bard and IP in that those two companies were not in the same line of business.⁴⁸ There were transfers of value between the two. Thus, the Director argued that the investment was an active part of Mobil's business. Despite these arguments, the tax court held that the investment was similar to IP's investment in Bard. The appellate division found it non-unitary and affirmed for the reasons set forth in the tax court opinion.

It should be noted that another taxpayer benefited from this decision. Texaco also had filed a refund claim related to its investment in Belridge: a claim for \$2,348,606 for its 1980 tax return attributable to the Belridge gain. After a federal tax matter was settled, the refund was ultimately issued in *Texaco, Inc. v. Director, Division of Taxation*.⁴⁹ The primary interest of this opinion is in the area of tax refunds, however, and not unitary taxation because the latter issue had been settled in the *Mobil* case.

The sixth in this line of cases provided a win for the Director. *American Trading & Production Corp. v. Director, Division of Taxation*,⁵⁰ an unpublished opinion, involved a deficiency assessment in the amount of \$638,548 plus interest for the years 1980-1982. The taxpayer (ATAPCO) was a privately held Maryland company, whose corporate management was in Baltimore, that had manufacturing and distribution as well as administrative offices in New Jersey. ATAPCO contested a deficiency assessment. The corporation had four business activities: (1) oil and gas exploration and production—it sold crude oil to Amoco, Exxon, and Crown; (2) manufacturing industrial and consumer products; (3) commercial real estate; and (4) marine transportation. It had also acquired stock under a number of different circumstances. Its stock holdings in five publicly held corporations were managed from Maryland (Exxon, Amoco, Crown Central Petroleum, Signet Banking, U.S. Fidelity & Guaranty Company). All corporate funds were commingled. Because the Director concluded that the business was unitary, the assessment included the value of publicly held stock in net worth and 50% of dividend income in "adjusted entire net income."⁵¹

The issue here, as before, was whether the income from publicly traded investments was part of a unitary business. Here, as compared to the situations in *International Paper*, *Mobil Oil*, and *American Home Products*, the income from and asset value of stock was very significant in

⁴⁸ See *id.* at 351.

⁴⁹ 13 N.J. Tax 572 (N.J. Tax Ct. 1994).

⁵⁰ No. 07-14-0302-87CB, slip op. (Tax Ct. Sept. 5, 1991).

⁵¹ *Id.* at 8 n.2.

relation to total income and assets. The other three taxpayer companies were primarily operating companies. Here, like Bendix, acquisitions were part of corporate strategy. Among the administrative activities located in New Jersey was the development and evaluation of acquisition opportunities for ATAPCO. The general operations of ATAPCO were largely dependent on income and assets of the five publicly held corporations. For the years in question, the intangible income percentage of ATAPCO's total income was 44.0% in 1980, 39.5% in 1981, and 52.7% in 1982; the current value of its investment in the publicly held stocks was 68.42% to 85.95% of adjusted net worth during the period.⁵² The court held that the business was unitary, and the taxpayer did not show by clear and cogent evidence that extraterritorial values were being taxed.

The final, and most recent case—one in which unitary themes in New Jersey reached their culmination and full development—was *Central National-Gottesman, Inc. v. Director, Division of Taxation*.⁵³ In that case, the taxpayer brought an action contesting the Division's denial of a refund request. The taxpayer was a New York corporation headquartered in New York. In 1984, it purchased all the stock of Lindemeyer Paper Corporation. In late 1987, the taxpayer merged the corporation as a 100% subsidiary into itself and became an S corporation in 1988. The taxpayer engaged in two activities: (1) investment in publicly held securities (the value of the security portfolio exceeded \$200 million during the period 1988-1990) and (2) the operation of a forest products business consisting of the purchase and sale in bulk of pulp, paper, newsprint, and paperboard and the wholesale distribution of printing-grade and writing-grade papers.

The primary issue in the case was whether the investment division and the forest products division should be considered a unitary business or two discrete businesses. Based upon the *Allied-Signal* case and the legal tests it affirmed, the court found no exchange of value, no economies of scale or centralized management,⁵⁴ and finally no functional integration despite the repayment of \$17 million from the forest products division to the investment division and a savings of fees connected with a pledge loan. The judge held that, like the investment division in *American Home Products*, the investment division of the taxpayer in the instant case could not be found to be part of a unitary business, even though the investments had been used for security and there were common pension arrangements for leaders within the company. The taxpayer's refund requests for the subject periods were, therefore, held appropriate and were granted.

⁵² See *id.* at 12.

⁵³ 14 N.J. Tax 545 (N.J. Tax Ct. 1995), *aff'd*, 291 N.J. Super. 277, 677 A.2d 265 (App. Div. 1996), *cert. denied*, 146 N.J. 569, 683 A.2d 1164 (1996).

⁵⁴ See *id.* at 552-53.

CONCLUSIONS

Taken together, the cases illustrate practical administrative difficulties of several varieties, theoretical difficulties, and possible systemic issues of tax policy evenhandedness, which call for legislative review. While some issues could be addressed administratively under the definition of income of the CBT,⁵⁵ the significance of the policy issues and the need to clarify terminology make it preferable for this task to be done through the legislature.

First, there is an administrative problem in distinguishing between taxable operational income and non-taxable, non-operational income. Large amounts of money are typically at stake, and litigation requires detailed evidentiary review of corporate finance, structure, records, minutes of meetings, and strategies. Recognizing these difficulties, Justice O'Connor offered some guidance in her *Allied-Signal* dissent. In the Justice's view, "[a]ny distinction between short-term and long-term investments cannot be of constitutional dimension. Whether an investment is short-term or long-term, what matters for due process purposes is whether the investment is operationally related to the in-state business."⁵⁶ According to the majority, the length of time of holding may distinguish operational (short term) from investment (long term) income.

The Justice also offered additional guidance in the classification process:

I presume that the Court's test allows taxation in at least those circumstances in which it is allowed by the Uniform Division of Income for Tax Purposes Act (UDITPA). . . . Presumably, investment income serves an operational function if it is, to give only some examples, intended to be used by the time it is realized for making the business' anticipated payments; for expanding or replacing plants and equipment; or for acquiring other unitary businesses that will serve the in-state business as stable sources of supply or demand, or that will generate economies of scale or savings in administration.⁵⁷

Unfortunately, this constitutional complexity once introduced into the tax system cannot, as a practical matter, be reversed. In other states whose statutes use a definition of "Business Income/Nonbusiness Income" that is not identical with operational income in a particular instance, successful challenges by taxpayers to inclusion of investment income in the tax base may occur as a result of this holding. For New Jersey purposes, the exclusion from entire net income that is based upon the United States Constitu-

⁵⁵ See N.J. STAT. ANN. § 54:10A-4(k) (West 1986 & Supp. 1997).

⁵⁶ *Allied Signal, Inc. v. Director, Div. of Taxation*, 504 U.S. 768, 793 (1992) (O'Connor, J., dissenting).

⁵⁷ *Id.* at 792-93.

tion is currently reflected in the top five lines of the New Jersey Corporation Business Tax Return (Form CBT-100). Sadly, the modern corporate bookkeeper must be a constitutional scholar to make the appropriate classifications.

Second, taxpayers' claims of non-operational income are likely to proliferate. The appellate court opinion in *Gottesman* may be significant as precedent because it may offer significant planning opportunities to taxpayers and their counsel. The court wrote:

Moreover, while our Supreme Court, interpreting federal constitutional law, has said that "it is a rare case" that a single corporate entity will not be "unitary," in [*Silent Hoist*] "there was a distinct sharing of the value of common management, accounting and operations that [took] the portfolio income of [the] taxpayer well within the concept of a unitary business." However, here, the corporation's investments were truly "distinct" from the "main line" of the plaintiff's forestry products business.⁵⁸

After the *Gottesman* case such claims may become more common, particularly for financially strong companies that are well counseled, and under some circumstances extend to operating divisions as well as investment divisions. In that sense this case may offer a map to taxplanners who wish to carve out certain income from the New Jersey tax base and find their way to a safe harbor.

The Director's contention in *Gottesman* that the entire corporation, including the investment division, was unitary rested on the following facts and circumstances, although they were not considered sufficient for a unitary finding:

1. Both divisions had the same four senior officers.
2. Both divisions used the same pension fund and employee benefits program.
3. A common payroll department serviced both divisions.
4. Office space, mailroom and telephone systems were shared by both divisions.
5. On one occasion the investment division made a charitable contribution of appreciated securities, a portion of which was allocated to the forest products division.
6. The forest products division returned \$17 million to the investment division shortly after a loan of \$18 million dollars had been obtained for working capital for the forest products division.

⁵⁸ *Gottesman*, 291 N.J. Super. at 282, 677 A.2d at 268 (citations omitted).

7. The forest products division obtained a lower fee for a letter of credit from Morgan Guarantee because the letter of credit was secured by the assets of the investment division held by Morgan Guarantee.⁵⁹

After this opinion, such activities and characteristics are considered those of a separate division—a discrete business activity—whose income from outside the state is immune from tax. It also seems likely that a company with hundreds of millions of dollars in assets and a management committee (or a “portfolio manager” as in the case of American Home Products) will have an easier time meeting these tests and criteria of non-operational or nonunitary income than a smaller company under the direction of an active president. The issue then is whether the principle that has been established is intrinsically unfair in its application to financially smaller businesses and will tend to erode confidence in the tax system itself for that reason.

It is interesting to speculate how companies may reorganize in light of this precedent. The court in *Silent Hoist* placed emphasis on the centralized management that was directed by Silent Hoist’s president and principal manager, but it is conceivable that with some corporate restructuring, the case could come out differently in 1997 than it did in 1985. Today, if a company like Silent Hoist had several bank accounts and hired someone to handle its investments—assuming no flow of value between the investment and the sales segments of the business—it could argue that it had a separate, nonapportionable line of business.

The Court in *Allied Signal* remarked, “we have held that for constitutional purposes capital gains should be treated as no different from dividends.”⁶⁰ Future nonoperational or nonunitary claims may be expected to relate to real estate in addition to portfolio investments as they have in the neighboring states of New York and Pennsylvania.⁶¹

Third, in the context of a single entity state not permitting separate accounting, the unitary concept is semantically confusing. The centralization of management test seems more meaningful when applied across corporate lines and boundaries to several corporations in a California-type

⁵⁹ See *Central National-Gottesman, Inc. v. Director, Div. of Taxation*, 14 N.J. Tax 545, 557 (N.J. Tax Ct. 1995).

⁶⁰ *Allied-Signal*, 504 U.S. at 780.

⁶¹ See *British Land (Maryland), Inc. v. Tax Appeals Tribunal*, 647 N.E.2d 1280 (N.Y. 1995) (making a unitary finding against the taxpayer); *Ross-Araco Corp. v. Commonwealth Bd. of Fin. and Revenue*, 674 A.2d 691 (Pa. 1996) (liberalizing the treatment of the disposition of assets in Pennsylvania and finding the sale to be “nonbusiness income”). See also *Kettler Realty Corp. v. Director, Div. of Taxation*, 12 N.J. Tax 470, 479 (N.J. Tax Ct. 1992), *aff’d*, 14 N.J. Tax 165 (App. Div. 1993), where the New Jersey Tax Court pointed out that New Jersey possessed the right to tax this investment income because Kettler was domiciled in New Jersey.

unitary situation than to a case involving a single corporate entity.⁶² For many years one of the indicia for distinguishing between a corporation and a non-corporate entity under Internal Revenue Code Section 7701 was whether or not the entity had centralized management. New York and New Jersey corporation law provide for the appointment of one president.⁶³ So it is conceptually and lexically confusing to the initiated and uninitiated alike (without a statutory definition of a “unitary business”) as to how a corporate unit is not also considered a taxable unit. Thus, *Gottesman* was in fact legally a corporation, but for constitutional purposes it was found not to have one of the fundamental characteristics of a corporation, namely, centralized management. In applying the Due Process Clause and the Commerce Clause to the New Jersey tax scheme, the CBT has been rewritten, contrary to Justice O’Hern’s earlier protestation in *Silent Hoist*, cited above.

Fourth, a codified definition of unitary business might allow the principle of *de minimis non curat lex* to appear less subjective in practice. A *de minimis* argument, while accepted in *Gottesman*, was rejected in *International Paper* with reference to sales between companies.⁶⁴ Its application seems to be contrary to the principle that tax exemption provisions are to be interpreted narrowly, and this may reflect the special status of a “Constitutional exclusion.” Though all life is relative, by most standards a \$17 million cash transfer is not *de minimis*.

RECOMMENDATIONS

Thus, unitary taxation has come to New Jersey. As more corporations claim that investment income is non-operational and as they establish investment programs outside the state for tax avoidance purposes, the New Jersey tax base is likely to decline relatively. If that is the case, and because the net worth base of the original franchise tax has been repealed, legislation should now be seriously considered to conform and update the 1945 tax law to these new facts of life. Evenhandedness in the tax structure is also a timely consideration in light of the use of comparable, new entities such as limited liability companies that can provide the benefits of limited liability with non subjectivity to corporation tax. These new entities offer a myriad of tax planning opportunities.

Accordingly, it is time that tax advisory groups or other assemblies of policy makers give systematic attention to updating the CBT, at a mini-

⁶² See *A.B. Dick Co. v. McGraw*, 678 N.E.2d 1100, 1101 (Ill. App. Ct. 1997).

⁶³ See N.J. STAT. ANN. § 14A:6-15(a) (West 1969 & Supp. 1997); N.Y. BUS. CORP. LAW § 715(a) (McKinney 1986).

⁶⁴ See *International Paper Co. v. Taxation Div. Dir.*, 11 N.J. Tax 147, 159 (N.J. Tax Ct. 1990).

mum by defining the term “unitary business,” so that such determinations would not be made solely on a case-by-case basis. Further, and more significantly, a tax system of unitary combination or corporate consolidation, including multiple corporate entities within the tax reporting group, should be seriously advanced. A first step in statutory revision should involve a statutory redefinition of terms. In 1993, the CBT was supplemented to define “operational income.”⁶⁵ From the point of view of uniformity of terminology among the states, this *Allied Signal*/New Jersey distinction between operational and nonoperational income is somewhat analogous to the statutory distinction of business and non-business income found in states that use a statutory definition to tax a unitary business.⁶⁶ Turning to the more standard terminology in New Jersey would be more consistent. Because New Jersey’s statute uses the word “allocation” to mean “apportionment” as the concept is used in other states, it would be appropriate to conform this usage to the prevailing practice as well.

Legislative initiatives toward combined returns have already been made. New Jersey Assembly Bill 2784, introduced May 8, 1995, provided among other things definitions of “unitary business” and “unitary group.” The bill was later withdrawn by its sponsors. In addition, A-941—pre-filed for introduction in the 1996 session—allows certain corporations to file “combined returns.” Finally, S-577, introduced January 29, 1996, allows “consolidated returns.” This is similar to S-931, which was introduced during an earlier legislative session on May 5, 1994.

There is logic in this initiative toward filing combined or consolidated returns. It puts financially smaller and larger corporations on a more even playing field. Because nonoperational income can be carved out of the tax base of a single corporation, it is appropriate for the CBT to be amended so that the entire net income of a unitary business that transcends corporate boundaries and has contact with New Jersey should be apportionable. This is in keeping with the precept that “the linchpin of apportionability in the field of state income taxation is the unitary-business principle,”⁶⁷ and this would introduce to New Jersey the aspect of unitary taxation that is currently absent. Tennessee, for example, follows the *Gottesman* principle and recognizes combined returns.⁶⁸

Such change would foreclose the tax avoidance technique of artificially dividing income from a unitary business into discretely incorporated

⁶⁵ See N.J. STAT. ANN. § 54:10A-6.1(a) (West 1986 & Supp. 1997).

⁶⁶ In such a system, the business income is apportioned and the investment income is allocated to the seat of management and control.

⁶⁷ *Mobil Oil Corp. v. Commissioner of Taxes*, 445 U.S. 425, 439 (1980) (deciding case that arose out of Vermont).

⁶⁸ See *Louis Dreyfus Corp. v. Huddleston*, 933 S.W.2d. 460 (Tenn. Ct. App. 1996).

segments of the unitary business whose constituent parts may have no nexus with New Jersey. This appears to be the direction Justice O'Connor may have had in mind for New Jersey in her *Allied-Signal* dissent. Accordingly, the pending legislative bills referred to above should be seriously considered, with the possible amendment to them that entities not originally included in the unitary group by taxpayer could be brought into it by the revenue agency. As Professor Richard Pomp of the University of Connecticut has observed, a state that does not have combined returns does not control its tax base. The use of combined returns would allow the taxing authority to move outside the corporate boundaries to follow and include income and activities of the unitary business rather than allow the taxpayer the choice of carving portions out of a single corporation through reincorporation, claiming that such business lines or investments are separate entities. Accordingly, some tax planning and avoidance opportunities would be eliminated.

There is one last issue that an advisory group might explore in any modernization study. Because the tax itself has been so changed by both statute and courts from its original status as a franchise tax on net worth⁶⁹ to a franchise tax whose only distinguishing feature is that income from exempt securities is in its tax base,⁷⁰ the tax itself might be recharacterized officially from a franchise tax to an income tax. If the Corporation Business Tax Act were to be revised to impose a tax on a unitary business that transcended corporate boundaries, then the characterization as a "franchise tax," whose distinctive characteristic is that exempt interest securities are in the tax base, could be reconsidered as well.

In sum, unitary theory is not fully compatible with the current New Jersey corporation business tax regime, and legislative changes would be appropriate.

⁶⁹ See *Werner Mach. Co. v. Director, Div. of Taxation*, 17 N.J. 121, 110 A.2d 89 (1954), *aff'd*, 350 U.S. 492 (1956).

⁷⁰ See *Garfield Trust Co. v. Director, Div. of Taxation*, 6 N.J. Tax 462, 470-71 (N.J. Tax Ct. 1984), *aff'd*, 7 N.J. Tax 664 (App. Div. 1985), *aff'd*, 102 N.J. 420, 508 A.2d 1104 (1986), *appeal dismissed*, 479 U.S. 925 (1986).