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Taxation - Federal Taxes: North Dakota's Unitary Taxation Method of Computing the Federal Income Tax Deduction for Multinational Corporations Held Improper

Linda E. Bata

TAXATION — FEDERAL TAXES: NORTH DAKOTA'S UNITARY TAXATION METHOD OF COMPUTING THE FEDERAL INCOME TAX DEDUCTION FOR MULTINATIONAL CORPORATIONS HELD IMPROPER

Following an audit of 1979, 1980, and 1981 corporate tax returns for Minnesota Mining and Manufacturing Company (3M), the Tax Commissioner for the State of North Dakota (Commissioner) assessed additional taxes against 3M.[1] The Commissioner found that 3M had underpaid its 1981 taxes because 3M did not use the worldwide apportionment factor to calculate its 1981 federal income tax deduction.[2] 3M protested the 1981 assessment and maintained that the deduction was properly calculated on the 1981 return.[3] An administrative decision by the hearing examiner affirmed the Commissioner's determination of a deficiency.[4] The district court affirmed the administrative decision and upheld the Commissioner's assessment.[5] The North Dakota Supreme Court reversed the district court and *held* that applying the worldwide apportionment factor to the federal income tax paid after the foreign tax credit was taken was not a proper method for calculating

1. Minnesota Mining & Mfg. v. Conrad, 418 N.W.2d 276, 276 (N.D. 1987). Minnesota Mining and Manufacturing Company (3M) is a multinational corporate taxpayer doing business in the State of North Dakota. *Id.* The Tax Commissioner for the State of North Dakota (Commissioner) issued a Notice of Determination and Assessment against 3M for $27,372 in additional corporate income tax, penalty, and interest. *Id.* The Commissioner determined that 3M's 1979 and 1980 taxes were overpaid, but that its 1981 taxes were underpaid. *Id.* The 1981 taxes were underpaid because 3M's method of calculating the state deduction for federal income taxes paid or accrued produced a larger deduction than the Commissioner's method allowed. *Id.*

2. *Id.* at 276, 278. The worldwide apportionment factor is the ratio of North Dakota taxable income to the worldwide income of the unitary group. *Id.* at 278. The worldwide income of the unitary group is arrived at by adding together all domestic and foreign income earned by the corporation and its subsidiaries throughout the world. *Id.* at 277. The resultant sum, after elimination of intercompany dividends and transfers, is the corporation's worldwide income. *Id.* 3M did not challenge the Commissioner's authority to require combined worldwide unitary filing. *Id.* at 278.

3. *Id.* at 276. 3M argued that the method used in 1981 to calculate the state deduction should also have been used in 1979 and 1980. *Id.* 3M thus requested a refund for the 1979 and 1980 tax years. *Id.* The request for refund for the years 1979 and 1980 was denied at the administrative hearing. *Id.*

4. *Id. See* Minnesota Mining & Mfg., slip op. at 7 (Tax Comm'r March 10, 1986)(admin. hearing). The administrative hearing was held before a hearing examiner. *Id.* at 1.

5. *Minnesota Mining & Mfg.*, 418 N.W.2d at 276. *See* Minnesota Mining & Mfg. v. Conrad, Civ. No. 37422 (Burleigh County Dist. Ct. July 23, 1986)(mem.). The district court did not specifically address the calculation of the deduction for federal taxes paid or accrued. *Id.* The district court stated generally that applying the worldwide apportionment factor to the corporation's combined federal taxable income after all adjustments provided by section 57-38-01.3 of the North Dakota Century Code have been made results in North Dakota taxable income. *Id.* at 2. *See* N.D. CENT. CODE § 57-38-01.3 (Supp. 1987)(providing for adjustments to federal taxable income for corporations).

the state deduction for federal income taxes paid.[6] *Minnesota Mining & Manufacturing v. Conrad*, 418 N.W.2d 276 (N.D. 1987).

All forty-five states which impose corporate income taxes use formula apportionment methods to determine what portion of a multistate corporation's taxable income is attributable to a particular state for corporate income taxation purposes.[7] Formula apportionment was first used in the late 1800s by various states to tax railroads.[8] States taxing railroads adopted a formula apportionment system known as the "unit rule" system in which the ratio of track miles located in the state compared to the total track miles owned by the railroad was used to determine what portion of the railroad's capital stock was taxable by the state.[9] The "unit rule" system was the first formula apportionment system to be endorsed by the United States Supreme Court.[10]

Since the acceptance of the "unit rule" system, a wide variety of formula apportionment methods have been upheld.[11] The most

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6. *Minnesota Mining & Mfg.*, 418 N.W.2d at 281. The North Dakota Supreme Court did not specify the proper method of calculating the federal income tax deduction. *Id.* Therefore, the case was remanded to the Commissioner for redetermination of the federal income tax deduction. *Id.*

7. Tannenwald, *The Pros and Cons of Worldwide Unitary Taxation*, 25 TAX NOTES 649, 650 (1984). Formula apportionment is preferred to separate transactional accounting, which was the predominant method of taxing corporate income in the early 1900s. *Id.* at 649. Separate accounting requires corporations to compute taxable income solely on the basis of revenues and expenses from in-state activities. *Id.* Thus, separate accounting disregards the corporate income generated by branches and subsidiaries located outside the taxing state. *Id.* States have abandoned separate accounting because corporations are able to shift income from states with high corporate tax rates to states with low corporate tax rates, thus reducing the aggregate corporate tax liability. *Id.* at 650. *See* Simmons, *Worldwide Unitary Taxation: Retain and Rationalize, or Block at the Water's Edge?*, 21 STAN. J. INT'L L. 157, 161 (1985)(separate accounting invites allocation of profits to jurisdictions with lower rates). Moreover, states have abandoned separate accounting because it fails to isolate savings created by factors such as centralized management, vertical integration, and economies of scale. *See* Mobil Oil Corp. v. Commissioner of Taxes, 445 U.S. 425, 438 (1980)(separate accounting fails to account for profits resulting from functional integration, centralization of management, and economies of scale); Tannenwald, *supra*, at 650 (separate accounting fails to separate the inseparable). Consequently, all forty-five states which levy corporate income tax prefer formula apportionment to separate accounting. Tannenwald, *supra*, at 650. Nevada, South Dakota, Texas, Washington, and Wyoming are the only states which do not impose corporate income taxes. *See* St. Tax Handbook (CCH) 644 (Oct. 1, 1987)(listing states which impose corporate income taxes).

8. *See* J. HELLERSTEIN, STATE TAXATION ¶ 8.5 (1983)(discussing early apportionment of interstate railroads, telegraph and express companies, toll bridges, and other transportation businesses).

9. *Id.*

10. *Id.*

11. *See* Hellerstein, *State Taxation of Interstate Business: Perspectives on Two Centuries of Constitutional Adjudication*, 41 TAX LAW. 37, 57 (1987)(discussing commerce clause requirement that taxes on interstate commerce be fairly apportioned to taxpayer's activities in the taxing state). The United States Supreme Court has invalidated only two apportionment formulas for state taxation of multistate businesses. *Id* at 58 n.169; *see* Norfolk & Western Ry. v. Missouri State Tax Comm'n, 390 U.S. 317, 326 (1968)(Court invalidated a rail mileage apportionment formula which "led to a grossly distorted result"

commonly used formula apportionment method is the three-factor formula.[12] Under the three-factor formula, the income attributable to the state is arrived at by multiplying the corporation's total income by a fraction which represents the ratio of sales, payroll, and property located in the state to the total sales, payroll, and property of the corporation.[13] Sales, payroll, and property are used as apportioning factors because their geographic locations are easily identified and because they are highly correlated to the production of income.[14] The three-factor formula is generally considered the most effective method of attributing a multistate corporation's taxable income to the states.[15]

Applying formula apportionment to a multijurisdictional business is unconstitutional if the apportionment results in taxation of

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on the particular facts of the case), *reh'g denied*, 390 U.S. 1046 (1968); Hans Rees' Sons, Inc. v. North Carolina *ex rel.* Maxwell, 283 U.S. 123, 135 (1931)(Court invalidated single-factor formula which caused income attributed to the state to be "out of all appropriate proportion to the business transacted . . . in that [s]tate"). State apportionment formulas are presumed valid. J. HELLERSTEIN, *supra* note 8, at ¶ 8.7. Therefore, the taxpayer has the heavy burden of showing by clear and cogent evidence that extraterritorial values were taxed and that the income attributed to the state was out of all appropriate proportion to business transacted in the state. Container Corp. v. Franchise Tax Bd., 463 U.S. 159, 164, 180-81 (1983)(citations omitted), *reh'g denied*, 464 U.S. 909 (1983).

12. Comptroller General, Report to Chairman, House Committee on Ways and Means, *Key Issues Affecting State Taxation of Multijurisdictional Corporate Income Need Resolving*, 1982 GAO/GGD-82-38, at 3. The three-factor formula was first approved by the United States Supreme Court in *Butler Bros. v. McColgan*. Note, *State Worldwide Unitary Taxation: The Foreign Parent Case*, 23 COLUM. J. TRANSNAT'L L. 445, 451 (1985). *See* Butler Bros. v. McColgan, 315 U.S. 501, 509 (1942)(sales, payroll, and property factors may be used to allocate to a state a just proportion of the profits earned by the unitary business). The three-factor formula was also adopted in the Uniform Division of Income for Tax Purposes Act (UDITPA). Note, *supra*, at 451. For the text of UDITPA as codified in North Dakota, see N.D. CENT. CODE ch. 57-38.1 (1983). The UDITPA was drafted in 1957 by the National Conference of Commissioners on Uniform State Laws and was designed to promote uniform formula apportionment and eliminate possible double taxation of interstate income. Note, *supra*, at 451. *But see* Note, *supra*, at 451-52 (nonuniformity continues to prevail because UDITPA has not been adopted by all states). North Dakota enacted the UDITPA in 1965. NORTH DAKOTA LEGISLATIVE COUNCIL, REPORT TO THE FIFTIETH LEGISLATIVE ASSEMBLY, 182, 184 (Taxation Committee)(1987) [hereinafter LEGISLATIVE COUNCIL REPORT]. *See* N.D. CENT. CODE ch. 57-38.1 (1983)(text of UDITPA).

13. Comptroller General, *supra* note 12, at 3. The three-factor formula may be expressed as follows:

$$\frac{\frac{\text{In-State Property}}{\text{Total Property}} + \frac{\text{In-State Payroll}}{\text{Total Payroll}} + \frac{\text{In-State Sales}}{\text{Total Sales}}}{3} \times \text{Total Corporate Income} = \text{Income Taxable By State}$$

Id.

14. Tannenwald, *supra* note 7, at 650. *See also Container*, 463 U.S. at 183 (sales, payroll, and property factors represent a very large share of corporate activities which generate value).

15. *See Container*, 463 U.S. at 170 ("[i]ndeed, not only has the three-factor formula met our approval, but it has become . . . something of a benchmark against which other apportionment formulas are judged").

extraterritorial values because a state may not tax value earned outside of its borders.[16] However, the United States Supreme Court has determined that formula apportionment does not result in taxation of extraterritorial value if the multijurisdictional business is "unitary."[17] Unfortunately, the United States Supreme Court has declined to clearly define the unitary business concept.[18] States are thus free to impose their own definitions of the unitary business concept within a minimal constitutional standard formulated by the Supreme Court.[19] This minimal constitutional standard provides that a business enterprise is sufficiently unitary if, among the enterprise's component parts, there is "some sharing or exchange of value not capable of precise identification or measurement . . . which renders formula apportionment a reasonable method of taxation."[20]

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16. *See* ASARCO, Inc. v. Idaho State Tax Comm'n, 458 U.S. 307, 315 (1982) ("[a]s a general principle, a State may not tax value earned outside its borders"). The due process clause prohibits states from taxing interstate commerce, unless there is (1) a minimal connection (nexus) between the interstate activity and the taxing state, and (2) a rational relationship between the income attributed to the state and the intrastate value of the business. Moorman Mfg. Co. v. Bair, 437 U.S. 267, 272-73 (1978), *reh'g denied*, 439 U.S. 885 (1978). The commerce clause prohibits states from taxing interstate commerce unless there is (1) a substantial nexus between the interstate activity and the taxing state, (2) fair apportionment, (3) no discrimination against interstate commerce, and (4) a fair relation between the tax and the services provided by the state. Complete Auto Transit, Inc. v. Brady, 430 U.S. 274, 279 (1977), *reh'g denied*, 430 U.S. 976 (1977).

In *Container Corp. v. Franchise Tax Board* the United States Supreme Court condensed the due process and commerce clause requirements for taxing interstate commerce into one concept which provides that a state is prohibited from taxing value earned outside its borders. *Container*, 463 U.S. at 164. *See* Simmons, *supra* note 7, at 164 n.38 (discussing constitutional requirements in *Container*). *See generally* Hellerstein, *supra* note 11, at 56-62, 74-77 (discussing commerce clause and due process clause requirements for taxation of interstate commerce).

17. *Container*, 463 U.S. at 164-65. When a state taxes the income of a unitary business, it theoretically taxes the value which has been contributed to the overall enterprise by the business operations undertaken in the taxing state. Simmons, *supra* note 7, at 164. Thus, income corresponding to the value contributed by activities within the state, not extraterritorial value, is taxed when the income of a unitary business is apportioned. *Id.*

18. Salger & Zaborske, *Use of the Unitary Business Concept and Combined Reporting*, MULTISTATE CORPORATE TAX ALMANAC 160 (W. Raabe ed. 1987). *See also* J. HELLERSTEIN, *supra* note 8, at ¶ 8.11[4][g][iv] (United Stated Supreme Court makes case by case factual determinations of unitary business).

19. *Container*, 463 U.S. at 166-69, 178. Deference is given to a state court's finding of unitary business. *Id.* at 175. The unitary business concept is uncertain because businesses are unable to determine which test of unity a state may apply. Salger & Zaborske, *supra* note 18, at 160. The three prominent tests of unity are the three unities test, the contribution or dependency test, and the factors of profitability test. *Id.* The three unities test asks whether there is unity of ownership, operation, and use among corporate units. *Id* at 161. The contribution or dependency test asks whether the corporate unit located in the state contributes to or is dependent on out-of-state corporate entities. *Id.* The factors of profitability test asks whether there is functional integration, centralization of management, or economies of scale. *Id.*

20. *Container*, 463 U.S. at 166. In *Container* the United States Supreme Court found that a flow of value is the prerequisite to a constitutionally acceptable finding of a unitary business. *Id.* at 178. Unitary taxation is based on the theory that the value of the entire unitary business is apportionable to a state for taxation if operations within the state contribute to the overall profitability of the enterprise. Simmons, *supra* note 7, at 162, 164.

Although most states use the unitary business concept to apportion the income of domestic corporations which have no foreign-source income, some states have used the concept to tax domestic corporations with worldwide operations.[21] North Dakota has used the worldwide unitary concept since 1973.[22] Under the worldwide unitary concept, all the income of a domestic enterprise's domestic and foreign subsidiaries is combined.[23] The three-factor apportionment formula is then applied to the enterprise's combined income to determine the portion of the combined income which is taxable by the state.[24] The worldwide unitary taxation practice creates significant state revenues;[25] however, it may discourage multinational corporations from locating in the state.[26]

In 1983 the United States Supreme Court, in *Container Corp. v. Franchise Tax Board*,[27] upheld the extension of the unitary busi-

21. LEGISLATIVE COUNCIL REPORT, *supra* note 12, at 184; *Text of Report by Treasury's Unitary Task Force*, 23 TAX NOTES 637 (1984) [hereinafter *Text of Report*]. As of 1984 all forty-five states which impose corporate income taxes utilized the unitary business concept to reach the income of single corporations operating across state borders. LEGISLATIVE COUNCIL REPORT, *supra* note 12, at 184; *Text of Report*, *supra*, at 637. The five states which do not impose corporate income taxes are Nevada, South Dakota, Texas, Washington, and Wyoming. *See* St. Tax Handbook (CCH) 664 (Oct. 1, 1987)(listing states which impose corporate income taxes). Twenty-three of those states which impose a corporate tax on single corporations which operate across state borders have also extended the concept to reach the income of multicompany groups operating across state borders through domestic subsidiaries. LEGISLATIVE COUNCIL REPORT, *supra* note 12, at 184; *Text of Report*, *supra*, at 637. Twelve of those twenty-three states, one of which was North Dakota, extended the concept worldwide to reach all the income of domestic multicompany groups operating across state and national borders through domestic and foreign subsidiaries. LEGISLATIVE COUNCIL REPORT, *supra* note 12, at 184; *Text of Report*, *supra*, at 637. For a list of the twelve states which used the worldwide unitary business concept as of 1984, see *infra* note 22.

22. LEGISLATIVE COUNCIL REPORT, *supra* note 12, at 184. North Dakota has used some method of formula apportionment since 1919 when the State's corporate income tax was first imposed. *Id.* at 183. The worldwide unitary concept was adopted in North Dakota under the North Dakota Tax Commissioner's administrative interpretation of the Uniform Division of Income for Tax Purposes Act (UDITPA). *Id.* at 184. *See* N.D. CENT. CODE ch. 57-38.1 (1983)(text of UDITPA). For a discussion of UDITPA, see *supra* note 12. As of 1984 the twelve states employing worldwide unitary taxation were Alaska, California, Colorado, Florida, Idaho, Indiana, Massachusetts, Montana, New Hampshire, North Dakota, Oregon, and Utah. Simmons, *supra* note 7, at 158-59 & n.5 (citing Daily Tax Rep. (BNA) No.85, at G-9 (May 2, 1984)). As of 1986 Alaska, Montana, and North Dakota were the only remaining states using worldwide unitary taxation. LEGISLATIVE COUNCIL REPORT, *supra* note 12, at 184.

23. *Text of Report*, *supra* note 21, at 637. For a discussion on combining domestic and foreign income of corporations, see *supra* note 2.

24. *Text of Report*, *supra* note 21, at 637.

25. *Minutes of the Taxation Committee*, N.D. LEGIS. COUNCIL, Jan. 14, 1986, at 8 (comments of Mr. Robert Kessel, North Dakota Tax Department). *See also*, Letter from Rep. Byron L. Dorgan, D-N.D., to President Reagan (Jan. 18, 1982), *reprinted in* 14 TAX NOTES 352, 352 (1982) (worldwide unitary taxation provides hundreds of millions of dollars in state revenue).

26. *Minutes of the Taxation Committee*, N.D. LEGIS. COUNCIL, Jan. 14, 1986, at 5 (comments of Ms. Maureen Pechacek, Supervisor of Income Tax for 3M Company).

27. 463 U.S. 159 (1983), *reh'g denied*, 464 U.S. 909 (1983).

ness concept for use in taxing worldwide corporations.[28] In *Container* the taxpayer was a Delaware corporation headquartered in Illinois which had various foreign subsidiaries and was doing business in California.[29] In calculating the California tax liability, the taxpayer corporation did not treat its foreign subsidiaries as part of the unitary business.[30] The taxpayer corporation did not include the foreign subsidiaries' income in the total unapportioned taxable income of its unitary business and omitted the subsidiaries' payroll, property, and sales from the three-factor apportionment formula.[31] The United States Supreme Court addressed the issue of whether the state could extend the unitary business concept to include the taxpayer's foreign subsidiaries as part of the unitary business for computation of the state corporate tax.[32] The Supreme Court concluded that the state court's finding of a unitary business was proper, that the state's application of the three-factor apportionment formula to a multinational enterprise was fair, and that the state's taxation method did not violate the foreign commerce clause.[33] Therefore, the Supreme Court ruled

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28. Container Corp. v. Franchise Tax Bd., 463 U.S. 159, 184 (1983), *reh'g denied*, 464 U.S. 909 (1983).

The *Container* decision applies only to domestic parent corporations. *Id.* at 189 n.26. The decision does not extend the unitary business concept to include domestic corporations with foreign parents or foreign corporations with either foreign parents or foreign subsidiaries. *Id.* For a discussion of the dangers of extending the worldwide unitary business concept to include foreign parent corporations, see Barclays Bank Int'l v. Franchise Tax Bd., Cal. Tax Rep. (CCH) ¶ 401-552 (Cal. Super. Ct. June 16, 1987)(intended decision; not reported). *See generally* Note, *State Worldwide Unitary Taxation: The Foreign Parent Case*, 23 COLUM. J. TRANSNAT'L L. 445, 459-74 (1985)(extending worldwide unitary taxation to foreign parents would create an enhanced risk of multiple taxation, offend foreign trading partners, disrupt federal uniformity in international taxation, and violate treaties).

29. *Container*, 463 U.S. at 163.

30. *Id.* at 174. If the taxpayer had treated its foreign subsidiaries as part of the unitary business, the income subject to apportionment would have been increased and the percentage of that income apportionable to the state would have been decreased. *Id.* The overall effect would have been to increase the taxpayer's tax liability. *Id.* at 174-75.

31. *Id.* at 174.

32. *Id.* at 163. In *Container* the United States Supreme Court actually addressed three issues: (1) whether it was proper for the state's taxing authority and the state court to find that the relationship between the taxpayer and its foreign subsidiaries constituted a unitary business, (2) whether application of the three-factor apportionment formula to a multinational enterprise violates the constitutional requirements of fair apportionment, and (3) whether the foreign commerce clause requires that states use separate accounting methods to tax multinational enterprises. *Id.*

33. *Id.* at 184, 197. The Supreme Court deferred to the state court's finding that the taxpayer corporation and its foreign subsidiaries constituted a unitary business because the state court applied the correct standards to the case and because the state court's judgment was within the realm of permissible judgment. *Id.* at 177-80. The Supreme Court concluded that the State's use of the three-factor formula to apportion the income of a multinational enterprise was fair because the taxpayer corporation was not able to meet its burden of proving that the income apportioned to the State was out of all appropriate proportion to the business transacted in the State. *Id.* at 182-84. The Supreme Court also concluded that the State's taxation method did not violate the foreign commerce clause

that California's use of the unitary business concept to tax the worldwide operations of a multinational enterprise was constitutional.[34]

In response to *Container*, members of the business community and major foreign trading partners of the United States urged the federal administration to support legislation to limit or prohibit worldwide unitary taxation in order to curtail state taxation of foreign-source income.[35] In order to promote international economic relations while also respecting states' rights, the administration established the Worldwide Unitary Taxation Working Group (Working Group) to study state worldwide taxation and formulate alternative methods of taxation for corporations which have foreign-source income.[36] The Working Group suggested that voluntary state action, rather than preemptive federal legislation, should be used to restrict the use of the worldwide unitary method.[37] The Working Group suggested that states should receive federal cooperation in promoting full taxpayer disclosure and accountability; that domestic multinationals, foreign multinationals, and purely domestic corporations should be treated nondiscriminatorily; and that states should limit the worldwide unitary method of taxation to the water's edge.[38] Under the water's edge doctrine, the unitary business concept is extended only to specifically defined "water's edge" corporations.[39] Essen-

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because it did not create an enhanced risk of multiple taxation and because it did not impair federal uniformity in an area where federal uniformity is essential. *Id.* at 193, 197. *But see id.* at 199, 205 (Powell, J., dissenting)(California's tax scheme violates the foreign commerce clause because it inherently leads to double taxation and prevents the federal government from speaking with one voice in an area which should be left to the federal government).

34. *Id.* at 184, 197.

35. *Text of Report, supra* note 21, at 637-38. Members of the business community and major foreign trading partners of the United States urged the federal administration to file a motion for rehearing in *Container*. *Id.* However, the administration declined to do so. *Text of Report, supra* note 21, at 638. For a discussion of *Container*, see *supra* notes 27-34, and accompanying text.

36. *Text of Report, supra* note 21, at 638. President Reagan's decision to establish the Worldwide Unitary Taxation Working Group (Working Group) was announced on September 23, 1983. *Id.* The Working Group was chaired by Treasury Secretary Regan and was composed of representatives of the federal government, state governments, and the business community. *Id.*

37. *Id.* at 638-39; Carlson & Bernstein, *Worldwide Unitary Combination: History and Prospects*, 15 TAX MGMT. INT'L J. 407, 418-19 (1986).

38. *Text of Report, supra* note 21, at 639-43. For the full text of the Working Group's final report, see U.S. TREASURY DEPT., FINAL REPORT OF THE WORLDWIDE UNITARY TAXATION WORKING GROUP (1984), *reprinted in* 24 TAX NOTES 581 (1984).

39. *Text of Report, supra* note 21, at 640. The Working Group proposed a list of corporations which would constitute the "water's edge" corporations: United States corporations included in a consolidated return for federal corporate tax purposes; United States possessions' corporations; companies incorporated in United States possessions or territories; domestic international sales corporations (or foreign sales corporations); certain tax haven corporations; foreign corporations exceeding a threshold level of activity in the

tially, the water's edge doctrine limits a state's use of unitary taxation to entities having threshold levels of activity within the borders of the United States or those having significant contacts with the United States.[40] By 1986 nine of the twelve states had formerly utilized the worldwide unitary method of taxation had voluntarily limited its application to water's edge corporations.[41] However, North Dakota, Montana, and Alaska continued to use the worldwide unitary method without limitation.[42]

Some businesses consider the use of the worldwide unitary taxation method to be a negative locational factor.[43] The harsh effects of North Dakota's use of the worldwide unitary taxation method are ameliorated by the deduction allowed on state corporate taxes for federal income taxes paid or accrued by the corporation.[44] Under subsection 1(c) of section 57-38-01.3 of the North Dakota Century Code, a corporation may reduce its state taxable income by the amount of its federal income tax liability.[45] How-

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United States; and United States corporations having more than fifty percent of their stock owned or controlled by another United States corporation. *Id.*

40. *See* Simmons, *supra* note 7, at 183-84 (generally describing the water's edge doctrine). *See also supra* note 39 (listing types of corporations which would be "water's edge" corporations under the Working Group proposals).

41. LEGISLATIVE COUNCIL R EPORT, *supra* note 12, at 184. Colorado, Florida, Indiana, Oregon, and Massachusetts voluntarily adopted the water's edge doctrine soon after the Working Group's final report was published on May 1, 1984. Carlson & Bernstein, *supra* note 37, at 408. After the federal administration announced in November 1985 that it would support restrictive federal legislation, Idaho, New Hampshire, and Utah repealed the worldwide combination. *Id.* California also adopted the water's edge method on September 5, 1986. *Id.* On September 29, 1986 the Taxation and Debt Management Subcommittee of the Senate Finance Committee held hearings on the restrictive federal legislation. *Id.* The sponsor of the legislation and the Assistant Secretary of Treasury testified that the preemptive legislation was no longer necessary because the states were voluntarily restricting their use of worldwide unitary taxation through state legislation. Simmons, *supra* note 7, at 183-84.

42. LEGISLATIVE COUNCIL REPORT, *supra* note 12, at 184. North Dakota will allow a multinational unitary business subject to worldwide combined reporting to elect to apportion income using the water's edge method beginning after December 31, 1988. Unitary Corporate Income Taxation Act, ch. 702, 1987 N.D. Laws 1965 (codified at N.D. CENT. CODE ch. 57-38.4 (Supp. 1987)). If the corporation elects the water's edge method, the election is binding for ten years, the corporation is required to file a domestic disclosure spreadsheet, and the federal tax deduction is not permitted. *Id. See* N.D. CENT. CODE ch. 57-38.4 (Supp. 1987)(water's edge method election). Pending legislation would make the water's edge election binding for only five years. H.R. 1164, 51st Leg., 1st Sess. (1989)(to be codified at N.D. CENT. CODE § 57-38.4-02(1)(c)).

43. *Minutes of the Taxation Committee*, N.D. LEGIS. COUNCIL, Jan. 14, 1986, at 5 (comments of Ms. Maureen Pechacek, Supervisor of Income Tax for 3M Company).

44. *Minutes of the Taxation Committee*, N.D. LEGIS. COUNCIL, Jan. 14, 1986, at 8 (comments of Mr. Robert Kessel, North Dakota Tax Department). North Dakota is one of only six states which allows a federal tax deduction. St. Tax Handbook (CCH) 664 (Oct. 1, 1987). Other states which allow federal tax deductions are Alabama, Arizona, Iowa, Louisiana, and Missouri. *Id.*

45. *See* N.D. CENT. CODE § 57-38-01.3(1)(c) (Supp. 1987). Subsection 1(c) of section 57-38-01.3 of the North Dakota Century Code provides in relevant part:

> 1. The taxable income of a corporation as computed pursuant to the provisions of the Internal Revenue Code of 1954, as amended shall be:

ever, the corporation may deduct only that portion of federal tax paid or accrued on income which is also taxable by the state.[46] The deductible amount is calculated by applying the apportionment factors to the federal tax paid or accrued.[47] The amount of the federal tax deduction allowed will be smaller if a foreign tax credit has been taken against the federal income tax liability of the corporation because the actual tax paid or accrued will be reduced.[48]

The foreign tax credit is a mechanism designed to eliminate double taxation of foreign-source income.[49] United States corporations are federally taxable on their entire net income, regardless of the income's source.[50] Thus, a domestic corporation's foreign-source income is federally taxable.[51] However, foreign-source income is also taxable by the foreign country in which it is earned.[52] In order to prevent double taxation of foreign-source income, an amount approximating the foreign tax paid is credited

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. . .

c. Reduced by the amount of federal income taxes, paid or accrued as the case may be during the applicable tax year to the extent that such taxes were paid or accrued upon income which becomes a part of the North Dakota taxable income.

Id.

46. *Id.* The state deduction for federal income tax paid or accrued is limited to the portion of the federal tax paid on income which becomes a part of North Dakota taxable income. *Id.* For example, consider a multistate corporation with $100,000 of federal taxable income. Brief for Appellant at 4, Minnesota Mining & Mfg. v. Conrad, 418 N.W.2d 276 (N.D. 1987)(No. 11,391). Assuming a federal tax rate of forty percent, the federal income tax would be $40,000. *Id.* If one-fourth of the federal taxable income ($25,000) is attributable to North Dakota, then one-fourth of the federal income tax ($10,000) is allowed as a state deduction. *Id.* Because only one-fourth of the federal taxable income becomes part of North Dakota taxable income, only one-fourth of the federal income tax is allowed as a deduction. *Id.*

47. Minnesota Mining & Mfg. v. Conrad, 418 N.W.2d 276, 278 (N.D. 1987). The calculation of the federal tax deduction may be expressed as follows:

$$\frac{\text{State Taxable Income}}{\text{Total Corporate Income}} \times \text{Federal Tax Paid or Accrued} = \text{Federal Income Tax Deduction}$$

Id.

48. *See* Anderson, Clayton & Co. v. DeWitt, 20 Ariz. App. 474, —, 513 P.2d 1357, 1359 (1973)(court construed a statutory provision for federal tax deduction similar to North Dakota's provision and discussed the proper calculation of state federal tax deduction when foreign tax credit has been taken against the federal tax liability).

49. B. BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS & SHAREHOLDERS ¶ 17.11 (5th ed. 1987) [hereinafter FEDERAL INCOME TAXATION]. *See* 26 U.S.C. §§ 901-908 (Supp. IV 1986) (amending 26 U.S.C. §§ 901-908 (1982)) (foreign tax credit provisions).

50. FEDERAL INCOME TAXATION, *supra* note 49, at ¶ 17.10.

51. *Id.* Domestic corporations are fully federally taxable on the foreign earnings of their domestic subsidiaries and unincorporated foreign branches. *Id.* Domestic corporations are also fully federally taxable on the foreign earnings of their foreign subsidiaries, but only to the extent that the earnings are repatriated. *Id.*

52. *Id.*

against the federal tax liability.[53] Thus, the foreign tax credit reduces the federal tax liability.[54]

State statutes allowing a deduction for federal tax paid or accrued are not always clear as to what should be included in federal tax paid or accrued.[55] Thus, a question arises as to whether the foreign tax credit should be included in the federal tax paid or accrued for determining the state deduction.[56] The Arizona Court of Appeals in *Anderson, Clayton & Co. v. DeWitt*[57] reviewed the calculation of the state federal tax deduction where a foreign tax credit had been used to reduce the federal tax liability.[58] Arizona allows a corporation to reduce state taxable income by the amount of the federal tax liability, but only to the extent that the federal tax is paid on income which is taxable by the State.[59] The issue addressed by the Arizona Court of Appeals was whether the Arizona Tax Commission's method of applying the ratio of Arizona income to worldwide income to the federal tax liability after the foreign tax credit was taken was a proper method for determining the portion of the federal tax paid on income taxable by the State.[60] The Arizona Court of Appeals held that the Commission's method did not allow the taxpayer to take the full deduction con-

53. *Id.* at ¶ 17.11. The amount credited is the amount of foreign tax paid or deemed paid, subject to a maximum amount limit computed under the rules of section 904 of the Internal Revenue Code. 7 Fed. Taxes (P-H) ¶ 30,471. *See* 26 U.S.C. § 904 (Supp. IV 1986)(amending 26 U.S.C. § 904 (1982))(limitations on foreign tax credit). The taxpayer may elect to credit the foreign tax against the federal tax liability, or, alternatively, the taxpayer may elect to deduct the foreign tax from before-tax income under section 162 or 164 of the Internal Revenue Code. 7 Fed. Taxes (P-H) ¶ 30,471. *See* 26 U.S.C. §§ 162, 164 (Supp. IV 1986)(amending 26 U.S.C. §§ 162, 164 (1982))(section 162 provides for the deduction of trade or business expenses; section 164 provides for the deduction of specified taxes).

54. FEDERAL INCOME TAXATION, *supra* note 49, at ¶ 17.11. The foreign tax is treated as a down payment on the federal tax liability. *Id.*

55. *See, e.g.*, Anderson, Clayton & Co. v. DeWitt, 20 Ariz. App. 474, —, 513 P.2d 1357, 1358 (1973)(Arizona statutes do not specify a particular formula for computing the deduction for federal taxes paid or accrued).

56. *Id.* at —, 513 P.2d at 1359.

57. 20 Ariz. App. 474, 513 P.2d 1357 (1973).

58. Anderson, Clayton & Co. v. DeWitt, 20 Ariz. App. 474, —, 513 P.2d 1357, 1359 (1973). In *Anderson, Clayton* the taxpayer corporation had income from domestic and foreign sources. *Id.* at —, 513 P.2d at 1358. For federal tax purposes, a foreign tax credit was taken against the federal tax liability of the corporation to avoid double taxation of the foreign-source income. *Id.* at —, 513 P.2d at 1359.

59. *See* ARIZ. REV. STAT. ANN. §§ 43-1022(11), 43-1043(A)(5), 43-961 (Supp. 1987)(allowing a deduction for federal income taxes paid or accrued). Arizona statutes allow corporations a deduction for federal income taxes paid or accrued but exclude from the deduction the portion of federal income tax paid which is allocable to income not taxable by Arizona. *See Anderson, Clayton*, 20 Ariz. App. at —, 513 P.2d at 1358 (discussing ARIZ. REV. STAT. ANN. §§ 43-123(c), 43-126(a)(5)(1956)(current version at ARIZ. REV. STAT. ANN. §§ 43-1022(11), 43-1043(A)(5), 43-961(Supp. 1987))).

60. *Anderson, Clayton*, 20 Ariz. App. at —, 513 P.2d at 1358-59. The Arizona Tax Commission's method of calculating the deduction for federal taxes paid or accrued may be expressed as follows:

templated by statute, which is a deduction for all federal income taxes paid or accrued on income which becomes taxable by Arizona.[61] The court stated that it was unrealistic to allocate the federal income tax actually paid between the fully federally taxed Arizona income and the balance of worldwide income, because the worldwide income included foreign-source income which has, in effect, been excluded from federal taxation.[62] The court approved the taxpayer's method which computed the state deduction for federal taxes paid by applying the ratio of Arizona income to worldwide income to the federal tax liability before the foreign tax credit was taken.[63]

Section 57-38-01.1 of the North Dakota Century Code provides that the federal definition of taxable income is the starting point for computing state taxable income and adjustments.[64] The

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$$\frac{\text{Arizona Income}}{\text{Worldwide Income}} \times \text{Federal Tax After Credit} = \text{Federal Income Tax Deduction}$$

Id. at —, 513 P.2d at 1359. For the filing of the Arizona income tax return, the taxpayer computed the state deduction for federal taxes paid by applying the ratio to the federal liability before the foreign tax credit was taken. *Id.* at —, 513 P.2d at 1359. The taxpayer's method of calculating the deduction may be expressed as follows:

$$\frac{\text{Arizona Income}}{\text{Worldwide Income}} \times \text{Federal Tax Liability Before Credit Taken} = \text{Federal Income Tax Deduction}$$

Id. at —, 513 P.2d at 1359. The Commission issued deficiency assessments against the taxpayer. *Id.* at —, 513 P.2d at 1358. The Commission contended that the taxpayer had taken a larger state federal income tax deduction than allowed by statute. *Id.* at —, 513 P.2d at 1358.

61. *Id.* at —, 513 P.2d at 1359. The Arizona Court of Appeals stated that the Commission's method "generally" complied with the statute. *Id.* at —, 513 P.2d at 1359. However, the court concluded that the Commission's method was not adequate when foreign-source income was involved. *Id.* at —, 513 P.2d at 1359.

62. *Id.* at —, 513 P.2d at 1359. Under the worldwide unitary tax concept, all of the income of a domestic corporation's domestic and foreign subsidiaries is combined. *Text of Report*, *supra* note 21, at 637. The three-factor apportionment formula is then applied to the corporation's combined income to determine the portion of the combined income which is taxable to the state. *Id.*

63. *Id.* at —, 513 P.2d at 1360. For the algebraic expression of the taxpayer's method of calculating the deduction for federal taxes paid, see *supra* note 60. The Arizona Court of Appeals also recognized that the method of applying the ratio of Arizona taxable income to domestic-source taxable income to the federal tax liability after the credit was taken and the method of applying the federal tax rate to the uncontested amount of income taxable by Arizona were alternative methods of calculating the federal tax deduction and appeared to be more consistent with the result required by the Arizona statutes than the Commission's method. *Anderson, Clayton*, 20 Ariz. App. at —, 513 P.2d at 1360-61.

64. Minnesota Mining & Mfg. v. Conrad, 418 N.W.2d 276, 278 (N.D. 1987). *See* N.D. CENT. CODE § 57-38-01.1 (1983). Section 57-38-01.1 of the North Dakota Century Code provides in relevant part:

> It is the intent of the legislative assembly to simplify the state income tax laws and to demonstrate that federal legislation is not necessary to deal with certain interstate tax problems, by adopting the federal definition of taxable income as the starting point for the computation of state income tax by all taxpayers and providing the necessary adjustments thereto to substantially preserve and maintain existing exemptions and deductions.

Id.

statutory provisions which adopted the use of the federal definition of taxable income as the base for determining state taxable income and the state deduction for federal income taxes were enacted long before the North Dakota Tax Commissioner began using the worldwide unitary taxation method.[65] When the Commissioner administratively adopted the worldwide unitary taxation method in 1973, the base for determining state taxable income was expanded from the federal taxable income of the taxpayer to the combined worldwide income of the unitary group.[66] However, the base for the state deduction continued to be federal income tax paid or accrued as provided by statute.[67] The Commissioner did not make a corresponding enlargement of the base for the state deduction.[68]

The North Dakota Supreme Court analyzed the calculation used for the state federal tax deduction for corporations taxed under the worldwide unitary taxation method in *Minnesota Mining & Manufacturing v. Conrad*.[69] The issue was whether the Commissioner's method of applying the worldwide formula apportionment factor to the federal tax liability after the foreign tax credit had been taken was proper.[70]

3M contended that once the Commissioner modified the stat-

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65. *Minnesota Mining & Mfg.*, 418 N.W.2d at 280. *See* Income Tax Law Revision and Simplification Act, ch. 446, 1967 N.D. Laws 1039, 1042 (codified at N.D. CENT. CODE § 57-38-01.3 (Supp. 1987))(providing for adjustments to federal taxable income of corporations to be made in computing North Dakota tax liability); Definition of "Taxable Income" Act, ch. 444, 1967 N.D. Laws 1037 (codified at N.D. CENT. CODE § 57-38-01(8)(Supp. 1987)). Subsection 8 of section 57-38-01 of the North Dakota Century Code provides in relevant part:

> "Taxable Income" in the case of . . . corporations shall mean the taxable income as computed for . . . [a] corporation for federal income tax purposes under the United States Internal Revenue Code of 1954, as amended, plus or minus such adjustments as may be provided by this act and chapter or other provisions of law.

N.D. CENT. CODE § 57-38-01(8)(Supp. 1987). For the relevant text of subsection 1(c) of section 57-38-01.3 of the North Dakota Century Code, see *supra* note 45.

66. *Minnesota Mining & Mfg.*, 418 N.W.2d at 280. Under the worldwide unitary taxation method, the state does not limit the apportionable tax base of a unitary business to federal taxable income. *Id.* at 277. Instead, the apportionable tax base consists of the combined worldwide income of the unitary business and includes foreign-source income which is essentially untaxed by the federal government because the federal tax burden is removed by the foreign tax credit. *Id.* at 277, 279.

67. *Id.* at 280. *See* N.D. CENT. CODE § 57-38-01.3(1)(c)(Supp. 1987)(providing for deduction for federal income taxes paid or accrued). For the relevant text of subsection 1(c) of section 57-38-01.3 of the North Dakota Century Code, see *supra* note 45.

68. *Minnesota Mining & Mfg.*, 418 N.W.2d at 280.

69. 418 N.W.2d 276, 278 (N.D. 1987).

70. Minnesota Mining & Mfg. v. Conrad, 418 N.W.2d 276, 276, 278 (N.D. 1987). North Dakota's state federal tax deduction is codified at subsection 1(c) of section 57-38-01.3 of the North Dakota Century Code. *See* N.D. CENT. CODE § 57-38-01.3(1)(c)(Supp. 1987). For the relevant text of subsection 1(c) of section 57-38-01.3 of the North Dakota Century Code, see *supra* note 45.

utory base for state taxable income, a corresponding modification of the base for the state deduction must be made in order to allow the taxpayer to deduct the full amount of federal taxes paid or accrued on income which has become part of North Dakota taxable income.[71] The North Dakota Supreme Court recognized from the language of section 57-38-01.1 of the North Dakota Century Code, which adopts the federal definition of taxable income, that the legislature intended that determinations of state taxable income and state deductions should be premised on the same base — federal taxable income.[72] The court stated that enlarging the taxable income base by employing worldwide unitary taxation without enlarging the state deduction base deprived taxpayers with foreign-source income of the full deduction for federal taxes paid.[73] The court was persuaded that the taxpayer is deprived of the full deduction because the federal tax actually paid is allocable only to the domestic-source income since the federal tax levied against the foreign-source income has been removed by the foreign tax credit.[74] Thus, the court concluded that the Commissioner's method discriminated against corporations which earned foreign-source income.[75]

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71. *Minnesota Mining & Mfg.*, 418 N.W.2d at 278. 3M suggested that the appropriate base for the state deduction would be the federal income tax liability prior to reduction by the foreign tax credit. *Id.* at 280.

72. *Id. See* N.D. CENT. CODE § 57-38-01.1 (1983)(declaring legislative intent to adopt the federal definition of taxable income). For the relevant text of section 57-38-01.1 of the North Dakota Century Code, see *supra* note 64.

73. *Minnesota Mining & Mfg.*, 418 N.W.2d at 280. The North Dakota Supreme Court stated that the Commissioner's method of computing the state deduction apportioned the federal income tax paid by 3M on domestic-source income on a worldwide basis. *Id.* at 278.

74. *Id.* at 279 (quoting Anderson, Clayton & Co. v. DeWitt, 20 Ariz. App. 474, —, 513 P.2d 1357, 1359-60 (1973)).

75. *Id.* at 279-80. The North Dakota Supreme Court stated that it did not believe that the legislature intended to make the deduction dependent on whether the source of the income was domestic or foreign. *Id.* at 280. The court used an example to illustrate the discrimination:

> Assuming that a corporate taxpayer, a United States parent company, had North Dakota taxable income of $2,000 before the federal tax deduction, federal taxable income from domestic sources of $1,000,000, and had unitary foreign subsidiaries which generated $1,000,000 of foreign source income, the combined worldwide taxable income of the unitary group would be $2,000,000. Assuming that no foreign dividends were paid to the parent corporation, that no foreign tax credit was taken, and that the federal income tax rate was 46 percent, the corporation's federal income tax would be $460,000 (46% X $1,000,000). The worldwide apportionment factor for North Dakota being 0.001 ($2,000/$2,000,000), the Commissioner's method would allow a North Dakota federal income tax deduction of $460 (0.001 x $460,000). Assuming further that a second corporate taxpayer had the same amount of income generated by its various divisions, except that all of the income was generated in the United States, the federal taxable income would be $2,000,000, rather than $1,000,000 as in the previous example. The second corporation's federal income tax would be $920,000 (46% X $2,000,000) and the apportionment factor for North Dakota would remain 0.001 ($2,000/$2,000,000). However, the federal income tax

3M proposed an alternative method of calculating the state deduction for federal taxes which, it asserted, would treat corporations with foreign and domestic-source income equally.[76] 3M proposed that the worldwide apportionment factor be applied to the federal income tax liability before it is reduced by the foreign tax credit.[77] The Commissioner asserted that 3M's proposed method violated subsection 1(d) of section 57-38-01.3 of the North Dakota Century Code which prohibits deduction of taxes paid to foreign countries, because under 3M's proposed method part of the state deduction is derived from the tax paid to foreign countries.[78] The North Dakota Supreme Court concluded that 3M's method would not allow a deduction for foreign taxes paid because 3M's method merely determined the portion of federal tax actually paid which is allocable to the State where the relationship of federal tax paid and total income has been affected by the presence of foreign-source income and its related foreign tax credit.[79]

Amoco Corporation, as amicus curiae, also proposed an alter-

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deduction would double under the Commissioner's method to $920 (0.001 X $920,000).

Id. at 279-80. In the example, the amount of the deduction allowed is determined solely by the income's source. *Id.* at 280.

76. *Id.* The method proposed by 3M was similar to the method approved by the Arizona Court of Appeals in *Anderson, Clayton*. *Id.* *See* Anderson, Clayton & Co. v. DeWitt, 20 Ariz. App. 474, —, 513 P.2d 1357, 1360 (1973). In *Anderson, Clayton* the court approved the taxpayer's method which computed the state deduction for federal income taxes paid by applying the ratio of Arizona income to worldwide income to the federal tax liability before the foreign tax credit was taken. *Id.* at —, 513 P.2d at 1359, 1360.

77. *Minnesota Mining & Mfg.*, 418 N.W.2d at 280. The method proposed by 3M for computing the state deduction for federal income taxes may be expressed as follows:

$$\frac{\text{North Dakota Taxable Income}}{\text{Worldwide Income}} \times \text{Federal Income Tax Liability Prior To Reduction By Foreign Tax Credit} = \text{State Deduction}$$

Id.

78. *Id.* *See* N.D. CENT. CODE § 57-38-01.3(1)(d)(1983 & Supp. 1987). Subsection 1(d) of section 57-38-01.3 of the North Dakota Century Code provides:

> 1. The taxable income of a corporation as computed pursuant to the provisions of the Internal Revenue Code of 1954, as amended, shall be:
>
> . . .
>
> d. Increased by the amount of any income taxes, including income taxes of foreign countries, or franchise or privilege taxes measured by income, to the extent that such taxes were deducted to determine federal taxable income.

Id.

79. *Minnesota Mining & Mfg.*, 418 N.W.2d at 280-81 (quoting Anderson, Clayton & Co. v. DeWitt, 20 Ariz. App. 474, —, 513 P.2d 1357, 1361 (1973)). The North Dakota Supreme Court noted that 3M did not elect to "deduct" foreign taxes, but rather elected to use the foreign tax "credit." *Id.* at 281. Therefore, 3M did not take a state "deduction" for foreign taxes in violation of subsection 1(d) of section 57-38-01.3 of the North Dakota Century Code. *Id.* at 280-81. *See* N.D. CENT. CODE § 57-38-01.3(1)(d)(1983 & Supp. 1987)(deduction not allowed for taxes paid to foreign countries). For the text of subsection 1(d) of section 57-38-01.3 of the North Dakota Century Code, see *supra* note 78.

native method of calculating the state deduction.[80] Under this alternative, North Dakota taxable income is divided by the corporation's total domestic-source taxable income.[81] That ratio is multiplied by the federal income tax actually paid.[82] This alternative method completely removes foreign-source income from the formula so that the federal tax actually paid is matched to the income on which it was paid.[83] The Commissioner asserted that this method violated chapter 57-38.1 of the North Dakota Century Code because it altered the worldwide apportionment formula.[84] However, the North Dakota Supreme Court rejected the Commissioner's objection, stating that no statutory authority required use of the worldwide apportionment factors in computing the state deduction for federal taxes paid or accrued.[85]

The North Dakota Supreme Court declined to direct the Commissioner to use a specific formula for computing the state deduction for federal taxes.[86] The court recognized that several methods might be appropriate, but held that the Commissioner's current method of computing the state deduction for federal taxes paid was improper.[87]

Multinational corporations doing business in North Dakota rely on the state federal income tax deduction to ameliorate the harshness of worldwide unitary taxation.[88] Prior to *Minnesota Mining & Manufacturing*, the uncertainty regarding the proper calculation of the state deduction was of concern to corporations with foreign-source income.[89] In *Minnesota Mining & Manufac-*

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80. *Minnesota Mining & Mfg.*, 418 N.W.2d at 281. *See* Brief for Amoco Corporation as amicus curiae at 6, Minnesota Mining & Mfg. v. Conrad, 418 N.W.2d 276 (N.D. 1987)(No. 11-391).

81. *Minnesota Mining & Mfg.*, 418 N.W.2d at 281.

82. *Id.* The method proposed by Amoco Corporation as amicus curiae for calculating the state deduction for federal taxes may be expressed as follows:

$$\frac{\text{North Dakota Taxable Income}}{\text{Domestic-Source Taxable Income}} \times \text{Federal Income Tax Actually Paid} = \text{State Deduction}$$

Id.

83. *Id.* (quoting Anderson, Clayton & Co. v. DeWitt, 20 Ariz. App. 474, —, 513 P.2d 1357, 1360-61 (1973)).

84. *Id.*. *See* N.D. CENT. CODE ch. 57-38.1 (1983)(Uniform Division of Income for Tax Purposes Act).

85. *Minnesota Mining & Mfg.*, 418 N.W.2d at 281.

86. *Id.*

87. *Id.*

88. *See Minutes of the Taxation Committee*, N.D. LEGIS. COUNCIL, Jan. 14, 1986, at 8 (comments of Mr. Robert Kessel, North Dakota Tax Department)(federal income tax deduction is significant locational factor for businesses).

89. *See* Brief for Amoco Corporation as amicus curiae at 18, Minnesota Mining & Mfg. v. Conrad, 418 N.W.2d 276 (N.D. 1987)(No. 11-391)(Amoco Corporation is a multinational

turing the North Dakota Supreme Court held that the Commissioner's method of applying the worldwide formula apportionment factor to the federal tax liability after the foreign tax credit had been taken did not allow taxpayers with foreign-source income the full deduction for federal taxes paid as contemplated by the statute.[90] Thus, the court acknowledged that taxpayer relief in the computation of the federal tax deduction was necessary.[91] Although the court did not specify what method should be used to calculate the federal tax deduction, the court suggested that 1) the method of applying the worldwide formula apportionment factor to the federal tax liability before the foreign tax credit was taken, and 2) the method of applying the ratio of North Dakota taxable income to domestic-source income to the federal tax liability after the foreign tax credit was taken, were acceptable solutions to the computation problem.[92] Since *Minnesota Mining & Manufacturing* the Commissioner has proposed rules which would provide an elective method of computing the federal tax deduction.[93] The proposed method attempts to match the amount of the foreign tax credit to the amount of income

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corporation which has protested Commissioner's assessments which resulted from disagreement over the proper method of calculation of the deduction for federal taxes paid or accrued).

90. *Minnesota Mining & Mfg.*, 418 N.W.2d at 278, 280. *See* N.D. CENT. CODE § 57-38-01.3(1)(c)(Supp. 1987)(providing for deduction for federal income taxes paid or accrued). For the relevant text of subsection 1(c) of section 57-38-01.3 of the North Dakota Century Code, see *supra* note 45.

91. *Minnesota Mining & Mfg.*, 418 N.W.2d at 281.

92. *Id.* at 280-81. The North Dakota Supreme Court stated that there may be other methods which would also provide a solution to the federal tax deduction computation problem. *Id.* at 281. *See, e.g.*, Anderson, Clayton & Co. v. DeWitt, 20 Ariz. App. 474, —, 513 P.2d 1357, 1361 (1973)(suggestion made to apply the federal tax rate to the amount of income taxable by Arizona).

93. *See* N.D. ADMIN. CODE ch. 81-03-05.4 (1989)(proposed rules) (providing an elective method of computing the federal income tax deduction). The elective computation method will be available to any taxpayer filing as a member of a worldwide unitary group, provided that neither North Dakota taxable income nor income relating to federal income tax paid is less than zero. N.D. ADMIN. CODE § 81-03-05.4-02 (1989)(proposed rules). The proposed method of computation may be expressed as follows:

1. Consolidated federal income paid
2. Separate company pro forma federal income tax liability for all of the profit companies that are on the consolidated return and included in the unitary group
3. Separate company pro forma federal income tax liability for all of the profit companies that are included on the consolidated return
4. Line 2 divided by line 3
5. Unitary companies' share of consolidated federal income tax paid (line 1 multiplied by line 4)
6. Federal taxable income of the unitary companies which are included on the consolidated return
7. Amount of federal taxable income reported on line 6 that is not taxable in North Dakota
8. Federal taxable income attributable to North Dakota (line 6 minus line 7)

apportioned to North Dakota.[94] Thus, the significance of *Minnesota Mining & Manufacturing* is that it acknowledged the need for taxpayer relief and has prompted the Commissioner to reevaluate the method of computing the federal tax deduction when worldwide unitary taxation is employed.[95]

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9. Line 8 divided by line 6
10. Consolidated federal income tax paid on income which is taxable in North Dakota (line 5 multiplied by line 9)
11. Federal income tax ratio
12. Federal income tax deduction (line 10 multiplied by line 11)

N.D. ADMIN. CODE § 81-03-05.4-03 (1989)(proposed rules). For the purposes of this computation several special definitions are provided in section 81-03-05.4-01 of the proposed rules. *See* N.D. ADMIN. CODE § 81-03-05.4-01 (1989)(proposed rules) (providing definitions applicable only in computing the federal income tax deduction). Section 81-03-05.4-01 of the proposed rules provides in part:

4. "Federal income tax ratio" means North Dakota taxable income divided by income relating to federal income tax paid.
5. "Income relating to federal income tax paid" means total income less income relating to foreign tax credit.
6. "Income relating to foreign tax credit" means income directly attributable to either the foreign tax credit or the possessions credit.
7. "North Dakota taxable income" means income which has been apportioned to North Dakota pursuant to North Dakota Century Code chapters 57-38, 57-38.1, and 57-59; provided, however, that no adjustment should be made for the federal income tax deduction.

. . .

9. "Total income" means the federal taxable income of those entities in the unitary group that are required to file a federal income tax return during the period in question, plus or minus the adjustments provided for in North Dakota Century Code section 57-38-01.3, with the exception of subdivisions c and f of subsection 1 of North Dakota Century Code section 57-38-01.3.

N.D. ADMIN. CODE § 81-03-05.4-01(4)-(7), (9) (1989)(proposed rules). "Income relating to foreign tax credit" is taken directly from federal form 1118. Letter from Debra McMartin, Office of North Dakota State Tax Commissioner, to Linda Bata (Feb. 6, 1989)(discussing the state deduction for federal income tax paid).

The proposed rule adds a special provision for taxpayers if the members of the unitary group have filed more than one federal income tax return:

> A taxpayer must compute its federal income tax deduction in the following manner if the members of the unitary group filed more than one federal income tax return:
>
> 1. Steps 1 through 10 in 81-03-05.4-03 must be repeated for each federal income tax return filed by the members of the worldwide group.
> 2. The sum of subsection 1 hereof must be multiplied by the federal income tax ratio.

N.D. ADMIN. CODE § 81-03-05.4-04 (1989)(proposed rules).

94. *See* Telephone interview with Debra McMartin, Office of North Dakota State Tax Commissioner (March 7, 1989) ("Because income sourcing of any kind is theoretically impossible the only way to grant relief is by attempting to match the amount of the foreign tax credits to the amount of income apportioned to North Dakota. In order to facilitate this matching we've chosen to use the number from federal form 1118 as a safe harbor definition of 'income relating to foreign tax credit'.").

95. *Minnesota Mining & Mfg.*, 418 N.W.2d at 281. *See* N.D. ADMIN. CODE ch. 81-03-05.4 (1989)(proposed rules) (providing an elective method of computing the federal income tax deduction).