BEFORE THE HEARING OFFICER
OF THE TAXATION AND REVENUE DEPARTMENT
OF THE STATE OF NEW MEXICO

IN THE MATTER OF THE PROTEST OF
XEROX CORPORATION, FEIN 16-0468020, **No. 03-22**
CORPORATE INCOME TAX ASSESSMENTS
FOR TAX YEARS 1995, 1996, and 1998,
ISSUED UNDER LETTER ID L0821166080

DECISION AND ORDER

A formal hearing on the above-referenced protest was held August 12, 2003, before Margaret B. Alcock, Hearing Officer. The Taxation and Revenue Department was represented by Bruce J. Fort, Special Assistant Attorney General. Xerox Corporation was represented by Mark Sheivachman, its Director of Tax Planning. The final brief on the legal issues raised by the parties was received by the Hearing Officer on November 12, 2003, at which time the matter was submitted for decision. Based on the evidence and arguments presented, IT IS DECIDED AND ORDERED AS FOLLOWS:

FINDINGS OF FACT

1. Xerox is a New York corporation with its worldwide business headquarters located at 800 Long Ridge Road, Stamford, Connecticut.

2. Xerox's worldwide imaging business, which is comprised of xerographic equipment and printing sales, rentals, and service, is managed from its Stamford, Connecticut headquarters. Neither Xerox nor any of its combined subsidiaries has any corporate management resident in New Mexico.

3. In June 2002, the Department completed a field audit of Xerox's reporting and payment of New Mexico corporate income tax for tax years 1995, 1996, and 1998.

4. For each of the audit years in question, Xerox filed a combined return with its unitary subsidiaries.

5. During the audit years, Xerox reported the following "special deductions" on its New Mexico returns:

1995: $552,720,255
1996: $ 48,569,698
1998: $ 45,269,338

6. Upon audit, the Department's auditor determined that in calculating New Mexico taxable income, Xerox had deducted its foreign dividends and Subpart F income, as well as the foreign gross-up required under Section 78 of the Internal Revenue Code.

7. The Department disallowed Xerox's deduction of foreign dividends and Subpart F income, but allowed the exclusion of the Section 78 gross-up.

8. None of Xerox's Subpart F income was related to boycott income.

9. In determining Xerox's corporate income tax liability for tax years 1995, 1996, and 1998, the Department included the dividends and Subpart F income Xerox received from its foreign subsidiaries as apportionable business income and then allowed factor relief using what is commonly referred to as the "Detroit formula." *See* Department Exhibit 2.

10. Xerox's foreign-source income payors during the audit years were all unitary with Xerox's domestic unitary operations.

11. Included in the group of foreign source income payors was Bessemer Insurance Company, a captive Bermuda insurance company.

12. Xerox did not include in its unitary group any domestic property and casualty insurance companies owned by its 100% indirectly owned subsidiary Talegen Holdings, Inc. ("Talegen") and Ridge Reinsurance Limited ("Ridge Reinsurance"), because Talegen and Ridge Reinsurance were not unitary with Xerox. The nonunitary nature of Talegen and Ridge Reinsurance was not challenged on audit by the Department.

13. Talegen and Ridge Reinsurance did not have nexus in New Mexico during the audit years.

14. Xerox owned 100% of Xerox Financial Services, Inc. ("XFSI"), a domestic holding company that was included in the New Mexico combined return. XFSI owned 100% of Talegen.

15. During the audit years, insurance was a significant portion of Xerox's business.

16. On November 26, 2002, the Department issued a Notice of Assessment of Taxes under Letter ID L0821166080, assessing Xerox for the following amounts:

Tax Year	*Tax Principal*	*Interest*	*Total*
1995	$27,644.00	$27,723.06	$55,367.06
1996	$36,785.00	$31,400.41	$68,185.41
1998	$ 8,671.00	$ 4,802.95	$13,473.95
			$137,026.42

17. On December 23, 2003, Xerox filed a written protest to the Department's assessment.

ISSUE TO BE DECIDED

The issue to be decided is whether New Mexico's corporate income tax scheme, which taxes a combined filer on dividends and Subpart F income received from foreign affiliates that are part of the taxpayer's unitary group, but excludes from tax income received from domestic affiliates that are not part of the unitary group, impermissibly discriminates against foreign commerce.

Xerox maintains that the United States Supreme Court's decision in *Kraft General Foods, Inc. v. Iowa Department of Revenue & Finance*, 505 U.S. 71 (1992) and the New Mexico Supreme Court's decision in *Conoco, Inc. v. New Mexico Taxation and Revenue Department*, 122 N.M. 736. 931 P.2d 730 (1996), *cert. denied*, 521 U.S. 1112 (1997) mandate a finding of discrimination. It is the Department's position that the holdings of *Kraft* and *Conoco* are limited to separate entity filers and have no application to corporations filing combined returns. In addition, the Department argues that a finding of discrimination cannot be based on a comparison of the tax treatment of income received from unitary affiliates with the tax treatment of income received from nonunitary affiliates.

DISCUSSION

In addressing the arguments raised by the parties, this decision will first set out the framework of the New Mexico income tax scheme challenged by Xerox, followed by a discussion of the appropriate comparison class to be used in determining the existence of discrimination under this scheme, and an examination of how New Mexico's tax applies within this comparison class.

I. **New Mexico's Corporate Income Tax Scheme**.

A. Constitutional Limitations and Formulary Apportionment. Both the Due Process Clause and the Commerce Clause of the United States Constitution prohibit a state from imposing an income-based tax on value earned outside of its borders. *ASARCO Inc. v. Idaho State Tax Commission*, 458 U.S. 307 (1982). When dealing with income that has been earned by a multistate or multinational taxpayer, most states, including New Mexico, use the guidelines set out in the Uniform Division of Income for Tax Purposes Act ("UDITPA") to allocate and apportion the taxpayer's income. *See*, NMSA 1978, §§ 7-4-1, *et seq*. Under UDITPA, a state must first distinguish between nonbusiness income, which is allocated to a single state (usually the state of the taxpayer's commercial domicile), and business income, which is apportioned among all of the states in which the taxpayer has nexus. Business income is apportioned according to a three-factor formula based on the amount of a corporation's property, payroll, and sales within a state compared with the amount of its property, payroll, and sales everywhere. A percentage is calculated for each of the three factors, and the average of the three is then applied against the corporation's total income to determine the amount the state will tax. NMSA 1978, §§ 7-4-10 through 7-4-18.

Formulary apportionment is based on the unitary business concept, which treats a commonly controlled group of affiliated corporations forming part of an integrated business enterprise as one entity, without regard to whether the enterprise crosses geographic boundaries or conducts its business through separate corporate entities. Once the scope of a unitary enterprise is defined, the taxable income of all of the entities making up the unitary group is determined, and the apportionment formula is applied to approximate the business income that is reasonably related to the group's activities within the taxing jurisdiction. Through a long line

of cases, the United States Supreme Court has upheld the states' use of the unitary business principle. *See, e.g.*, *Container Corporation of America v. Franchise Tax Board*, 463 U.S. 159 (1983); *Mobil Oil Corp. v. Commissioner of Taxes of Vermont*, 445 U.S. 425 (1980); *Hans Rees' Sons, Inc. v. North Carolina ex rel. Maxwell*, 283 U.S. 123 (1931); *Bass, Ratcliff & Gretton, Ltd. v. State Tax Commission*, 266 U.S. 271 (1924). The Court has been equally consistent in holding that a state may not include in its tax base the income of nonunitary members of a taxpayer's corporate group whose activities are unrelated to the state or to the common business enterprise of the unitary group. *See, e.g., Allied-Signal, Inc. v. Director, Division of Taxation*, 504 U.S. 768 (1992); *F. W. Woolworth Co. v. Taxation and Revenue Department of New Mexico*, 458 U.S. 354 (1982); *ASARCO, supra*.

B. Federal Returns as the Basis for State Reporting. Like most states, New Mexico uses federal taxable income as the starting point for determining New Mexico "base income" subject to tax. NMSA 1978, § 7-2A-2 (C). Section 243 of the Internal Revenue Code ("IRC") allows corporations to deduct dividends received from domestic subsidiaries in calculating federal taxable income. The purpose of this dividends-received deduction is to prevent double taxation of the same earnings—once as income of the subsidiary, which is included on the federal return, and a second time in the form of dividends paid by the subsidiary to its parent corporation. In contrast, the income of a U.S. corporation's foreign subsidiaries is not included in the federal tax base, and no federal deduction is allowed for dividends paid by a foreign subsidiary to its parent company. As a result of using this federal tax scheme as the starting point for its own calculations, New Mexico excludes domestic dividends but includes foreign dividends in the state tax base.

C. Application of New Mexico's Tax Scheme to Separate Entity Filers. For tax years 1995 forward, New Mexico has offered corporations a choice of three filing methods to report income to New Mexico (*see*, NMSA 1978, §§ 7-2A-8, 7-2A-8.3, and 7-2A-8.4): separate corporate entity; combination of unitary domestic corporations; and federal consolidated group. The separate corporate entity filing method allows each corporation doing business in the state to file a separate tax return, even when the corporation is unitary with a larger group of affiliated corporations. Using this method, only the income of the individual corporation is reported to New Mexico; the income of its unitary affiliates is not part of the tax base. In these circumstances, New Mexico's reliance on federal taxable income as the starting point for calculating state tax results in more favorable treatment of domestic income than foreign income, *i.e*., while neither the earnings nor the dividends of domestic subsidiaries are included in the state tax base, the dividends of unitary foreign subsidiaries are subject to tax.

In *Conoco, Inc. v. New Mexico Taxation and Revenue Department*, 1997-NMSC-005, 122 N.M. 736, 931 P.2d 730, *cert*. *denied*, 521 U.S. 1112 (1997), the New Mexico Supreme Court concluded that the favorable treatment accorded to the domestic dividends of separate entity filers resulted in unconstitutional discrimination. Relying on the United States Supreme Court's decision in *Kraft General Foods, Inc. v. Iowa Department of Revenue & Finance*, 505 U.S. 71 (1992), which struck down a similar tax scheme in Iowa, the New Mexico court held that "[t]axation of dividends from foreign subsidiaries under the separate corporate entity method violates the Foreign Commerce Clause of the United States Constitution." 1997-NMSC-005, ¶ 26. The court further held that New Mexico's application of factor relief under

the so-called "Detroit formula" was not a sufficient remedy since it reduced, but did not completely eliminate, the discriminatory treatment between foreign and domestic dividends.

D. Application of New Mexico's Tax Scheme to Domestic Combined Filers. Under New Mexico's combination of unitary domestic corporations reporting method, the combined income of all domestic corporations (and foreign corporations engaged in trade or business in the United States) that are members of an affiliated group engaged in a unitary business is reported on the New Mexico return. UDITPA's three-factor formula is then applied to apportion this income between New Mexico and the other states in which the group does business. As a result of using federal taxable income to determine New Mexico base income, intercompany transactions among the domestic members of the unitary group are eliminated in determining taxable income. Foreign members of the unitary group that do not engage in business in the United States are excluded from the reporting group, but income (including dividends) paid by foreign subsidiaries to their U.S. parent is included in the state tax base.

Following the Supreme Court's decision in *Kraft, supra*, a number of taxpayers challenged the inclusion of foreign-source income in the calculation of state taxes using domestic or "water's edge" combined reporting methods.[1] These taxpayers argued that under *Kraft*, the exclusion of dividends received from domestic members of the unitary group mandated exclusion of dividends received from foreign members of the group. In *In re Appeal of Morton Thiokol*, 864 P.2d 1175, 1186 (Kan. 1993), the state of Kansas rejected this

[1] At one time, a number of states calculated taxable income using worldwide combined reporting, which includes both foreign and domestic subsidiaries in the unitary reporting group. Most states now allow corporations to elect a method under which the total combined income to be apportioned is limited to the "water's edge" or geographic boundaries of the United States, even when the scope of the unitary business

argument, finding that the combined reporting method eliminated any facial discrimination under the Foreign Commerce Clause because the full measure of domestic subsidiaries' earnings is included in the apportionable tax base while the inclusion of foreign earnings is limited to the amount of the dividend paid:

> Clearly, *Kraft* does not hold that the taxation of foreign dividends by a combination method is facially unconstitutional. Revenue contends that the aggregate tax imposed by Kansas on a unitary business with a domestic subsidiary would not be less burdensome than that imposed by Kansas on a unitary business with a foreign subsidiary because the income of the domestic subsidiary would be combined, apportioned, and taxed while only the dividend of the foreign subsidiary would be taxed. Allowing a deduction for the domestic dividend avoids double taxation. It is the use of the domestic combination method which distinguishes the Kansas and the Iowa tax schemes.... In a combined filing state, such as Kansas, the hypothetical parent's tax base includes the combined federal taxable income of its combined domestic subsidiaries as well as dividends from foreign subsidiaries. We conclude there is no showing that this method is discriminatory under the holding in *Kraft*; therefore, it is not violative of the federal Constitution's Commerce Clause (Art. I, § 8, cl. 3).

The same conclusion was reached by the Maine Supreme Court in *E. I. Du Pont de Nemours & Co. v. State Tax Assessor*, 675 A.2d 82, 88 (Me. 1996), which upheld the constitutionality of Maine's water's edge combined reporting method against a challenge based on the *Kraft* decision:

> Although the dividends paid to parent corporations with domestic subsidiaries are not taxed, the apportioned income of the domestic subsidiaries is subject to tax. Because the income of the unitary domestic affiliates is included, apportioned, and ultimately directly taxed by Maine as part of the parent company's income, the inclusion of dividends paid by foreign subsidiaries does not constitute the kind of facial discrimination against foreign commerce that caused the Supreme Court to invalidate Iowa's tax scheme in *Kraft*.

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crosses national borders. *See, Barclays Bank PLC v. Franchise Tax Board of California,* 512 U.S. 298, 306 (1994).

See also, *Bernard Egan & Co. v. Florida Department of Revenue*, 769 So. 2d 1060 (Fla. 2000), *cert. denied*, 534 U.S. 995 (2001).

New Mexico has not addressed the application of *Kraft* to taxpayers filing under the combination of unitary domestic corporations method. The New Mexico Supreme Court's decision in *Conoco, supra*, is limited to separate entity filers. While the court expressed reservations on the issue, it was careful to distinguish the facts of other state cases upholding the combined reporting method from the facts presented in *Conoco*:

> Like the Supreme Court of Kansas in *Thiokol*, the *Du Pont* Court was able to distinguish the challenged tax scheme from Iowa's tax scheme because Maine included a portion of the domestic subsidiaries' income in the tax base of the parent. However, this "taxing symmetry" is not present in the New Mexico tax scheme.

1997-NMSC-005, ¶ 12. The supreme court ultimately concluded that New Mexico's "[t]axation of dividends from foreign subsidiaries *under the separate corporate entity method* violated the Foreign Commerce Clause…." (emphasis added). *Id*, ¶ 26.

II. Application of New Mexico's Tax Scheme to Xerox.

A. Xerox's 1995, 1996, and 1998 Corporate Income Tax Returns. During the tax years at issue, Xerox filed a combined return with its unitary subsidiaries. Xerox excluded two of its domestic subsidiaries, Talegen Holdings, Inc. and Ridge Reinsurance Limited, from the combined return because those subsidiaries were not unitary with Xerox. Xerox also excluded income from its unitary foreign subsidiaries by taking "special deductions" for foreign dividends and Subpart F income on its New Mexico returns. On audit, the Department agreed that Talegen and Ridge Reinsurance were not unitary with Xerox and that the income and dividends from these entities were properly excluded from the state tax base. The Department

disallowed Xerox's deduction of dividends and Subpart F income from its foreign subsidiaries, all of which were unitary with Xerox's worldwide imaging business. The Department did allow Xerox factor relief for its foreign-source income pursuant to NMSA 1978, § 7-4-19(C).

In challenging New Mexico's taxation of income received from its foreign subsidiaries, Xerox raises an issue of discrimination that has not been addressed in either the *Kraft* line of cases dealing with separate entity filers or the *Morton Thiokol* line of cases dealing with domestic combined filers. While those cases addressed the disparate treatment of dividends from domestic and foreign subsidiaries that were unitary with the U.S. parent subject to tax, Xerox's protest challenges the disparate treatment of dividends from unitary foreign subsidiaries when compared with the treatment of dividends from nonunitary domestic subsidiaries.

B. **New Mexico's Taxation of Xerox's Foreign-Source Income Conforms to the Unitary Business Principle Approved by the United States Supreme Court**. As discussed in Part I(A), above, the unitary business principle used to calculate the amount of state tax due from multijurisdictional taxpayers has been sanctioned by a long line of United States Supreme Court decisions. In *Mobil Oil, supra*, 445 US at 439, the Court characterized this principle as the "linchpin of apportionability in the field of state income taxation." In that case, the Court held that the Commerce Clause does not bar a state from including foreign-source dividends in a corporate taxpayer's apportionable tax base, as long as the dividends are received from a corporation that is unitary with the taxpayer. In *NCR Corp. v. Taxation and Revenue Department*, 115 N.M. 612, 856 P.2d 982 (Ct. App.), *cert. denied*, 115 N.M. 677, 857 P2d 788, *cert. denied*, 512 U.S. 1245 (1994), the New Mexico Court of Appeals reached a similar

conclusion, rejecting a claim that New Mexico's taxation of a corporate taxpayer's foreign-source income violates the Due Process and Foreign Commerce Clauses of the U.S. Constitution. As stated by the court:

> The income the Department seeks to tax is derived from NCR's subsidiaries that operate together as a fully-integrated unitary business. *Cf. Kewanee Indus., Inc. v. Reese*, 114 N.M. 784, 788 n. 5, 845 P.2d 1238, 1242 n. 5 (1993). The tax in question is not a tax on any of NCR's foreign subsidiaries; instead, the tax falls upon an apportioned share of NCR's income which it receives in the form of royalties, interest, and dividends from its unitary foreign subsidiaries. The fact that the tax is apportioned in part upon NCR's foreign income sources does not constitute a bar to state taxation. *See Mobil Oil Corp*., 445 U.S. at 439-40, 100 S. Ct. at 1232-33.

115 N.M. at 617, 856 P.2d at 987.

In this case, New Mexico's taxation of Xerox's 1995, 1996, and 1998 income followed the unitary business principle. Here, as in *NCR*, the Department required Xerox to include in New Mexico base income the dividends and Subpart F income that Xerox received from its unitary foreign subsidiaries. Under the combined filing method (and in contrast to the separate filing method discussed in *Conoco*), Xerox was also required to include on its return the income of any domestic subsidiaries that were part of Xerox's unitary business. UDITPA's three-factor formula was then applied to apportion the income of Xerox's unitary business operations between New Mexico and the other jurisdictions in which Xerox does business.

An issue of continuing dispute in the area of corporate income taxation is whether a state that includes foreign dividends in its tax base is also required to provide factor representation for the activities of the foreign subsidiary producing that income. The United

States Supreme Court has not yet addressed this issue[2], while state courts are split in their decisions. *Compare, e.g., Tambrands, Inc. v. State tax Assessor*, 595 A.2d 1039 (Me. 1991) and *E. I. Du Pont de Nemours & Co. v. State Tax Assessor*, 675 A.2d 82, 88 (Me. 1996) (holding that factor relief is required when foreign dividends are included in the tax base); with *NCR Corp. v. Commissioner of Revenu*e, 438 N.W.2d 86 (Minn.), *cert. denied*, 493 U.S. 848 (1989); and *NCR Corp. v. South Carolina Tax Commission*, 402 S.E.2d 666 (S.C. 1991) (holding that factor relief is not required).

In *NCR Corp. v. Taxation and Revenue Department*, 115 N.M. 612, 856 P.2d 982 (Ct. App.), *cert. denied*, 115 N.M. 677, 857 P2d 788, *cert. denied*, 512 U.S. 1245 (1994), the New Mexico Court of Appeals held that New Mexico was not required to include the property, payroll, and sales of NCR's foreign subsidiaries in the denominator of the appor-tionment factor applied to the taxable portion of NCR's foreign income. Nonetheless, in determining Xerox's state tax liability in the present case, the Department did provide factor relief under the so-called "Detroit formula," which includes in the denominators of the parent corporation's property, payroll, and sales factors a percentage of the property, payroll, and sales of the dividend-generating foreign subsidiary. *See*, Jerome R. Hellerstein & Walter Hellerstein, **State Taxation**, Vol. I, ¶ 9.15(2)(a), n.487 (3d ed. 2000) for a more complete discussion of the Detroit formula.

The United States Supreme Court has held that the Constitution imposes no single apportionment formula on the states. *Wisconsin v. J.C. Penney*, 311 U.S. 435, 445 (1940). *See*

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[2] While Justice Steven's dissent in *Mobil Oil, supra*, concluded that factor representation is required in these circumstances, the majority declined to rule on the issue, finding that it had not been properly raised in the

also, *NCR, supra*, 115 N.M. at 616, 856 P.2d at 986. A taxpayer challenging a state's apportionment formula has the burden of showing by clear and cogent evidence that a state tax results in the taxation of extraterritorial values. *Container, supra*, 463 U.S. at 161. Here, Xerox has not presented any evidence or argument to show that New Mexico's apportionment formula—as applied under the combined filing method and modified by the Detroit formula—does not result in a fair approximation of the corporate income that is "reasonably related" to Xerox's activities in New Mexico. *Moorman Manufacturing Co. v. Blair*, 437 U.S. 267, 273 (1978); *Exxon Corp. v. Wisconsin Department of Revenue*, 447 U.S. 207, 223 (1980).

C. New Mexico's Exclusion of Dividends from Xerox's Nonunitary Subsidiaries is Based on the Constitutional Prohibition Against Taxing Extraterritorial Value. Xerox attempts to equate the exclusion of its nonunitary domestic dividends with the deduction of unitary domestic dividends in *Kraft* and *Conoco*, which was based on the federal dividends-received deduction ("DRD") incorporated as part of Iowa's and New Mexico's corporate income tax schemes. In its reply brief, however, Xerox states that "[i]t is not Xerox's position that the Hearing Officer must find New Mexico's dividend received deduction statute unconstitutional." Reply Brief, page 1. This is not surprising, since such a finding would leave Xerox in exactly the same position it is now: the dividends Xerox receives from its unitary foreign subsidiaries would be included in the tax base, while the dividends Xerox receives from its nonunitary domestic subsidiaries would be excluded from the tax base. This is because, unlike the deduction of domestic dividends in *Kraft* and *Conoco*—or in the *Morton Thiokol* line of cases—New Mexico's exclusion of Xerox's nonunitary domestic

lower court proceedings.

dividends is not based on the federal DRD. Instead, it is based on the United States Supreme Court's long-standing position that it is unconstitutional for a state to tax the income of nonunitary members of a taxpayer's corporate group whose activities are unrelated to the state or to the group's unitary business enterprise. This rule applies equally to the income of both foreign and domestic subsidiaries. *See*, *Allied-Signal, supra; ASARCO, supra; Woolworth, supra*.

A constitutionally-mandated tax exclusion is not the same as a tax deduction voluntarily granted by the state. Because the income Xerox receives from its nonunitary subsidiaries does not qualify as business income subject to apportionment, that income is not subject to state tax in the first place, and there is nothing to deduct. Even if New Mexico changed its law to deny corporate taxpayers the DRD for domestic dividends, the Constitution still would require the exclusion of Xerox's nonunitary domestic dividends from New Mexico's tax base. For this reason, Xerox's focus on the DRD and its reliance on the *Kraft* and *Conoco* decisions is misplaced.

Equally misplaced is Xerox's reliance on recent state court decisions involving special deductions granted to corporations based on their activities within a particular state. *See*, *DDI, Inc. v. State of North Dakota*, 657 N.W.2d 228 (N.D. 2003) (striking down North Dakota's limitation of its DRD to dividends paid out of income previously taxed by North Dakota); *Farmer Brothers v. Franchise Tax Board*, 108 Cal.App.4th 976, 134 Cal.Rptr.2d 390 (2d Dist. 2003) (striking down California's limitation of its DRD to dividends paid out of income previously taxed by California); *Ceridian Corporation v. Franchise Tax Board*, 85 Cal.App.4th 875, 102 Cal.Rptr.2d 611 (1st Dist. 2000) (striking down California's limitation

of the DRD for insurance dividends to corporations domiciled in California and dividends received from payors subject to California's gross premiums tax). In each of these cases, the state had structured its corporate income tax scheme in such a way as to favor in-state commerce by allowing a special deduction for income the state was constitutionally permitted to tax. In *DDI, supra*, 657 N.W.2d 228, 229, the North Dakota Supreme Court explained the state tax commissioner's application of that state's DRD as follows:

> The Commissioner determined those dividends were business income subject to apportionment, *and to the extent the Commissioner determined the dividends were includable in the taxpayers' North Dakota apportioned income*, the Commissioner applied the dividends received deduction. (emphasis added)

The DRD was not applied to dividend income not subject to apportionment in North Dakota (which would include dividends the taxpayer received from nonunitary subsidiaries) because that income was never part of the state's tax base.

In this case, New Mexico's exclusion of Xerox's nonunitary domestic dividends from the New Mexico tax base is mandated by the U.S. Constitution. Unlike the tax schemes addressed in *Kraft* and *Conoco* and the other state cases relied upon by Xerox, this tax exclusion does not result from the manner in which New Mexico has chosen to structure its corporate income tax system or on the state's voluntary decision to allow a DRD for income otherwise subject to tax.

III. The Disparate Treatment of Dividends from Unitary and Nonunitary Subsidiaries Does Not Violate the Foreign Commerce Clause.

In considering claims of discriminatory taxation under the Commerce Clause, the United States Supreme Court has noted that "it is necessary to compare the taxpayers who are

'most similarly situated.'" *Kraft*, 505 U.S. 71, 81, n. 23 (1992) (quoting *Halliburton Oil Well Cementing Co. v. Reily*, 373 U.S. 64, 71 (1963)). *See, e.g.*, *General Motors Corp. v. Tracy*, 519 U.S. 278 (1997) (Ohio's differential tax treatment of natural gas sales by local public utilities and interstate gas marketers did not violate the Commerce Clause in the absence of a similarly situated comparison class). In *Kraft*, 505 U.S. at 76, the domestic commerce advantaged by Iowa's allowance of the federal DRD was the "flow of value" between Kraft and its unitary domestic subsidiaries, while the foreign commerce disadvantaged by Iowa's tax scheme was the flow of value between Kraft and its unitary foreign subsidiaries. This flow of value between a parent corporation and its subsidiaries is a hallmark of the unitary business relationship. *See*, *Container, supra*, 463 U.S. at 178. The same relationship does not exist between a parent corporation and its nonunitary subsidiaries, who do not share the "functional integration, centralization of management, and economies of scale" that define the unitary group. *Mobil Oil*, 445 U.S. 425, 438.

During the tax years at issue, the income Xerox received from its nonunitary domestic subsidiaries represented the return on a passive investment that had no relation to Xerox's unitary imaging business or to Xerox's business activities in New Mexico. Xerox's attempt to compare the tax treatment of dividends from its nonunitary domestic subsidiaries with the tax treatment of dividends from its unitary foreign subsidiaries is like comparing the proverbial apples and oranges. As the Supreme Court stated in *Kraft*, 505 U.S. at 78:

> We have previously found that the Commerce Clause is not violated when the differential tax treatment of two categories of companies "results solely from differences between the nature of their businesses, not from the location of their activities." *Amerada Hess Corp. v. Director, Div. of Taxation, N.J. Dept. of Treasury*, 490 U.S. 66, 78, 109 S.Ct. 1617, 1624, 104 L.Ed2d 58 (1989).

Here, New Mexico's exclusion of dividends Xerox received from its domestic subsidiaries was based on the nonunitary relationship between Xerox and those subsidiaries. If Xerox had received dividends from nonunitary foreign subsidiaries, those foreign dividends also would have been excluded from the tax base. The differential tax treatment of which Xerox complains was not based on the location of a subsidiary's activities, *i.e.*, foreign or domestic, but on whether the subsidiary's activities were unitary or nonunitary with the business operations of its parent corporation. This differential treatment does not violate the Foreign Commerce Clause.[3]

CONCLUSIONS OF LAW

1. The Taxpayer filed a timely, written protest to the Notice of Assessment of Taxes issued under Letter ID L0821166080**,** and jurisdiction lies over the parties and the subject matter of this protest.

2. New Mexico's corporate income tax scheme, which taxes a combined filer on dividends and Subpart F income received from foreign affiliates that are part of the taxpayer's unitary group, but excludes from tax income received from domestic affiliates that are not part of the unitary group, does not violate the Foreign Commerce Clause.

3. Xerox was not entitled to deduct the income it received from its unitary foreign subsidiaries when filing its 1995, 1996, and 1998 New Mexico corporate income tax returns using the combination of unitary domestic corporations reporting method.

For the foregoing reasons, the Taxpayer's protest IS DENIED.

DATED December 3, 2003.

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[3] Based on this decision, it is not necessary to address the Department's argument concerning the distinction between foreign dividends and Subpart F income.