**STATE OF NEW MEXICO**
**ADMINISTRATIVE HEARINGS OFFICE**
**TAX ADMINISTRATION ACT**

**IN THE MATTER OF THE PROTEST OF**
**GENERAL ELECTRIC COMPANY & SUBSIDIARIES**
**TO ASSESSMENTS ISSUED UNDER LETTER**
**ID NO.'s L0142804528 & L1492544464 [CONSOLIDATED PROTESTS]**

***v.*** **D&O No. 18-12**

**NEW MEXICO TAXATION AND REVENUE DEPARTMENT**

# DECISION AND ORDER ON MOTIONS FOR SUMMARY JUDGMENT

A summary judgment hearing on the above-referenced protest occurred on November 8, 2016, before Brian VanDenzen, Chief Hearing Officer. Attorney Timothy R. Van Valen appeared representing General Electric Company & Subsidiaries ("Taxpayer"). Staff Attorney Peter Breen appeared representing the Taxation and Revenue Department ("Department"). Department Protest Auditor Andrick Tsabetsaye also appeared. The matter came before the Chief Hearing Officer on the Taxpayer's Motion for Summary Judgment filed on August 24, 2016 and the Department's Response thereto filed on September 21, 2016. Taxpayer filed its reply to the Department's response on October 18, 2016.

The Taxpayer's motion presents a statement of facts which the Department does not dispute. The Department presented four additional facts, which Taxpayer does not dispute. Based on the undisputed facts, review of exhibits and arguments presented, IT IS DECIDED AND ORDERED AS FOLLOWS:

## FINDINGS OF FACT

*Procedural History*

1. On September 11, 2014, under letter id. no. L1492544464, the Department assessed Taxpayer $3,284,854.00 in corporate income tax, $656,970.80 in penalty, and $387,024.21 in interest for a combined total assessment of $4,328,849.01 for the corporate income tax reporting periods from December 31, 2008 through December 31, 2010.

2. On October 21, 2014, Taxpayer timely protested the Department's assessment (referred to as the original protest), a protest the Department received on October 24, 2014.

3. On November 13, 2014, the Department acknowledged receipt of Taxpayer's protest.

4. On January 7, 2015, the Department requested a hearing in this matter with the Administrative Hearings Office's predecessor, the Hearings Bureau[1].

5. On January 7, 2015, the Hearings Bureau issued Notice of Administrative Hearing, setting this matter for a scheduling hearing on January 20, 2015, within 90-days of the protest.

6. On January 20, 2015, the scheduling hearing occurred, satisfying the 90-day hearing requirement without objection of the parties.

7. On January 20, 2015, the Hearings Bureau issued a Scheduling Order and Notice of Administrative Hearing, setting this matter for hearing on February 23, 2016, among other deadlines for discovery and motions.

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[1] On July 1, 2015, pursuant to the Administrative Hearings Office Act, the Hearings Bureau left the Taxation and Revenue Department and became the independent Administrative Hearings Office ("AHO"). For events before July 1, 2015, the Hearings Bureau will be used even though this decision is issued under AHO's caption. AHO will be used for events after July 1, 2015.

8. After two joint motions to extend the preliminary witness and exhibit list exchange deadlines, on September 16, 2015, the parties jointly moved to vacate the entire previous scheduling order and formal February 23, 2016 hearing date.

9. On September 23, 2015, the Administrative Hearings Office issued an Amended Scheduling Order and Notice of Administrative Hearing, vacating the previous scheduling order and setting the matter for an anticipated summary judgment hearing on February 23, 2016.

10. On February 22, 2016, the Administrative Hearings Office *sua sponte* continued the summary judgment hearing until April 25, 2016 because of a conflicting district court matter.

11. On April 5, 2016, the parties jointly moved to vacate the April 25, 2016 hearing date.

12. On April 18, 2016, the Administrative Hearing Office issued a Continuance Order, Amended Scheduling Order, and Notice of Administrative Motions Hearing, setting a schedule for summary judgment pleadings and a summary judgment motion hearing date of July 27, 2016.

13. On April 29, 2016, under letter id. no. L0412804528, the Department assessed Taxpayer $2,414,566.00 in corporate income tax, $482,913.20 in penalty, and $229,536.58 in interest for a combined total assessment of $3,127,015.78 for the corporate income tax reporting periods from December 31, 2011 through December 31, 2013.

14. On May 18, 2016, the parties filed a joint motion to vacate and reset summary judgment motion deadlines and the summary judgment motions hearing date on the original protest.

15. On May 23, 2016, the Administrative Hearings Office issued its Fourth Continuance Order, Amended Scheduling Order, and Notice of Administrative Motions Hearing,

resetting the motions deadlines and motions hearing on the original protest until November 3, 2016.

16. On July 25, 2016, Taxpayer timely protested the assessment under letter id.# L0412804528 (referred to as the second protest).

17. On August 8, 2016, the Department acknowledged receipt of Taxpayer's second protest under letter id. # L0412804528.

18. On August 24, 2016, Taxpayer filed its motion for summary judgment on the original protest, with attached Exhibits #1 through #5. Each exhibit is detailed in the subparagraphs of this finding of fact.

a. Exhibit #1, affidavit of Timothy Pierce, had three sub-exhibits attached, which will be detailed below and treated as distinct exhibits throughout the decision.

   i. Exhibit #1(A): Reports created by Taxpayer's legal entity data base effective December 31, 2008, 2009, and 2010.

   ii. Exhibit #1(B): Schedule of foreign dividends paid by foreign subsidiaries of Taxpayer and federal Subpart F income from controlled foreign subsidiaries for tax years 2008, 2009, and 2010.

   iii. Exhibit #1(C): The Departments audit work papers.

   iv. Exhibit #1(D): Audit before Detroit Formula Spreadsheet.

   v. Exhibit #1(E): Detroit Formula Spreadsheet.

   vi. Exhibit #1(F): Form 1118.

b. Exhibit #2, initial draft regulation of the Department.

c. Exhibit #3, transmittal memo of then-Department Tax Policy Director James P. O'Neil accompanying the initial draft regulation.

d. Exhibit #4, second draft regulation with memorandum

e. Exhibit #5, approval by the Attorney General's Office that the proposed rule was within the parameters of TRD's rulemaking authority, along with a handwritten note of then-Assistant Attorney General Elizabeth Glenn to then-Tax Policy Director James O'Neil.

19. On September 13, 2016, the Department requested a hearing of Taxpayer's second protest under letter id. # L0412804528.

20. On September 14, 2016, the Administrative Hearings Office issued Notice of Telephonic Scheduling Conference, setting the second protest under letter id. # L0412804528 for a scheduling hearing on October 21, 2016.

21. On September 21, 2016, the Department filed its Response for Motion for Summary Judgment on the original protest.

22. On October 18, 2016, Taxpayer filed its reply to the Department's response to the Motion for Summary Judgment, along with supporting exhibit #1.

23. On October 21, 2016, a scheduling hearing occurred within 90-days of the Department's receipt of Taxpayer's second protest under letter id. # L0412804528, with neither party objecting to the fact that conducting that hearing satisfied the 90-day hearing requirement.

24. On October 24, 2016, a scheduling order was issued, setting the second protest under letter id. # L0412804528 for a merits hearing on October 17, 2017.

25. On November 3, 2016, the Administrative Hearings Office issued a *sua sponte* continuance order, moving the November 3, 2016 summary judgment hearing on the original protest to November 8, 2016.

26. On November 8, 2016, the summary judgment hearing of the original protest under letter id. # L1492544464 occurred.

27. On September 5, 2017, the parties jointly moved to consolidate the second protest under letter id. # L0412804528 with the original protest under letter id. L1492544464, where there remained the outstanding summary judgment motions. The parties asserted that the cases involved the same substantive legal issue. The request for consolidation was granted on September 18, 2017, pursuant to NMSA 1978, Section 7-1B-8 (D) (2015).

*Undisputed Material Facts*

28. During tax years 2008-2010 ("the audit period"), Taxpayer was a diversified technology and financial services company with operations and subsidiaries around the world, headquartered in Connecticut. [Taxpayer Ex. #1, ¶5; Taxpayer Ex. #1(C), pages B3 and B5].

29. During the audit period, Taxpayer conducted its activities in New Mexico, other states, and foreign countries. [Taxpayer Ex. #1, ¶9].

30. Taxpayer conducts activities through numerous domestic and foreign subsidiaries. [Taxpayer Ex. #1, ¶10].

31. During the audit period, Taxpayer had 419 foreign subsidiaries from which it received dividends, most of which were more than 50% owned by Taxpayer or United States subsidiaries of Taxpayer. [Taxpayer Ex. #1, ¶12].

32. During the audit period, most of Taxpayer's foreign incorporated subsidiaries conducted no business operations in the United States or New Mexico. [Taxpayer Ex. #1, ¶13].

33. During the audit period, Taxpayer elected to be a consolidated group, not a separate or combined, corporate filer under NMSA 1978, Section 7-2A-8.4. Taxpayer's consolidated filing included the income of all domestic subsidiaries doing business in the United

States but excluded the income of foreign subsidiaries doing business exclusively outside of the United States. [Taxpayer Ex. #1, ¶14].

34. Taxpayer's consolidated group included domestic subsidiaries not engaging in business in New Mexico. [Taxpayer Ex. #1, ¶15].

35. Taxpayer's consolidated group did not include unitary foreign subsidiaries not engaged in business in New Mexico. [Taxpayer Ex. #1, ¶16].

36. On July 31, 2012, the Department initiated a corporate income tax audit of Taxpayer for the corporate income tax years of 2008, 2009, and 2010. [Taxpayer Ex. #1(C), p. B3].

37. During the audit, the Department rejected Taxpayer's exclusion of dividends received for its foreign subsidiaries and federal Subpart F income from Taxpayer's New Mexico corporate income tax base. The Department recalculated Taxpayer's corporate income tax base, including those disputed dividends received from Taxpayer's foreign subsidiaries.

38. New Mexico claims an average apportionment factor to be applied against Taxpayer's income of 0.1895% for 2008, 0.1749% for 2009, and 0.2075% for 2010. [Taxpayer Ex. #1(C), p. B10, B10.1, B10.2].

39. The Department's auditors added foreign dividends, including federal Subpart F income, to Taxpayer's New Mexico corporate income tax "base income" for the audit period as follows [Dept. Ex. #1, ¶18]:

| Tax Year | Foreign Dividends Added |
|---|---|
| 2008 | $ 15,232,767,172 |
| 2009 | $ 6,586,518,407 |
| 2010 | $ 7,066,625,869 |
| | $ 28,885,911,448 |

40. Additional New Mexico corporate income tax for the audit period solely due to the addition of foreign dividends, including federal Subpart F income, to Taxpayer's New Mexico corporate income tax "base income" for the audit period was as follows [Dept. Ex. #1, ¶19]:

| Tax Year | Additional Corporate Income Tax |
|---|---|
| 2008 | $ 1,400,221 |
| 2009 | $ 1,033,327 |
| 2010 | $ 1,182,192 |
| | $ 3,615,740 |

41. Following the addition of foreign dividends and Subpart F income to Taxpayer's New Mexico corporate income tax base, the Department's auditors required Taxpayer to prepare and submit "Controlled Foreign Corporation Detroit Formula Factor Representation" worksheets for each of the years in the audit period in order to apply the "Detroit Formula" of apportionment "factor relief" to the inclusion of the dividends Taxpayer received from its foreign subsidiaries and Subpart F income. [Dept. Ex. #1, ¶18; Dept. Ex. #1(c) pages 5.3-5.4].

42. Under the Detroit Formula, foreign dividends paid by a foreign subsidiary to a domestic corporation are included in the tax base to which an apportionment factor is applied to determine income taxable in New Mexico. The Detroit Formula adds to the denominator of each of the three standard UDITPA apportionment factors (property, payroll, and sales) a percentage of the foreign subsidiary's apportionment factors. The foreign subsidiary's percentage added is the net foreign dividend paid to its domestic parent divided by the foreign subsidiary's net earnings times each of the three factors. *See Conoco, Inc. v. Taxation and Revenue Dep't*, 1997-NMSC-005, ¶ 13, 122 N.M. 736, 931 P.2d 730.

43. Taxpayer completed the "Controlled Foreign Corporation Detroit Formula Factor Representation" worksheets as instructed by the Department. [Dept. Ex. #1, ¶ 21].

44. The Department repealed a New Mexico corporate income tax regulation setting forth the Detroit Formula effective May 31, 1998, following the New Mexico Supreme Court's 1997 decision in *Conoco, Inc. See* Vol. IX No. 10 N.M. Reg. 395 (May 30, 1998).

45. During the audit period, there was no New Mexico statute or Department regulation expressly setting forth, or requiring the use of, the Detroit Formula.

46. The Department's auditors' application of the "Detroit Formula" resulted in the Department's assessment, as described in Finding of Fact #1, of additional corporate income tax solely attributable to the inclusion of foreign dividends or federal Subpart F income in Taxpayer's tax base.

47. The amount of tax added for each year solely due to inclusion of foreign dividends with application of the Detroit Formula (without correction of other audit errors, including errors in the Detroit Formula calculations) is as follows:

| Tax Year | Additional Corporate Income Tax |
|---|---|
| 2008 | $ 1,322,044 |
| 2009 | $ 975,296 |
| 2010 | $ 1,048,718 |
| | $ 3,346,058 |

48. The addition of foreign dividends and federal Subpart F income to Taxpayer's New Mexico corporate income tax base, when summed across all years, would have resulted in the following additional New Mexico corporate income tax solely due to their inclusion:

| | |
|---|---|
| Tax Due Under New Mexico UDITPA: | $3,615,740 |
| Tax Due With Application of Detroit Formula: (7.5% reduction) | $3,346,058 |

49. Taxpayer paid the following foreign taxes which were creditable for federal tax purposes during the audit period, but for which New Mexico offered no similar, corresponding credit for a consolidated group filer:

| Tax Year | Amount of Foreign Tax Paid |
| --- | --- |
| 2008 | $ 2,885,928,890 |
| 2009 | $ 2,218,168,697 |
| 2010 | $ 2,754,739,151 |
| | $ 7,858,836,738 |

50. The Department adopted 3.4.1.12 NMAC (the "Regulation"), on May 31, 1998. Vol. IX No. 10 N.M. Reg. 395 (May 30, 1998).

51. The Regulation provides an express exclusion from the New Mexico corporate income tax base for foreign source dividends received by corporations filing under the New Mexico statutory separate corporate entity method. 3.4.1.12 NMAC.

52. The Department's initial draft of the Regulation excluded foreign dividends from the corporate income tax base for taxpayers reporting to New Mexico under the New Mexico statutory separate corporate entity, combination of unitary corporations, and federal consolidated group methods. The language in the initial draft of the Regulation stated:

> Foreign source dividends received by a group of corporations filing in accordance with Sections 7-2A-8.3 or 7-2A-8.4 are excludible from the group's base income to the extent such dividends are paid by corporations which are not members of the combined or consolidated group because New Mexico's taxation of such dividends has been ruled unconstitutional. [Ex. #2].

53. The October 3, 1997 transmittal memorandum accompanying the initial draft of the Regulation from the Department's Director of Tax Policy at the time, James P. O'Neill, to other employees of the Department also stated:

> Since our own court didn't buy our "Detroit fix," it is probably time to think about rolling over. Although the US Supreme Court [in Kraft] addressed only separate

> entity filers, it is incredible that they wouldn't apply the same logic for combined and consolidated filers. So this proposal anticipates the ultimate result. [Ex. #3].

54. However, on November 25, 1997, the second draft of the Regulation removed the language that included corporations filing under the combination of unitary corporations method and the federal consolidated group method in the exclusion of foreign dividends. [Ex. #4].

55. Although then Assistant Attorney General Elizabeth Glenn approved the draft Regulation on February 4, 1998 as to whether it was lawful and consistent with Department authority, she sent a hand-written note to Mr. O'Neill stating:

> As we discussed, I signed this, but I'm a little concerned about . . . [the Regulation]. I think it may needlessly raise questions or draw attention to TRD's method of taxing foreign source dividends because it doesn't specify who is the determinative authority of the method's constitutionality. As it reads now, the taxpayer could protest the taxes on the grounds that they are unconstitutional even though no court has ruled on the particular method the legislature or TRD comes up with. [Ex. #5].

56. Although the Department did not tender any undisputed facts or argument asserting a unitary relationship in this protest, the audit narrative submitted as an uncontested exhibit indicates the Department conducted a previous audit on Taxpayer for the periods of 1991-1994. During that previous audit, the audit narrative indicates that the Department had found significant evidence of a functional connection, if not unitary relationship, between Taxpayer and its foreign affiliates. During the present audit, Taxpayer did not indicate that there had been any substantial change in the relationship between it and its foreign affiliates since the previous audit. [Taxpayer Ex. #1(C), p. B5.1 through B5.2].

57. During the audit that triggered the assessments in dispute in this protest, the Department asked Taxpayer to complete the Business Connection Questionnaire to explore the question of unitariness, but Taxpayer declined to do so. [Taxpayer Ex. #1(C), p. B5.2].

58. In addition to providing Detroit Formula factor relief for all foreign dividends or Subpart F income generated by foreign entities where Taxpayer owned at least 50%, the Department provided Taxpayer with a 80% deduction on dividend income from foreign payors that it owned between 20% and 50% and a 70% deduction on dividend income from foreign payors that it owned up to 20%. [Taxpayer Ex. #1(C), p. B5.4].

## DISCUSSION

The main issue in this protest is whether the Department's corporate income tax assessment impermissibly and unconstitutionally discriminated against foreign commerce under the United States Constitution's Commerce Clause by taxing Taxpayer's dividends and Subpart F income received by foreign affiliates while treating domestic dividends more favorably by excluding them from the base income of the consolidated group. Another issue, based on Taxpayer's argument that in the event it is found liable for the assessment, is whether penalty should be abated because its tax filings were premised on a good-faith, mistake of law. The third issue is whether Taxpayer is entitled to the award of costs and fees under NMSA 1978, Section 7-1-29.1 (2015).

As to the main issue in the protest, Taxpayer argues, based on case law that will be addressed, that inclusion of foreign source dividends in the New Mexico corporate income tax base is improper for three reasons. First, it constitutes facial discrimination under the Commerce Clause because of discrimination. Second, it results in inevitable multiple taxation of foreign commerce. Third, it results in an unfair apportionment of income from foreign commerce. Taxpayer indicates that there is no longer legal authority in statute or regulation to employ the Detroit Formula after its repeal in response to case law. Finally, Taxpayer emphasizes that the Department at one point contemplated a regulation that would have eliminated potential disparate treatment of foreign dividends for all three reporting methods precisely because the Department was concerned that in light of case law, its

approach under all three reporting methods would be found unconstitutional.

In response, the Department counters that because Taxpayer elected to file a consolidated return, Taxpayer has waived constitutional protections against foreign and non-unitary income and the Commerce Clause and Foreign Commerce Clause Protection are not implicated. The Department argues that the two main cases that support Taxpayer's arguments only apply to separate entity corporate income tax filers rather than the consolidated group return at issue here, and that other states that have considered that issue have permitted inclusion of foreign dividends in reporting methods other than separate filing. The Department further responds that dividends of all kinds are included in the definition of business income, making the exclusion of foreign dividends contrary to law. The Department contends that the apportionment formula method under UDITPA is widely accepted in constitutional jurisprudence, even if there is a theoretical possibility of double taxation in its application and acknowledging that with any apportionment scheme, absolute consistency is not always achievable. Further, the Department avers that Taxpayer did not overcome its heavy burden of showing the Department's apportionment of tax in this case, as modified to provide factor relief under the Detroit Formula, was unfair or externally inconsistent. Finally, the Department rejects Taxpayer's argument about the meaning of the draft regulation that was never promulgated.

**Burden of Proof and Standard of Review upon Summary Judgment.**

Pursuant to NMSA 1978, Section 7-1-17 (C), the assessments issued in this case are presumed correct. The Taxpayer has the burden to overcome the presumption of correctness that attached to the assessments. *See Archuleta v. O'Cheskey*, 1972-NMCA-165, ¶11, 84 N.M. 428. Unless otherwise specified, for the purpose of the Tax Administration Act, "tax" is defined to include interest and civil penalty. *See* NMSA 1978, § 7-1-3 (X). Under Regulation 3.1.6.13 NMAC, the presumption of correctness under Section 7-1-17 (C) extends to the Department's

assessment of penalty and interest. *See Chevron U.S.A., Inc. v. State ex rel. Dep't of Taxation & Revenue*, 2006-NMCA-50, ¶16, 139 N.M. 498, 503 (agency regulations interpreting a statute are presumed proper and are to be given substantial weight). Moreover, like here where Taxpayer claims an exemption from state taxation of foreign dividend and federal Subpart F income, "[w]here an exemption or deduction from tax is claimed, the statute must be construed strictly in favor of the taxing authority, the right to the exemption or deduction must be clearly and unambiguously expressed in the statute, and the right must be clearly established by the taxpayer." *Wing Pawn Shop v. Taxation and Revenue Department*, 1991-NMCA-024, ¶16, 111 N.M. 735 (internal citation omitted); *See also TPL, Inc. v. N.M. Taxation & Revenue Dep't*, 2003-NMSC-7, ¶9, 133 N.M. 447.

Summary judgment is appropriate when there is no genuine dispute as to any material fact and the moving party is entitled to prevail as a matter of law. *See Romero v. Philip Morris, Inc.,* 2010-NMSC-035, ¶7, 148 N.M. 713. In controversies involving a question of law, or application of law where there are no disputed facts, summary judgment is appropriate. *See Koenig v. Perez,* 1986-NMSC-066, ¶10-11, 104 N.M. 664. If the movant for summary judgment makes a prima facie showing that it is entitled to a judgment as a matter of law, the burden shifts to the opposing party to show evidentiary facts that would require a trial on the merits. *See Roth v. Thompson*, 1992-NMSC-011, ¶17, 113 N.M. 331. While the Department filed a response in opposition to Taxpayer's motion for summary judgment, the Department never expressly requested summary judgment in its favor as part of that response even though its counter-claim clearly suggested that the Department believed it was entitled to summary judgment as a matter of law. Even if the nonmoving party does not file their own motion for summary judgment, summary judgment may be granted to the nonmoving party if there is no genuine dispute of fact, they are entitled to judgment as a matter of law, and the moving party was generally on notice of the nonmoving

party's counter-claim in its response to the moving party's summary judgment pleading. *See Martinez v. Logsdon*, 1986-NMSC-056, ¶12, 104 N.M. 479. The Department did not dispute any of the facts asserted in Taxpayer's motion for summary judgment. The Department did assert, emphasize and restate four facts in its response to the motion for summary judgment as undisputed, material facts, which Taxpayer did not dispute. The articulated undisputed facts from both parties briefs, as well as some facts from the attached exhibits, have been adopted above.

At the end of the summary judgment hearing, there was a discussion in this matter about whether the matter was ripe for a final decision and order upon summary judgment or instead a simply order addressing the summary judgment pleadings and setting further proceedings. Both sides initially indicated that a final decision and order might be appropriate, and then discussed that coming back for further proceeding might be appropriate. Frankly, the discussion did not particularly clarify the question, as both sides expressed uncertainty and shifting thoughts on the subject. However, in subsequently reviewing the pleading, Taxpayer actually moved for full summary judgment, not restricted to "partial summary judgment" in any manner in its pleading[2]. Similarly, the Department did not indicate in its response that the summary judgment pleading should be limited to a particular issue or addressed on a partial basis. Since there are no disputed facts and neither side expressed a strong preference in their pleadings for a limited ruling, this matter is ripe for a final decision and order on summary judgment, disposing of the case. Not only is issuing a final decision and order consistent with the pleadings of the parties and the undisputed material facts, it also is in the interest

[2] The Administrative Hearings Office now generally disfavors the practice of "partial" summary judgment for various reasons, including but not limited to the uncertainty exhibited by the parties and hearing officer in this case about what exactly they sought in terms of the order to be issued, the necessity of needing a final order for appeal, and the different confidentiality provisions that apply to a final judgment and order versus a lesser order under NMSA 1978, Section 7-1-8.3. While there may still be some limited circumstances where "partial summary judgment" will be entertained, generally, a matter is either ripe for a final judgment and order upon summary judgment or it needs to proceed to hearing if the parties are unable to present complete uncontested facts and stipulations upon which a final decision and order can be issued.

of efficiency of appeal, which requires a final judgment, of this important issue.

**Overview of New Mexico Corporate Income Tax Scheme and Related Federal Underpinnings.**

***New Mexico's Corporate Income Tax and Franchise Tax Act.***

Subject to the limitations of the United States Constitution's Due Process and Commerce Clause, under NMSA 1978, Section 7-2A-3, New Mexico levies an income tax on the "the net income of every domestic corporation and upon the net income of every foreign corporation employed or engaged in the transaction of business in, into or from this state or deriving any income from any property or employment within this state." As used under the Corporate Income and Franchise Tax Act, the term "corporations" includes corporations, joint stock corporations, certain real estate trusts, financial corporations, banks, other business associations, limited liability companies and partnerships taxed as corporations under the Internal Revenue Code. *See* NMSA 1978, § 7-2A-2 (D). In pertinent part, "net income" is defined by statute to mean "base income adjusted to exclude (1) income from obligations of the United States less expenses incurred to earn that income; and (2) other amounts that the state is prohibited from taxing because of the laws or constitution of this state or the United States…" NMSA 1978, § 7-2A-2 (H) (note that definition continues to include net operating loss carryback and carryover deductions, which are not pertinent to the disputed issues in this case).

***Constitutional Limitations and Apportionment.***

The dispute in this case is not whether Taxpayer is subject to New Mexico Corporate Income Tax, which it most assuredly is as a corporation doing business in New Mexico, but the potential constitutional limitations on what New Mexico may tax. In other words, using Section 7-2A-2 (H) (2)'s definitional exclusion from net income, are there any amounts of income not subject to taxation because of the laws and constitution of the United States?

Generally, a state may not impose an income tax on the value earned outside of its border under the Due Process and Commerce Clauses of the United States Constitution. *See ASARCO Inc. v. Idaho State Tax Commission*, 458 U.S. 307, 314 (1982). Specifically, the Commerce and Due Process Clauses of the United States Constitution impose distinct but parallel limitations on New Mexico's power to tax value earned from out-of-state business activities. *See Mobil Oil Corp. v. Comm'r of Taxes*, 445 U.S. 425, 454 (1980); *Norfolk & Western R. Co. v. Missouri Tax Comm'n.*, 390 U.S. 317, 325, n.5 (1969). However, a state may tax an apportioned share of a multistate entity's income earned outside of its territory if the activity that generated that income was part of a "unitary business." *MeadWestvaco Corp. v. Ill. Dep't of Revenue*, 553 U.S. 16, 19 (U.S. Apr. 15, 2008); *Allied-Signal*, 504 U.S. at 772; *Hunt Wesson v. Franchise Tax Bd.*, 528 U.S. at 460; *Exxon Corp. v. Wisconsin*, 447 U.S. 207, 224 (1980); *Mobil Oil Corp.*, 454 U.S. at 442. "[T]he linchpin of apportionability in the field of state income taxation is the unitary-business principle." *Mobil Oil Corp.*, 445 U.S. 425, 439. Taxpayer bears the burden of establishing by clear and cogent evidence that the state seeks to tax extraterritorial values. *Allied-Signal*, 504 U.S. 768, 782, citing *Exxon Corp*. 447 U.S. 207, 224.

This protest involves potential limitations on state taxation under the Commerce Clause, and more specifically a subset within the Commerce Clause addressing foreign commerce, referred to as the Foreign Commerce Clause. The Commerce Clause of the United States Constitution grants to Congress the power "[t]o regulate Commerce with foreign nations, and among the several States, and with Indian Tribes." USCS Const. Art. I, § 8, Cl 3. In *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274, 279 (U.S. 1977), the United States Supreme Court established a four-part test to determine whether a state's attempts at taxation of multijurisdictional corporations conducting business and generating income in multiple states impermissibly interferes with the

Commerce Clause. That four part test is (1) whether there is a substantial nexus between a taxpayer and the taxing State; (2) whether the tax is fairly apportioned; (3) whether the tax discriminates against interstate commerce; and (4) whether the tax is fairly related to the services provided by the State. *Id*. The Foreign Commerce Clause component of the Commerce Clause will be addressed in greater detail below.

In an effort to address these constitutional boundaries on taxing of extraterritorial value, New Mexico, like many states, has adopted the Uniform Division of Income for Tax Purposes Act ("UDITPA") to address apportionment and allocation of income earned by multistate or multinational entities. *See* NMSA 1978, §§7-4-1 through 7-4-21; *see also ASARCO Inc. v. Idaho State Tax Commission*, 458 U.S. 307, 311 fn.3 (1982) (short discussion of history of UDITPA) ; *see also J. Hellerstein & W. Hellerstein*, State Taxation, ¶9.01 (3rd ed. 2001-2015) (discussion of history of adoption of UDITPA, or similar statutory regimes, by numerous states). UDITPA distinguishes between business income (apportionable to any state where a taxpayer has nexus) and nonbusiness income (allocated only to a single location, usually a taxpayer's domicile). *See* NMSA 1978, §7-4-10 (A) (2013) ("…all business income shall be apportioned..."). Under UDITPA, 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 percentage of the three is then applied against the corporation's total income to determine the percentage amount of income subject to New Mexico taxation. *See* NMSA 1978, §§ 7-4-10 through 7-4-18. The general idea behind UDITPA is to ensure that each state only taxes an apportioned share of a unitary corporation's income, a share under the formula roughly commensurate with the portion of the income attributable to activities conducted within that respective state, and thus to ensure that if all

states were to do the same, the aggregate amount under the apportionment formulas across the different jurisdictions would roughly equal the corporation's total income.

***Reporting Methods*.**

Mechanically, but of substantive significance in this protest, New Mexico's corporate income tax structure allows a taxpayer subject to the Corporate Income and Franchise Tax Act to elect one of three reporting methods. *See* Regulation 3.4.10.8 (B) NMAC. The first permissible reporting method is the separate corporate entity method. *See* Regulation 3.4.10.8 (B) (1) NMAC and Regulation 3.4.10.7 (A) NMAC. This method entails allowing each corporation doing business in New Mexico, even if they are part of a larger unitary group, to file a separate corporate income tax in New Mexico. As will be discussed in much greater detail, the New Mexico Supreme Court has expressly prohibited the state from including foreign dividend income for separate method filers because under the structure of the taxing scheme, domestic dividends were provided favorable treatment over foreign dividends in contradiction to the Foreign Commerce Clause. *See Conoco, Inc. v. New Mexico Taxation and Revenue Department*, 1997-NMSC-005, 122 N.M. 736, 931 P.2d 730 (1996). In recognition of the *Conoco, Inc.* holding, Department Regulation 3.4.1.12 NMAC (1998) now allows a separate entity corporate filer to exclude foreign source dividends from its base income.

The second permissible reporting method is the combination of unitary corporations, also commonly referred to as a combined return or as combined reporting. *See* NMSA 1978, § 7-2A-8.3 (2013) and Regulation 3.4.10.8 (B) (2) NMAC. New Mexico statute defines a "unitary corporation" as

> two or more integrated corporations, other than any foreign corporation incorporated in a foreign country and not engaged in trade or business in the United States during the taxable year, that are owned in the amount of more than fifty percent and controlled by the same person and for which at least one of the following conditions exists:
>
> (1) there is a unity of operations evidenced by central purchasing,

> advertising, accounting or other centralized services;
> (2) there is a centralized management or executive force and centralized system of operation; or
> (3) the operations of the corporations are dependent upon or contribute property or services to one another individually or as a group.

NMSA 1978, § 7-2A-2 (Q) (2014)[3].

Generally, this method requires a corporation to report the combined income of all its unitary subsidiaries as one return. In a previous administrative decision discussed in more detail below, the combined return reporting method treatment of dividends had been found to not offend the Foreign Commerce Clause. *See In the Matter of the Protest of Xerox Corporation*, Taxation and Revenue Decision and Order No. 03-22, Dec. 3, 2003, (non-precedential; publicly available at http://realfile.tax.newmexico.gov/03-22__xerox_corporation.pdf ) (referred to as "*Xerox*").

The third reporting method, and the one Taxpayer elected in this protest, is the federal consolidated group. *See* NMSA 1978, § 7-2A-8.4 (1993) and Regulation 3.4.10.8 (B) (3) NMAC. Under Section 7-2A-8.4,

> [a]ny corporation that is subject to taxation under the Corporate Income and Franchise Tax Act [7-2A-1 NMSA 1978] and that reports to the internal revenue service for federal income tax purposes its net income consolidated with the net income of one or more other corporations may elect to report to New Mexico on the same basis.

The New Mexico consolidated group reporting method is premised on the corporation reporting income federally on a consolidated group basis. Under the Internal Revenue Code ("I.R.C."), 26 U.S.C. § 1501[4] establishes the privilege of filing a federal consolidated return for an affiliated group

[3] It should be noted that since, under the uncontested facts, Taxpayer owned more than 50% of the affiliates at issue in this protest, and since the Department's audit narrative shows evidence of the other definitional three factors that Taxpayer declined to refute when given a chance at audit, it appears in this case that this statutory definition of a unitary business between Taxpayer and its foreign affiliates was met. At the very least, Taxpayer presented no evidence to refute there was a unitary business relationship. *See Mobil Oil Corp.*, 445 U.S. 425, 439 (where that taxpayer made no effort to show that the foreign operations were distinct from its line of business).

[4] Citations to I.R.C. are also interchangeable with 26 U.S.C. As an example, I.R.C. § 1501 is also 26 U.S.C. § 1501. Under blue book citation, citation to the Internal Revenue Code are made using I.R.C. rather than 26 U.S.C. However, the appendix to NMRA 23-112 seem to suggest that the citation be to the United States Code, and thus 26 U.S.C. will be used

of corporations, as defined by 26 U.S.C. § 1504. Under the definition contained in NMSA 1978, Section 7-2A-2 (A) (2014), New Mexico incorporates the I.R.C. definition of an affiliated group. An affiliated corporation is a corporation connected through stock ownership amounting to 80% of voting power or value with a common parent corporation. *See* 26 U.S.C. § 1504 (A). Foreign corporations may not be included in a consolidated group. *See* 26 U.S.C. § 1504 (B).

Because this is the reporting method at issue in this protest, a more detailed overview of the consolidated group method, the differences between it and the combined return reporting method, and the method of calculation of the federal consolidated taxable income is important to resolution of this protest. The New Mexico Supreme Court, in providing a basic overview of what a consolidated return is, quoted with favor *Merten's* Law of Federal Income Taxation, §46.01 (1978 revision):

> A consolidated return is an income tax return which reports the income and deductions of a parent corporation and its subsidiaries. The actual return form used is the regular Form 1120 used by corporations generally.
>
> Although the word 'consolidated' might be considered as implying that each item of income and deduction for all the corporations included in the return is computed on a combined basis, nevertheless, as the principles governing consolidated returns have developed, this concept has been rejected. Instead, for most items there are separate computations for each corporate entity, the taxable incomes so computed then being combined to arrive at consolidated taxable income. Actual 'consolidation' is limited to certain specified items which are aggregated for all the members of the group of corporations included in the return and to the elimination of most transactions occurring within the group.
>
> Consolidated returns were originally instituted as an administrative measure (without explicit statutory authorization) to prevent avoidance of excess profits taxes by manipulations among taxpaying entities owned by the same interests.

*Getty Oil Co. v. Taxation & Revenue Dep't*, 1979-NMCA-131, ¶ 11, 93 N.M. 589, 603 P.2d 328.

In their preeminent State Taxation treatise, Hellerstein and Hellerstein note a few salient

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in this decision when referring to provisions of I.R.C.

similarities and differences between consolidated group method and combined returns. *See J. Hellerstein & W. Hellerstein*, ¶8.11[1]. According to Hellerstein and Hellerstein, most state consolidated return filings are elective and based on filing a federal consolidated return. *See id.* A consolidated return does not require that the different corporate entities are engaged in a unitary business. *See id.* "The [consolidated] return is that of all affiliates, and each may be made liable for the consolidated tax, at least in cases in which the group has made an election to file on a consolidated basis." *Id*. A combined return is based on the unitary principle, rather than on a voluntary election by affiliated entities like the consolidated return. "The purpose of the combined reporting," according to Hellerstein and Hellerstein, "is to determine the income or other tax base of an in-state taxpayer by viewing the taxpayer as part of the unitary business, and applying apportionment factors to the entire unitary business to the taxable net income of the unitary business." *Id*.

The Supreme Court of Oregon also provides a detailed overview of the differences between combined reporting and a consolidated group return.

> A *combined report* is an accounting method whereby each member of a group carrying on a unitary business computes its individual taxable income by taking a portion of the combined net income of the group. A *consolidated return* is a taxing method whereby two corporations are treated as one taxpayer. The difference is stated in Keesling, *A Current Look at the Combined Report and Uniformity in Allocation Practices*, 42 J of Tax 106, 109 (February 1975):
>
> > "Because of its importance, it should be emphasized that the combined report is not the same as a consolidated return…"

*Caterpillar Tractor Co. v. Dep't of Revenue*, 289 Or. 895, 898-99, 618 P.2d 1261 (1980) (emphasis in the original).

***New Mexico's Calculation of Base Income Looks to Federal Law, the Dividends Received Deduction, and Federal Definition of Dividends and Subpart F Income***

Regardless of the reporting method selected, the starting point for determining base income subject to New Mexico corporate income is the corporation's federal taxable income. *See* NMSA 1978, § 7-2A-2 (C) (2014). Under the I.R.C., a corporation may deduct dividends received from domestic subsidiaries from its federal taxable income. *See* 26 U.S.C. § 243. The purpose of the dividend received deduction under 26 U.S.C. 243 is to avoid double taxation both on the income from which the dividends are distributed and on the dividend received income. *See King Enters. v. United States*, 189 Ct. Cl. 466, 484-85, 418 F.2d 511 (1969) (Discussing Legislative history, intent and purpose of dividends received deduction). *See also OBH, Inc. v. United States*, 397 F. Supp. 2d 1148, 1157 n.5 (D. Neb. 2005) (non-precedential, but helpful summary of the purpose of the section in a footnote: "Congress passed § 243 to alleviate a double taxation problem. Prior to the enactment of § 243, dividend-received income was taxed twice: once when the payor corporation paid tax on the money prior to distributing a dividend and then again when the receiving corporation paid tax on the dividend income.").

Conversely, under the I.R.C., the dividends received from foreign subsidiaries of a company remain as part of that company's federal taxable income. Although the foreign dividends are included in the initial federal taxable base that becomes the starting point for New Mexico taxation, the I.R.C. does provide a subsequent foreign tax credit under 26 U.S.C. §901 that reduces the federal tax by the amount of foreign taxes paid on a taxpayer's foreign subsidiary's income. However, that credit is added into the equation after the base income which New Mexico uses its starting point has already been determined. New Mexico does not have a similar credit for the payment of foreign taxes. Consequently, since New Mexico relies on the federal taxable income to determine a corporation's base income, dividends from domestic subsidiaries (which are removed

under 26 USC § 243) are not included in the federal base income generally subject to New Mexico tax while dividends received from foreign subsidiaries remain in the federal taxable income potentially subject to New Mexico corporate income tax.

The federal taxable income of a consolidated group is determined under 26 CFR 1.1502-11. Under 26 CFR 1.1502-11(a), consolidated taxable income is generally calculated by computing the separate taxable income of each member of the group as if the member of the group was filing a return as a separate entity, with additional adjustments as specified, and then aggregating the total from the separate entities that are part of the group. Separate taxable income is determined in the same manner as for determining income of a separate corporation, with numerous exceptions. *See* 26 CFR 1.1502-12.

One pertinent exception is the dividends received deduction under 26 U.S.C. §243, which is not calculated on a separate basis. *See* 26 CFR 1.1502-12 (n). Instead, under 26 CFR 1.1502-26, the dividends received deduction is calculated by aggregating the deduction of the members of the group. In pertinent part, 26 CFR 1.1502-26 reads

> (a) In general. (1) The consolidated dividends received deduction for the taxable year shall be the lesser of:
>
> (i) The aggregate of the deduction of the members of the group allowable under sections 243(a)(1), 244(a), and 245 [26 USCS §§ 243(a)(1), 244(a), and 245] (computed without regard to the limitations provided in section 246(b) [26 USCS § 246(b)]), or
>
> (ii) 85 percent of the consolidated taxable income computed without regard to the consolidated net operating loss deduction, consolidated section 247 [26 USCS § 247] deduction, the consolidated dividends received deduction, and any consolidated net capital loss carryback to the taxable year.

Parsing 26 CFR 1.1502-26, the consolidated group is allowed to aggregate dividends as allowed under "sections 26 USCS §§ 243(a)(1), 244(a), and 245 (computed without regard to the limitations provided in section 26 USCS § 246(b)." Those sections allow a dividends earned deduction for

dividends received from domestic corporations subject to taxation under 26 USCS § 243 (a) (a portion of the same deduction of domestic dividends discussed above for a separate entity filer), preferred stock under now repealed 26 USCS § 244(a), and from certain foreign corporations under 26 USCS § 245.

Under 26 USCS § 245, there are two main types of foreign corporations entitled to be included in the consolidated dividend. First, a 10% owned foreign corporation, which is "any foreign corporation (other than a passive foreign investment company) if at least 10 percent of the stock of such corporation (by vote and value) is owned by the taxpayer." 26 USCS § 245(a). Second, a wholly owned foreign subsidiary. *See* 26 USCS § 245(b). In other words, 26 USCS § 245 does allow inclusion of all foreign dividends in the consolidated dividends received deduction, but only in limited circumstances and at least with respect to 10% owned companies, only the U.S. sourced portion of the dividend. In contrast, 26 USCS § 243 (a) allows inclusion of domestic dividends from the dividends received deduction at rates between 50% to 100%. At first blush, this is similar to the disparate treatment found under the separate entity reporting.

Because this protest involves a dispute of the treatment of dividends and federal Subpart F income, federal definitions of those concepts provide additional context to the analysis. The I.R.C. defines a "dividend" in pertinent part as "any distribution of property made by a corporation to its shareholders—(1) out of its earnings and profits accumulated after February 28, 1913, or (2) out of its earnings and profits of the taxable year…, without regard to the amount of the earnings and profits at the time the distribution was made." 26 USC § 316. Taxpayer, as a large multinational corporation, is a shareholder owning a significant percentage of stock in many of its affiliated and unitary entities, meaning that it will receive dividend distributions from the income earned from those affiliate entities. The tax treatment of those dividend distributions are at the heart of this protest. Similarly,

under 26 USC § 952, the general concept is that "Subpart F income" means the sum of insurance income, the foreign base company income, and a calculation of income of the corporation less income attributable to earnings and profits included in the gross income of a United State person multiplied by a boycott factor of a controlled foreign company. In other words, Subpart F income establishes fairly complex rules for determining when a U.S. shareholder of a controlled foreign company may be subject to federal taxation based on the income of the controlled foreign company. Again, the treatment and state taxation of Taxpayer's federal Subpart F income is at issue in this case.

**Foreign Commerce Clause Limitations on State Corporation Income Taxation.**

Against this structural backdrop, there is the broader question of this protest: whether the Department's assessment of Taxpayer's foreign dividend income and federal Subpart F income violates the Foreign Commerce Clause, as contained in the broader Commerce Clause discussed and cited fully above. In addition to the *Complete Auto Transit, Inc.'s* four factor Commerce Clause analysis, on questions related to the Foreign Commerce Clause, the United States Supreme Court has added two additional factors: (1) "whether the tax creates a substantial risk of international multiple taxation"; and (2) "whether the tax prevents the Federal Government from speaking with one voice when regulating commercial relations with foreign governments." *Japan Line, Ltd. v. Cty. of L.A.*, 441 U.S. 434, 451 (1979).

In *Japan Line, Ltd.*, the United States Supreme Court held that California could not tax a foreign corporation engaged in shipping without violating the Foreign Commerce Clause because the tax in question would result in multiple taxation and because it was an impediment to the federal government's authority to speak with one voice on foreign trade. The United States Supreme Court was motivated to add the two additional Foreign Commerce Clause factors in *Japan Line, Ltd.* at 447-448 (internal citations omitted) because of the possibility of unaddressable

multiple taxation:

> …neither this Court nor this Nation can ensure full apportionment when one of the taxing entities is a foreign sovereign. If an instrumentality of commerce is domiciled abroad, the country of domicile may have the right, consistently with the custom of nations, to impose a tax on its full value. If a State should seek to tax the same instrumentality on an apportioned basis, multiple taxation inevitably results. Hence, whereas the fact of apportionment in interstate commerce means that "multiple burdens logically cannot occur," the same conclusion, as to foreign commerce, logically cannot be drawn. Due to the absence of an authoritative tribunal capable of ensuring that the aggregation of taxes is computed on no more than one full value, a state tax, even though "fairly apportioned" to reflect an instrumentality's presence within the State, may subject foreign commerce "'to the risk of a double tax burden to which [domestic] commerce is not exposed, and which the commerce clause forbids.'"

Shortly after issuance of *Japan Line*, the United States Supreme Court again addressed questions of state taxation vis-à-vis foreign commerce in *Mobil Oil Corp. v. Comm'r of Taxes*, 445 U.S. 425 (1980). Although the legal analysis is not precisely on point, the facts of *Mobil Oil Corp*. are remarkably similar to the facts in this protest and thus the outcome of that case still has value in the analysis of this protest. In *Mobil Oil Corp*., the multinational Mobil Oil Corp., which conducted much of its business through wholly or partially owned domestic and foreign subsidiaries, had subtracted all of its foreign dividends from its net income on its Vermont Corporate Income Tax Return. *See Mobil Oil Corp.*, 445 U.S. 425, 428-431. Taxpayer in this protest also removed its foreign dividend income and federal Subpart B income from its New Mexico corporate income tax base. Just as New Mexico did in this protest, Vermont in *Mobil Oil Corp.* assessed the taxpayer, the deficiency in tax attributable to Vermont's recalculation and inclusion of foreign dividends in the apportionable income tax base, subject to Vermont apportionment and taxation. *See id*. at 430-431. Mobil Oil Corp. contended that inclusion of this income violated the Due Process Clause, the Commerce Clause, and the Foreign Commerce Clause and the inclusion would result in an unfair and inequitable apportionment of the income

attributable to Vermont. *See id*. at 432.

As part of the analysis of the case, the Supreme Court found that Mobil Oil made no effort to show that the foreign affiliates were not part of its unitary business operations and had failed to sustain its burden of proving that the income was nonbusiness income that must be allocated to the state of domicile rather than apportioned by the state. *See id*. at 439-442. As part of its various challenges, Mobil Oil Corp. also argued that under *Japan Line*, the inclusion and apportionment of the foreign source dividend income would result in a substantial risk of impermissible multiple taxation. *See id*. at 442. As such, Mobil Oil Corp. contended that "because of the risk of multiple taxation abroad, allocation of foreign-source income to a single situs is required at home. Appellant's reasoning tracks the rationale of *Japan Line*, that is, that allocation is required because apportionment necessarily entails some inaccuracy and duplication." *Id*. 446. The Supreme Court rejected this argument, distinguishing between the property taxes assessed in *Japan Line*, where situs was an important consideration, and an apportioned income tax, where situs is of far less value. *See id*. at 445-446 and at 448. Ultimately, the *Mobil Oil Corp.* Supreme Court held that nothing under the Due Process Clause or the Commerce Clause prevented Vermont from taxing its proportionate, apportioned share of Mobil Oil Corp. income, including the foreign-source dividend income. *See id*. at 449.

In 1983, four years after *Japan Line* and three years after *Mobil Oil Corp.*, the United States Supreme Court again discussed the application of the Foreign Commerce Clause to a state's attempt at taxation in *Container Corp. of Am. v. Franchise Tax Bd.*, 463 U.S. 159 (1983). *Container Corp.* involved California's combined reporting taxation of a unitary series of entities. The Supreme Court analyzed three major issues in *Container Corp*.: first, whether that taxpayer and its foreign subsidiary were properly found to be a unitary business; second whether the standard three-factor

apportionment applied to a multinational business violated the constitutional requirement for fair apportionment; and third, whether the state had "an obligation under the Foreign Commerce Clause… to employ the 'arm's-length' analysis used by the Federal Government and most foreign nations in evaluating the tax consequences of intercorporate relationships?" *Container Corp.*, 463 U.S. 159, 163. The Supreme Court ultimately found, after a thorough and comprehensive analysis, that it was proper for the state to find a unitary business relationship under the facts of the case, proper for the state to apply the standard three-factor apportionment to taxpayer and its unitary subsidiaries, and that the Foreign Commerce Clause did not prohibit the tax or compel the state to employ the Federal Government's "arms-length" analysis. *See Container Corp.*, 463 U.S. 159, 184-197.

In analyzing the Foreign Commerce Clause component of the case, the *Container Corp.* Supreme Court clarified and distinguished a few key points from its previous ruling in *Japan Line*, all of which have relevancy to resolution of this protest. First, the *Container Corp.* Supreme Court noted that *Japan Line* involved a property tax rather than an income tax at issue before, which the court found minimized the importance of situs in the analysis. *See Container Corp.*, 463 U.S. 159, 187-188. Secondly, the court noted that any potential double taxation, although a possibility, was not the result of California's formulary apportionment scheme. *See Container Corp.*, 463 U.S. 159, 188. Thirdly, and perhaps most relevant here in this protest, the *Container Corp.* Supreme Court noted that the tax in question was not directed at a foreign corporation, but instead fell on a domestic corporation doing business in the United States, a question it had expressly left unresolved in *Japan Line*. *See Container Corp.*, 463 U.S. 159, 188-189. Because of these differences, the *Container Corp.* Supreme Court held that imposition of taxation did not violate either of the two additional Foreign Commerce Clause factors articulated in *Japan Line*, the substantial risk of multiple taxation or interfering with federal

government's ability to speak with one voice. *Container Corp. See Container Corp.*, 463 U.S. 159, 187-196.

Turning to another of the important cases for resolution of this protest, in 1992 the United States Supreme Court considered when a state's taxing of a corporation's foreign dividends might run afoul of the Foreign Commerce Clause in *Kraft Gen. Foods v. Iowa Dep't of Revenue & Fin.*, 505 U.S. 71 (1992). The question at issue in *Kraft* was "whether the disparate treatment [by Iowa] of dividends from foreign and from domestic subsidiaries violates the Foreign Commerce Clause." *id*. at 73. Similar to New Mexico's taxing scheme, Iowa's starting point for calculating corporate income tax was federal taxable income, which excludes domestic dividends from the income while leaving foreign dividends included in the taxable income. Again like New Mexico, and unlike the federal government, Iowa had no subsequent credit for payment of foreign tax on foreign dividends, meaning that Iowa taxed a single filer corporation's foreign dividends but not its domestic dividends. *See id*. at 73-74.

The Supreme Court considered whether on its face, Iowa's tax scheme and structure violated the Foreign Commerce Clause. *See id*. at 75. The Supreme Court held in *Kraft* that the disparate treatment inherent in Iowa's single-filer corporate tax scheme between foreign and domestic dividends amounted to facial discrimination against foreign commerce and thus amounted to a violation of the Foreign Commerce Clause. *Kraft* did not specifically address either combined returns or consolidated group returns. But in a much cited footnote by state court's addressing combined returns, the *Kraft* Supreme Court stated

> If one were to compare the aggregate tax imposed by Iowa on a unitary business which included a subsidiary doing business throughout the United States (including Iowa) with the aggregate tax imposed by Iowa on a unitary business which included a foreign subsidiary doing business abroad, it would be difficult to say that Iowa discriminates against the

> business with the foreign subsidiary. Iowa would tax an apportioned share of the domestic subsidiary's entire earnings, but would tax only the amount of the foreign subsidiary's earnings paid as a dividend to the parent.
>
> In considering claims of discriminatory taxation under the Commerce Clause, however, it is necessary to compare the taxpayers who are "most similarly situated." A corporation with a subsidiary doing business in Iowa is not situated similarly to a corporation with a subsidiary doing business abroad. In the former case, the Iowa operations of the subsidiary provide an independent basis for taxation not present in the case of the foreign subsidiary. A more appropriate comparison is between corporations whose subsidiaries do not do business in Iowa.

*Kraft*, 505 U.S. 71, 80 n.23 (internal citations omitted).

In 1997, in *Conoco, Inc. v. Taxation & Revenue Dep't*, 1997-NMSC-005, 122 N.M. 736, the New Mexico Supreme Court considered whether New Mexico's separate entity filer corporate income tax method, even with the Department's attempt at formulary apportionment factor relief pursuant to the Detroit Formula, survived Foreign Commerce Clause scrutiny in light of *Kraft*. The two taxpayers at issue in *Conoco, Inc.* had elected to file their respective New Mexico corporate income tax returns under the separate entity method. *See id*. at ¶6. Under that method, like in *Kraft*, the New Mexico Supreme Court noted that New Mexico's reliance on the federal taxable income resulted in the inclusion of foreign dividend income while excluding domestic dividend income from New Mexico corporate income tax. *See id*. at ¶7. Unlike the federal government, which the court noted has a subsequent credit for taxes paid to foreign governments designed to mitigate against the possibility of multiple taxation on foreign subsidiaries, New Mexico does not have a similar credit for foreign taxes paid after determination of federal base income, leading to those taxpayers' claim that New Mexico's statute, like Iowa's statute, facially discriminated against foreign commerce. *See id*.

The New Mexico Supreme Court carefully reviewed the *Kraft* decision, highlighting a few

key parts of that decision that informed its analysis of the issue. The New Mexico Supreme Court noted that Iowa and New Mexico used the same starting point, the federal taxable income as the base income, but that unlike Iowa, New Mexico used the Detroit Formula. *See id*. at ¶8. The New Mexico Supreme Court noted that the US Supreme Court had considered and rejected Iowa's argument that the offending provision was mitigated by the fact that a taxpayer could change their corporate structure or domicile to avoid the disparate treatment of dividends. *See id*. The New Mexico Supreme Court also cited the United States Supreme Court's rejection of Iowa's argument that the administrative efficiency in relying on the federal base income definition justified the statutory scheme. *See id.* at ¶9.

After reviewing the *Kraft* decision in more detail, the New Mexico Supreme Court then turned to a series of decisions from other states that considered the application of *Kraft* to their respective state tax obligations. The New Mexico Supreme Court reviewed the Rhode Island decision, *Dart Industries, Inc. v. Clark*, 657 A.2d 1066 (R.I. 1995), where the Rhode Island Supreme Court had found that *Kraft* controlled the outcome in finding Rhode Island's tax scheme, similar to both Iowa and New Mexico, unconstitutional. *See Conoco, Inc.*, 1997-NMSC-005, ¶10. In particular, the New Mexico Supreme Court cited a portion of the *Dart* decision where the Rhode Island Supreme Court had pointed out that "[a]lthough the Rhode Island and Iowa statutes differ in minor respects, the fatal flaw in the Iowa statute is present in the Rhode Island statute: a preference for domestic commerce over foreign commerce." *Id; Dart* at 88. In contrast to the holding in *Dart*, the New Mexico Supreme Court then analyzed two state cases that reached an opposite conclusion from *Dart* and *Kraft: In re Appeal of Morton Thiokol, Inc.*, 254 Kan. 23, 864 P.2d 1175 (Kan. 1993) and *E.I. Du Pont de Nemours & Co. v. State Tax Assessor*, 675 A.2d 82, (Me. 1996). See *See Conoco, Inc.*, 1997-NMSC-005, ¶11-13.

In *Morton Thiokol, Inc.*, the Kansas Supreme Court considered in pertinent part whether Kansas' combination method corporate filing scheme violated the Foreign Commerce Clause like Iowa's single filer scheme, as found in *Kraft*. *See In re Appeal of Morton Thiokol, Inc.*, 254 Kan. 23, 864 P.2d 1175 (1993). The Kansas Supreme Court noted that like Iowa, the Kansas tax base is determined by looking to federal taxable income. *See In re Appeal of Morton Thiokol, Inc.*, 254 Kan. 23, 25, 864 P.2d 1175 (1993). The Kansas Supreme Court relied on footnote 23 from the *Kraft* decision in its analysis, finding that under that footnote, courts must be careful to select the appropriate comparison between similar circumstances. *See id*. at 36-37. The Kansas Supreme Court found that the taxpayer in that case was asserting an incorrect comparison of two non-combined subsidiaries that would not be subject to Kansas tax. *See id*. at 38. In an extended passage quoted by the New Mexico Supreme Court in *Conoco, Inc.*, 1997-NMSC-005, ¶11, the Kansas Supreme Court in *Morton Thiokol, Inc.* stated:

> [In *Kraft*, t]he Supreme Court compared a parent corporation with a domestic subsidiary which does not do business in Iowa to a parent corporation with a foreign subsidiary which does not do business in Iowa. In this comparison, Iowa discriminated against the parent corporation with the foreign subsidiary because Iowa allowed a deduction for the dividends received by the parent with the domestic subsidiary, but not for the dividends received by the parent with the foreign subsidiary. . . . [However,] *Kraft* "does not address the taxation of foreign dividends by domestic combination states." Clearly, *Kraft* does not hold that the taxation of foreign dividends by a combination method is facially unconstitutional. . . . Allowing a deduction for the domestic dividend avoids double taxation. It is the use of the domestic combination method which distinguishes the Kansas and Iowa tax schemes.

In light of that analysis, the Kansas Supreme Court resolved the pertinent issue before it by concluding that "[i]n 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)." *In re Appeal of Morton Thiokol, Inc.*, 254 Kan. 23, 38.

In the other case that the New Mexico Supreme Court considered in *Conoco, Inc.*, *E.I. Du Pont de Nemours & Co. v. State Tax Assessor*, 675 A.2d 82, (Me. 1996), the Maine Supreme Judicial Court reached a similar conclusion to the Kansas Supreme Court about the applicability of *Kraft* to a combined filing state. The Maine Supreme Judicial Court found that Maine's water's edge combined reporting method provided a "taxing symmetry" between foreign and domestic dividends not present in Iowa's single filer method. *See E.I. Du Pont de Nemours & Co. v. State Tax Assessor*, 675 A.2d 82, 88. As the Maine Supreme Judicial Court expands,

> [f]ar from discriminating against foreign commerce, Maine's water's edge combined reporting method provides a type of "taxing symmetry" that is not present under the single entity system. **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*. Thus, Maine's use of a water's edge combined reporting method distinguishes Maine's taxing scheme from the scheme invalidated by the United States Supreme Court in *Kraft*.

*Id.* (emphasis added).

After reviewing *Kraft*, *Dart Industries, Morton Thiokol, Inc.,* and *E.I. Du Pont de Nemours*, the New Mexico Supreme Court in *Conoco, Inc.*, 1997-NMSC-005, ¶13, stated that because of the similarity between Iowa and Rhode Island's tax scheme, "New Mexico's tax scheme violates the Foreign Commerce Clause unless saved by the Detroit Formula." As the New Mexico Supreme Court explained,

> [t]he Detroit formula, named after an agreement between the Ford Motor Company and the city of Detroit, operates to reduce the New Mexico taxable income base by adding into the denominators of the parent

> corporation's property, payroll, and sales a portion of the property, payroll, and sales of dividend-producing foreign subsidiaries. This portion is determined by dividing the net dividends the parent corporation receives from foreign subsidiaries by these subsidiaries' total net profit. This addition into the divisors lowers the fractional multiplier used against a taxpayer's total income, which lowers its New Mexico taxable income base.

*Id*. ¶14 (internal citations excluded).

The *Conoco, Inc.* New Mexico Supreme Court rejected the Department's argument that the Detroit Formula remedied the disparate treatment of foreign and domestic dividends because the Detroit Formula "does not eliminate dividends paid by foreign subsidiaries in every case," including for the two taxpayers at issues in *Conoco, Inc*. *Id*. at ¶15. The New Mexico Supreme Court in *Conoco, Inc.*, ultimately held that "the taxing of dividends **under the separate corporate entity method** is unconstitutional, even with the Detroit Formula." *Id.* at 16 (emphasis added).

Thus, in New Mexico, it is clear that under the separate corporate entity method, the Department may not tax a corporation's foreign subsidiary dividend income without running afoul of the Foreign Commerce Clause, as articulated in *Kraft* and *Conoco, Inc*. In contrast, two other New Mexico cases found that combined return reporting method did not offend the Foreign Commerce Clause. In one case, *NCR Corp. v. Taxation & Revenue Dep't*, 1993-NMCA-060, 115 N.M. 612, the New Mexico Court of Appeals considered a Foreign Commerce Clause challenge to the Department's standard three-factor formulary apportionment of NCR's unitary business income. *See NCR*, 1993-NMCA-060, ¶5. NCR's argument, and thus the Court of Appeals analysis, seemed to be premised largely on *Japan Line* rather than *Kraft*[5]. *See NCR*, 1993-NMCA-060, ¶12. Relying

[5] The 1992 *Kraft* decision was not addressed in the 1993 *NCR* decision. Perhaps this is why Judge Donnelly indicated in his dissent to the Court of Appeals' decision in *Conoco, Inc.*, that NCR did not address the question of whether disparate treatment of foreign subsidiary dividends versus domestic dividends violated the Foreign Commerce Clause. *See Conoco, Inc. v. State Taxation & Revenue Dep't*, 1997-NMCA-004, ¶ 56, 122 N.M. 745, 931 P.2d 739 (Donnelly J, dissenting), *overruled by Conoco, Inc*., 1997-NMSC-005. Or perhaps *Kraft* was not addressed because at time of the administrative hearing, *Kraft* had not been issued and the record had developed under a different theory of the case.

heavily on *Container Corp.'s* clarification and distinguishing of *Japan Line*, the Court of Appeals ultimately affirmed the Department's assessment in the case. *See NCR*, 1993-NMCA-060. Critical to the *NCR* court's analysis was the fact that NCR, a domestic company doing business in New Mexico, was found to have a unitary business relationship with the foreign subsidiaries that generated unitary income for NCR. *See NCR*, 1993-NMCA-060, ¶20. As the Court of Appeals explained, "[t]he 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." *Id*. Because the tax fell on an apportioned share of unitary business income of a domestic corporation engaged in business in New Mexico, the New Mexico Court of Appeals found that the tax did not run afoul of the Foreign Commerce Clause. *See id*. As the Court of Appeals explained,

> Contrary to the contentions of NCR, in the instant case, New Mexico is taxing only an apportioned share of the income of NCR, a domestic corporation, not imposing a tax on tangible property of a foreign corporation. Unlike the situation in *Japan Line*, multiple taxation, although real, is not inevitable, the tax was fairly apportioned under the formula set forth in UDITPA, and the legal incidence of the tax here does not fall on a foreign owner but instead is upon a unitary, domestic entity.

*NCR Corp.*, ¶ 26.

Building on NCR, perhaps in a more persuasive manner because it addressed both *Kraft* and *Conoco, Inc.*, is the *Xerox* administrative decision and order of Hearing Officer Margaret Alcock, issued by the Administrative Hearings Office's precursor entity, the Department's Hearings Bureau. *See In the Matter of the Protest of Xerox Corporation*, Taxation and Revenue Decision and Order No. 03-22, Dec. 3, 2003 (non-precedential; publicly available at http://realfile.tax.newmexico.gov/03-22__xerox_corporation.pdf ). Although the administrative decision is non-precedential, Hearing Officer Alcock's well-regarded *Xerox* decision and order is still

insightful to the analysis of this protest. *See J. Hellerstein & W. Hellerstein*, ¶4.21[1][d] (in perhaps the preeminent authority on state and local taxation, the hearing officer's *Xerox* opinion is cited for its thoughtfulness). The hearing officer cited favorably both *Morton Thiokol, Inc.'s* and *E.I. Du Pont de Nemours'* rejection of the application of Foreign Commerce Clause under *Kraft* to the combined filing schemes in Kansas and Maine respectively. *See Xerox*, p. 8-10. The hearing officer noted that the holding of *Conoco, Inc.* was limited to separate corporate entity method filers. *See Xerox*, p. 10. The hearing officer then addressed the New Mexico Court of Appeals decision in *NCR Corp. v. Taxation & Revenue Dep't*, 1993-NMCA-060, 115 N.M. 612, noting that the court had allowed taxation of a corporate taxpayer's foreign-source income over a Foreign Commerce Clause challenge because the income was derived from the subsidiaries of a fully-integrated unitary business and New Mexico only taxed an apportioned share of the corporation's total unitary business income. *See Xerox*, p. 11-12; *See also NCR Corp. v. Taxation & Revenue Dep't*, 1993-NMCA-060, ¶20. In an important passage, Hearing Officer Alcock found that "[u]nder the combined filing method (and in contrast to the separate filing method discussed in *Conoco*), Xerox was also required to include on its [combined] return the income of any domestic subsidiaries that were part of Xerox's unitary business." *Xerox*, p.12. In other words, through the unitary business lens underpinning the combined reporting method, Xerox was compelled to include the dividends of any unitary subsidiary—foreign or domestic—in its taxable income. The dividing line for disparate treatment was not between foreign and domestic subsidiaries of Xerox, but between unitary and non-unitary subsidiaries. *See Xerox*, p. 16-18. Because of this equal treatment of all subsidiaries premised under the unitary business principal rather than on location of the subsidiary, the hearing officer found that New Mexico's combined reporting scheme as applied to Xerox had not violated the Foreign Commerce Clause. *See Xerox*, p. 18.

In *Xerox*, the Department had also employed the Detroit Formula to provide factor relief by adding representation of the activities of the foreign subsidiary that produced the unitary income, even though the hearing officer indicated that *NCR, Inc*. held that no such relief was required. *See Xerox*, p. 13. By the Department providing this Detroit Formula relief discussed by the hearing officer, Hellerstein and Hellerstein noted in commenting on the *Xerox* decision that

> New Mexico had, in principle at least, **provided substantial equality** between income from unitary foreign and domestic subsidiaries **by including the income in the apportionable tax base** (whether in the form of dividends or through combination) and by providing representation of the subsidiaries' factors in the formula employed to apportion such income.

*J. Hellerstein & W. Hellerstein*, ¶4.21[1][d] (emphasis added).

In the absence of presentation of clear and cogent evidence to the contrary, the hearing officer found that Xerox had not met its heavy burden[6] of showing that the apportionment formula employed by the Department was not a fair approximation of that taxpayer's income reasonably related to that taxpayer's in-state activities. *See Xerox*, p. 13.

Like New Mexico in *NCR* and *Xerox*, other states have ruled that mandatory combined reporting regimes, where an apportioned share of the unitary income of a corporation is subject to tax, do not run afoul of the Foreign Commerce Clause. *See Caterpillar, Inc. v. Comm'r of Revenue*, 568 N.W.2d 695 (Minn. 1997) (the Minnesota Supreme Court found that Minnesota's water's edge combined reporting system, and its accompanying apportionment formula, did not facially discriminate against foreign commerce); *See GE v. Comm'r, N.H. Dep't of Revenue Admin.*, 154 N.H. 457, 914 A.2d 246 (2006) (New Hampshire Supreme Court distinguishing between the seperate entity reporting at issue in *Kraft* and New Hampshire's water's edge

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[6] Citing *Container Corporation of America v. Franchise Tax Board*, 463 U.S. 159, 161 (1983). *See also Allied-Signal*, 504 U.S. 768, 782, citing *Exxon Corp*. 447 U.S. 207, 224.

combined reporting for unitary businesses); *See Agilent Techs. v. Dep't of Revenue of the Colo*., 2016 Colo. Dist. LEXIS 1, *15-18 (non-precedential district court decision, finding that Colorado's combined reporting regime does not violate Foreign Commerce Clause). Overall, most of the various states considering some form of mandatory combined reporting based on the unitary business principal have found it not to run afoul of the issues addressed by *Kraft* and *Conoco, Inc*.

However, one exception is found in Ohio. There, the Supreme Court of Ohio, relying on *Kraft*, found that Ohio's Combined Reporting tax scheme facially discriminated against foreign commerce, and thus violated the Foreign Commerce Clause. *See Emerson Elec. Co. v. Tracy*, 90 Ohio St. 3d 157, 735 N.E.2d 445, 2000 Ohio LEXIS 2293, 2000-Ohio-174. In comparing the separate entity filing statute at issue in *Kraft* against Ohio's combined reporting statute (Ohio allowed an 85% reduction in foreign dividends and a 100% elimination of domestic dividends), the Ohio Supreme Court stated

> we find that the two statutes do not, in any relevant way, differ in their discriminatory effect. Both laws demonstrate a preference for domestic commerce over foreign commerce, albeit to varying degrees. While [the Ohio Statute] does not, as the Iowa statute did, entirely prohibit the deduction of dividends derived from foreign subsidiaries, this difference in the degree of discrimination has no constitutional significance. When a tax, on its face, has discriminatory economic effects, it is not necessary to consider the extent of the discrimination before finding it unconstitutional under the Commerce Clause. *Fulton Corp. v. Faulkner* (1996), 516 U.S. 325, 333, 116 S. Ct. 848, 855, 133 L. Ed. 2d 796, 806, fn. 3; *Associated Industries of Missouri v. Lohman* (1994), 511 U.S. 641, 649-650, 114 S. Ct. 1815, 1822, 128 L. Ed. 2d 639, 648; *Maryland v. Louisiana* (1981), 451 U.S. 725, 760, 101 S. Ct. 2114, 2136, 68 L. Ed. 2d 576, 604.

*Emerson Elec. Co. v. Tracy*, 90 Ohio St. 3d 157, 160, 735 N.E.2d 445, 448, 2000 Ohio LEXIS 2293, *6-7, 2000-Ohio-174.

***Application of Foreign Commerce Clause legal authority to New Mexico's Consolidated Group Method.***

Returning to this protest, the question is whether *Kraft* and *Conoco, Inc*. treatment of separate entity filers or the rationale expressed in *Xerox, Morton Thiokol, Inc.,* and *E.I. Du Pont de Nemours* addressing combined reporting apply to New Mexico's third permitted reporting method, the federal consolidated group method, under Section 7-2A-8.4 and Regulation 3.4.10.8 (B) (3) NMAC. This appears largely a question of first impression in New Mexico. As discussed above, the consolidated group is allowed pursuant to 26 CFR 1.1502-26 to deduct the aggregate of the members of the group is domestic dividends permitted by 26 U.S.C. 243 (a) from its consolidated group federal taxable income, the starting place for New Mexico's corporate income tax calculation. New Mexico does not have any subsequent equivalent statutory deduction or credit for foreign dividends or foreign taxes paid, although the evidence showed that the Department did provide a limited percentage deduction on the foreign dividends, as described in FOF # 58. This potentially disparate treatment suggests initially that *Kraft* and *Conoco, Inc.* control the outcome of this protest. However, when looking holistically at the consolidated group return, where the aggregation of the group's domestic income under the parent corporation ensures that the income associated with generation of domestic dividends by the parent corporation's group affiliates is taxed, the disparate treatment and discriminatory effect that motivated the decisions in *Kraft* and *Conoco, Inc.* is not present to a significant degree under the consolidated group method.

This is because of a critical difference between separate entity filers and consolidated group filers makes the consolidated group method closer to the combined reporting method at least for purposes of the issue in this protest. While the domestic dividends may be deducted from the consolidated group in calculating the income tax base, in its aggregation of all the income of the group members, the consolidated group return still captures the income of the group members

attributable to the generation of the domestic dividends as part of the base income for the consolidated group, subjecting that income to state taxation under the consolidated group method. In other words, unlike the separate entity return, the consolidated group aggregation ensures that the income generation activity of the entire group, including the income ultimately distributed through domestic dividends, is still included. Thus, although the domestic dividends may be deducted out to avoid double taxation, the total aggregate income of the consolidated group encompasses the total domestic income of the consolidated group, including the income earned that led to the distribution of the dividend, meaning that the total domestic income is subject to state taxation just as the foreign dividend income and federal Subpart F income is subject to state taxation. *See Bernard Egan & Co. v. State Dep't of Revenue*, 769 So. 2d 1060 (Fla. 2000), *cert. denied*, 534 U.S. 995 (2001) (Because in one form or another the domestic dividend income was included in the consolidated group, there was no violation of the Foreign Commerce Clause by inclusion of foreign dividend income); *Cf. also E.I. Du Pont de Nemours & Co.*, 675 A.2d 82, 88 (although domestic dividends paid to parent corporation are deducted, the apportioned income of the all domestic subsidiaries is subject to tax, leading to tax symmetry); *Cf. NCR Corp.,* 1993-NMCA-060; *Cf. also Xerox; Cf. also In re Appeal of Morton Thiokol, Inc.*, 254 Kan. 23.

Similar to the combined return, under the consolidated group method there is also in theory substantial equality between income from foreign and domestic subsidiaries, as the domestic income that led to the dividend distribution is included in the aggregate taxable income of the consolidated group. *Cf. E.I. Du Pont de Nemours & Co.*, 675 A.2d 82, 88 (taxing symmetry of inclusion of the domestic income of all domestic subsidiaries in parent corporation's income distinguishes case from *Kraft*). The inclusion of the aggregate domestic income, including the income that generated the dividend distribution, in the total base income leads to the taxing symmetry concept that the New

Mexico Supreme Court used to distinguish between cases addressing the Foreign Commerce Clause in *Conoco, Inc.*: "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." 1997-NMSC-005, ¶ 12. Of course, in the very next sentence, the New Mexico Supreme Court in *Conoco, Inc.* concluded that such "taxing symmetry [was] not present in New Mexico's tax scheme." *Id.* But the scheme at issue in *Conoco, Inc.* that lacked that tax symmetry was the separate entity filer method, rather than the consolidated group scheme at issue here. Because the domestic income of the Taxpayer's domestic subsidiaries is included in aggregated consolidated group's tax base under the consolidated group method, there is similar tax symmetry in the consolidated group method as in the other state cases that the New Mexico Supreme Court referenced in *Conoco, Inc.*, making this protest distinct from *Kraft* and *Conoco, Inc*. Certainly, and contrary to Taxpayer's reply brief, the inclusion of the entire domestic income, including the income that led to the dividend distribution, in the total taxable income does not demonstrate the "discriminatory economic effects" that motived the New Mexico Supreme Court to act in *Conoco, Inc.*, 1997-NMSC-005, ¶15 (in paragraph cited in Taxpayer's reply brief, the New Mexico Supreme said that when a tax on its face has a discriminatory economic effect, it was proper for court to conclude it was unconstitutional regardless of the extent of inequality of the tax).

A few of the arguments of the parties require further analysis, especially because this is a complex issue with potentially sounds arguments supporting each position. Although the Department ultimately prevails on this close question, the Department's argument in this case was not particularly helpful because it continually returned to an argument that has been soundly rejected in case law. The

Department repeatedly argued[7] that by voluntarily submitting a consolidated group return instead of one of the other methods where the constitutionality was not at issue, Taxpayer has waived all nexus and Commerce Clause defenses to state income taxation. As support for this proposition, the Department cites only *Bernard Egan & Co.* As cited favorably above, the *Bernard Egan* case does address a Foreign Commerce Clause challenge under the consolidated group reporting method (the only case either side presented, or that the undersigned was able to locate, that squarely addressed Kraft in the context of consolidated group filing), which certainly supports the Department's broader position. However, contrary to the Department's fixation on the waiver issues, *Bernard Egan* does not reach that conclusion through the "waiver" or "nexus" analysis. In fact, nowhere in the two page decision are the words "waiver," "nexus", or their functional equivalents used, let alone is there any discussion of how the voluntary nature of a consolidated group return alters the constitutional analysis under the Foreign Commerce Clause. Instead, importantly the *Bernard Egan* court holds that because Florida has made certain adjustments necessary to avoid discrimination and because one in one form or another the domestic dividends are included, Bernard Egan & Co. failed to carry its burden of demonstrating the Florida statute unconstitutional. *Bernard Egan & Co.*, 1061-1062.

The Department's waiver argument is also contradicted by numerous statements by the United States Supreme Court in *Kraft* and the New Mexico Supreme Court in *Conoco, Inc*. Although not precisely on point, the United States Supreme Court rejected Iowa's argument that because the taxpayer could have structured its subsidiaries differently in order to avoid the disparate treatment but

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[7] The Department's brief cites the rejected voluntary election/wavier argument, or some variation thereof, in five of the Department's seven bulleted legal arguments. *See* Department Response to Taxpayer's Motion for Summary Judgment, III (A) (express discussion of waiver), III(B) ("''unlike Taxpayer here, who elected to file a consolidated return, there was no issue of waiver in *Container*…"), III(C) (in addressing Xerox, indicating that unitariness is moot in light of voluntary election); III(D) (election of reporting method distinguishes this case from *Conoco Inc*.); II(G) ("short answer is that Taxpayer should not have opted out of separate" filing). The Department's remaining arguments defend the apportionment method rather than address the Foreign Commerce Clause issue.

choose not to, there was no violation of the Foreign Commerce Clause. *See Kraft*, ¶77-78. That is, the fact that the taxpayer had viable alternatives available to it that would not have resulted in the disparate treatment of foreign and domestic dividends did not, in the eye of the *Kraft* Supreme Court, excuse the facial discrimination under the statute. The New Mexico Supreme Court in *Conoco, Inc*. noted this same point. *See Conoco, Inc.*, 1997-NMSC-005, ¶ 20. And it is also an argument rejected by the Ohio Supreme Court in *Emerson Elec. Co. v. Tracy*, 90 Ohio St. 3d 157, 160, 735 N.E.2d 445, 448, 2000 Ohio LEXIS 2293, *6-7, 2000-Ohio-174, as quoted above.

Moreover, in *Conoco, Inc*., the New Mexico Supreme Court expressly considered and rejected the Department's "voluntary election" defense to the separate entity filer statute, an argument strikingly familiar to the Department's waiver argument in this case. The New Mexico Supreme Court in *Conoco, Inc.*, 1997-NMSC-005, ¶ 23, summarized the Department's voluntary election defense as

> [t]he Department argues that [Taxpayers] are not entitled to relief because any discrimination against foreign commerce was a result of their decision to utilize separate entity filing over other options. The Department cites footnote 23 from *Kraft* to show that the Court approved domestic combined reporting and therefore argues that the Taxpayers had the option of choosing a constitutional method of filing.

Again, that argument is essentially the Department's argument in this case: by Taxpayer electing to file under the consolidated group method as opposed to other methods, Taxpayer waived any Constitutional Commerce Clause issues. In rejecting the Department's voluntary election defense, the New Mexico Supreme Court stated

> [e]ven if the Court implicitly approved domestic combined reporting, an interpretation we are not inclined to accept and do not adopt in this opinion, **the existence of constitutional options should not preclude taxpayer relief from the unconstitutional aspects of the option exercised by the taxpayer. Courts will not ignore constitutional challenges merely because the claimant could have chosen another option, the constitutionality of which is not questioned**. In Intel's action before the Department's hearing officer, the officer stated that

> [taxpayer] has exercised the right given it by the Secretary in Regulation CIT 9:2 to file under the separate corporate entity filing method. Having made a valid election of filing methods, [taxpayer] is entitled to have that filing method applied to it in a constitutional manner.
>
> We agree with both the Court of Appeals and the hearing officer and find that the presence of other reporting options is not relevant to the Taxpayers' claim.

*Conoco, Inc.* , 1997-NMSC-005, ¶ 23 (emphasis added, internal citations removed).

In sum, because the New Mexico Supreme Court's statement expressly rejected the very argument contained throughout the Department's argument in this case, the Department's recycled and rejected waiver argument is not persuasive.

The Department's argument was virtually silent on the differences and similarities between combined returning and consolidated groups, assuming without saying that they are identical. However, the structure of each reporting method is critical to the analysis of this case, and a more disciplined and detailed approach would have been far more helpful than focusing on the recycled and rejected voluntary waiver argument or in making unstated assumption that a combined return and consolidated return are identical. Moreover, the Department failed in this case to assert as uncontested facts (or highlight in any manner) significant portions of the Department's audit narrative addressing two potential fertile subjects. First, the Department failed to address the audit narrative's suggestion of a unitariness of Taxpayer with its foreign subsidiaries (which certainly would have pushed the facts and the analysis in this matter even closer to the *Xerox, Morton Thiokol, Inc.,* and *E.I. Du Pont de Nemours* rationale). Moreover, the Department also failed to highlight the fact that in the audit narrative, in addition to the factor relief under the Detroit Formula, the auditor indicated that the Department provided some deductions for the foreign dividends paid depending on Taxpayer's ownership interest in the foreign entity. The Department allowing a percentage deduction on foreign

dividend payment, especially on top of the Detroit Formula factor relief, is certainly relevant to the question of disparate treatment between foreign and domestic dividends, even if it by itself it's not dispositive of the question.

Turning to some of the Taxpayer's arguments, Taxpayer's first argument about facial discrimination is addressed largely by the analysis above. Without rehashing the entire discussion again, in short summary in considering the treatment of the foreign dividends and the inclusion of the domestic income that led to the dividend distribution, unlike the separate entity return where there is facial discrimination, there is a taxing symmetry under the consolidated group method. *See Bernard Egan & Co.,* 769 So. 2d 1060 (Fla. 2000).

The Taxpayer next argued that the New Mexico scheme results in inevitable multiple taxation of foreign commerce, and thus the tax must be struck down. The hearing officer is not convinced that inevitable double taxation will result in this case, especially in light of the fact that the Department took steps to mitigate double taxation in this matter, including employing the Detroit Formula and allowing Taxpayer to make percentage deductions on the foreign-sourced income. However, like the tax found not to violate the Foreign Commerce Clause by the United States Supreme Court in *Container Corp.*, the tax at issue is not a tax on a foreign corporation, but instead is an apportioned tax on the entire income of a domestic consolidated group, including domestic income that resulted in the distribution of dividends and foreign subsidiary income. Even though both the domestic income and foreign income were included in the consolidated group's tax base, the Department still employed the Detroit Formula (and also provided deductions on the foreign dividend income and federal Subpart F income depending on Taxpayer's ownership percentage) to mitigate the possibility of double taxation on the foreign income. Again, *Container Corp* is instructive:

> Allocating income among various taxing jurisdictions bears some resemblance, as we have emphasized throughout this opinion, to slicing a

> shadow. In the absence of a central coordinating authority, absolute consistency, even among taxing authorities whose basic approach to the task is quite similar, may just be too much to ask. If California's method of formula apportionment "inevitably" led to double taxation, that might be reason enough to render it suspect. But since it does not, it would be perverse, simply for the sake of avoiding double taxation, to require California to give up one allocation method that sometimes results in double taxation in favor of another allocation method that also sometimes results in double taxation… Although double taxation is a constitutionally disfavored state of affairs, particularly in the international context, *Japan Line* does not require forbearance so extreme or so one-sided.

463 U.S. 159, 192-93 (1983) (internal citations removed). *See also Mobil Oil Corp.*, 463 U.S. 425 (as discussed in detail above, upholding a state's apportioned tax on unitary foreign source dividend income over a challenge under *Japan Line* for potential risk of multiple taxation).

Taxpayer's third argument, that New Mexico's consolidated group method results in unfair apportionment of income from foreign commerce, also is similarly answered by the United States Supreme Court's analysis in *Container Corp.*, and to a lesser extent, *Mobil Oil Corp.* First off, the *Container Corp.* Supreme Court emphasized that Taxpayer has the burden to demonstrate unfair apportionment:

> The Constitution does not [invalidate] an apportionment formula whenever it may result in taxation of some income that did not have its source in the taxing State . . . . Nevertheless, we will strike down the application of an apportionment formula if the taxpayer can prove by clear and cogent evidence that the income attributed to the State is in fact out of all appropriate proportions to the business transacted . . . in that State.

*Container Corp.*, 463 U.S. 159, 169-70 (Internal citations and quotations removed).

Against this backdrop, the *Container Corp.* Supreme Court found that the standard three-factor apportionment, widely accepted and employed used, generally avoids the type of distortions that would lead to finding of unfair apportionment. *See id.* at 182-184. The *Container Corp.* Supreme Court found, that despite that taxpayer's argument to the contrary, a variance of 14% between that

taxpayer's proposed method and the three factor apportionment employed by California was safely within the margin of error for any method of income attribution and not in any way indicative of unfair, distortive apportionment. *See id.* 184. As the Department argues, it is difficult to find the Taxpayer established by clear and cogent evidence that the minuscule 0.1895% (with slight but insignificant variations in each audited year) percentage of income attributed to New Mexico under apportionment was out of all appropriate proportion to the business transacted in New Mexico. As such, Taxpayer failed here to meet its heavy burden, just as in *Container Corp.* and *Mobil Oil Corp.*, 445 U.S. 425, 428-429 (where the Court noted the tiny proportions of the state's total sales, payroll, and property compared to that taxpayer's worldwide enterprise).

Taxpayer's fourth and fifth arguments are related: Taxpayer argues that the Department lacked any legal authority in this protest to employ the Detroit Formula factor relief because its previous rulemaking proceeding after *Conoco, Inc.* had repealed that usage of the Detroit Formula. Taxpayer also emphasized that the Department during that rulemaking had contemplated a regulation that would have eliminated potential disparate treatment of foreign dividends for all three reporting methods precisely because the Department was concerned that its approach would be found unconstitutional.

As to using the Detroit Formula relief, this argument is not particularly persuasive. While it is true that Taxpayer would prefer to not pay any tax on the foreign source income, and thus complains that the Detroit Formula is insufficient to save the state's attempt at taxation (an issue already addressed above), the Detroit Formula actually slightly[8] reduces Taxpayer liability compared to the standard three factor apportionment because it incorporates Taxpayer's relevant foreign payroll, sales,

[8] As Taxpayer indicates using the undisputed material facts, the Detroit Formula only reduced Taxpayer's liability by approximately $270,000.00, from $3,615,740 to 3,346,058, or a reduction of under 7.5%.

and property into the denominator of the equation. If, as here, Taxpayer has failed to establish how the three factor apportionment formula is unfairly out of proportion with Taxpayer's state activities, than surely Taxpayer cannot carry its heavy burden to show that the additional factor relief provided to Taxpayer's benefit under the Detroit Formula is not proportionate. Moreover, even if the Detroit Formula is no longer expressly stated by regulation, the Department by statute is allowed to make equitable adjustments to apportionment under NMSA 1978, Section 7-4-19 (1986), which it choose to do in the form of factor relief, to Taxpayer's favor in reducing the apportionment percentage, in this case. As to the draft regulations, and the discussions thereof, the hearing officer is also unpersuaded. The proposed draft regulation was in fact never adopted. And as the Department intimates, the participants in those discussions of the rejected draft regulation, while certainly some of the respected luminaries in the field of New Mexico state taxation, did not have the luxury of subsequent legal opinion and analysis to inform their speculation about how the combined reporting and consolidated group methods would be treated after *Conoco, Inc.'s* holding addressing separate entity filers.

In summary, as to Taxpayer's challenges to the inclusion of foreign dividend and Subpart F income, because under the consolidated group method there is a taxing symmetry of the treatment of foreign-sourced income and the aggregate of domestic income, which includes the income activity that led to the dividend distribution, the Department's assessments as they relate to the foreign dividends and federal Subpart F income were appropriate and did not afoul of the Foreign Commerce Clause, Commerce Clause, or Due Process Clause.

**Taxpayer's Argument for Abatement of Penalty.**

Taxpayer argued that in the event it was found liable for the assessed tax, penalty should nevertheless be abated because any error it made in this matter resulted from a mistake of law made

in good faith and on reasonable grounds. The Department argues that this issue was long ago decided by *Container Corp.*, *NCR Corp.*, and *Xerox*, and thus Taxpayer's wishful thinking is not grounds to find Taxpayer non-negligent.

When a taxpayer fails to pay taxes due to the state because of negligence or disregard of rules and regulations, but without intent to evade or defeat a tax, NMSA 1978 Section 7-1-69 (2007) requires that

> there *shall* be added to the amount assessed a penalty in an amount equal to the greater of: (1) two percent per month or any fraction of a month from the date the tax was due multiplied by the amount of tax due but not paid, not to exceed twenty percent of the tax due but not paid.

(*italics* added for emphasis).

The statute's use of the word "shall" makes the imposition of penalty mandatory in all instances where a taxpayer's actions or inactions meets the legal definition of "negligence." *See Marbob Energy Corp. v. N.M. Oil Conservation Comm'n*, 2009-NMSC-013, ¶22, 146 N.M. 24 (use of the word "shall" in a statute indicates provision is mandatory absent clear indication to the contrary). Regulation 3.1.11.10 NMAC defines negligence in three separate ways: (A) "failure to exercise that degree of ordinary business care and prudence which reasonable taxpayers would exercise under like circumstances;" (B) "inaction by taxpayer where action is required"; or (C) "inadvertence, indifference, thoughtlessness, carelessness, erroneous belief or inattention." Taxpayer meets this definition of negligence, and thus is potentially subject to civil negligence penalty under Section 7-9-69.

However, in instances where a taxpayer might otherwise fall under the definition of civil negligence generally subject to penalty, Section 7-1-69 (B) provides a limited exception: "[n]o penalty shall be assessed against a taxpayer if the failure to pay an amount of tax when due results

from a mistake of law made in good faith and on reasonable grounds." In this case, the law is far from as clear as the Department suggests. Although this decision has rejected Taxpayer's argument that the logic of *Kraft* and *Conoco, Inc.* extend to consolidated filers, this is an issue of first impression in New Mexico that should be carefully considered by our appellate courts. In light of those cases, and some of the similarities between a separate entity filer and a consolidated group, Taxpayer presented a good faith legal justification based on reasonable grounds as to why it excluded foreign dividend and Subpart F income from it base income, even if that argument did not prevail here (and frankly, this was a very close case). Consequently, Taxpayer's mistake in this case was a mistake of law made in good faith and on reasonable grounds. Therefore, civil negligence penalty shall be abated under Section 7-1-69 (B)

**Taxpayer's Argument for Awarding of Costs and Fees.**

In its motion for summary judgment, Taxpayer argued that under NMSA 1978, § 7-1-29.1 (2003), Taxpayer was entitled to attorney's fees and costs in this protest. NMSA 1978, § 7-1-29.1 (2003) provides that when a taxpayer is the prevailing party in an administrative proceeding before the Department, the taxpayer shall be awarded reasonable administrative costs, including attorney's fees. The taxpayer is a "prevailing party" if it has substantially prevailed with respect to (a) the amount in controversy or (b) most of the issues involved in the case or the most significant issue or set of issues involved in the case. § 7-1-29.1(C)(1). But the taxpayer will not be treated as a prevailing party if the Department "establishes that the position of the department in the proceeding was based upon a reasonable application of the law to the facts of the case." § 7-1-29.1(C)(2).

In this case, Taxpayer did not prevail on the major issue. Even if Taxpayer had prevailed, the Department's position in this proceeding would still have been based on a reasonable

application of the law to the facts of this protest in light of *Morton Thiokol, Inc., E.I. Du Pont de Nemours*, and *Xerox*'s treatment of combined reporting and the novelty of the question as applied to the similar consolidated group method. Wherefore, Taxpayer's request for attorney's fees and costs is denied under Section 7-1-29.1(C)(2).

## CONCLUSIONS OF LAW

A. Taxpayer filed a timely, written protests of the Department's assessments and jurisdiction lies over the parties and the subject matter of this protest.

B. At the request of the parties, and pursuant to NMSA 1978, Section 7-1B-8 (D) (2015), Taxpayer's protest of both parties were consolidated upon the parties' statement that both protests involved the substantially identical legal issues.

C. Taxpayer moved for full summary judgment in this case, asserting that there was no genuine dispute of facts and that the matter was ripe for decision as a matter of law. As there is no genuine dispute as to any material fact, and Taxpayer was aware of the Department's counter claims, summary judgment is appropriate in this matter. *See Romero v. Philip Morris, Inc.,* 2010-NMSC-035, ¶7, 148 NM 713; *See also Martinez v. Logsdon*, 1986-NMSC-056, ¶12, 104 N.M. 479 (summary judgment may be granted to nonmoving party when they are entitled to it as a matter of law and the moving party had general notice of nonmoving party's claims).

D. The holding of *Conoco, Inc. v. New Mexico Taxation and Revenue Department*, 1997-NMSC-005, expressly addressed separate entity filers, and has not been expressly extended to either combined return filers or consolidated group filers.

E. New Mexico's corporate income tax scheme, vis-à-vis the consolidated group reporting method, does not violate the Foreign Commerce Clause because in addition to the foreign dividend income, it includes the aggregate income of the domestic consolidated group,

including the income that led to distribution of dividends, in the base income. *See Bernard Egan & Co. v. State Dep't of Revenue*, 769 So. 2d 1060 (Fla. 2000), *cert. denied*, 534 U.S. 995 (2001); *Cf. NCR Corp. v. Taxation & Revenue Dep't*, 1993-NMCA-060; *Cf. also Xerox; Cf. also In re Appeal of Morton Thiokol, Inc.*, 254 Kan. 23, 864 P.2d 1175 (Kan. 1993); *Cf. also E.I. Du Pont de Nemours & Co. v. State Tax Assessor*, 675 A.2d 82, (Me. 1996).

F. Unlike the facts and circumstances in *Japan Line*, New Mexico's imposition of tax in this case is not against a foreign corporation, but against the apportioned income of a consolidated group of domestic corporations, the parent of which does business in New Mexico, making this case distinguishable from *Japan Line*. Moreover, the risk of multiple taxation that motivated the property tax as issue in Japan Line is not as acute as an apportioned income tax. *See Container Corp. of Am. v. Franchise Tax Bd.*, 463 U.S. 159 (1983).

G. Taxpayer did not meet its heavy burden of establishing that the Department's use of the standard three-factor apportionment, or the subsequent factor relief under the Detroit Formula, resulted in an unfair apportionment not at all appropriate to the proportions of business transacted in the state. *See Container Corp. of Am. v. Franchise Tax Bd.*, 463 U.S. 159 (1983).

H. NMSA 1978, Section 7-4-19 (1986) gave the Department authority to employ the Detroit Formula to provide Taxpayer further factor, to Taxpayer's benefit, to the apportionment of income.

I. The Department's argument that Taxpayer waived any Commerce Clause challenges in this matter by voluntarily electing to file a consolidated group return was expressly rejected by the New Mexico Supreme Court in *Conoco, Inc. v. New Mexico Taxation and Revenue Department*, 1997-NMSC-005, ¶23.

J. Under NMSA 1978, Section 7-1-67 (2007), Taxpayer is liable for accrued interest under the assessment. Interest continues to accrue until the tax principal is satisfied

K. Taxpayer established that it made a mistake of law, in good faith and on reasonable grounds, and thus is not subjected to civil negligence penalty under NMSA 1978, Section 7-1-69 (B).

L. Because Taxpayer was not prevailing party, Taxpayer is not entitled to the awarding of costs and fees in this matter. *See* NMSA 1978, Section 7-1-29.1 (2015).

For the foregoing reasons, Taxpayer's protest **IS PARTIALLY GRANTED AND PARTIALLY DENIED**. The Department is ordered to abate the assessed penalty. Taxpayer is ordered, less any other adjustments previously agreed to by the parties[9], to pay the remaining assessed tax plus accumulated interest as calculated by the Department pursuant to NMSA 1978, Section 7-1-67 (2013).

DATED: April 6, 2018

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Brian VanDenzen, Esq.
Chief Hearing Officer
Administrative Hearings Office
P.O. Box 6400
Santa Fe, NM 87502

[9] The parties indicated at the end of the oral argument that they may have reached an agreement on some other minor adjustments to the assessment beyond the foreign source income issue, though they did not provide a details. The parties should proceed accordingly with those adjustments.

## NOTICE OF RIGHT TO APPEAL

Pursuant to NMSA 1978, Section 7-1-25 (2015), the parties have the right to appeal this decision by filing a notice of appeal with the New Mexico Court of Appeals within 30 days of the date shown above. If an appeal is not timely filed with the Court of Appeals within 30 days, this Decision and Order will become final. Rule of Appellate Procedure 12-601 NMRA articulates the requirements of perfecting an appeal of an administrative decision with the Court of Appeals. Either party filing an appeal shall file a courtesy copy of the appeal with the Administrative Hearings Office contemporaneous with the Court of Appeals filing so that the Administrative Hearings Office may being preparing the record proper. The parties will each be provided with a copy of the record proper at the time of the filing of the record proper with the Court of Appeals, which occurs within 14 days of the Administrative Hearings Office receipt of the docketing statement from the appealing party. *See* Rule 12-209 NMRA.

**CERTIFICATE OF SERVICE**

On April 6, 2018, a copy of the foregoing Decision and Order was mailed to the parties listed below in the following manner: