OFFICIAL TRANSCRIPT

PROCEEDINGS BEFORE

THE SUPREME COURT

OF THE

UNITED STATES

CAPTION: KRAFT GENERAL FOODS, INC., Petitioner v.

IOWA DEPARTMENT OF REVENUE AND FINANCE

CASE NO: 90-1918

PLACE: Washington, D.C.

DATE: April 22, 1992

PAGES: 1 - 50

ALDERSON REPORTING COMPANY

1111 14TH STREET, N.W.

WASHINGTON, D.C. 20005-5650

202 289-2260

RECEIVED
SUPREME COURT, U.S
MARSHAL'S OFFICE

'92 APR 29 A10:38

IN THE SUPREME COURT OF THE UNITED STATES

- X

KRAFT GENERAL FOODS, INC., :

Petitioner :

v. : No. 90-1918

IOWA DEPARTMENT OF REVENUE :

AND FINANCE :

- X

Washington, D.C.

Wednesday, April 22, 1992

The above-entitled matter came on for oral argument before the Supreme Court of the United States at 11:01 a.m.

APPEARANCES:

JEROME B. LIBIN, ESQ., Washington, D.C.; on behalf of the Petitioner.

MARCIA MASON, ESQ., Assistant Attorney General of Iowa, Des Moines, Iowa; on behalf of the Respondent.

KENT L. JONES, ESQ., Assistant to the Solicitor General, Department of Justice, Washington, D.C.; on behalf of the United States, as amicus curiae supporting Respondent.

CONTENTS

ALDERSON REPORTING COMPANY, INC.
1111 FOURTEENTH STREET, N.W.
SUITE 400
WASHINGTON, D.C. 20005
(202)289-2260
(800) FOR DEPO

PROCEEDINGS

(11:01 a.m.)

CHIEF JUSTICE REHNQUIST: We'll hear argument next in No. 90-1918, Kraft General Foods v. Iowa Department of Revenue and Finance.

Mr. Libin, you may proceed.

ORAL ARGUMENT OF JEROME B. LIBIN

ON BEHALF OF THE PETITIONER

MR. LIBIN: Thank you, Mr. Chief Justice, and may it please the Court:

This case involves a challenge to a different type of state statute, namely a taxing statute. It involves specifically how the State of Iowa taxes dividends received by parent companies doing business there from their foreign subsidiaries and perhaps domestic subsidiaries.

Petitioner is a multi-state, multinational corporation engaged in business throughout this country and in foreign countries. Its domicile is in Illinois, it does business in Iowa, of course, and other states. During the year at issue it received approximately $10 million in dividends from foreign subsidiaries, each of which engaged in business only in foreign countries.

Under Iowa's law it was required to include those dividends in its tax base and to compute its Iowa income tax with respect to those dividends by full inclusion. Had it received any dividends from other subsidiaries during that year it would not have been required to include those dividends in its tax base under the Iowa law. The Iowa law adopts the Federal Internal Revenue Code as the basis for taxation, and under the Federal Internal Revenue Code only dividends from foreign subsidiaries doing business in foreign countries are required to be included in income and receive no offsetting deduction.

Petitioner challenged the Iowa statute as being facially discriminatory, singling out for inclusion in the tax base only the dividends from foreign subsidiaries doing business in foreign countries. The Iowa Court, Supreme Court, rejected petitioner's challenge, holding that the statute was constitutional because it could find no basis for a benefit resulting that was peculiar to Iowa with respect to application of the statute.

QUESTION: Well, Mr. Libin, now I take it that under the Federal Income Tax Code that there is a foreign tax credit and these dividends, if taxed in the foreign country, then a credit is given on the Federal income tax, dollar for dollar.

MR. LIBIN: That is correct, Justice O'Connor.

QUESTION: And you think that the state has to provide a second dollar of credit, is that it?

MR. LIBIN: No, we do not request that. That would be impermissible, I think, and the footnote number 30 in Container, in the decision of this Court in Container indicates that a credit at the state level for foreign taxes paid would probably not be permissible because you already have received full credit at the Federal level.

QUESTION: Exactly. So why isn't it perfectly rational for the state to exclude, then, any recognition of the foreign, or go ahead and tax the foreign subsidiary dividend?

MR. LIBIN: It certainly has the power to tax foreign subsidiary dividends without a credit, Justice O'Connor, but what we believe is clearly correct under this Court's decisions is that it does not have the power to single out those dividends for taxation vis-a-vis all other kinds of dividends, because they're, that is discrimination under the Foreign Commerce Clause. It singles out dividends generated in foreign commerce for taxation, it does not impose a tax on dividends generated in domestic commerce. And under Complete Auto in Japan line, the test for determining whether a statute infringes on and violates the Foreign Commerce Clause is whether it is non-discriminatory.

QUESTION: Well, the state just wants to piggy-back on the Federal income tax law, a perfectly reasonable desire on the part of the state, and many states do the same thing, don't they?

MR. LIBIN: Many states do the same thing. 26 of the states that piggy-back off of the Federal tax law have eliminated this discrimination. They have faced up to the problem and said it is not correct to tax only foreign subsidiary dividends, so we will either tax both or neither.

QUESTION: Mr. Libin, a minute ago you said you can't tax dividends from foreign commerce versus dividends from domestic commerce, but that's one -- it isn't necessarily dividends from foreign commerce. It could be a foreign subsidiary that does business in the United States, just as in other cases it could be a domestic subsidiary that does foreign commerce business.

MR. LIBIN: Under the statutory scheme, Justice Scalia, if a foreign subsidiary does business in the United States dividends paid by it to its parent company will receive an offsetting deduction to reflect that domestic content, so that there is symmetry with respect to that situation and other domestic corporations.

QUESTION: What if, what if a domestic corporation does foreign business?

MR. LIBIN: If a domestic corporation does foreign business, then under the Federal scheme, because it is a domestic corporation, it is engaged partly domestic, partly foreign commerce in that setting, its dividends are, receive the benefit of the deduction because of the domestic content again. It is only the pure foreign corporation doing business in a foreign country that is singled out for taxation without an offsetting deduction. That's the only case that is subject to tax in Iowa.

QUESTION: Now, I wish to understand this, and correct me if I'm wrong. You had the option under the Federal income tax law to deduct, to elect a deduction of these dividends, and if you had exercised that option you would have had the same deduction under Iowa law, correct?

MR. LIBIN: Not a deduction for the dividends, Justice Kennedy. There is an ability to deduct the foreign tax that's withheld on the dividends, but only the foreign tax, not the whole dividend.

QUESTION: And is that the same both for Federal and Iowa law?

MR. LIBIN: Iowa allows that deduction if you elect to take a deduction for withholding taxes rather than a credit for the full amount of foreign taxes paid, namely both withholding tax and tax on the earnings of the subsidiary that paid the dividends.

QUESTION: I want to be sure that I follow. If you elect the deduction route --

MR. LIBIN: Yes.

QUESTION: -- can you deduct the same amount or a greater amount or a lesser amount under state law?

MR. LIBIN: Same amount.

QUESTION: That you can deduct --

MR. LIBIN: Same amount. In this case the dividends at gross were $10 million.

QUESTION: So in one sense, then, for some taxpayers at least, there is no discrimination?

MR. LIBIN: No, there will always be discrimination because the deduction for withholding taxes will not equal the full amount of the dividend by any means, it's just the tax piece. The deduction for domestic dividends is the full amount of the dividend. It becomes awash for tax purposes if the dividend has domestic content. You put it into income, you take it out of income. On the foreign side you put it into income, the most you can deduct is the withholding tax piece of that, which might be 10 or 15 percent of the dividend, whatever the rate is in the foreign country.

QUESTION: Right.

MR. LIBIN: That's all you deduct. The balance remains subject to tax, and it's the only situation where there's tax.

QUESTION: But overall --

QUESTION: But that's not a credit, you just --

MR. LIBIN: Not a credit. You have a choice under Federal law, credit or deduction for the tax.

QUESTION: Overall, Mr. Libin, your foreign subsidiary isn't treated any worse than a domestic corporation in Iowa, is it?

MR. LIBIN: Yes, it is, Justice Rehnquist, because the dividends that it pays to its parent in Iowa are taxed in Iowa. The domestic subsidiary's dividends are not taxed.

QUESTION: Yeah, but it's the domestic -- I'm talking, not talking about a domestic, how about just an -- okay, a domestic subsidiary. It's income is taxed.

MR. LIBIN: It's income is taxed in Iowa, that's correct, but that's a totally different tax on a totally different entity for a totally different --

QUESTION: Well, but we don't necessarily weigh these things, put them into numerous sub-classes and sub-compartments. The basic question is does this favor Iowa corporations over foreign corporations.

MR. LIBIN: Well, we don't believe that's quite the test, Your Honor. We believe in the foreign area the question is whether it favors domestic corporations generally over foreign corporations.

QUESTION: Well, supposing you apply my test, which you may be right, maybe it's not the right one, but generally it doesn't favor foreign corporations over Iowa corporations, does it?

MR. LIBIN: Well, we think it does even there if we applied your test, Mr. Chief Justice, because under the Armco analysis it would be appropriate to look at the fact that Iowa's tax on earnings would be applied by other jurisdictions as well. So that all subsidiaries, it can be assumed, pay tax on their earnings, yet only the foreign subsidiary has its dividends taxed. And we believe that even under that analysis there is discrimination under the Iowa law with respect to --

QUESTION: And the foreign sub has paid a tax on its earnings abroad?

MR. LIBIN: Yes, correct, Justice White.

QUESTION: As well as withheld on the dividends paid?

MR. LIBIN: On the dividend itself, correct, as the record shows in this case. Exactly right. And for that reason the Iowa tax, in our judgment, facially discriminates against one category of dividend to the exclusion of all others, and there is no benefit to Iowa companies or to domestic companies generally. They are, the foreign subsidiaries are singled out for the burden imposed by the Iowa statute.

Now, the respondent and the United States undertake to suggest perhaps that there's really no commerce involved here for some reason, it's really only a matter of place of incorporation. But as we have indicated with respect to the structure of the taxing scheme, it is a combination of commerce and structure that is relevant here, and therefore clearly commerce is totally involved in this.

QUESTION: What about a foreign sub that does business only in the foreign country, doesn't ship any products or anything, nothing that it does crosses any international boundary. I suppose you would say it's nevertheless commerce because of the transfer of capital and funds across borders?

MR. LIBIN: Yes we would, Justice White, exactly right. The dividend remittance itself is a part of commerce. I think the Mobil case indicates --

QUESTION: Or the capital investment in the first place.

MR. LIBIN: Correct, the formation of the subsidiary in the first place, exactly. So there can't be any question that foreign commerce is fully implicated in

ALDERSON REPORTING COMPANY, INC.
1111 FOURTEENTH STREET, N.W.
SUITE 400
WASHINGTON, D.C. 20005
(202)289-2260
(800) FOR DEPO

this case. And we think that the suggestions of the respondent that we could avoid this problem by using domestic subsidiaries is simply not appropriate because, as was stipulated in this case, there are many reasons why corporations seeking to do business in foreign countries must use foreign subsidiaries, either because the law requires it to do business there or perhaps to own property there or to manufacture there. That was stipulated by the parties.

As well as the commercial, the obvious commercial advantages of being locally identified, of being able to perhaps deal more easily with banks and with other creditors, and to market goods with local identification. So the suggestion that has been offered here by respondent that there may be a way to avoid this problem by using domestic corporations is simply not a viable suggestion in our opinion.

We also think that the notion of a domestic holding company, which was also proposed, to own the stocks of foreign subsidiaries --

QUESTION: Why? What's the matter with that?

MR. LIBIN: Well, number one, we're not clear on exactly how it works, frankly. It was sort of unsolicited tax advice that we received. But I think respondent suggests that you must do this outside of Iowa because

Iowa would tax these dividends when they were paid to the foreign, to the domestic holding company, and if you assume every state has Iowa's tax, which is a perfectly appropriate assumption in issues of this sort, then it, the dividends would be taxed by any state where you formed a holding company.

Ultimately we think it's a matter of not being free to make a tax neutral decision, as many cases in this Court have indicated is one of the values recognized by the Commerce Clause, that state laws that effectively induce you or require you to make a decision as to how to operate because of tax considerations violate the Commerce Clause.

QUESTION: Well, don't all tax laws pressure you to operate one way or another?

MR. LIBIN: Well, they give you choices, obviously, in the original structure of your operations. Of course, Mr. Chief Justice, that is correct.

QUESTION: Well, what case of ours is it that you think says that if a tax law tends to push you one way or another it violates the Commerce Clause?

MR. LIBIN: Well, I think we have seen in the Halliburton case, for example, where there was a use tax imposed for property bought or manufactured or self-constructed outside of Louisiana and brought into

Louisiana. One of the points the Court made in striking down that statute was that it basically induced people to construct the assets in Louisiana, and it did so because of tax motivations, and therefore --

QUESTION: You think that case is still good law?

MR. LIBIN: Well, I think its basic concepts have been followed and applied in cases like Boston Stock Exchange where this same issue was raised. You, the New York statute in Boston Stock Exchange effectively induced people to sell their securities in New York to avoid a higher tax, and therefore it foreclosed a tax neutral decision on where to make the sale.

And certainly in structuring foreign operations there are many considerations besides taxes that must be taken into account, and if it develops that a tax law ultimately forecloses those options because it directs you in a particular, to establish your structure in a particular way, then it becomes unconstitutional.

QUESTION: But the basic decision of a state to levy a tax at all certainly pushes the corporation one way or the other.

MR. LIBIN: It certainly does. The tax simply cannot be discriminatory. We have no problem, as we said, with Iowa taxing these dividends, but if it's going to tax foreign subsidiary dividends of this type it should tax all dividends. It should not single out foreign subsidiary dividends paid by foreign corporations doing business in foreign countries, and that is the flaw in the Iowa statute.

And as we say, 26 states that have adopted the Federal law have eliminated this discrimination. 10 states besides Iowa maintain it. Not one of those states, interestingly enough, has filed an amicus brief in support of Iowa's position in this case. There is no other state --

QUESTION: Why is that?

MR. LIBIN: I do not know.

QUESTION: They think we won't notice them?

(Laughter.)

MR. LIBIN: That is possible, Justice Scalia. I don't know, but they're not here. They're not here defending their own statute.

QUESTION: Can you argue that the foreign dividends are really different in kind, they're qualitatively different because the underlying income from which they are derived is not taxed by the Federal or the state government, and that gives this a unique character that the state is entitled to recognize?

MR. LIBIN: I don't think so, Justice Kennedy.

QUESTION: Or is that just another way of saying that there is discrimination in your view?

MR. LIBIN: Well, there's certainly discrimination on the face of it under any circumstances. Whether that unique character justifies it, we would say no, Justice Kennedy, because that ignores, as we were suggesting earlier, the fact that foreign subsidiaries pay taxes in their foreign countries. They bear the same burdens with respect to the earnings that they generate as domestic subsidiaries do.

So the uniqueness of the foreign dividend is only the fact that it's the first time the funds come home, so to speak. But at that level, at the dividend receiving level, all dividends ought to be taxed the same way. There should be no justification for a state to single out dividends received in foreign commerce, no justification for that.

I think you have to assume equality of treatment at the subsidiary level under the Armco case and others where you posit the situation where if Iowa taxes earnings then we assume everybody does. But Iowa does and we test the statute on that basis, and that's the only appropriate way to do it.

QUESTION: May I ask you to clarify, you may have already covered this and I may not have fully followed the argument at one point, but I think your opponents contend that the discrimination actually favors the foreign subsidiaries because they're only taxing the dividends from the foreign whereas they tax the entire stream of income from the domestic subsidiary. What's your response to that?

MR. LIBIN: Well, Justice Stevens, we think that it's imperative to recognize the fact that earnings are taxed in foreign countries as well as earnings taxed domestically, and applying --

QUESTION: If that were not true would they be right?

MR. LIBIN: If that were not true I think the issue would be a situation where you'd have to decide whether it's appropriate even to take the tax on earnings into account, because the subsidiary is a totally different entity from the parent company. It's a little bit like the Armco case where you had a manufacturing, a tax on manufacturing activity, which would be the subsidiary's earnings generation, and a tax on the sale of manufactured products at wholesale, that would be equivalent to the dividend. And this Court said let's see who pays the wholesale tax, and it was only out-of-state people, only foreign people. And the fact that the in-state people paid the manufacturing tax was irrelevant.

QUESTION: Well, I was hoping I'd get an answer that didn't depend on my thinking through another case.

MR. LIBIN: I'm sorry.

QUESTION: Why is it in this case that they are wrong in saying that the foreign subsidiary, the dividends from the foreign subsidiary impose a lesser burden, taxing that impose a lesser burden than taxing the entire stream of income from a domestic subsidiary? And your answer, I think, is well, they're subjected to a tax by the foreign government. Now, apart from that is there another answer?

MR. LIBIN: Yes, because, the other answer is it's not appropriate to take the domestic subsidiary tax into account. We're looking at the tax on dividends at the parent level, and whether the subsidiaries are taxed at all in the first instance ought to be irrelevant to how a state taxes dividends. The dividends are a separate item of income. Container footnote 30 indicates earnings are income of the subsidiary. Dividends are income of the parent.

And your own dissent in the Mobil case suggests dividends are not always paid out of earnings immediately, they may not mirror the earnings of any given year, they may be paid later or earlier. There is no correlation between the two. So in our view as a threshold it is inappropriate even to look at how subsidiaries are taxed.

QUESTION: Would it be permissible for Iowa, I know they don't have the three factor formula there, I guess they only have two factor, but say it was a three factor state, it's easier to think about. Supposing that instead of taxing the dividends they took the, they treated the unitary business as including the entire income of the foreign subsidiary and then added to the base the property, wages, and whatever the three factors are, in the foreign subsidiary. Would that be permissible in your view?

MR. LIBIN: Well, that might be one way to change the law. It would not eliminate the discrimination necessarily because it would in the end turn on an arithmetical calculation whether you came out with foreign subsidiary dividends still subject to tax or not. But the kind of factor adjustments you're suggesting in the apportionment formula do not on their face eliminate the issue of discrimination. They may change the mathematical outcome, but they don't eliminate the discrimination.

So for the reasons we have indicated we think that the Iowa statute really is in violation of the Foreign Commerce Clause as being facially discriminatory.

We also believe it violates the Equal Protection Clause because the classification that Iowa has adopted for dividends here is, in its words, based on the convenience of following the Federal law. But the convenience in adopting the language of the Federal statute, which may well exist for certain purposes, cannot justify in any legitimate or rational way facial discrimination as a substantive issue. You cannot say, I assume Iowa is not saying, we are discriminating between these categories of dividends because it's convenient to discriminate.

QUESTION: This is convenience for whom -- I'm sorry, Chief.

QUESTION: Go ahead.

QUESTION: Convenience for whom? For the taxpayer?

MR. LIBIN: They suggest for the taxpayer.

QUESTION: They're saving you the trouble of filling out forms, these small companies with foreign subsidiaries?

MR. LIBIN: That is one suggestion, Justice Scalia, and the other is convenience for the state in allowing the Federal Government to audit the numbers in the first instance.

QUESTION: Haven't we said in some cases that, we have said administrative convenience doesn't justify discrimination where the scrutiny, if you want to call it, that is other than rational basis, if it's all heightened?

I thought some of our cases had said administrative convenience will justify discrimination when it's just a question of rational basis.

MR. LIBIN: Yes, Your Honor, that is correct, Chief Justice Rehnquist. In the Madden case and the Carmichael case you did suggest administrative convenience would be acceptable where, where there were dissimilarly situated taxpayers involved, where you had a situation, for example, where it was convenient to impose a tax on companies with eight or more employees, but not fewer than eight, because it just was too much of a burden to police that. There were substantive differences in the focus of the discrimination. Here dividends received by parent companies is just money flowing up to the parent company, and there's no substantive difference in the dollars that are received when they are received.

QUESTION: But there is a factual difference.

MR. LIBIN: The factual difference is where, the source of the payment, but that is, there's no legitimate basis to say we're going to draw a line based on source just because it's convenient to do so.

QUESTION: Well --

QUESTION: That assumes the point at issue.

MR. LIBIN: Well, I don't, I don't think it really does because the point at issue is what is the convenience all about. The convenience is on checking numbers once you record them. It does not mean that you can establish a line between foreign subsidiary dividends and all other dividends because it's convenient to draw that line.

QUESTION: Well, but I think you denigrate the state's convenience argument somewhat. I take it they have, your state, or the State of Iowa has no capacity to do foreign audits. They don't have, they're not like the California Franchise Tax Board with auditors overseas and so forth. It seems to me this convenience element is very, very important for the state.

MR. LIBIN: But the discrimination, Justice Kennedy, can be easily dealt with by doing what other states have done in saying this is a category of dividends we cannot tax. We don't choose to tax it simply because it's convenient to do so. That seems to us is simply not a rational basis.

QUESTION: Well, the question is they say that adopting the Federal scheme is a very important administrative convenience.

MR. LIBIN: We agreed with that. We don't dispute that.

QUESTION: So that they're enabled to tax what they're constitutionally entitled to.

MR. LIBIN: We don't dispute that it's convenient to adopt the Federal scheme, but having adopted it, it seems to us Iowa must then justify the discrimination as if it had written the law itself. And if all it said were we're going to discriminate because it's convenient to do so, that in our judgment would not be valid under this Court's prior decisions.

I would like to save the rest of my time for rebuttal.

QUESTION: Very well, Mr. Libin.

Ms. Mason, we'll hear from you.

ORAL ARGUMENT OF MARCIA MASON

ON BEHALF OF THE RESPONDENT

MS. MASON: Mr. Chief Justice, and may it please the Court:

The Iowa corporate income tax does not discriminate against foreign commerce. Kraft includes foreign dividends in its Iowa apportionable tax base because of the way it chooses to structure its business, and not because it engages in foreign commerce. Obviously some methods or structures of operating will be more profitable than other methods, but Kraft's conclusion that the use of foreign subsidiaries is integral to doing foreign commerce is based on lots of factors unrelated to taxes and which may vary depending on the type of business you look at and the particular foreign country in which they do business.

The parties stipulated that multinational corporations typically do foreign commerce through foreign subsidiaries for various reasons, and the non-exclusive reasons listed included the better ability to limit their liability in the foreign country, the marketing advantages of being perceived as being a local company, a greater ease in borrowing of money in that country, and so forth. The parties did not stipulate that all foreign countries require that in order to do commerce in those countries you use a foreign subsidiary. That was not stipulated to.

QUESTION: May I interrupt with just -- recalling the dialogue with Justice White by your opponent, what about the suggestion that the very transaction, the dividend transaction itself is in foreign commerce, the payment by a foreign subsidiary to a domestic parent? Isn't that a transaction in foreign commerce?

MS. MASON: I don't believe the State of Iowa has ever argued that that is not part of commerce. What the State of Iowa is arguing is that Kraft can do the same thing that it does, can do foreign commerce, can do business in these foreign countries through domestically incorporated subsidiaries, subsidiaries incorporated somewhere in the United States.

QUESTION: I'm not sure that's responsive to, if I understood Justice White's question at any rate, of the concern that the flow of money across national boundaries in these dividends is taxed differently than a similar flow of money within the United States, and therefore there's a discrimination, at least a differential treatment between domestic and foreign.

MS. MASON: Well, there obviously is a differential treatment between domestic and foreign dividends. That's, that just goes without --

QUESTION: And ergo between domestic and foreign commerce.

MS. MASON: No, we don't believe that that follows.

QUESTION: But if the dividend is itself a transaction in commerce, why is that not so?

MS. MASON: Because we believe that it's not proper to focus solely on the Internal Revenue Code and therefore the Iowa treatment of dividends without looking beyond dividends to the income of the entire unitary business that is being taxed. And if you look at the entire tax structure, the Iowa income tax, and we're not looking at two different taxes here, it's all the Iowa income tax, the, there is a reason to treat them differently. And that reason is the same reason the Internal Revenue Code has, which is how the underlying earnings from which the dividends are paid get treated.

The foreign earnings, as you pointed out previously, do not all get taxed. A lot of times foreign earnings are reinvested in the foreign country and used to expand operations there. The only time the foreign earnings get taxed in the Internal Revenue Code, and therefore also by Iowa, is if they are returned to the U.S. shareholder in the form of dividends, and then it's only that amount that gets returned as dividends that is taxed.

But with the domestic subsidiary, whether it's doing business in the United States or doing business abroad, all of its earnings will be taxed by the United States and an apportioned share will be taxed in the states in which it does business.

So we believe it's not proper to focus only on how the dividends are treated. Obviously if that's done Iowa can't win, because it's just obvious that we are treating domestic dividends differently from foreign subsidiary dividends paid out of foreign earnings. We don't --

QUESTION: But your opponent's point is you're not taxing the foreign subsidiary, you're taxing, you're taxing the parent. And what is the fact that some different entity is treated differently for some other purpose, what does that have to do with your taxation of the parent?

MS. MASON: Well, Kraft has stipulated that these dividends are paid by unitary, that it's part of their unitary income, that they are paid by unitary payors. So we -- and they are 100 percent owned subsidiaries. They are in effect really merely an extension of Kraft's own business that it could have done through a separate division of its business rather than through a separate corporation. So we believe that if you look at the burden on the unitary business as a whole, that that is proper to do.

Because Kraft is arguing that Iowa is somehow discouraging investing in foreign subsidiaries and pushing them somehow to invest in domestic subsidiaries instead, and I think if you look at the burden of the overall unitary business you can see that that's not what Iowa is doing. It's not encouraging doing business within the United States through domestic subsidiaries rather than doing foreign commerce or even doing foreign commerce through foreign subsidiaries.

The point was mentioned earlier about the holding company and why that wouldn't work, and we believe that it would work. Companies are doing it, and in 1980 the Coopers and Lybrand accounting firm was advising corporations to do that as a way to cope with this Court's Mobil Oil decision. And there's nothing in the record in fact that would show that it would be somehow burdensome to set up a domestic holding company.

QUESTION: Ms. Mason, do you defend the rationale of the Iowa Supreme Court in the test it employed to sustain the tax scheme?

MS. MASON: We believe that the Iowa Supreme Court was correct.

QUESTION: In focusing on whether the statute benefits in-state business, you think that's the correct focus and test for a challenge under the Foreign Commerce Clause?

MS. MASON: I believe the Iowa Supreme Court was correct because the Iowa income tax has, there's nothing, there's no local in-state bias about it. It treats all companies subject to the Iowa income tax the same.

QUESTION: Well, I would have thought that isn't the test that we would employ in, when the challenge is to foreign commerce. That the question is whether it discriminates against foreign commerce as opposed to all domestic U.S., not just a benefit, or to the in-state business.

MS. MASON: Of course in this particular case the specific issue of whether a lack of a benefit to local commercial interest is alone sufficient to satisfy the discrimination problem does not really have to be decided because Iowa's position is that this is not discriminating against foreign commerce in favor of either doing Iowa business or doing business within the United States through a domestic subsidiary. But going --

QUESTION: Well, that isn't the rationale of the Iowa Supreme Court.

MS. MASON: Correct. The Iowa Supreme Court looked at the fact that all companies that pay Iowa income tax pay tax on, include foreign dividends in their tax base. That includes Iowa companies which also receive foreign dividends and will be affected by this statute.

QUESTION: Well, what if we thought the Iowa rationale, Iowa Supreme Court's rationale was not the right one? Why wouldn't we remand and tell them what standard to use rather than try to decide the case under a new standard that you're now arguing?

MS. MASON: I don't believe that Iowa is arguing a completely new standard. Iowa did argue --

QUESTION: Well, completely or not, it's new.

MS. MASON: Iowa did argue to the Iowa Supreme Court that if you look at the overall burden of the unitary business --

QUESTION: You may have argued it, but that isn't what they said.

MS. MASON: Well, certainly this Court could, if it wanted to, could remand this to the Iowa Supreme Court and have them decide it under what this Court says is the proper standard. This is, however, a facial challenge to the constitutionality of the statute, so this Court could also very easily go ahead and decide the constitutionality question at this level rather than remanding it. There's no additional findings of fact that need to be made, and so forth, because it is a facial challenge to the statute.

The -- as I was saying about the fact that Kraft could structure its business in such a way as to avoid having foreign dividends included in the tax base, in the Amerada Hess case where oil companies had claimed that a denial of a deduction for the Windfall Profits Tax discriminated against oil producers who also marketed their oil, in other words integrated oil companies, in favor of independent retailers who did not produce their oil but who could effectively deduct an equivalent to the Windfall Profits Tax as part of their cost of goods sold. In that case operating an integrated oil company may have been more efficient and profitable than using separate corporations, as Kraft argues that using foreign subsidiaries is the more profitable way of doing foreign commerce.

But the Court stated that whatever different effect the statute had on the two groups was based solely from differences between the nature of their businesses and not from the location of their activity. And that is definitely true in this case. Two subsidiaries could both be doing business in the same geographical location and the dividends from a domestic subsidiary doing business in the foreign country would be deductible.

The Commerce Clause protects the marketplace. It does not protect the particular structure or method of operating in that market. And the anti-discrimination requirement promotes equal treatment of foreign commerce, but not identical treatment of all taxpayers that are engaged in such commerce.

If the foreign government requires the use of foreign subsidiaries, then obviously it's that foreign government and not Iowa which is placing some restriction on the doing of foreign commerce. And indeed Kraft could have set up a domestic holding company to receive the foreign income, and then would pass that income on to the parent company, Kraft, in the form of what would be deductible domestic dividends.

Kraft argues that if we look at what happens if all states apply the same tax scheme as Iowa, then those foreign dividends will still be taxed by some state, and that is true. But what Kraft does not point out is that if all states applied Iowa's tax scheme, then the earnings of domestic subsidiaries, regardless of what state the domestic subsidiary does business in, will be taxed as well by the states. And the earnings of a domestic subsidiary are likely to be greater than dividends from a foreign subsidiary, assuming equal earnings, because the foreign subsidiary is not likely to pay out all of its earnings in the form of dividends.

We believe that if you look at the entire unitary business, and we believe that is proper to do, that the subsidiaries are really an extension of Kraft's own business and you look at how the Iowa corporate income tax taxes that unitary business, that the state tax burden on a unitary business that operates through domestic subsidiaries will likely actually be greater than the state tax burden on a unitary business that does foreign commerce through foreign subsidiaries.

This is a facial challenge to the statute, as I mentioned, and therefore Kraft has the burden of showing that it, the statute is unconstitutional, and that burden is that it must establish that there is no set of circumstances which exist under which the statute would be valid. And the fact that a statute might operate unconstitutionally under some specified set of circumstances is insufficient to make the statute invalid on its face. And Kraft cannot show that this statute discourages or burdens foreign commerce or even doing foreign commerce through foreign subsidiaries.

With regard to the Equal Protection issue, Kraft characterizes the state's interest as being administrative convenience. Iowa sees it more as being a necessity, as being quite essential that we be able to piggy-back onto the Internal Revenue Code, and not just being merely convenient for the state. The --

QUESTION: May I go -- excuse me, go ahead.

QUESTION: Go ahead.

QUESTION: I just want to go back to the commerce discussion for a moment earlier. Does the record tell us whether the businesses of the subsidiaries, the foreign subsidiaries, are commerce within different foreign countries or are they commerce between those foreign countries and the United States? Does it tell us?

MS. MASON: I'm not sure if that's really in the record. My impression is that it's doing business within that country.

QUESTION: Within the country. Is it your view that transactions, business transactions between corporations, or whatever they might be in France and Germany, with one another are foreign commerce within the meaning of the Commerce Clause of the United States Constitution?

MS. MASON: No, it's definitely not would be our position. The Commerce Clause is part of the U.S. Constitution to protect the states basically from each other and not to protect France and Germany.

QUESTION: But, and the record doesn't really tell us, then, whether these companies are engaged in foreign commerce or not, if you've answered my first question correctly. I wonder if we have a hypothetical case here.

MS. MASON: Well, since they're challenging the statute on its face, I guess it doesn't really matter now. I mean, hypotheticals, you could probably find a hypothetical where a company doing foreign commerce through foreign subsidiaries will pay more tax than a company that does foreign commerce through domestic subsidiaries or that does U.S. commerce. But as I mentioned before in talking about the burden of proof, the fact that you can come up with those circumstances doesn't show that the statute is unconstitutional on its face.

QUESTION: We don't ordinarily decide hypothetical cases.

MS. MASON: Right. With regard again --

QUESTION: Do you concede that the payment of the dividend at least is foreign commerce?

MS. MASON: We've never argued that it's not. It seemed like in the Mobil Oil case, which discussed dividends and whether dividends from foreign unitary subsidiaries could be included in the tax base, appeared to assume that it is part of commerce.

QUESTION: Well, don't you think it would be discrimination against foreign commerce if you taxed only dividends paid by foreign subsidiaries and no dividends paid by domestic subsidiaries? Surely that would be a discrimination against foreign commerce, wouldn't it?

MS. MASON: Well, you'd have to look at what happens to the underlying earnings. We believe there are cases --

QUESTION: I don't care what happens to the underlying earnings. Indeed, I don't care if the foreign subsidiary makes all its earnings domestically. It's a foreign subsidiary and the money comes from England to the United States, and you tax that and you don't tax any other dividends. Wouldn't that be discrimination against foreign commerce?

MS. MASON: We're not basing it on -- I was not basing it on where it comes from. As I said, a domestic subsidiary could be sending dividends from a foreign country and it would be coming across national lines, but that would be deductible.

QUESTION: But all the dividends here at issue are coming from abroad. Aren't there transfers from abroad? The money is coming into this country from abroad?

MS. MASON: Yes.

QUESTION: That seems to me foreign commerce.

MS. MASON: That may be foreign commerce, but the point that the State of Iowa is making is that so also is then the dividends that are coming over from domestic subsidiaries, and those dividends coming over from domestic subsidiaries are deductible.

QUESTION: Well, what if you, what if Iowa just taxed dividends from corporations organized and doing business in another state and didn't tax any, any other dividends? They just tax dividends coming into Iowa from another state. Would that be a discrimination against interstate commerce?

MS. MASON: I believe in that case that it probably would. There your underlying earnings, you don't really have a justification for treating that, you don't have a rational basis or any other real justification for treating that differently based on how the underlying earnings from which those dividends were paid are being taxed.

QUESTION: May I ask one other question that may be in the papers and I just don't know it. Under your statute would this company have had the option if it chose to, instead of having its foreign dividends taxed, to have included its foreign earnings and the foreign sales into the basic factor for the entire business? Do you understand what I'm trying to say?

MS. MASON: I think, if I understand you, you're asking if we would allow like a combined --

QUESTION: Yeah.

MS. MASON: -- report.

QUESTION: Right.

MS. MASON: And the answer to that would be no.

QUESTION: You would not.

MS. MASON: Iowa is not a combined reporting state. We're single entity and we include, we tax the income of Kraft, which is business income, but we don't look at all of the earnings of all subsidiaries that are unitary with Kraft.

Addressing briefly now the necessity of coupling with the Internal Revenue Code. If we decoupled, even to the extent of just excluding foreign dividends, the burden to the State of Iowa is much greater than simply changing a tax form and adding one additional line to that. Corporate distributions is a very complex area of the law of accounting.

Corporate accounting, as I understand it, and I don't really understand it that well because it is complex, and in looking at the Bittker and Eustice book on corporate income taxation, the one word that comes up over and over again is the word complex. The State of Iowa would have to develop the expertise in the audit staff to first of all figure out if the corporate distribution even is a dividend or if it's really something else that should be in the taxable base, and that's something that the IRS may or may not concern itself with. Because under the Internal Revenue Code it would be taxable anyway, whether it is characterized by the company as a dividend or characterized as some other taxable item of income. So the department would have to do that.

It would also have to be able to verify the proper amount, and since Iowa has a net income tax, Iowa would have to be able to figure out what expenses of the company were attributable to receiving those foreign dividends.

I see my time has run out.

QUESTION: Thank you, Ms. Mason.

MS. MASON: Thank you.

QUESTION: Mr. Jones, we'll hear from you.

ORAL ARGUMENT OF KENT L. JONES
ON BEHALF OF THE UNITED STATES
AS AMICUS CURIAE SUPPORTING RESPONDENT

MR. JONES: Mr. Chief Justice, and may it please the Court:

Looking at Iowa's entire scheme of taxation, as this Court's cases say we must, it becomes evident that by including foreign subsidiary dividends in its tax base Iowa does not discriminate against foreign commerce. And this is for a very simple reason. Both Iowa and the United States tax all of the domestic and foreign source income of domestic corporations. They also tax the domestic source income of foreign corporations. But they tax only that portion of the foreign income of foreign corporations that is distributed as dividends to the United States.

In short, Iowa's tax is less inclusive of foreign source income derived by a foreign subsidiary than it is either of domestic or foreign source income derived by a domestic subsidiary. For this simple reason it cannot be said that Iowa's tax facially discriminates either against foreign commerce or against foreign subsidiaries.

QUESTION: This is on the assumption that you're just free to ignore the tax placed on foreign subsidiaries by the foreign state?

MR. JONES: No, sir, that is in fact the only issue of substance left to discuss, and I agree, and that's what I want to discuss now.

QUESTION: So you're not ignoring it?

MR. JONES: I'm not going to ignore it.

QUESTION: You're just about to --

MR. JONES: I'm just about to launch into it.

QUESTION: Before you do, when you say it's less inclusive, it's less inclusive in terms of computing the gross income. But is it also different in that with respect to your domestic subsidiaries you include their sales and the other half of the formula, which you don't do --

MR. JONES: I don't believe that is a correct characterization of Iowa's apportionment method, but I can tell you for certain that Iowa's apportionment method is not challenged in this case. What, the only issue, all of the issues have been excluded except one, facial discrimination --

QUESTION: Right.

MR. JONES: -- so we focused on that. But I believe the answer to your question is that Iowa would include, uses the single factor test, at least they did the last time it came before this Court.

QUESTION: Sales.

MR. JONES: Yes, sir. And that that factor would look to the sales of the corporation whose earnings were being allocated, which would be the parent in this situation.

QUESTION: But it doesn't look to sales in the foreign subsidiary?

MR. JONES: And it doesn't look to sales of the domestic subsidiary when it's allocating a parent's income. What this case really is about is not discrimination against a foreign subsidiary. The claim is that a corporation in the United States is being discriminated against if it uses a foreign subsidiary to conduct foreign commerce. And what our argument demonstrates, we believe, is that the corporation that uses the foreign subsidiary to conduct its foreign commerce actually has less of its income exposed to state taxation than if it used any other method of organization.

QUESTION: To taxation by a state of the United States.

MR. JONES: That's correct. And that leaves open the question that I need to address, which is Kraft's argument now is that even though they may have less of their income subject to a state tax, they want to complain about the fact that they may have a higher national level tax when they use a foreign subsidiary. This is because the foreign government may choose to tax both the earnings of the foreign subsidiary and the dividends as those dividends are distributed to a United States corporation.

What we showed in our brief is that exactly the same result applies to a similarly situated domestic corporation. That is to say under the Internal Revenue Code the United States taxes both the earnings of a domestic corporation and it taxes the dividends of a domestic corporation when they are distributed abroad, when they are distributed to a foreign corporation. The result is thus precisely parallel treatment of foreign and domestic commerce, not discrimination.

Now this isn't the first time this subject has come before the Court. In fact this same argument of multiple burdens on international distributions of dividends has been twice considered by this Court and twice rejected, in Container Corp. and in the Mobil case. And in fact as recently as --

QUESTION: Which is the other case?

MR. JONES: The Mobil.

QUESTION: Mobil, yes.

MR. JONES: Mobil v. Vermont. As recently as page 10 of their opening brief in this Court, Kraft acknowledged that they were not complaining about multiple burdens. They only raised it in their reply brief for the first time. In Container Corporation what this Court held was that the risk of additional burdens at the national level is mitigated by the credits allowed under the Internal Revenue Code for foreign taxes. The Court also held, as counsel has acknowledged, that there was no constitutional requirement for the states to provide similar credits.

As the Court held in the Mobil case, concurrent taxation by the state and Federal Governments of income received in the United States is a, quote, well established norm. When the Federal Government allows a credit for the foreign taxes that are paid the result is that the state and the foreign government, rather than the state and the United States, stand as the concurrent taxing authorities for this particular kind of income.

QUESTION: Well, Mr. Jones, if we were to say that the payment of the dividends by the foreign subsidiary to the parent in the U.S. is itself foreign commerce --

MR. JONES: Yes.

QUESTION: -- does that affect your analysis at all?

MR. JONES: No, I, whether -- in a facial challenge one might quibble about whether it is necessarily foreign commerce, because foreign subsidiaries can earn their money in the United States.

QUESTION: But if we were to say it was, then how does that affect the analysis? Does, does the tax scheme now facially discriminate against that stream?

MR. JONES: No. The -- we acknowledge that in the worst case, which is the way we attempt to address this question of discrimination, the worst case, or the best case, if you will, for Kraft, where all of the earnings are derived abroad, we're talking about foreign commerce. Our point is that the state scheme actually imposes a lesser burden on this method of conducting that commerce than if it were conducted by means of either a domestic subsidiary or by the parent.

Kraft faults us for suggesting that they could use a domestic subsidiary to conduct this commerce. Of course that would put the case on a face-to-face comparison. Our point was not that Kraft would pay less state taxes if it conducted the foreign commerce with a domestic subsidiary. Our point was that it would not pay less, that it would not attain any advantage by using a domestic rather than a foreign corporation -- yes, using a domestic rather than a foreign to conduct its foreign commerce.

So neither -- the synopsis of it is that the state does not discriminate either against foreign commerce, because it tends to tax less of it --

QUESTION: Well, what about an Iowa corporation that establishes a subsidiary abroad and that's the only business they've got.

MR. JONES: Yes, sir.

QUESTION: And the only income they've got is, are dividends from a foreign corporation. Now, Iowa, you can't say that Iowa is taxing the earnings of, the basic earnings, can you?

MR. JONES: If I understood your hypothetical, you're saying there's a domestic corporation not in Iowa that receives its only income --

QUESTION: Well, it's either in Iowa or any other state, except -- let's say an Iowa corporation has one foreign corporation, one foreign subsidiary, it does business abroad.

MR. JONES: Right.

QUESTION: And its only income are dividends from the foreign subsidiary.

MR. JONES: Correct.

QUESTION: Now, don't you think in that case Iowa is discriminating against foreign commerce?

MR. JONES: No, I don't think so, because --

QUESTION: Why not?

MR. JONES: -- in that case --

QUESTION: Because the reason you gave before doesn't apply.

MR. JONES: Yes, it still applies. In that case --

QUESTION: Well, where in the United States, certainly not in Iowa, are the earnings of the, of, that produces the dividends being taxed?

MR. JONES: I'm not sure I can answer that because I'm not sure I understood it, but --

QUESTION: Tell me why it isn't discriminatory.

MR. JONES: Okay. It is not discriminatory because Iowa would tax less of the income derived -- Iowa only taxes the portion of the foreign earnings that are distributed as dividends. So it, when the corporation receives the dividends Iowa is taxing only that portion. It could be $1, it could be 1 percent, or it could be 100 percent of the after tax earnings abroad.

QUESTION: But it isn't taxing any dividends from domestic corporations.

MR. JONES: It doesn't need to, because if a domestic corporation --

QUESTION: It doesn't need to? I mean, it may not, but it isn't.

MR. JONES: Justice White, if a domestic corporation did exactly the same commerce Iowa would tax the entire foreign earnings of that corporation, rather than only the portion distributed as dividends. It taxes more. And that's why, having taxed the full income of the domestic subsidiary, it allows a deduction. It only assesses a one state level tax. When the dividends come in it hasn't taxed those dividends, and so it needs to tax them. It only takes the one bite. It takes them either against the full earnings by a domestic subsidiary or against the distributed earnings from a foreign subsidiary. That's not discrimination. If it is, it benefits the foreign subsidiaries.

QUESTION: Thank you, Mr. Jones.

Mr. Libin, you have 5 minutes remaining.

REBUTTAL ARGUMENT OF JEROME B. LIBIN

ON BEHALF OF THE PETITIONER

MR. LIBIN: Thank you, Mr. Chief Justice. I hope I can clarify one or two points here. I'd like to stay with Justice White's question for the moment. If an Iowa parent company had a Kentucky subsidiary, did all its business in Kentucky, and another subsidiary that did all its business in Germany, Iowa would not tax the income of either of those subsidiaries. If each paid a dividend to the Iowa parent, Iowa would tax the German dividends and would not tax the Kentucky dividends. That's what this case is really about. Iowa excludes dividends from domestic subsidiaries wherever they're located, wherever they earn their money, whether it taxes them or not.

QUESTION: But they do include all earned income of the subsidiary.

QUESTION: Not in your example.

MR. LIBIN: Not if it's not doing any business in Iowa. Doing business elsewhere in the United States they do not include the income of the subsidiary or the dividends.

QUESTION: Even if it's a unitary business?

MR. LIBIN: Even if it's a unitary business because they do not require combined reporting. That's correct.

QUESTION: But they could, I guess?

MR. LIBIN: They could, but they have chosen not to.

QUESTION: For Federal purposes, I take it it's, that a wholly-owned domestic subsidiary of Kraft includes, all that income is included on the Federal return?

MR. LIBIN: That is correct, and that's the difference. The Federal scheme taxes those earnings because the Federal Government has jurisdiction over all domestic subsidiaries. Iowa does not.

QUESTION: Does Kraft tax an apportioned part of that amount to the extend that there's a unitary business?

MR. LIBIN: Not unless it has Iowa, the subsidiary has to be doing business in Iowa before Iowa can tax. The subsidiary --

QUESTION: Even if it's a unitary business the subsidiary --

MR. LIBIN: Even if it's a unitary business, that's correct. The subsidiary has to be doing business.

QUESTION: Well, what is the significance of being a unitary business in Iowa then?

MR. LIBIN: Because then the dividends would be included in the parent company's income except for the fact that Iowa then excludes them. They would have the ability to tax the dividends under Mobil because they're unitary, but Iowa chooses to relieve itself of the tax when the dividend is from a unitary domestic subsidiary. It only imposes the tax when the dividend is from a unitary foreign subsidiary.

QUESTION: And it does not include the earnings of the Kentucky subsidiary in the total earnings subject to tax?

MR. LIBIN: That is correct. That is correct.

QUESTION: Strange.

MR. LIBIN: They get a free ride in Iowa. But the foreign subsidiary dividends do not. Thank you very much.

CHIEF JUSTICE REHNQUIST: Thank you, Mr. Libin.

The case is submitted.

(Whereupon, at 11:59 a.m., the case in the above-entitled matter was submitted.)

CERTIFICATION

Alderson Reporting Company, Inc., hereby certifies that the attached pages represents and accurate transcription of electronic sound recording of the oral argument before the Supreme Court of The United States in the Matter of:

NO. 91-1918 - KRAFT GENERAL FOODS, INC., Petitioner v.

IOWA DEPARTMENT OF REVENUE AND FINANCE

and that these attached pages constitutes the original transcript of the proceedings for the records of the court.

BY Michelle Sanders

(REPORTER)