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Container Corporation of America v. Franchise Tax Board: The Supreme Court Encourages Apportionment Taxation

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CONTAINER CORPORATION OF AMERICA V FRANCHISE TAX BOARD: THE SUPREME COURT ENCOURAGES APPORTIONMENT TAXATION

State apportionment taxation of corporate income remains controversial. In the most recent case, *Container Corporation of America v. Franchise Tax Board*,[1] the California Franchise Tax Board applied an apportionment formula to the worldwide income of the Container Corporation of America, a unitary business. The corporation argued that this tax violated both the due process clause[2] and the commerce clause[3] of the United States Constitution. The United States Supreme Court, however, rejected the corporation's arguments and held that state taxation of a unitary business' worldwide income under an apportionment formula violates neither due process nor the commerce clause.

This Note reviews the Supreme Court's analysis of state apportionment taxation in the *Container* case and addresses the constitutionality of the apportionment formula as applied to foreign-owned unitary businesses.[4] The Note concludes that the Supreme Court in *Container* did not adequately address the effects on foreign policy of state worldwide apportionment taxation.

FORMULA APPORTIONMENT AND THE UNITARY BUSINESS CONCEPT

The Formula Apportionment Taxation Method

Corporate taxes are calculated by one of three methods: separate accounting, geographical allocation, and formula apportionment.[5]

1. 103 S. Ct. 2933 (1983).
2. U.S. CONST. amend. XIV, § 1.
3. U.S. CONST. art. I, § 8, cl. 3.
4. The Court in *Container* expressly reserved this issue. 103 S. Ct. at 2952 n.26.
5. For an excellent recent work on state taxation, see J. HELLERSTEIN, STATE TAXATION I: CORPORATE INCOME AND FRANCHISE TAXES (1983) [hereinafter cited as STATE TAXATION I]; *see also* J. HELLERSTEIN & W. HELLERSTEIN, STATE AND LOCAL TAXATION (4th ed. 1978). A good collection of essays on worldwide apportionment taxation before *Container* may be found in THE STATE CORPORATION INCOME TAX: ISSUES IN WORLDWIDE UNITARY COMBINATION (C. McLure ed. 1984). For a detailed discussion of state taxation in light of federalism, see P HARTMAN, FEDERAL LIMITATIONS ON STATE AND LOCAL TAXATION (1981). A number of law

The separate accounting method, which the federal government uses, treats parent corporations and their subsidiaries as separate entities for tax purposes if the corporations deal with each other at arm's length.[6] The geographical allocation method attributes all income to the state of its source, where it is taxed in full.[7] The apportionment method, which most states use, allows a state to tax a corporation's income according to the degree of the corporation's activities within the state.[8] States using apportionment argue that the separate accounting method enables businesses to shift income to avoid taxation.[9] Apportioning income allows the state to weigh the taxed entity's state operations against its overall operations to achieve a better estimate of the business' true income for state tax purposes. The unitary business principle is the foundation of the apportionment scheme because this principle defines the operations that factor into the apportionment formula.[10]

States are not limited to one particular method of apportionment.[11] Nevertheless, most states use a three-factor formula that weighs the payroll, property, and sales of the company's operations within the state against the payroll, property, and sales of the

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review articles have been written on the subject. *See, e.g.*, Hellerstein, *Recent Developments in State Tax Apportionment and the Circumscription of Unitary Business*, 21 NAT'L TAX J. 487 (1968); W Hellerstein, *State Income Taxation of Multijurisdictional Corporations, Part II: Reflections on* ASARCO *and* Woolworth, 81 MICH. L. REV. 157 (1982); Hellerstein, *State Income Taxation of Multijurisdictional Corporations and the Supreme Court*, 35 NAT'L TAX J. 401 (1982); Note, *State Taxation of Nondomiciliary Corporations*, 40 WASH. & LEE L. REV. 191 (1983).

6. *See* I.R.C. § 901 (1982); J. HELLERSTEIN & W HELLERSTEIN, *supra* note 5, at 432; *see also* STATE TAXATION I, *supra* note 5, ¶ 8.3.

7. *See* J. HELLERSTEIN & W. HELLERSTEIN, *supra* note 5, at 398; *see also* STATE TAXATION I, *supra* note 5, ¶ 8.4.

8. *See* J. HELLERSTEIN & W. HELLERSTEIN, *supra* note 5, at 399; *see also* STATE TAXATION I, *supra* note 5, ¶ 8.5.

9. Under the federal scheme, the Internal Revenue Service can reallocate income to combat corporate attempts to shift income to avoid taxation. *See* I.R.C. § 482 (1982).

10. *See* Mobil Oil Corp. v. Commissioner of Taxes, 445 U.S. 425, 439 (1980) (the unitary business principle is the "linchpin" of apportionment).

11. *See Container*, 103 S. Ct. 2943 ("[A] fairly apportioned tax would not be found invalid simply because it differed from the prevailing approach adopted by the States."); *see also id.* at 2941.

whole, or unitary, business.[12] The Court in *Container* viewed this three-part formula as the "benchmark" for determining taxable income under the apportionment method of taxation.[13]

The Unitary Business Concept

The concept of the unitary business arose with the first interstate railroads.[14] States through which railroads ran quickly realized that taxing a proportionate share of the railroad's entire operation would raise more money than taxing merely the track itself. Upholding this scheme in the *State Railroad Cases*,[15] the United States Supreme Court reasoned that taxes upon the track alone would produce little revenue and would not reflect the true value of the track to the railroad's operation; the railroad "must be regarded, for many, indeed most purposes, as a unit."[16]

The unitary business concept recognizes that an integrated, multifaceted business generates income not picked up by the separate accounting method of taxation. Because this integration yields ex-

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In-State Property of All Unitary Corporations Operating in State		In-State Payroll of All Unitary Corporations Operating in State		In-State Sales of All Unitary Corporations Operating in State		Combined Total Net Income* Earned Everywhere By the Unitary Group		Income Earned Within The Taxing State
————	+	————	+	————	X		=	
Everywhere Property of Unitary Group		Everywhere Payroll of Unitary Group		Everywhere Sales of Unitary Group				

AVERAGED BY DIVIDING THESE FACTORS BY THREE

*All intercorporate transactions are eliminated in this formula. Whitenack, *State Tax Litigation After the* Container *Decision: The Potential Tax Break for Foreign Nationals*, 20 TAX NOTES 771, 771 (1983). This formula is embodied in the Uniform Division of Income for Tax Purposes Act (UDITPA).

13. 103 S. Ct. at 2943.

14. *See* Adams Express Co. v. Ohio State Auditor, 165 U.S. 194 (1897); State R.R. Tax Cases, 92 U.S. 575 (1875); *see also* Weissman, *Unitary Taxation: Its History and Recent Supreme Court Treatment*, 48 ALBANY L. REV. 48 (1984).

15. 92 U.S. 575 (1875).

16. *Id.* at 608.

tra savings and income, the true value of the corporation's activities within the state can be determined properly only by referring to the income of the company's entire operation.[17]

CHALLENGING STATE APPORTIONMENT TAXATION

Corporations often have contended that apportionment taxation violates both the due process clause and the commerce clause of the United States Constitution.[18] In *Container*, however, the Supreme Court approved both the unitary business concept and the use of the apportionment formula.[19] The apportionment method's constitutionality under the interstate commerce clause and the due process clause therefore appears secure. A review of the Court's analysis with regard to these two constitutional provisions, however, reveals weaknesses in its analysis of the foreign commerce clause issue.[20]

Due Process Clause

Satisfaction of the due process requirements is a threshold ques-

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17. Originally, "unitary" analysis was more rigid, involving examination of "unities," such as ownership and management. *See* STATE TAXATION I, *supra* note 5, ¶ 8.5, at 332. The Court has developed a less formal standard, relying on functional aspects of the taxed entity. *See* Exxon Corp. v. Wisconsin Dep't of Revenue, 447 U.S. 207, 224-25 (1980); *see also* STATE TAXATION I, *supra* note 5, ¶ 8.11, at 424; Note, *State Taxation of Multinationals and The Unitary Business Concept: A Contemporary View*, 10 BROOKLYN J. INT'L L. 115 (1984).

18. *See* Container Corp. of Am. v. Franchise Tax Bd., 103 S. Ct. 2933 (1983); ASARCO Inc. v. Idaho State Tax Comm'n, 458 U.S. 307 (1982); F W Woolworth Co. v. Taxation & Revenue Dep't, 458 U.S. 354 (1982); Exxon Corp. v. Wisconsin Dep't of Revenue, 447 U.S. 207 (1980); Mobil Oil Corp. v. Commissioner of Taxes, 445 U.S. 425 (1980); Moorman Mfg. Co. v. Bair, 437 U.S. 267 (1978); United States Steel Corp. v. Multistate Tax Comm'n, 434 U.S. 452 (1978); Norfolk & W Ry. v. Missouri State Tax Comm'n, 390 U.S. 317 (1968); General Motors Corp. v. Washington, 337 U.S. 436 (1964); Butler Bros. v. McColgan, 315 U.S. 501 (1942); Bass, Ratcliff & Gretton, Ltd. v. State Tax Comm'n, 266 U.S. 271 (1924); Underwood Typewriter Co. v. Chamberlain, 254 U.S. 113 (1920).

19. 103 S. Ct. at 2945-50. Although the Court expressed hostility to further constitutional challenges to apportionment, *id.* at 2946, the opinion may have invited even more litigation by failing to outline adequately the proper standards by which the lower courts are to determine what constitutes a unitary business. In *Container*, the Court showed deference to the state's reliance on a number of factors in determining unitariness. *See id.* at 2948 ("We need not decide whether any one of these factors would be sufficient as a constitutional matter to prove the existence of a unitary business.").

20. *See infra* text accompanying notes 21-40.

tion in state tax challenges.[21] A jurisdictionally sufficient nexus must exist between the corporation and the taxing state to justify the state's taxation of income generated outside the state. Due process requires some minimal connection between the activities taxed and the taxing state,[22] and a rational relation between the taxed income and "values connected with the taxing state."[23] Essentially, a state cannot tax beyond its borders.[24]

What constitutes taxation by a state beyond its borders, however, is unclear. The unitary business principle is based on the premise that "economies of scale, centralization and integration" add to the profits of the whole,[25] and consequently, profits of the parts. If these premises are true, the apportionment method does not in fact tax income generated beyond the state's borders. The difficulty with the apportionment scheme is that, as applied, particularly in the foreign commerce area, it allows the state to tax at levels that simply do not reflect the activities conducted within the state.[26] For example, in *Mobil Oil Corporation v. Commissioner of Taxes*,[27] Mobil operated at a loss in Vermont, yet paid taxes there.[28] Without income, tax liability such as this seems incongruous.

Commerce Clause

The due process clause and the commerce clause analyses overlap. In *Complete Auto Transit v. Brady*,[29] the United States Supreme Court placed four limitations on state taxation of interstate

21. L. TRIBE, AMERICAN CONSTITUTIONAL LAW, § 6-15, at 353 (1978).

22. *See, e.g.*, National Bellas Hess, Inc. v. Department of Revenue, 386 U.S. 753, 756 (1967).

23. *See* Norfolk & Western R.R. Co. v. State Tax Comm'n, 390 U.S. 317, 325 (1968); *see also* Miller Bros. v. Maryland, 347 U.S. 340, 344-45 (1954) ("[D]ue process requires some definite link, some minimum connection, between a state and the person, property or transaction it seeks to tax.").

24. Farmers Loan & Trust Co. v. Minnesota, 280 U.S. 204, 210 (1930).

25. Mobil Oil Corp. v. Commissioner of Taxes, 445 U.S. 425, 438 (1980).

26. Critics argue that cost differences, different accounting standards, and different exchange rates result in a skewed depiction of the foreign company's formula "factors." Milton. *The States Have Made It A Nightmare*, N.Y. Times, Feb. 26, 1984, § F, at 2, col. 3.

27. 445 U.S. 425 (1980).

28. *Id.* at 430.

29. 430 U.S. 274 (1977).

commerce:[30] (1) the tax must be applied to an activity with a substantial nexus to the taxing state; (2) the tax must be fairly apportioned; (3) the tax must not discriminate against interstate commerce; and (4) the activity must be fairly related to the taxing state.[31] The first and last prongs of the test mirror the due process concern of an adequate connection between the taxed activity and the taxing state.[32] At the core of the commerce clause analysis, however, is the concern that the state will utilize its taxing powers to discriminate against interstate commerce.[33] The Court, therefore, has frequently invalidated state taxes that provide a local industry with an advantage over an out-of-state corporation doing business within the state.[34]

That the state employs an apportionment formula and other states do not is considered by the Court to be nondiscriminatory, however.[35] As the Court has pointed out, "the anti-discrimination principle has not in practice required much in addition to the requirement of fair apportionment."[36] The Court has defined fair apportionment very broadly: an apportionment scheme is fair if it is internally and externally consistent.[37] An internally consistent apportionment scheme would "if applied by every jurisdiction, result in no more than all of the unitary business's income being taxed."[38] External consistency, in contrast, exists when the factors used in the apportionment formula reasonably measure the sources of income.[39] For a business to challenge successfully a tax scheme on this basis, it must 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' or has

30. Additional tests are applied if foreign commerce is the subject of state taxation. *See* Japan Line, Ltd. v. County of Los Angeles, 441 U.S. 434, 444-51 (1979).

31. 430 U.S. at 279.

32. The Court uses interchangeably "substantial nexus" and "minimum connection" in state tax cases. *See* National Bellas Hess, Inc. v. Department of Revenue, 386 U.S. 753, 756 (1967).

33. For an excellent historical survey, see Shores, *State Taxation of Interstate Commerce—Quiet Revolution or Much Ado About Nothing?*, 38 TAX L. REV. 127 (1982).

34. L. TRIBE, *supra* note 21, § 6-16, at 354-55.

35. *See* 103 S. Ct. at 2943.

36. *Id.*

37. *Id.* at 2942.

38. *Id.*

39. *Id.*

'led to a grossly distorted result.' "[40]

Recent Developments

Container is the latest in a series of corporate challenges to apportionment taxation. In *ASARCO, Inc. v. Idaho State Tax Commission*[41] and *F W Woolworth Co. v. Taxation & Revenue Department*,[42] the challenges succeeded. In *Mobil Oil Corp. v. Commissioner of Taxes*,[43] and more importantly in *Container*, however, the Court upheld expansive apportionment plans. In *Mobil*, for example, the Court allowed Vermont's taxing authorities to apportion income that included dividend income from Mobil's overseas subsidiaries and affiliates. Similarly, in *Container* the Court permitted a state to determine a corporation's franchise tax on the basis of total worldwide income. The apportionment method, therefore, has evolved to the point where states now include in the apportionment formula not only income from interstate commerce but also income from international commerce. Companies that carry on international business naturally object vigorously to this expansion.

THE FOREIGN COMMERCE CLAUSE AND FORMULA APPORTIONMENT

In *Container*, The Container Corporation argued that California's franchise tax violated both the commerce clause and the due process clause. The attack failed even though California's use of apportionment resulted in double taxation. A challenge based on the foreign commerce clause[44] also failed. The Court's analysis of this issue, however, was faulty

History of the Foreign Commerce Clause

History supports the view that states, acting in their capacity as

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40. *Id.* (citations omitted).

41. 458 U.S. 307 (1982).

42. 458 U.S. 354 (1982).

43. 445 U.S. 425 (1980).

44. U.S. CONST. art. I, § 8, cl. 3 ("The Congress shall have Power [t]o regulate Commerce with foreign nations ").

states, should have little or no influence over foreign affairs.[45] Under the Articles of Confederation,[46] Congress had no power to regulate commerce.[47] The dismal failure of the Union under the Articles can be blamed in part on this lack of national control over trade.[48] James Madison described the practical problems hindering the development of the young nation:

> [S]ome of the states, which have no convenient ports for foreign commerce, were subject to be taxed by their neighbors, through whose ports their commerce was carried on. New Jersey, placed between Philadelphia and New York, was likened to a cask tapped at both ends and North Carolina, between Virginia and North Carolina, to a patient bleeding at both arms.[49]

The activity of freewheeling, independent states wreaked havoc on interstate and international trade.[50] The Framers of the new Constitution unanimously favored reform.[51] The Framers sought to avoid the problems that arose under the Articles by explicitly vesting the power to define foreign relations in Congress[52] rather than in the individual states.[53]

Case law following ratification of the Constitution supports the view that foreign commerce is an exclusively federal concern. In *Gibbons v. Ogden*,[54] for example, the United States Supreme Court held that New York's grant of a monopoly affecting navigation between New York and New Jersey conflicted with a federal statute licensing such interstate commerce and, therefore, was void under

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45. State governments of course can influence the federal government in the formulation of foreign policy.

46. The Articles were the nation's first effort to construct a workable federal structure. The loose confederation of states linked by a weak national government proved untenable. *See generally* P SMITH, THE CONSTITUTION: A DOCUMENTARY AND NARRATIVE HISTORY 71-92 (1978). The national government's failure to enforce the Treaty of Paris of 1783 was evidence of problems with the Articles. *See* M. FARRAND, THE FRAMING OF THE CONSTITUTION OF THE UNITED STATES 46 (1913).

47. *See* ARTICLES OF CONFEDERATION art. IX.

48. M. FARRAND, *supra* note 46, at 45.

49. J. MADISON, JOURNAL OF THE FEDERAL CONVENTION 33 (1840).

50. Madison attributed Great Britain's monopolizing practices to a "want of authority in Congress to regulate commerce " *Id.* at 46.

51. M. FARRAND, *supra* note 46, at 45-47.

52. *See* U.S. CONST. art. I, § 8.

53. *See* U.S. CONST. art. I, § 10.

54. 22 U.S. (9 Wheat.) 1 (1824).

the supremacy clause. Although the decision was based on the supremacy clause, Chief Justice Marshall indicated in the opinion that congressional power to regulate "commercial intercourse" extended to all activity having an interstate impact, however indirect. Marshall contended that "when a state proceeds to regulate commerce with foreign nations it is exercising the very power that is granted to Congress, and is doing the very thing that Congress is authorized to do."[55] Justice Johnson, in his concurring opinion, also concluded that the regulation of foreign commerce is exclusively a federal concern: "But the power to regulate *foreign* commerce is necessarily exclusive. The states are unknown to foreign nations; their sovereignty exists only with relation to each other and the general government."[56]

The application of the foreign commerce clause to state taxation can be traced to *Brown v. Maryland*.[57] Primarily an import-export clause[58] case, *Brown* examined the constitutionality of an import licensing scheme.[59] Discussing the limitations of state taxing power in the context of the commerce clause, Chief Justice Marshall stated that "the taxing power of the states must have some limits. It cannot reach and restrain the action of the national government within its proper sphere."[60]

Since the early nineteenth century, the Supreme Court has left no doubt that the power over foreign commerce and foreign affairs is the exclusive province of either the legislative branch, the executive branch, or both. As a result of this broad interpretation, disputes over jurisdiction in foreign matters generally have been between Congress and the President rather than between the states and the federal government.[61]

The Modern Foreign Commerce Clause Analysis Before Container

Few modern cases have discussed the foreign commerce clause.

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55. *Id.* at 199-200.
56. *Id.* at 228 (emphasis added).
57. 25 U.S. (12 Wheat.) 419 (1827). For a general analysis of the conflict between federal and state taxation, see McCulloch v. Maryland, 17 U.S. (4 Wheat.) 316 (1819).
58. U.S. CONST. art. I, § 10, cl. 2.
59. 25 U.S. at 436.
60. *Id.* at 448.
61. *See* L. TRIBE, *supra* note 21, at § 4-3.

Japan Line, Ltd. v. County of Los Angeles[62] contains perhaps the most fully developed foreign commerce analysis to date. In *Japan Line*, a Japanese corporation challenged California's attempt to impose an *ad valorem* property tax on their shipping containers.[63] The foreign corporation asserted that the tax produced international double taxation and thereby violated both the home port doctrine[64] and the foreign commerce clause.[65] In considering the case's foreign commerce issues, the Court maintained that even if the tax satisfied the *Complete Auto Transit* four-pronged test,[66] further analysis was necessary because the case required the Court to "constru[e] Congress' power to 'regulate Commerce with foreign Nations.' "[67] Because of this need for a more extensive constitutional inquiry, the Court employed two additional disjunctive tests: (1) whether the tax creates a substantial risk of international double taxation, and (2) whether the state tax "prevents the Federal Government from 'speaking with one voice when regulating commercial relations with foreign governments.' "[68] In requiring additional scrutiny of state taxes affecting foreign commerce, the Court expressed concern over the lack of recourse available to foreign businesses victimized by double taxation.[69] The need for federal uniformity "where federal uniformity is essential"[70] also militated against identical treatment of foreign and interstate commerce problems.

Later cases and commentators have construed *Japan Line* narrowly.[71] These courts and commentators base their narrow con-

62. 441 U.S. 434 (1979).

63. *Id.* at 437.

64. The basic premise of the home port doctrine is that vessels are properly taxable in their home ports. *Id.* at 441-42. The Court in *Japan Line* refused to rule on the home port issue, instead basing its decision on the commerce clause. *Id.* at 442-44. For a discussion of the home port doctrine, see Comment, *Limitations on State Taxation of Foreign Commerce: The Contemporary Validity of the Home-Port Doctrine*, 127 U. PA. L. REV. 817 (1979).

65. 441 U.S. at 442-43.

66. *See supra* notes 29-31 and accompanying text.

67. 441 U.S. at 446.

68. *Id.* at 451.

69. *Id.* at 447.

70. *Id.* at 448.

71. *See* Mobil Oil Corp. v. Commissioner of Taxes, 445 U.S. 425, 448 (1980); Alcan Aluminum Ltd. v. Franchise Tax Bd., 558 F Supp. 624, 629 (S.D.N.Y. 1983); *see also* STATE TAXA-

struction on the Court's use of the term "instrumentalities of commerce"[72] and on the nature of the challenged tax in *Japan Line*. Until *Container* the United States Supreme Court refused to apply the *Japan Line* analysis to any case in which a property tax was not at issue.[73] The sweeping language and the depth of analysis that the Court used in *Japan Line*, however, warrant a broader reading of the case.[74]

Container *and the Foreign Commerce Clause*

Although the Court in *Container* deliberately emphasized the narrow reading of *Japan Line*,[75] it applied the *Japan Line* tests in considering the constitutionality of the California income tax. The Court maintained that the California tax was constitutional despite the possibility that it might impose double taxation because the *Japan Line* tests did not impose any absolute prohibition on "state-induced double taxation in the international context."[76] The closer scrutiny mandated by the foreign commerce clause simply required a court to take into consideration "the context in which the double taxation takes place and the alternatives reasonably available to the taxing state."[77] The Court contended that Califor-

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TION I, *supra* note 5, ¶ 4.15; *Japan Line Ltd. v. County of Los Angeles*, 441 U.S. 434 (1979), 5 INT'L TRADE L. J. 319 (1980); Note, *Constitutional Law—Commerce Clause—State Tax of Instrumentalities of Foreign Commerce Invalid When Tax Results in Multiple Taxation and Impairs Federal Uniformity in Regulation of Foreign Trade*, 12 VAND. J. TRANSNAT'L L. 999 (1979). *Contra* Hellerstein, *State's Power to Tax Foreign Commerce Dominates Supreme Court's Agenda*, 51 J. TAX'N 106 (1979).

72. 441 U.S. at 444; *see, e.g.*, Alcan Aluminum Ltd. v. Franchise Tax Bd., 558 F. Supp. 624, 629 (1983).

73. *See, e.g.*, Mobil Oil Corp. v. Commissioner of Taxes, 445 U.S. 425, 448 (1980). The perfunctory treatment given the foreign commerce clause issue in *Mobil* is due in part to the way the case was presented to the Court. *See id.* ("[P]roblems of multiple taxation at the international level are simply not germane to the issue of multiple state taxation that appellant has framed.").

74. This seems particularly true when one considers the reasons that the Court gave to justify heightened analysis under the foreign commerce clause. Lack of a proper remedy when foreign entities are taxed is just as likely under a property tax as under an income or franchise tax. Likewise, the concern for federal uniformity would play a role regardless of the object being taxed; foreign businesses and governments are annoyed either way.

75. 103 S. Ct. at 2952 n.24. The Court distinguished *Japan Line*, but then applied the *Japan Line* tests. *Id.*

76. *Id.* at 2953.

77. *Id.*

nia had no reasonable alternative. The decision not to tax at all was unreasonable,[78] and although the arm's length method was a valid alternative, it was neither necessarily effective[79] nor mandated.[80] Because all of the other alternatives available to California also could produce double taxation, the Court concluded that California's use of a worldwide apportionment formula for assessing its franchise tax did not violate the foreign commerce clause.[81]

The Court also found that the California tax did not interfere with federal uniformity and therefore did not violate the second part of the *Japan Line* test. In general, a state tax interferes with federal uniformity only if the tax "*either* implicates foreign policy issues which must be left to the Federal Government *or* violates a clear federal directive."[82] Although noting that it possessed "little competence" in the foreign policy area and could only "develop objective standards that reflect very general observations about the imperatives of international trade and international relations," the Court maintained that the tax did not implicate foreign policy issues—it merely had "foreign resonances."[83] The Court observed, for example, that the tax did not create any "*automatic* 'asymmetry' " in international taxation, and that retaliation was thus unlikely.[84] Furthermore, because the Container Corporation was incorporated in the United States, the "legal incidence" of the tax was domestic.[85]

In addition to finding that the California tax did not implicate any foreign policy issues, the Court also found that the tax did not violate any federal statutes or treaties and therefore was not inconsistent with any federal directive.[86] In reaching this conclusion, the Court pointed out Congress' failure to pass any legislation on this

78. *Id.*

79. *Id.* The dissent in *Container* disagreed with this conclusion. According to Justice Powell, double taxation is an inherent by-product of worldwide apportionment. The arm's length method produces double taxation only in certain circumstances, and in those circumstances the double taxation effect can be eliminated. *Id.* at 2958-59.

80. *See supra* note 11.

81. 103 S. Ct. at 2956.

82. *Id.* at 2955 (emphasis in original).

83. *Id.*

84. *Id.* (emphasis in original).

85. *Id.* at 2955-56; *see infra* notes 98 & 204 and accompanying text.

86. *Id.* at 2956-57.

matter after many years of debate,[87] as well as to the failure of the Solicitor General to file an amicus curiae brief in the case.[88] These factors led the Court to conclude that the tax was neither "fatally inconsistent with federal policy" nor "pre-empted by federal law."[89]

THE *Container* DISSENT APPLIES THE *Japan Line* TEST

Justice Powell, joined by Chief Justice Burger and Justice O'Connor,[90] maintained that the California taxing scheme violated the foreign commerce clause.[91] Applying the two-part *Japan Line* test, Justice Powell attacked the majority's failure to recognize the double taxation that results from any scheme that bases its tax on the total assets of a unitary business that is more profitable, or engages in more business,[92] outside of the taxing state.[93] Double taxation results because the income earned by a corporation in a foreign country is reflected in both the state's apportionment formula as well as in the foreign country's tax. Theoretically, if both the state and the foreign country used the same apportionment formula, no double taxation would result because both taxing entities would be taxing their proportionate share of the corporation's total income. As Justice Powell observed, however, most foreign countries apply an arm's length rather than an apportionment system of taxation.[94] Under an arm's length system, the foreign nation taxes all, rather than a proportionate share, of the corporation's total income. Consequently, if the foreign nation taxes all of the income, and each state taxes its proportionate share of that same income, double taxation inevitably results. This double taxation, Powell noted, easily could be avoided by the use of an inter-

87. *Id.*
88. *Id.* at 2956.
89. 103 S. Ct. at 2957.
90. *Id.*
91. *Id.*
92. Double taxation is likely to occur if the corporation engages in substantial business, as measured by its sales, property, and payroll outside of the taxing state.
93. 103 S. Ct. at 2958.
94. *Id.* In situations in which the corporation engages in less business or produces less profits outside the taxing state, the state would not benefit from applying the apportionment formula method and is under no obligation to calculate its franchise tax in this manner.

national agreement requiring the taxing entities to use the same accounting method.[95] Justice Powell thus dismissed the majority's contention that California would not necessarily reduce the possibility of double taxation by adopting a different accounting method. Justice Powell maintained that double taxation would be averted if California simply based its apportionment taxation on the corporation's domestic income, as reported in its federal tax report.[96]

Justice Powell also attacked the constitutionality of the California tax under the second part of the *Japan Line* test. He argued that worldwide apportionment taxation of a foreign corporation's domestic subsidiary necessarily implicates foreign policy issues that should be left to the federal government.[97] The dissent expressed skepticism over the majority's emphasis on the domestic incidence of the tax.[98] Appraising the reality of the taxing scheme, the dissent contended that foreign governments were justified in their concern over the heavier tax burdens faced by companies domiciled in their jurisdictions. California taxed foreign corporations through their domestic subsidiaries and discouraged direct investment overseas.[99] The dissent found particularly disturbing the states' authority to tax domestic but not foreign corporations on the basis of worldwide income, thus allowing states to discriminate against domestic businesses.[100] Finally, Justice Powell expressed incredulity over the majority's reliance on the absence of an amicus curiae brief from the Solicitor General; the *Chicago Bridge & Iron Co.* brief clearly reflected the Solicitor General's sentiments.[101] The California tax, according to Justice Powell,

95. *Id.* at 2959.

96. *Id.* at 2957 n.1. This alternative essentially mirrors the solution presented in the Mathias/Conable Bills introduced in Congress in May 1983. *See infra* notes 183-86 and accompanying text.

97. 103 S. Ct. at 2959.

98. *Id.* at 2959-60; *see supra* note 85; *infra* notes 103 & 204 and accompanying text.

99. 103 S. Ct. at 2959.

100. *Id.* at 2960. Under the equal protection clause and the commerce clause, states are not allowed to discriminate in favor of domestic, i.e., state-based businesses. This constitutional restriction does not preclude the state from discriminating against a domestic corporation. *Id.* at 2560 n.5.

101. *Id.* at 2560.

therefore, was "flatly inconsistent with federal policy."[102]

The Apportionment Method Violates the Japan Line *Test*

The majority in *Container* seemed unimpressed by foreign commerce arguments. The Court's reliance on the domestic corporation distinction,[103] although offering hope for foreign-based corporations,[104] nevertheless was not justified adequately.[105] The Court had available a substantial and sound basis of both precedent and general constitutional theory to have decided the case differently Given the domestic corporation distinction, much of the Court's analysis, contrary to Justice Powell's view,[106] would apply to both foreign and domestic corporations.

Formula Apportionment Creates Double Taxation

The majority based its conclusion that worldwide apportionment taxation did not unduly burden foreign commerce on the belief that the arm's length method would not, if implemented, be any more effective in avoiding double taxation than the California tax. The Court seemed to prefer apportionment over the arm's length approach. The Court noted, for example, the "basic theoretical weaknesses" of the arm's length method.[107] Moreover, although the Court observed that the Constitution did not mandate any one particular method of state taxation, it intimated that the apportionment method was preferable and would be upheld under almost all circumstances with only nominal review.[108]

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102. *Id.* at 2561.

103. *See supra* note 98 and accompanying text. This distinction is quite important; lower federal courts have adhered to the domestic incidence theory in order to deny standing to foreign parents seeking to sue on behalf of their American subsidiaries. *See, e.g.*, Alcan Aluminum Ltd. v. Franchise Tax Bd., 558 F. Supp. 624 (S.D.N.Y. 1983).

104. Amicus briefs filed by foreign-based companies in *Container* sought to convince the Court to write a narrow decision, thereby leaving open the opportunity for a foreign parent to challenge the tax in future litigation. The briefs appear to have succeeded. *See* Peters, *Supreme Ct. in* Container, *Upholds State's Broad Power Unitary Taxation Method*, 59 J. TAX'N 300, 303 (1983).

105. *See* Kaplan, *The Unitary Tax Debate, The United States Supreme Court, and Some Plain English*, 10 J. CORP. TAX'N 283, 292 n.30 (1984).

106. 103 S. Ct. at 2960 (Powell, J., dissenting).

107. 103 S. Ct. at 2948.

108. *Id.* at 2948-50. Some commentators have found this judicial preference both "ex-

The Court's conclusion that arm's length and formula apportionment taxation are equally likely to result in double taxation is erroneous.[109] Double taxation is much more likely to occur when two jurisdictions apply different taxation methods,[110] and "no other taxing jurisdiction in an industrially developed country uses such formulary taxation."[111]

Double taxation is effectively eliminated in the international context by bilateral tax treaties. International tax treaties resolve the inevitable disputes that arise when more than one jurisdiction seeks to tax the same income.[112] As one commentator notes, "Basically, a tax treaty decides which of the contracting states has the exclusive or primary right to tax various types of income and it determines the manner in which double taxation is to be avoided with respect to such income."[113]

In the international context, subsidiaries and parents are independent legal entities. Accordingly, transactions between a subsidiary and its parent are transactions between unrelated parties.[114] The arm's length method of taxation embodies this concept. In addition, a simple mechanism enables the taxing party to adjust transfer prices between the parties when their transactions are not at arm's length.[115]

The model arm's length corrective mechanism provision is the

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treme" and "troubling." *See* Kaplan, *supra* note 105, at 291.

109. *See* Kaplan, *supra* note 105, at 291 (the statement by the Court that the "direct method is as apt to result in double taxation as is formula apportionment—without much doubt will be regarded as incorrect by most knowledgeable observers").

110. *Id.* Conversely, formula apportionment in interstate commerce theoretically does not result in double taxation if all of the states apply the same apportionment method.

111. *Id.* at 286. The tax is "aberrant in international terms." *Id.* at 284.

112. *See* Whittaker, *An Examination of the O.E.C.D. and U.N. Model Tax Treaties History, Provisions and Application to U.S. Foreign Policy*, 8 N.C.J. INT'L LAW & COM. REG. 39, 40 (1983).

113. S. FROMMEL, TAXATION OF BRANCHES AND SUBSIDIARIES IN WESTERN EUROPE, CANADA AND THE U.S.A. 155 (2d ed. 1978).

114. S. FROMMEL, *supra* note 113, at 70-71. Arm's length prices are the prices established in "comparable open market transactions between unrelated parties." *Id.* at 73. For a general discussion of international taxation, see Kingson, *The Coherence of International Taxation*, 81 COLUM. L. REV. 1151 (1981).

115. S. FROMMEL, *supra* note 113, at 76.

O.E.C.D. Model Treaty, Article 9.[116] Other countries also include a corrective mechanism in their tax laws. In the United States, 28 U.S.C. section 482 enables the Internal Revenue Service to make arm's length adjustments; similarly, in the United Kingdom, the Inland Revenue Service has authority to adjust profits in transactions that are not at arm's length.[117] France has similar provisions,[118] and German tax authorities are empowered to impose a constructive dividend to enforce arm's length dealings.[119]

The use of consolidated worldwide profits and apportionment is rare internationally The United Nations Group of Eminent Persons considered and rejected apportionment in 1974.[120] Germany

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ARTICLE 9

ASSOCIATED ENTERPRISES

1. Where

(a) an enterprise of a Counteracting State participates directly or indirectly in the management, control or capital of an enterprise of the other Contracting State, or

(b) the same persons participate directly or indirectly in the management, control or capital of an enterprise of a Contracting State and an enterprise of the other Contracting State,

and in either case conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly.

2. Where a Contracting State includes in the profits of an enterprise of that State—and taxes accordingly—profits on which an enterprise of the other Contracting State has been charged to tax in that other State and the profits so included are profits which would have accrued to the enterprise of the first-mentioned State if the conditions made between the two enterprises had been those which would have been made between independent enterprises, then that other State shall make an appropriate adjustment to the amount of the tax charged therein on those profits. In determining such adjustment, due regard shall be had to the other provisions of this Convention and the competent authorities of the Contracting States shall if necessary consult each other.

REPORT OF THE OECD COMMITTEE ON FISCAL AFFAIRS, MODEL CONVENTION FOR THE AVOIDANCE OF DOUBLE TAXATION WITH RESPECT TO TAXES ON INCOME AND CAPITAL (1977), *reprinted in* J. BISCHEL, INCOME TAX TREATIES 804 (1978).

117. ICTA 1970 s. 485, *cited in* S. FROMMEL, *supra* note 113, at 77.

118. CGI art. 57, *cited in* S. FROMMEL, *supra* note 113, at 78.

119. KSTDV art. 19, *cited in* S. FROMMEL, *supra* note 113, at 78.

120. S. FROMMEL, *supra* note 113, at 63.

infrequently used the method until it abandoned it in 1965.[121] Interestingly, the European Court of Justice has characterized multinationals as "economic units."[122] In the United States, at the federal level, arm's length taxation is well established.[123]

The correct conclusion about double taxation is, therefore, the one drawn by Justice Powell; double taxation inevitably results when formula apportionment is applied on a worldwide basis. Foreign income that has been factored into the formula by California has already been taxed by the foreign country where it was earned by the arm's length method. State tax systems, unlike the federal system,[124] do not allow a foreign tax credit, and a foreign country is not likely to allow the taxpayer to write off taxes paid to American subgovernments. *Container* simply ignores the reality of international taxation. More significantly, it nullifies the foreign commerce clause concerns that underlie *Japan Line*.[125]

Formula Apportionment Violates the Federal Uniformity Concept

Worldwide formula apportionment is a federal issue; the states' power to tax is in direct conflict with the national government's authority over foreign affairs. In *Container*, the Court admitted that it lacked expertise in foreign affairs.[126] It has, however, repeatedly protected the federal government's exclusive authority over that area.[127]

Constitutional Objections to Formula Apportionment

Both the principle of federal exclusivity and the foreign com-

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121. *Id.*

122. Art. 85(1) EEC Treaty, *cited in* S. FROMMEL, *supra* note 113, at 59. It may be that apportionment makes more sense in federal structures such as the United States and the European Economic Community.

123. In 1961, the House of Representatives passed an amendment to 28 U.S.C. § 482, which would have implemented the apportionment method; the bill was rejected by the Senate. S. FROMMEL, *supra* note 113, at 74.

124. *See* I.R.C. § 901 (1982).

125. *See* Delap, *From* Moorman *to* Chicago Bridge: *U.S. Supreme Court Decisions Relating to "Unitary" Taxation*, 2 J. STATE TAX'N 197, 215 (1983).

126. *See* 103 S. Ct. at 2955.

127. *See* United States V Curtiss-Wright Export Co., 299 U.S. 304 (1936); *see also* Zschernig v. Miller, 389 U.S. 429 (1968); Hines v. Davidowitz, 312 U.S. 52 (1941).

merce clause justify stricter limits on state legislation of commerce. Although no express constitutional terms grant foreign affairs power either to states or to the federal government, the federal government's exclusive power has long been established.[128] Article I, section 8 of the United States Constitution grants certain foreign policy powers to the Congress, implicitly denying them to the states; article I, section 10 of the Constitution denies certain foreign policy powers to the states, implicitly granting them to the Congress. These specific allocations reflect a constitutional scheme that vests all foreign policy power in the federal government.[129] In many cases, therefore, state statutes with adverse impacts on foreign policy have been struck down as unconstitutional.[130] The Supreme Court has upheld federal foreign policy power in broad terms as a necessary incident of national power.[131] The nature of the activity at issue, whether it relates to foreign matters or is essentially domestic, therefore, dictates the source of the power.

The foreign commerce clause similarly demands strict limits on state statutes affecting foreign policy.[132] The nature of the commerce affected by the state statute determines the kind of scrutiny it receives, and the distinction between national and local commerce delineated by the United States Supreme Court in *Cooley v. Board of Wardens*[133] comes into play. In *Cooley*, the Court established that states could regulate *local* aspects of commerce, but that only Congress may regulate *national* commerce.[134] Under the federal exclusivity doctrine, foreign policy is as "national" as an

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128. L. TRIBE, *supra* note 21, § 4-5, at 172.

129. *See id.* The supremacy clause also empowers the federal government to determine foreign policy.

130. *See, e.g,* Zschernig v. Miller, 389 U.S. 429 (1968) (statutory probate scheme); Hines v. Davidowitz, 312 U.S. 52 (1941) (alien registration); Chy Lung v. Freeman, 92 U.S. 275 (1876) (alien entry restrictions); Henderson v. Mayor of New York, 92 U.S. 259 (1875) (alien entry requirements).

131. *See* United States v. Curtiss-Wright Export Corp., 299 U.S. 304, 318 (1936) ("The powers to declare and wage war, to conclude peace, to make treaties, to maintain diplomatic relations with other sovereignties, if they had never been mentioned in the Constitution, would have vested in the federal government as necessary concomitants of nationality."). Language such as this suggests an extraconstitutional characterization of foreign policy power.

132. *See* Reeves, Inc. v. Stake, 447 U.S. 429 (1980).

133. 53 U.S. (12 How.) 299 (1851).

134. L. TRIBE, *supra* note 21, § 6-4, at 324.

issue can be; the *Cooley* analysis, therefore, precludes states from legislating in any way that affects foreign policy

The Court in *Container* referred to its "residual concern" for foreign policy implications,[135] and found mere "resonances" instead of "implications" arising from the California tax.[136] The Court also concluded that American foreign policy was "not seriously threatened."[137] Nevertheless, in another federal exclusivity case, *Zschernig v. Miller*,[138] the Court struck down a state probate statute because it "impair[ed] the effective exercise of the Nation's foreign policy , [had] a direct impact upon foreign relations and *may well* [have] adversely affected the power of the central government to deal with those problems."[139] *Container* suggests not only that state legislation must seriously affect foreign policy in order to violate the Constitution but also that serious effects cannot be shown prospectively [140]

The Court did not look beyond the threat of foreign retaliation in searching for foreign policy implications. Foreign reaction was

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135. 103 S. Ct. at 2957.

136. *Id.* at 2955.

137. *Id.* at 2956.

138. 389 U.S. 429 (1968).

139. *Id.* at 440-41 (emphasis added). In an earlier opinion the Court addressed the problems of states' involvement in foreign affairs:

> If that government should get into a difficulty which would lead to war, or to suspension of intercourse, would California alone suffer, or all the Union? If we should conclude that a pecuniary indemnity was proper as a satisfaction for the injury, would California pay it, or the Federal government? If that government has forbidden the States to hold negotiations with any foreign nations, or to declare war and has taken the whole subject of these relations upon herself, has the Constitution, which provides for this, done so foolish a thing as to leave it in the power of the State to pass laws whose enforcement renders the general government liable to just reclamations which it must answer, while it does not prohibit to the States the acts for which it is held responsible?
>
> The Constitution of the United States is no such instrument. The passage of laws which concern the admission of citizens and subjects of foreign nations to our shores belongs to Congress, and not to the States. It has the power to regulate commerce with foreign nations: the responsibility for the character of those regulations, and for the manner of their execution, belongs solely to the national government. If it be otherwise, a single State can, at her pleasure, embroil us in disastrous quarrels with other nations.

Chy Lung v. Freeman, 92 U.S. 275, 279-80 (1875).

140. The Court maintained that retaliation from foreign governments was not likely. 103 S. Ct. at 2955-56.

significant, however, both before and after the decision.

Foreign Reaction to Formula Apportionment

Before *Container*, the European Economic Community submitted two formal protests to the United States government regarding apportionment.[141] In 1981, several industrial federations from Japan, Great Britain, and Germany observed that many investments in California had been stalled as a result of California's apportionment tax.[142] Similarly, in the 1980 Double Tax Treaty between the United States and the United Kingdom, the United Kingdom sought and initially obtained a provision, Article 9(4), prohibiting state use of the apportionment method.[143] Over thirty-five foreign groups filed amicus curiae briefs opposing unitary taxation in *Chicago Bridge & Iron Co.*[144] Several foreign groups also filed opposing briefs in *Container*[145]

The British response provides a particularly useful gauge of world reaction because Britain is one of America's largest trading partners and perhaps its closest ally[146] Conflict between the

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141. Saunders, *The Shifty Fifty*, FORBES, July 4, 1983, at 131.

142. *Disputing a State's Tax Reach*, BUS. WEEK, Nov. 2, 1981, at 131-32.

143. Art. 9(4) read as follows:

> Except as specifically provided in this Article, in determining the tax liability of an enterprise doing business in a Contracting State, or in a political subdivision or local authority of a Contracting State, such Contracting State, political subdivision, or local authority shall not take into account the income, deductions, receipts, or outgoings of a related enterprise of the other contracting State or of an enterprise of any third State related to an enterprise of the other Contracting State.

Convention for the Avoidance of Double Taxation, April 16, 1985, United States—United Kingdom, art. 9(4), *reprinted in* J. BISCHEL, *supra* note 116, at 851.

144. *See* Kaplan, *supra* note 105, at 291 n.26.

145. *See, e.g.*, Amicus Curiae Brief by Canadian Corporations, Container Corp. v. Franchise Tax Bd., 103 S. Ct. 2937 (1983); Amicus Curiae Brief by British Corporations and the Unitary Tax Campaign, Container Corp. v. Franchise Tax Bd., 103 S. Ct. 2933 (1983).

146. Britain is the largest direct investor in the United States. Wallis, *Examining the Unitary Tax*, 84 DEP'T ST. BULL. 68, 69 (1984). Corporations from other countries also have been vocal in their criticism and have pressured the American government to change state tax practices. *See, e.g.*, STATE TAX REV. (CCH) December 6, 1983, at 1 (Japan, Australia, Canada); *Current and Quotable: Canadian Minister of Finance on the Unitary Tax Method*, 20 TAX NOTES 684 (1983); Washington Post, February 11, 1984, at Cl, col. 4 (Japan); *see also* Allen, *The* Container *Case: The Unitary Tax in the United States and as Perceived by the International Community*, 18 INT'L LAW 127 (1984) (Japan). Foreign lobbyists also have brought pressure to bear on state governments, with some success.

United States and the United Kingdom over worldwide apportionment has existed since 1978 when negotiations began for the renewal of the tax treaty between the United States and the United Kingdom. Under the proposed terms of the renegotiated treaty,[147] states such as California would have been precluded from taxing income generated outside of the United States. The proposed treaty, therefore, would have allowed states to apportion income resulting from any American operations but would have required the states to apply the arm's length method of taxation when allocating overseas income from either the foreign parent or the foreign subsidiary In approving the renegotiated treaty, however, the United States Senate deleted the language pertaining to state apportionment.[148] The British accepted this deletion on the assumption that Congress would enact appropriate legislation forbidding the states from using the worldwide apportionment method.[149] The British also reasoned that the deal included granting American corporations operating in the United Kingdom the benefit of the Advance Corporation Tax.[150] Understandably, British officials were quite bitter when legislation forbidding apportionment failed to

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Keidanren, a trade group representing 812 Japanese corporations, and 110 associations, has been particularly successful. Another powerful group is the Organization for Fair Taxation of International Organizations (OFTIO). *The Unitary Method Fight Doesn't Stop at the Water's Edge*, 24 TAX NOTES 821 (1984). Governor Orr of Indiana, for example, announced plans to scrap the state's worldwide unitary tax scheme on the same day that Sony Corp. disclosed its plan to build a $20 million laser-disc plant in Indiana; a governor's aide admitted that Sony's plan affected the state's decision to abandon the unitary tax scheme. Oregon likewise repealed its worldwide tax scheme in a special session of the legislature, under pressure from the Japanese. The Japanese company NEC made construction of a $25 million fiber optics plant contingent upon assurances that worldwide unitary taxation would not be applied. Wall St. J., Aug. 1, 1984, at 10, col. 2. The North Dakota Tax Commissioner argued that Japanese pressure tactics were counterproductive on the whole, but events do not seem to bear his assertion out. *Id.* One must question the propriety of having foreign groups exerting economic pressure at the state level. State governments often have neither the expertise nor the influence to respond adequately.

147. *See supra* note 143.

148. *See* 125 CONG. REC. 18400 (1978).

149. *See* Jones, *Unitary Taxation—Will 1983 Bring Relief?*, ACCOUNTANCY, March 1983, at 14.

150. J. BISCHEL, *supra* note 116, at 701 (the Advance Corporation Tax was the impetus for the Art. 9(4) political subdivision language). The Advance Corporation Tax (ACT) is a tax that a corporation must pay each time it issues a dividend. This tax is credited against the income tax owed by the corporation. *Id.* at 691. There is movement in the House of Commons to remove ACT privileges from American companies. *See infra* note 152.

appear.[151]

The British have mounted a strong campaign to pressure the United States Congress to enact the necessary legislation. In 1982, for example, Michael Grylls, a conservative member of Parliament, suggested in amendments to the 1982 Finance Bill that a similar tax be imposed on American companies doing business in the United Kingdom.[152] Mr. Grylls also proposed in September 1983 that the ACT credit accorded American corporations be withdrawn.[153] The Confederation of British Industry (CBI) has joined the British Unitary Tax Campaign in its fight against unitary taxation.[154] At its 1983 annual conference, the CBI called for abrogation of the 1980 tax treaty, and planned to apply pressure in the House of Commons to withdraw the tax privileges afforded American companies.[155] Peter Welch, British Chairman of the Unitary Tax Campaign, sent Treasury Secretary Regan a pot of tea, evoking the Boston Tea Party to demonstrate British outrage over state worldwide unitary taxation.[156]

The Thatcher government has been vocal in its criticism of unitary taxation. Prime Minister Thatcher made her opposition to the state scheme known to President Reagan in her Fall 1983 visit to

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151. In hearings before Congress in 1980, British officials testified that state use of the worldwide apportionment method "violate[d] the treaties of Friendship and Commerce" and "invite[d] retaliation," thus seriously burdening American businesses overseas. *State Taxation of Interstate Commerce and Worldwide Corporate Income: Hearings on S.983 Before the Sub-Committee on Taxation and Debt Management Generally of the State Comm. on Finance*, 96th Cong. 2d Sess. 75 (1980) (statement of John S. Nolan, British National Committee, International Court of Justice).

152. *Euromarket News*, COMMON MKT. REP. (CCH), May 18, 1982, at 4, 5.

153. *Euromarket News*, COMMON MKT. REP. (CCH), Sept. 28, 1983, at 5. Chancellor of the Exchequer Nigel Lawson announced that he would await the results of the Treasury Task Force on Unitary Taxation before considering Mr. Grylls's proposal to withdraw the ACT from companies domiciled in worldwide unitary states. Shepard, *British Unitary Retaliation Unlikely Just Yet*, 24 TAX NOTES 224 (1984). Such threats are taken seriously by American firms. Robert Ragland, of the National Association of Manufacturers, commented that "some companies like Ford are going to get hit right between the eyes." Wilson, *The Furor Over Unitary Taxes*, DUN'S BUSINESS MONTH, January 1984, at 65.

154. *Euromarket News*, COMMON MKT. REP. (CCH) August 23, 1983, at 6.

155. *Euromarket News*, COMMON MKT. REP. (CCH) Nov. 22, 1983, at 7. An executive from BAT Industries commented that if the unitary tax practices were allowed to continue, "we can say goodbye to the fruits of 40 years of hard work spent negotiating tax treaties." *Id.* at 7-8.

156. Wallis, *Examining the Unitary Tax*, 84 DEP'T ST. BULL. 68, 69 (1984).

America.[157] Similarly, the Chancellor of the Exchequer expressed his government's disappointment over the *Container* decision and also pressed for action by the executive to rectify the unitary tax problem.[158] Finally, in an Official Note submitted to the United States Treasury Working Group on Unitary Taxation, the British government criticized apportionment taxation as being opposed to "well-established international principles and practices of taxation.[159] The Note further argued that apportionment taxation presented unreasonable fiscal and administrative burdens and was damaging to American relations with the United Kingdom and other countries.[160]

The reaction of the British government and the British business community clearly indicates the kind of adverse impact that state worldwide apportionment taxation has had on American foreign policy and on international commercial relations. The Supreme Court in *Container* did not address adequately our trading partners' concerns or the potential foreign policy ramifications of upholding the California tax. Regardless of whether the issues litigated in *Container* involved domestic-based corporations, the Court should have noted that states applying worldwide apportionment do not always distinguish between foreign and domestic parents.[161] If the Court had been more concerned about foreign policy effects, it would have recognized the deleterious consequences that result from state worldwide apportionment taxation.

State worldwide apportionment taxation clearly has affected foreign policy The federal government has taken the brunt of the reaction from our trading partners, having expended significant re-

157. *Unitary Taxation: A California Tea-Party?*, ECONOMIST, Oct. 1, 1983, at 19.

158. *Current and Quotable: The Chancellor of the Exechequer on the Unitary Tax Method*, 20 TAX NOTES 450 (1983).

159. *Euromarket News*, COMMON MKT. REP. (CCH) Dec. 28, 1983, at 7-8.

160. *Id.* J.D. Taylor Thompson, Commissioner and Under-Secretary of Britain's Inland Revenue, reiterated these views at a Washington, D.C. seminar hosted by Senator Mathias and Representative Wyden on worldwide unitary taxation. *Showcase for Opponents of the Unitary Method*, 24 TAX NOTES 1219-20 (1984). The British press also has been critical of state unitary taxation. *See Exporting American Taxes*, ECONOMIST, Oct. 1, 1983, at 13; *Unitary Taxation: A Californian Tea-Party?*, THE ECONOMIST, Oct. 1, 1983, at 19; *Unite and Soak*, THE ECONOMIST, July 2, 1983, at 22.

161. *See, e.g.*, Shell Petroleum v. Graves, 709 F.2d 593 (9th Cir. 1983), *cert. denied*, 104 S. Ct. 537.

sources responding to the problem. Several potentially damaging actions by foreign governments may ensue. First, foreign governments may retaliate against American corporations doing business in their countries by suspending existing tax advantages or by imposing new tax burdens. Second, foreign governments may demand renegotiation of existing tax treaties, which may be detrimental to the interests of Americans and American corporations operating abroad. Third, a subtler form of damage is the potential loss of good will between nations, which may affect other aspects of foreign relations. Relations between the United States and its international partners have suffered, and are in danger of suffering even greater harm, as a direct consequence of state activity The international situation created by California's taxing scheme, therefore, is a perfect case for federal preemption under either a dormant commerce clause or a general federal exclusivity theory [162]

Invalidating California's tax scheme would have been contrary to the Burger Court's general states rights orientation.[163] The Court's

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162. *See* Javaras & Browne, *Litigation Prospects After* Container: *The Foreign Parent Issue*, 21 TAX NOTES 1027, 1032 (1984).

163. The states rights orientation has been bolstered by the mixed signals that the Reagan Administration has given on the unitary tax issue. In *Chicago Bridge & Iron Co.*, the Solicitor General in an amicus curiae brief criticized the tax scheme. Following the Supreme Court's decision in *Container*, President Reagan refused to press for a rehearing of *Container* and instructed the Treasury Group Task Force on Unitary Taxation, which was created following the *Container* decision, not to consider preemptive legislation. ST. TAX REV. (CCH), December 13, 1983, at 1; *see also Chairman's Report on the Worldwide Unitary Taxation Working Group: Activities, Issues and Recommendations*, 24 TAX NOTES 581, 583 (1984) [hereinafter cited as *Task Force Report*]. One should remember that President Reagan as Governor of California observed that "federal intervention in state tax matters is objectionable in principle." *A California Tea-Party?*, THE ECONOMIST, Oct. 1, 1983, at 23. Secretary Reagan clarified the position of the Executive in his letter to the President accompanying the Report of the Treasury Task Force on Unitary Taxation. The Treasury Department views state worldwide unitary taxation as troublesome, noting that if the states enact corrective water's edge legislation, "the United States will be able to speak with one voice in dealing with its foreign trading partners." 24 TAX NOTES, at 81. The State Department also spoke on the issue. In his remarks before the Coral Gables Chamber of Commerce, W. Allen Wallis, Under Secretary for Economic Affairs, called state unitary taxation a "major irritant [which] may rank with the most controversial issues I have handled in the economic area." Wallis, *Examining the Unitary Tax*, 84 DEP'T ST. BULL. 68, 69 (1984).

The General Accounting Office pointed out during the course of the Task Force proceedings that state tax practices presented a "bewildering variety" of rules for the multistate and multinational business, raising international tax issues and states' rights issues that should be resolved by Congress. *Task Force Report*, at 584.

decision in *Container*, however, upset the basic federal principle that the conduct of American foreign affairs is the exclusive domain of the federal government.[164] Conduct includes the day-to-day relations between governments and state taxation has affected and disrupted those relations. On this basis alone, the Court should have struck down California's use of worldwide unitary apportionment.

ALTERNATIVES TO FORMULA APPORTIONMENT

The Treaty Alternative

One way of preventing the states from apportioning corporate income on a worldwide basis is to modify existing treaties. Implementing the British modification discussed above is a possible solution. Language in the O.E.C.D. Model Treaty, also discussed above, would be an even more complete and effective modification. The O.E.C.D. Treaty covers taxes "imposed on behalf of its political subdivisions or local authorities, irrespective of the manner in which they are levied."[165]

The advantage of the treaty alternative is that a valid treaty would have the preemptive force of a federal statute[166] but would require only Senate approval. The great disadvantage of abolishing the tax by treaty is that, because these treaties are usually bilateral, new treaties would have to be negotiated with each treaty partner.

Alternative State Policies Toward Taxation of Multinationals

States might voluntarily adopt a water's edge approach, only applying the apportionment method to corporate activities within the United States.[167] Most states use the water's edge method of ap-

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164. "In international relations and with respect to foreign intercourse and trade the people of the United States act through a single government with unified and adequate national power." Board of Trustees v. United States, 289 U.S. 48, 59 (1933).

165. MODEL CONVENTION FOR THE AVOIDANCE OF DOUBLE TAXATION WITH RESPECT TO TAXES ON INCOME AND ON CAPITAL, REPORT OF THE O.E.C.D. COMMITTEE ON FISCAL AFFAIRS 1977, *reprinted in* J. BISCHEL, *supra* note 116, at 793, 798. The tax treaty between the United States and the United Kingdom only covers taxes imposed by the contracting state. *See* J. BISCHEL, *supra* note 116, at 820.

166. Reid v. Covert, 354 U.S. 1, 18 (1956).

167. Massachusetts chose to track *Container*. Its scheme applies worldwide unitary taxa-

portionment.[168] Interestingly, Illinois, in defining "unitary group," excludes from the group "members whose business activity outside the United States is 80 percent or more of any such member's total business activity."[169] Florida joined the ranks of states applying worldwide apportionment shortly after the Court decided the *Container* case.[170]

The Reagan administration favors the voluntary approach.[171] In May 1984, the Treasury Task Force on Worldwide Unitary Taxation—a group of state, business, and federal representatives—released its results.[172] The Group was unable to reach a concrete solution. In fact, subsequent squabbling over the conclusions of the Group has undermined substantially the utility of the Task Force Report.

In the Report, Treasury Secretary Regan announced that the Group had agreed in principle to the water's edge approach and had agreed to increased federal administrative assistance in promoting corporate disclosure of information.[173] The Group could not agree either on the treatment of dividends received by domestic parents from foreign subsidiaries or on the treatment of corporations whose participation in foreign operations is twenty percent or less of its total business.[174]

The Governors of California and Idaho, participants in the Group, filed a separate statement when Secretary Regan issued a supplemental report later in 1984.[175] The governors criticized Secretary Regan for his issuance of an ultimatum in his letter to Presi-

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tion to domestic multinationals while applying water's edge to foreign multinationals. Solet, *Unitary Taxation Comes to Massachusetts*, 28 BOSTON BAR J. 9, 13-14 (1984).

168. Eleven states now employ worldwide unitary taxation. Wall St. J., Aug. 1, 1984, at 10, col. 2.

169. 1983 ILL. LEGIS. SERV. 1355 (West).

170. 1983 FLA. LEGIS. SERV. 349 (West). Subsequently, both houses of the Florida legislature passed differing repeals of worldwide unitary taxation and are expected to resolve their differences in the next legislative session. Wall St. J., Aug. 1, 1984, at 10. Other states have repudiated the worldwide unitary taxing method. *See infra* notes 175-79.

171. *See supra* note 163.

172. *See Chairman's Report on the Worldwide Unitary Taxation Working Group, Activities, Issues and Recommendations*, 24 TAX NOTES 581, 583 (1984).

173. *Task Force Report, supra* note 164, at 584-85.

174. *Id.* at 585.

175. *Additional Views of Worldwide Unitary Taxation Working Group Members*, 24 TAX NOTES 1043 (1984).

dent Reagan in May 1984, which stated that he, Secretary Regan, would recommend federal preemptive legislation if the states did not make substantial progress by July 31, 1985.[176] The governors also highlighted their differences with Secretary Regan's perception of consensus. They had "significant differences" with Secretary Regan and wished to reiterate that acceptance of the water's edge approach was conditioned on the federal government's active assistance in enforcing arm's length pricing and in forcing companies to be honest in providing tax information.[177] The Treasury Secretary claimed consensus where none existed. We are, therefore, making little progress in solving the problem by state volunteerism.[178] Of course, the Task Force's failure may be irrelevant as states capitulate to foreign pressure.[179]

The Task Force experience suggests that voluntary abandonment of apportionment taxation is improbable. Substantial revenue is at issue, revenue that is needed to fulfill increasing state social policy obligations.[180]

Congressional Alternatives

The best, but perhaps the most elusive solution, is express congressional preemption of state worldwide apportionment tax. Since 1965, Congressmen have introduced no less than thirty-one bills that would prohibit states from applying the apportionment method of taxation.[181] Recent bills are Senate bills 655[182] and 1225[183] and House Reports 2918[184] and 4980.[185] These bills would

176. *Id.*

177. *Id., see also* Wall St. J., Sept. 4, 1984, at 7, col. 1.

178. This is unfortunate, considering that the Task Force was the Administration's "best hope." N.Y. Times, May 2, 1984, at D11, col. 2. President Reagan had hoped to take a compromise solution with him to the London Economic Summit in July 1984. *A Taxing War on Sticky-Fingered States*, FORTUNE, June 25, 1984, at 113.

179. *See supra* note 146.

180. *See* Peirce, *Taxing of Worldwide Income Calls for Restraint by States*, NATION'S CITIES WEEKLY, July 18, 1983, at 5. States utilizing worldwide unitary taxation estimate annual revenues of $600 million from the practice. N.Y. Times, May 2, 1984, at D11, col. 2.

181. Richman, *The Effect of State Taxes on Multinational Companies*, 14TH ANNUAL INSTITUTE ON INTERNATIONAL TAXATION (PLI), 215, 228 (1983).

182. S. 655, 97th Cong., 1st Sess. (1981).

183. S. 1225, 98th Cong., 1st Sess. (1983).

184. H.R. 2918, 98th Cong., 1st. Sess. (1983).

185. The newest federal preemption proposal is H.R. 4980, 98th Cong., 2d Sess. (1983)

limit worldwide apportionment by prohibiting states from taxing foreign source income unless the income is subject to federal income taxation.[186]

Under the statutory solution to the unitary tax problem, therefore, states are limited to the apportionment taxation of foreign-source income that returns to the United States. This solution assumes that federal methods for determining foreign income on the federal tax return are adequate.[187] Congress, however, seems satisfied with this method. The advantage of this solution is that it conforms state practice to federal and international practice when conformity is necessary, but does not enforce conformity when only interstate commerce is affected. The unitary tax, as originally developed to deal with interstate taxation problems, would remain intact.

THE FOREIGN PARENTS STANDING PROBLEM

A common problem faced by foreign-owned companies is their inability to acquire standing in federal courts. In the last few years, three foreign parent corporations have tried to challenge California's worldwide apportionment scheme. In all three cases, however, the court dismissed the suit on the ground that the corporation lacked standing.[188] In *EMI Ltd. v. Bennett*,[189] for example, the

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(proposed by Rep. Ron Wyden). H.R. 4980 mirrors the Mathias/Conable bills.

186. S. 1225 reads in pertinent part:

SEC. 7518 INCOME OF CORPORATIONS ATTRIBUTABLE TO FOREIGN CORPORATIONS

(a) In General.—Where two or more corporations are members of the same affiliated group of corporations—

(1) for purposes of imposing an income tax on any corporation which is a member of such group, no State, or political subdivision thereof, may take into account, or include in income subject to such tax, any amount of income of, or attributable to,

(2) any other corporation which is a member of such group and which is a foreign corporation, unless such amount is includable in the gross income of the corporation described in paragraph (1) for purposes of chapter 1 (including any amount includable in gross income under subpart F of part III of subchapter N of chapter 1) for the taxable year in which or with which the taxable period (for purposes of State or local law) ends.

S. 1225, 98th Cong., 1st Sess. (1983).

187. State representatives on the Treasury Unitary Tax Force hinged their acceptance of the water's edge approach to federal assistance in enforcement and in reporting procedures. *See supra* note 177 and accompanying text.

188. Shell Petroleum v. Graves, 709 F.2d 593 (9th Cir. 1983), *cert. denied*, Shell Petro-

United States District Court for the Northern District of California refused to hear a suit brought by EMI, Ltd., a British corporation, challenging California's apportionment taxation of its American subsidiary The British corporation contended that it had standing to bring the suit because the California tax diminished the value of its majority stock in the subsidiary [190] The court ruled that the corporation lacked standing on the ground that, because California assessed a tax against the subsidiary and not the parent, EMI suffered only an indirect harm as a shareholder and thus lacked any right to sue.[191] The primary injury, and the primary right to sue, according to the court, belonged to the corporation, and only derivatively to the shareholder.[192] On the same basis, the court concluded that the treaty provisions of the United States-United Kingdom Income Tax Convention did not grant standing to the foreign corporation.[193]

The facts in *Shell Petroleum v. Graves*[194] were similar to those in *EMI Ltd.* Shell, a Netherlands company, opposed California's application of a unitary tax on two of its subsidiaries doing business in California on the basis that the tax would disproportionately attribute income to the state of California.[195] Applying the same reasoning as that set forth in *EMI Ltd.*, the United States Court of Appeals for the Ninth Circuit ruled that Shell lacked standing to sue because shareholders generally cannot sue to seek redress of an injury to the corporation.[196] The court observed, moreover, that the United States-Netherlands Treaty did not grant standing to the Netherlands corporation.[197] Finally, the court

leum v. Franchetti, 104 S. Ct. 537; Alcan Aluminum Ltd. v. Franchise Tax Bd., 558 F Supp. 624 (S.D.N.Y. 1983); EMI Ltd. v. Bennett, 560 F Supp. 134 (N.D. Cal. 1982), *cert. denied*, 103 S. Ct. 1189 (1983). For a discussion of the standing issue, see Javares & Browne, *supra* note 163.

189. 560 F Supp. 134 (N.D. Cal. 1982).

190. *Id.* at 135. Shell also challenged the tax because of the Franchise Tax Board's request for information, which Shell could not supply under United Kingdom law. The court also rejected this basis for standing. *Id.*

191. *Id.*

192. *Id.*

193. *Id.*

194. 709 F.2d 593 (9th Cir. 1983), *cert. denied*, 104 S. Ct. 537.

195. *Id.* at 595.

196. *Id.*

197. *Id.*

ruled that because "plain, speedy and efficient" state remedies remained available to Shell, Shell's claim was not ripe for adjudication.[198]

In the most recent foreign parent case, *Alcan Aluminum Ltd. v. Franchise Tax Board*,[199] a Canadian parent, Alcan, challenged the application of California's unitary tax to its wholly owned American subsidiary, Alcancorp.[200] Unlike Shell and EMI, Alcan maintained that the tax directly injured it as the parent corporation.[201] The United States District Court for the Southern District of New York held that, because California had not levied a direct tax on the parent corporation, Alcan had not suffered a direct injury Therefore, Alcan lacked standing to bring suit in federal court.[202]

The district court's reasoning in *Alcan* is disturbing, particularly when read in conjunction with the United States Supreme Court's holding in *Container* In ruling that the foreign parent corporation lacked standing, the court relied on its conclusion that the American subsidiary was the taxpayer. The court thus rejected Alcan's assertion that California imposed a tax directly upon the parent company, reasoning that because the unitary tax by definition did not tax nonCalifornia income, foreign commerce was not taxed at all.[203] If the courts always consider the American subsidiary to be the taxpayer, however, the tax will always be domestic in nature, and, under the "domestic incidence" language in *Container*, no foreign commerce issue ever will be raised.[204] The foreign parent corporation thus will be denied any opportunity to contest the constitutionality of a state's taxation of its American subsidiary under the foreign commerce clause.[205] The district court's rationale in *Alcan* extends the fiction of the unitary business to a new extreme.

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198. *Id.* at 597.

199. 558 F Supp. 624 (S.D.N.Y. 1983).

200. *Id.* at 625.

201. *Id.* at 627.

202. *Id.* at 627-28.

203. *Id.* at 627.

204. "As previously demonstrated, the unitary tax is imposed *neither* upon foreign commerce *nor* upon Alcan itself." *Id.* at 628 (emphasis in original). Such a statement runs counter to the Supreme Court's reservation of the foreign parent issue in *Container. See supra* note 4.

205. *See* J. HELLER, CATCH-22 (1961).

CONCLUSION

The Supreme Court in *Container* upheld the constitutionality of state worldwide apportionment taxation of unitary businesses. The Court, however, did not adequately consider the important concept of federal exclusivity in foreign affairs or the heightened scrutiny demanded when foreign commerce is affected by state legislation. Perhaps when a foreign-based corporation acquires standing, a different decision will follow.

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