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INTRODUCTION

The use of the unitary tax method by various states in the United States has engendered increasing controversy in the past few years. This method of taxation has its origins in efforts by state taxing authorities to tax the full income of corporations doing business both within and outside the state.[1]

Congress has failed to enact legislation that effectively limits the states' authority to tax income of corporations resident or doing business within their territories. Nor has the Supreme Court successfully articulated meaningful delineations of the scope of state taxing authority. As a result, the states have been given free rein to operate in this area, often giving rise to difficult jurisdictional problems. Traditionally, states have sought to tax the out-of-state income (both U.S. and foreign) of corporations domiciled within their boundaries by considering only the income of the corporation's subsidiaries located in the state. The more recent target of taxation has been not only these subsidiary companies, but also the foreign parent companies of these domiciled subsidiaries. Such activities come under the category of unitary taxation.

Three constitutional issues are raised by the practice of the unitary taxation method. First, the fourteenth amendment due process clause[2] requires that strictly lawful procedures be followed by the states. Second, the interstate commerce clause[3] embodies the national interest in assuring that excessive state taxation does not impede the free flow of commerce among the states. Both of these issues attend any situation where the income of a multijurisdictional corporation is taxed, regardless of whether the taxing state attempts to reach beyond United States borders. When a state does seek to tax income outside U.S. borders, however, the

† This article does not reflect the Reagan Administration's recent announcement to preempt state unitary tax legislation. However, the relevance of Professor Baker's analysis remains unchanged. (Eds.)

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1. Hellerstein, *State Income Taxation of Multijurisdictional Corporations: Reflections on Mobil, Exxon, and H. R. 5076*, 79 MICH. L. REV. 113, 126 nn. 74 & 75 (1980); *See* G. ALTMAN & F. KEESLING, ALLOCATION OF INCOME IN STATE TAXATION 101 (2d ed. 1950).

2. U.S. CONST. amend. XIV, § 1.

3. U.S. CONST. art. I, § 8, cl. 3.

third constitutional issue surfaces under the foreign commerce clause[4]: to assure states do not infringe upon the authority of a nation to regulate commerce with foreign nations. This article examines these constitutional issues and reviews the recent responses of the U.S. Executive and Congress to this issue.

I. WHAT IS UNITARY TAXATION?

The unitary method of taxation was a response to the increased complexity of corporations conducting business activity in several jurisdictions. It was created to assess the income of a functionally related enterprise (the "unitary business") operating in more than one state.[5] Taxing authorities found that it was especially difficult to assess the income attributable to any given state, and other methods of taxation[6] failed to do so accurately. Formula apportionment[7] provides a means of determining a reasonable share of the total income of a multijurisdictional corporation by imputing it to a single jurisdiction. A state first determines whether a unitary business exists; if a business is a part of a unitary enterprise, the state will apportion the total income of the unitary business between the taxing jurisdiction and the rest of the world, using a formula. The unitary method of formula apportionment is employed by forty-five states and the District of Columbia.[8] The formulas vary,[9] but the most widely adopted formula is that used by California, which bases its assessment of income on the proportion of the unitary business' total payroll, property, and sales located within the State.[10] This form of taxation has been constitutionally upheld[11] and has been recognized by the twenty-three states that have adopted the Uniform Division of Income for Tax Purposes Act.[12]

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4. *Id.*

5. Smith, *A Levy That Spans the Ocean*, Wall St. J., Dec. 23, 1983 at 8, col. 4.

6. The other two means of taxing corporate income are separate accounting and specific allocation. Hellerstein, *supra* note 1, at 116. Specific allocation, which traces income to a single source, is not widely used in the taxation of multijurisdictional corporations since there is difficulty in ascertaining the specific source of income generated by such a corporation. *Id.* at 116-117. Under the separate accounting method, income attributed to a certain geographic or functional area of the multijurisdictional enterprise is treated separately from other parts of the enterprise. *Id.* at 117. *See infra* notes 74-78 and accompanying text.

7. The terms "unitary method" and "formula apportionment" are used interchangeably.

8. Weissman, *Unitary Taxation: Its History and Recent Supreme Court Treatment*, 48 ALB. L. REV. 48 (1983).

9. *Id.*

10. Hellerstein, *supra* note 1, at 117-18. "By averaging the ratios of the taxpayer's property, payroll, and sales within a state to its property, payroll, and sales throughout the business, the formula yields a fraction that can be applied to the taxpayer's net income to determine the portion taxable by the state." *Id.* at 118.

11. *See, e.g.*, Hans Rees' Sons, Inc. v. North Carolina *ex rel* Maxwell, 283 U.S. 123 (1931); Bass, Ratcliff & Bretton, Ltd. v. State Tax Comm'n, 266 U.S. 271 (1924); Underwood Typewriter Co. v. Chamberlain, 254 U.S. 113 (1920).

12. Container Corp. of America v. Franchise Tax Bd., 463 U.S. 159, 165 (1983).

The unitary method of taxation is used to assess income not only of operations within several of the United States, but also of business operations in other countries, resulting in the state taxing foreign corporations. This result occurs either when the foreign parent corporation has a subsidiary doing business in a state using the unitary method, or when a parent company with foreign subsidiaries is itself a resident of the state, dependent, of course, upon the existence of a unitary business relationship between the parent and the subsidiary or affiliate. The unitary method, when used to tax such an enterprise, is referred to as "worldwide combined reporting."[13] Ten states[14] now use the worldwide combined reporting method.

II. DUE PROCESS

A state may not tax value earned outside its territory absent some connection between itself and the activity sought to be taxed. The due process clause imposes two restrictions on states. First, some minimal connection between the income-generating activity sought to be taxed and the taxing state must be established.[15] The Supreme Court has included in this requirement that part of the business take place within the state[16] and that some bond of control or ownership must exist between the state and remaining parts of the "unitary business."[17] The second requirement imposed by the due process clause is that the "out-of-state activities of the purported 'unitary business' be related in some concrete way to the in-state activities."[18] In essence, this requirement mandates the existence of a unitary business.[19] If there was doubt in anyone's mind that apportionment of income required the presence of a unitary business, that doubt was allayed by the Court's decision in *ASARCO, Inc. v. Idaho State Tax Commission.*[20] ASARCO is a New Jersey corporation having its principle commercial headquarters in New York. Its primary business in Idaho, the taxing state, is silver mining, though it also mines other metals in other states. Idaho sought to tax the dividends, interest

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13. Weissman, *supra* note 8, at 48 n. 2.

14. As of this writing the ten states that use worldwide reporting are Alaska, California, Idaho, Indiana, Montana, New Hampshire, North Dakota, Oregon (although repeal of its law will become effective January 1, 1986) and Utah. Massachusetts until recently used worldwide combined reporting; however the Massachusetts Supreme Judicial Court has held that the state tax commissioner lacks the authority to use this method in the absence of regulations aprising taxpayers of the law. *See* Polaroid Corp. v. Comm'n of Revenue #53479, 1984. *See also* Sheppard, *No Unitary Method in Massachusetts*, 25 TAX NOTES 1057 (1984).

15. Hellerstein, *supra* note 1, at 121.

16. *Container*, 463 U.S. at 165; *see also* Exxon Corp. v. Wisconsin Dept. of Revenue, 447 U.S. 207, 220 (1980); Wisconsin v. J.C. Penney Co., 311 U.S. 435, 444-445 (1940).

17. *Container*, 463 U.S. at 166; *see also* ASARCO v. Idaho State Tax Comm'n, 458 U.S. 307, 327-328 (1982).

18. *Container*, 463 U.S. at 174-5.

19. *See generally ASARCO*, 458 U.S. 307 *and* F.W. Woolworth Co. v. Tax'n and Revenue Dept. of New Mexico, 458 U.S. 354 (1982).

20. *ASARCO*, 458 U.S. 307.

income, and capital gains of ASARCO's five foreign subsidiaries. The Court held that intangible income, such as the dividends, interest, and capital gains realized by a corporate taxpayer from investments in affiliated corporations, will be apportionable income only if a unitary business relationship exists between the corporation whose securities generate the income and the corporation receiving the income.[21] Two earlier Supreme Court cases, *Mobil Oil Corp. v. Commissioner of Taxes of Vermont* and *Exxon Corp. v. Wisconsin Department of Revenue*,[22] can be distinguished because the corporations in those cases operated unitary businesses, whereas *ASARCO* proved that the essential factors which evidence the existence of a unitary business were wholly absent.[23]

In *ASARCO*, the Court "assumed that the position of Idaho [was] that a unitary business relationship between ASARCO and the dividend paying companies is a necessary prerequisite to its taxation of the income in question, but that the unitary business concept should be expanded to cover the facts of the *ASARCO* case."[24] The *amicus curiae* brief of the Multistate Tax Commission,[25] however, espoused a theory that, had this position been adopted by the Court, would have broadened the concept of the unitary method dramatically. The view set forth in the brief was that "there can exist a relationship between stock investments and the business of the owner of the investments which is sufficient alone to justify the apportionment of any income from the investments."[26] The Court did not address this theory, and its holding that a unitary business relationship is required would seem to preclude any possibility that anything less than that would suffice. The ruling in *ASARCO* left open hope for multinational corporations. First, it held that the dividends, interest income, and capital gains of foreign subsidiaries would not, under these circumstances, form a portion of the tax base of a corporation. The decision was significant if for no other reason than it was the first time in fifty years that an income taxpayer had successfully shown a due process violation with regard to the elements of nexus and rational relationship.[27] More-

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21. *Id.* at 329-330. *See* Peters, *Supreme Court Requires Unitary Relationship before States Can Tax Investment Income*, 57 J. TAX'N 314 (1982). Query: would it be different if the income at issue were operating income? The Court didn't differentiate in Mobil Oil Corp. v. Comm'r of Taxes, 445 U.S. 425 (1980), nor in *Exxon*, 447 U.S. 207.

22. *Mobil*, 445 U.S. 425; *Exxon*, 447 U.S. 207.

23. *ASARCO*, 458 U.S. at 320-324.

24. Peters, *supra* note 21, at 315.

25. The Multistate Tax Commission is the "administrative agency of the Multistate Tax Compact, whose purposes include the promotion of accuracy, equity, uniformity and convenience in the state tax treatment of multistate and multinational businesses. There are nineteen member states and ten associate member states of the Compact." Hellerstein, *supra* note 1, at 114 n. 6. The constitutionality of the Compact was sustained in U.S. Steel Corp. v. Multistate Tax Comm'n, 434 U.S. 452 (1978).

26. Peters, *supra* note 21, at 315.

27. The last time the Court had found such an argument persuasive was in *Hans Rees*, 283 U.S. at 134-135. Unsuccessful attempts included Moorman Mfg. Co. v. Bair, 437 U.S. 267 (1978); Butler Bros. v. McColgan, 315 U.S. 501 (1942); Norfolk & W. Ry. v. North Caro-

over, multinationals could still hope at this point that the Court would find unconstitutional state taxation on a worldwide basis.[28] It should be noted, however, that Idaho conceded that ASARCO was not a unitary business, a fact that substantially weakens the impact of the decision in favor of the corporation.

Alcan Aluminum Ltd. v. Franchise Tax Board of the State of California[29] illustrates that the significance of the determination of whether a business will be classified as a unitary business cannot be underestimated, for it is this determination that will decide the method of taxation that will be used. The requirement that a unitary business exist before worldwide combination reporting is used is susceptible to a great many more qualifications and much more complexity than that of the first requirement of nexus.

The United States Supreme Court affirmed the California Supreme Court decision in *Butler Brothers v. McColgan*,[30] which set forth the seminal definition of a unitary business. The California Supreme Court determined that a unitary business is one characterized by unity of ownership, unity of use, and unity of management.[31] This definition has been criticized as overbroad,[32] and indeed, almost any multijurisdictional corporation could fit this description. The California court's further comments indicate that each situation will have to be decided on its own facts and whether those facts demonstrate interdependence.[33] The Supreme Court, in its decisions, has announced several distinguishing characteristics of the unitary business beyond the three unities announced in *Butler Brothers*.[34]

From its initial efforts to determine the scope of the unitary business, the Court has said that the existence of a "vertical" enterprise suffices.[35] Vertical enterprises are those whose different components, such as drill-

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lina *ex rel* Maxwell, 297 U.S. 682 (1936); Maxwell v. Kent-Coffey Mfg. Co., 204 N.C. 365, 168 S.E. 397 (1933), *aff'd per curiam*, 291 U.S. 642 (1934). The Court did, however, invalidate the District of Columbia's single-factor sales formula for apportioning corporate income on statutory rather than constitutional grounds. *See* General Motors Corp. v. Dist. of Columbia, 380 U.S. 553 (1965).

28. ADVISORY COMMISSION ON INTERGOVERNMENTAL RELATIONS, SPECIAL REPORT—STATE TAXATION OF MULTINATIONAL CORPORATIONS, March, 1983, *reprinted in* TAX NOTES, 995, 1001, (1983) [hereinafter cited as SPECIAL REPORT].

29. 539 F. Supp. 512 (S.D.N.Y. 1982).

30. 315 U.S. 501 (1942).

31. Butler Bros. v. McColgan, 17 Cal.2d 664, 111 P.2d 334, (1941).

32. Weissman, *supra* note 8, at 65. *See also* Keesling & Warren, *The Unitary Concept in the Allocation of Income*, 12 HASTINGS L.J. 42, 47-48 (1960).

33. The court wrote, "[i]f the operation . . . of the business done within the state is dependent upon or contributes to the operation of the business without the state, the operations are unitary; otherwise, if there is no such dependency, the business within the state may be considered to be separate." Edison California Stores v. McColgan, 30 Cal.2d 472, 183 P.2d 16, 21 (1947).

34. 315 U.S. at 508.

35. *See, e.g., Hans Rees*, 283 U.S. 123; *Underwood Typewriter* 254 U.S. 113.

ing, refining, and sales, are in different states. A strong argument can be made for taxing such an operation because each component part does derive from the taxing state some benefit that may justify a tax imposition. This central operations criterion has been used to justify both taxing of component parts in states of the United States[36] and in integrated businesses operating across national boundaries.[37]

The principle was later extended to horizontal operations, which are defined as a series of similar operations under common management, control, or both,[38] or that share risks. Interrelations will exist between the affiliated firms, but one is not the customer of the other. The Court has recognized the problem of the practice of tax avoidance, whereby companies doing business in a state seek to dodge some of their tax burdens by setting up apparently discrete entities elsewhere. The logic is more strained here, however. Assuming that the rationale a state relies on to tax income earned outside its borders is that some of the resources of that state were used to generate the income, the argument is much weaker in the case of an enterprise that is horizontally integrated.[39]

In its recent cases, the Court appears to have retained its previous distinction between vertically integrated businesses and those businesses engaged in the same line of business. In *Exxon*, an oil company conducting marketing activities in Wisconsin challenged that state's formula apportionment which took into consideration all of its operating income, arguing instead that the state should tax only the company's marketing activities. Similarly, in *Mobil*, an oil company challenged Vermont's inclusion in its tax base income received by the company in the form of dividends from subsidiaries and affiliates doing business abroad. In both of these cases, the Court found the existence of a unitary business. The continuous flow and interchange of common products between subsidiaries and domestic corporations noted in *Mobil* and *Exxon*[40] were sufficient to constitute a unitary business relationship.

On the contrary, no unitary business was found to exist in *Woolworth Co. v. Taxation and Revenue Department of New Mexico.*[41] At issue in *Woolworth*, as in *Mobil*, were dividends of four foreign subsidiaries[42] of the F.W. Woolworth company, a corporation domiciled in New York and operating a chain of retail stores throughout the United States.

36. *Underwood Typewriter*, 254 U.S. 113.

37. *Bass*, 266 U.S. 271.

38. *See Butler Bros.*, 315 U.S. 501.

39. A possible rationale for permitting the use of the unitary method in this situation might be derived from examination of the enterprise's "operational interdependence" which would ascertain the degree of interdependance between subsidiaries controlled by a parent corporation. *See* Hellerstein, *Recent Developments in State Tax Apportionment and the Circumscription of Unitary Business*, 21 NAT'L. TAX J. 487, 501-503 (1968).

40. *See infra* notes 64-68 and accompanying text.

41. 458 U.S. 354 (1982).

42. Woolworth owned all of the outstanding stock of three of the foreign subsidiaries and approximately 53% of another. *Id.* at 362.

The subsidiaries in question conducted retail sales similar to those operated by Woolworth in the United States. The *Woolworth* Court noted

> a critical distinction between a retail merchandising business . . . and the type of multi-national business . . . in which refined, processed, or manufactured products (or parts thereof) may be produced in one or more countries and marketed in various countries, often worldwide. In operations of this character, there is a flow of international trade, often an interchange of personnel, and substantial mutual interdependence.[43]

The same kind of interaction and interdependence did not exist between the corporation and the subsidiaries as existed in *Mobil* and *Exxon*. Similarly, ASARCO's silver mining and its subsidiary's (Southern Peru) autonomous business were found to be insufficiently connected to permit the companies to be classified as a unitary business.[44] The distinction between vertically integrated enterprises, which supply a stream of products and services, and affiliated corporations may not be as cut and dried as it first appeared, as evidenced by the Court's comment that Woolworth potentially had authority to operate its subsidiaries as integrated divisions of a single unitary business.[45] It was unclear how Woolworth would be able to conduct its business as an "integrated" rather than a "discrete" business, since its subsidiaries were engaged in the same kind of business—not providing raw materials to or purchasing products from Woolworth.[46] The statement suggests that under some circumstances, a horizontal business might be considered to be a unitary enterprise.

Centralization of management and control occupied a lesser role in ascertaining the existence of a unitary business in *ASARCO* and *Woolworth*.[47] The Court still looked into the "nature and extent of intercorporate sales, the actual exercise of control by ASARCO over the affiliated corporations, and the centralization of management services,"[48] but it failed to find a sufficient management or control linkage in *ASARCO*[49]

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43. *Id.* at 371 (footnote omitted). However, the Court did not decide *Woolworth* on the grounds that it was not a vertically integrated business.

44. Peters, *supra* note 21, at 315.

45. *Woolworth*, 458 U.S. at 362.

46. 458 U.S. 354.

47. *See* Peters, *supra* note 21, at 318.

48. *Id.* at 314.

49. The Court recognized that there were some occasions when the corporations conducted transactions with each other. There also were some centralized services as well as the use of a patent for a fee. In short, the potential for ASARCO to exercise control over the companies existed. However, the majority did not find compelling the factors the dissent found persuasive; the dissent recognized a relationship between ASARCO's investment decision making and business conducted in the taxing state. It also emphasized the importance of the investments on the business conducted by ASARCO in the taxing state and the business advantages, such as stability, source of raw materials and outlet for products derived from the investments.

The majority conducted a detailed analysis of only the one subsidiary that would be most likely to be named a unitary business, Southern Peru. ASARCO owned 51.5% of and *Woolworth*.[50] The Court summarized the major relevant issue to be whether contributions to the income of the subsidiaries or affiliates resulted from the taxpayer's activities in the taxing state. Because the extent of managerial control did not rise to the level of creating a unitary business, the state's attempts to tax the income in question were no more than a "mere effort to reach profits earned elsewhere under the guise of legitimate taxation."[51]

An argument somewhat similar to the corporate form argument is one that alleges that the constitutionality of a unitary tax will depend on the accounting system. Exxon's challenge of the Wisconsin unitary tax focused on both prongs of the due process test. Exxon argued that its separate accounting is evidence that neither prong of the due process test was satisfied.[52]

The Supreme Court apparently adopted Wisconsin's argument that a state is justified in applying its apportionment formula merely by virtue of the existence of a unitary business within the state. Most striking, though, was the definitive way in which the Court dispensed with the issue of separate accounting. Exxon had argued that Wisconsin should use separate accounting rather than apportionment and thereby include income only from the marketing activities. After *Exxon*, however, a company's separate accounting for tax purposes will not be binding on a state.[53] Although a company may still use separate accounting to prove

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Southern Peru's outstanding stock and received 35% of its copper output. The Court, however, found other aspects of the relationship controlling. Pursuant to a management contract with Southern Peru, ASARCO could elect only 6 of the 13 directors, though a vote of 8 was necessary to pass any resolution. ASARCO was only one of Southern Peru's stockholders; a unanimous vote of all four was required to alter the articles or by-laws. Based on these and other findings of the trial court, the Court found Southern Peru to be a discrete enterprise, operating independently of ASARCO and not otherwise controlled by ASARCO. The majority rejected Idaho's argument that corporate purpose should define a unitary business. 458 U.S. at 362.

50. In *Woolworth*, the Court examined the three requisite elements of a unitary business. *See supra* text accompanying note 31. First, the Court found "little functional integration" between the parent and the subsidiary. The subsidiaries were free to choose their own store sites, advertising, accounting, legal purchasing, personnel, training, and financing. 458 U.S. at 364-365. Second, the Court found that management was not centralized and that "each subsidiary operated as a distinct business enterprise." *Id.* at 366. Finally, the Court observed, that economies of scale were intentionally ignored. *Id.* at 366-368. Support for the last two elements—centralized management and economies of scale—was evidenced by separate offices (with one exception), and the absence of exchange of personnel, central merchandise or management training, any central nonretailing policies or tax planning, department or section devoted to overseeing the foreign subsidiary operations, or formal interchange of ideas between parent and subsidiary management. *Id.*

The Court did not find pervasive the presence of several common directors, frequent informed communications, or that major financial decisions by the subsidiaries required parent approval. Also, the Court gave little weight to the fact that the parent and subsidiary published unsolicited financial statements. 458 U.S. at 368-369.

51. *ASARCO*, 458 U.S. at 328, *quoting Bass*, 266 U.S. 271, 283 (1924).

52. *Exxon*, 447 U.S. at 221.

53. *Id.*

that certain income is unrelated to the business' activities,[54] it cannot use separate accounting to avoid a state's application of its apportionment formula if a portion of the unitary business is found to exist within the state.[55]

The type of income received by the corporation has no bearing on whether a state will be allowed to tax. Only in *Exxon* was the taxable income dispute over operating income. Operating income is clearly more susceptible to taxation under the unitary principle, since that money would be used to further the business, part of which has been established to exist in the taxing state. In *Mobil*, however, the dispute concerned dividend income received by a nondomiciliary corporation. The Court's decision to allow taxation established that the due process clause does not preclude inclusion of foreign source dividend income from subsidiaries and affiliates in the apportionable tax base of a nondomiciliary corporation.[56] Dividend income was also at issue in *ASARCO* and *Woolworth*, and though the Court held these sums not taxable by the states, the decision was based on the absence of a unitary business relationship rather than the type of income.[57]

The analysis in *Mobil* shows that the corporate form of a business enterprise will not be a decisive factor in determining the existence of a unitary business. The *Mobil* Court stated:

> Superficially, intercorporate division might appear to be a more attractive basis for limiting apportionability. But the form of business organization may have nothing to do with the underlying unity or diversity of a business enterprise. Had appellant [Mobil] chosen to operate its foreign subsidiaries as separate divisions of a legally as well as functionally integrated enterprise, there is little doubt that the income derived from those divisions would meet due process requirements for apportionability. . . Transforming the same income into dividends from legally separate entities works no change in the underlying economic realities of a unitary business, and accordingly it ought not to affect the apportionability of income the parent receives.[58]

Thus, the multicorporate form will not in and of itself shield income distributed as dividends from apportionment in the enterprise's tax base if a unitary business is found to exist, "for the linchpin of apportionability in the field of state income taxation is the unitary business principle."[59] The

54. In determining whether certain income will be taxed, the Court "looks to the 'underlying economic realities of a unitary business,' and . . . [if the income will be nontaxable, it] must derive from 'unrelated business activity' which constitutes a 'discrete business enterprise.'" *Id.* at 223-224 (quoting *Mobil*, 445 U.S. at 439, 441-442).

55. Weissman, *supra* note 8, at 81. *See also* John Deere Plow Co. v. Franchise Tax Bd., 38 Cal. 2d 214, 238 P.2d 569 (1951), *appeal dismissed*, 343 U.S. 939 (1952); *Butler Bros.*, 315 U.S. 501.

56. Hellerstein, *supra* note 1, at 126.

57. *ASARCO*, 458 U.S. at 330; *Woolworth*, 458 U.S. at 372.

58. *Mobil*, 445 U.S. at 440-441.

59. *Id.* at 439.

taxpayer must show that underlying economic realities warrant the formal and legal distinction between the separate corporate entities.[60]

Exxon and *Mobil* struck fear in the hearts of corporate executives; the opinions reflected a continuation of judicial restraint from earlier cases, but afforded no further delineation of the unitary business or restrictions imposed by the due process clause. The Court's unwillingness to announce a single definition of a unitary business was equivalent to an announcement that, absent congressional action, the states would continue to enjoy broad leeway in taxing a portion of a corporation's worldwide income.[61]

With the decision of *ASARCO* and *Woolworth* came rekindled hope that the Court, in the absence of repeatedly requested congressional action, would limit the scope of the states' taxing power. Some thought this would signal a return by the Court to a closer economic analysis of interstate and international tax issues. Further, in the absence of due process restrictions, surely the Court would seize upon the commerce clause. The Supreme Court's most recent opinion addressing the unitary taxation method, *Container Corp. of America v. Franchise Tax Board*,[62] corrected these ill-placed hopes.

Container is a Delaware corporation headquartered in Illinois whose business activities involved the production and distribution of paperboard and paperboard-based packaging.[63] Container controlled twenty foreign subsidiaries in Western Europe and Latin America during the three-year period at issue, though Container and its subsidiaries were highly decentralized.[64]

In its due process clause argument, Container focused on one of the major inherent problems of formula apportionment, alleging that formula apportionment was inaccurate due to differing wage and profit rates between the parent corporation and its foreign subsidiaries.[65] Such an argument, however, had little chance of success after the Court's decision in *Mobil*,[66] on which the *Container* court relied heavily. Because Container was found to be carrying on a unitary business, "a state may apply an apportionment formula to the taxpayer's total income to arrive at a rough approximation of the corporate income attributable to activities within the state."[67] While neither formula is perfect, the Court found that separate accounting results in no greater accuracy than formula apportionment. Only gross miscalculations of taxes will warrant a state tax being

60. *Id.* at 440-441.
61. Hellerstein, *supra* note 1, at 151.
62. 463 U.S. 159.
63. *Container*, 117 Cal. App. 3d 988, 991, 173 Cal. Rptr. 121, 123 (1981).
64. *Id.*
65. *See* 463 U.S. at 174-5, where Container disclosed the amount of money required to produce one dollar of net income during the years in question.
66. *See supra* text accompanying note 61.
67. 117 Cal. App. 3d at 1003, 173 Cal. Rptr. at 131.

struck down, and here the Court found none that would merit such a remedy.[68]

III. COMMERCE CLAUSE & FOREIGN COMMERCE CLAUSE

The use of the unitary method of taxation prompted complaints of commerce clause violations from many corporations. The Supreme Court had identified the major restraint imposed by the commerce clause to be that a state tax may not unconstitutionally burden interstate commerce by subjecting a multijurisdictional enterprise to taxation not borne by a single jurisdictional business.[69] Such a situation arises due to multiple taxation.

The Supreme Court addressed the commerce clause restrictions on implementing the unitary tax in *Complete Auto Transit, Inc. v. Brady.*[70] *Complete Auto* added predictability to commerce clause challenges to unitary taxes by establishing a four-part test. The unitary tax will be upheld if it "is applied to an activity with a substantial nexus with the taxing State, if [it is] fairly apportioned, does not discriminate against interstate commerce, and is fairly related to the services provided by the State."[71]

However, when a foreign corporation is taxed, internationally accepted standards establishing principles for taxation become involved. Two important sets of rules for this purpose are: "(1) those defining a *permanent establishment*, such as a branch or subsidiary corporation, that can be taxed by the host country; and (2) those specifying the procedures to be used to account for transactions between related parties in measuring the income of a permanent establishment."[72] Under this second set of rules, the branch or subsidiary is to be treated as a separate entity. This is often called the "water's edge" or "arm's length" rule. It is practiced by the federal government[73] and the Internal Revenue Service

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68. The Court found that only a 14% discrepancy in taxable income allocable to California resulted from application of the unitary tax as would have resulted from Container's own separate accounting method. 463 U.S. at 174-5 nn. 11-12, 184. Although 14% seems not to be an insignificant amount, the Court compared it to the situation in *Hans Rees*. North Carolina's one-factor formula assessing taxable income on the basis of tangible property was struck down after a finding that a 250% discrepancy in taxable income attributable to the taxing entity resulted from the application of the formula method. 283 U.S. at 135. *Hans Rees* imposes a theoretical limit on the permissible distortion resulting from formula apportionment. It is unlikely, however, that a taxpayer will be able to make the requisite showing that "there is no rational relationship between the income attributed to the state and the intrastate values of the enterprise." *Container*, 463 U.S. at 180 (quoting *Exxon*, 447 U.S. at 220) and that the income apportioned to a state is "out of all appropriate proportion to the business transacted in that state." *Id.* (quoting *Hans Rees*, 283 U.S. 123, 135.)

69. *See Mobil*, 445 U.S. at 442-446.

70. 430 U.S. 274 (1977).

71. *Id.* at 279.

72. SPECIAL REPORT, *supra* note 28, at 998.

73. *Id.*, at 998 n. 18.

in the form of section 482 adjustments.[74] It is also used in concluding foreign tax treaties.[75] This approach treats transactions occurring between related foreign and domestic corporations as being performed at arm's length: "income attributable to the foreign entity is calculated by reference to a transaction *between individual parties*."[76]

The significance of the divergent practices of federal and state taxing authorities arises from the power of Congress "to regulate commerce with foreign nations."[77] Moreover, the Constitution forbids states from making separate arrangements with foreign governments.[78] Suggestions to make the states conform to federal practice have long been discussed and considered.[79] Yet Congress has still failed to act on any proposed legislation. Based on this lethargy, the Court has been reluctant to prescribe that states' taxing practices emulate the federal mode. In *Mobil*, where such treatment was said to be mandatory, the Court stated, "[a]bsent some explicit directive from Congress, we cannot infer that treatment of foreign income at the federal level mandates identical treatment by the States."[80]

The Court did not take a definitive stand on the issue until *Japan Line Ltd. v. County of Los Angeles*.[81] In *Japan Line*, the Court found unconstitutional Los Angeles' local property tax on Japanese cargo containers which had already been taxed in Japan. The Court held that the commerce clause will not allow a state to "impose a [fairly apportioned,] non-discriminatory ad valorem property tax on foreign-owned instrumentalities (cargo containers) of international commerce"[82] used exclusively in furtherance of such commerce. Although it recognized that "interstate commerce must bear its fair share of the state tax burden,"[83] the Court said that multiple taxation may well be offensive to the Commerce Clause.[84] The Court, therefore, identified two more hurdles, in addition to the requirements of *Complete Auto*,[85] that must be overcome to validate

74. "Section 482 of the Internal Revenue Code and the regulations promulgated pursuant to the Code make it clear that commonly controlled entities are to be treated as if they were separate entities for the purpose of determining taxable income from intercompany transactions." Weissman, *supra* note 8, at 54. *See* Treas. Reg. 1.482-1(b)(1) (1968). The regulations under section 482 are designed to require that all intercompany transactions be conducted at arm's length and allow the Internal Revenue Service to intervene by correcting any understatements of income or other misallocations which do not accurately reflect the tax conduct of two otherwise uncontrolled taxpayers.

75. For example, the OECD treaty and the model income tax treaty issued in June 1981 reflect a "water's edge" rule. SPECIAL REPORT, *supra* note 28, at 998.

76. *Id.*

77. U.S. CONST. art. I, § 8, cl. 3.

78. U.S. CONST. art. I, §10, cl. 1.

79. *See infra* notes 131-137 and accompanying text.

80. 445 U.S. at 448.

81. 441 U.S. 434 (1979).

82. *Id.* at 435-36.

83. *Id.* at 444. (quoting Washington Revenue Dept. v. Ass'n of Washington Stevedoring Cos., 435 U.S. 734, 750 (1978)).

84. *Id.* at 446.

85. *See supra* text accompanying note 71.

a tax on interstate commerce.[86] These factors are "the enhanced risk of multiple taxation" that may result from simultaneous application of state taxes and taxes imposed by a foreign government,[87] and the possibility that "a state tax on the instrumentalities of foreign commerce may impair federal uniformity in an area where federal uniformity is essential."[88]

Japan Line can be distinguished from earlier cases where multiple taxation was alleged. For example, in *Mobil*, the Court noted that "the factors favoring use of the allocation method in property taxation have no immediate applicability to an income tax."[89] Also, *Japan Line* involved multiple taxation at the international level, whereas *Mobil*, which had conceded the power of the state of its commercial domicile to tax 100% of its foreign source dividends, was ultimately concerned solely with multiple taxation among the states.[90] While multiple taxation resulting from different states' taxes might burden foreign commerce, the Court could ultimately remove the burden, if it so chose, because it has the power to mandate and restrict state taxing measures. In *Japan Line*, however, the Court lacked a similar power since it had no authority to dictate the taxing measures of one of the taxing entities—Japan. The Court, therefore, lacked the ability to enforce full apportionment by all potential taxing bodies.[91] Moreover, actual multiple taxation existed in *Japan Line*, since Japan had already taxed the full value of the cargo containers.[92] Consequently, any levy on them by a state would result in double taxation. These factors compelled the Court to deny Los Angeles the power to tax the Japanese containers at all.[93]

The second restriction imposed on unitary taxation by the commerce clause after *Japan Line* was that a state tax could not prevent the federal government from speaking with one voice when regulating commercial relations with foreign governments.[94] The Court looked at factors other than the fact that *Japan Line* involved a foreign taxing entity. Also miti-

86. *Japan Line*, 441 U.S. at 446.

87. *Id.*

88. *Id.* at 448-51. The *Japan Line* Court noted some of the problems inherent in the taxation of entities involved in international commerce:

> A state tax on instrumentalities of foreign commerce may frustrate the achievement of federal uniformity in several ways. If the State imposes an apportioned tax, international disputes over reconciling apportionment formulae may arise. If a novel state tax creates an asymmetry in the international tax structure, foreign nations disadvantaged by the levy may retaliate against American-owned instrumentalities present in their jurisdictions . . . If other States followed the taxing State's example, various instrumentalities of commerce could be subject to varying degrees of multiple taxation.

Id. at 450 (footnote omitted).

89. *Mobil*, 445 U.S. at 448.

90. *Id.*

91. *Japan Lines*, 441 U.S. at 447.

92. *Id.* at 452 n. 17.

93. *Id.* at 447-48.

94. *Id.* at 449.

gating against implementation of the unitary tax was evidence of federal government intent in the rationale behind the Customs Convention on Containers—to remove impediments to the use of containers as instruments of international traffic[95]—to which both Japan and the United States were signatories.

After adopting additional criteria for determining the validity of a tax on foreign instrumentalities, the Court again had to consider what level of risk was appropriate. Two possible tests were available. The Court rejected the predominant national interest test, which called for national intervention if the state action fell clearly within the domain of national interests.[96] Instead, it adopted the serious national harm test which was much more susceptible to the interests of states' autonomy. This test requires a showing of serious economic or political harm being done to the nation by failure of states to harmonize tax practices with the federal government and foreign governments.[97]

In *Container*, the Court did not articulate further restrictions on states' authority to tax and thus did not broaden the factors in *Japan Line*. *Container* based its commerce clause claim on the issue of multiple taxation.[98] Before the Supreme Court, the issue was whether California was required to employ the arm's length method of taxation.[99] Since the claim involved international commerce, the two additional requirements mandated by *Japan Line* had to be applied.

In considering the first of *Japan Line's* criteria—that a state's tax should not increase the risk of multiple taxation,[100] the Court distinguished property tax in *Japan Line* and income tax at issue in *Container*. The Court conceded the existence of double taxation, but it indicated that, absent demanding that the state not tax the multinational corporation at all, it was unable to present a cure. The Court refused to favor either the separate accounting method or the formula apportionment method since both result in double taxation.[101] The *Container* Court

95. *Id.* at 453.

96. SPECIAL REPORT, *supra* note 28, at 1002.

97. *Id.*

98. Through its method of separate accounting, Container alleged that during the years in question, California's apportionment formula attributed an average of four million dollars more to domestic operations and four million dollars less to Container's foreign subsidies. Weissman, *supra* note 8, at 90 (citing Container's Brief). Furthermore, Container claimed that in one instance the California formula apportioned slightly less to Colombia than the Colombia subsidiaries paid in Colombian income taxes, while Container's Dutch subsidiary paid taxes equivalent to 97% of the pretax income attributed to the Netherlands by the formula. Based on these facts, Container argued that the tax violated the Court's two considerations outlined in *Japan Line*.

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

100. *Id.* at 185-6.

101. The Court noted that, although "double taxation is a constitutionally disfavored state of affairs, particularly in the international context, *Japan Line* does not require forebearance so extreme or one-sided [as to force upon the state the separate accounting methodology]." *Id.* at 193.

found no cure for multiple taxation, and refused either to espouse an absolute prohibition against double taxation in the foreign commerce realm[102] or to require a state to adopt the arm's length approach.

The Court next considered whether California's tax of Container would "impair federal uniformity in an area where federal uniformity is essential."[103] A state's tax would "violate this so-called 'one-voice' standard if it either implicates foreign policy issues . . . or violates a clear federal directive."[104] Noting that the most obvious foreign policy implication is the threat that a state tax might offend U.S. trading partners and lead them to retaliate, the Court articulated three factors that prevented California's tax of Container from having adverse foreign policy implications.[105]

First, the Court distinguished *Japan Line*, where the California tax in question created an automatic asymmetry in international taxation.[106] Second, the Court emphasized that the tax here was imposed on a domestic corporation rather than a foreign enterprise.[107] In a footnote,[108] the Court stated that this factor would be less important in a case where a domestic corporation was owned by foreign interests.[109] Finally, the Court noted that Container was subject to California tax in one way or another, and that the amount it paid was more a function of California's tax rate than of its allocation method.[110] The Court estimated that disfavorable foreign response to this factor would be at most "attenuated."[111]

The Court also concluded that California's tax did not violate a federal directive, basing its decision primarily on its reading of congressional intent.[112] The Court first noted that federal tax statutes do not preempt state use of the unitary tax.[113] Although tax treaties usually mandate the use of the arm's length methodology, that requirement is usually waived by either signatory country in regard to its own domestic corporations. Moreover, none of the tax treaties have prescribed a specific tax system for states.[114] Finally, the Court cited Congress' failure to enact legislation

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102. *Id.* at 189.

103. *Id.* at 186 (quoting *Japan Line*, 441 U.S. at 448). Interestingly, the Court voiced its own feelings of incompetence in trying to delineate foreign policy. Nevertheless, it proceeded to enumerate criteria for determination of state infringement on federal turf in the foreign policy context. *Id.* at 194.

104. *Id.* at 193-4.

105. *Id.* at 194.

106. *Id.* at 194-5 (quoting *Japan Line* 441 U.S. at 453).

107. *Id.* at 195.

108. *Id.* n. 32.

109. *See infra* discussion of foreign-based multinational corporations.

110. *Container*, 463 U.S. at 195.

111. *Id.*

112. *Id.* at 196.

113. *Id.*

114. *Id.* The Court also noted that on at least one occasion, Congress has attached a reservation declining to consent to a provision that would restrict states' authority to use the apportionment formula. *See* 124 CONG. REC. 18400, 19076 (1978).

regulating state taxation.[115]

IV. THE PREDICAMENT OF FOREIGN CORPORATIONS WITH DOMESTIC SUBSIDIARIES

The Court's decision in *Container* left open the question of whether the worldwide unitary method may be applied to tax the worldwide income of a foreign corporation that has a U.S. domestic subsidiary. It has been predicted that the next case regarding the unitary tax will be such a case.[116] Westinghouse is currently seeking certiorari, hoping that the Court will reach the issue of the appropriateness of applying the unitary tax to domestic subsidiaries of a foreign corporation on its set of facts.[117] Similarly, Alcan Aluminum, Ltd., a Canadian corporation with a U.S. subsidiary subject to California's unitary tax, is challenging its imposition by seeking certiorari after the District Court's dismissal of the action on the ground that it lacked standing to sue.[118] The Supreme Court refused to hear Shell Petroleum, N.V.'s appeal, despite the fact that the ten EEC countries urged the Court to review it.[119] Nevertheless, *Shell* illustrates some of the major problems inherent in a situation where a state seeks to assess taxes due on a domestic subsidiary whose parent is a foreign multinational corporation.

Shell Petroleum, N.V. (SPNV), a Netherlands holding company having a place of business in the Netherlands, alleged that the California Tax Board assessed or planned to assess additional taxes under the California tax apportionment formula on two of its subsidiaries—Shell Oil and Scallop Nuclear. SPNV contended that the Board, in finding a unitary business to exist, would combine the income of all the companies worldwide that are more than fifty percent owned, directly or indirectly, by SPNV.[120] Such an application, SPNV alleged, would result in gross disproportion between the income attributed to California activities and the income actually earned by Shell Oil and Scallop Nuclear in California.[121]

As discussed earlier, the earlier Supreme Court cases have continually held that the taxpayer's accounting system will not impeach the validity of the taxing formula. This is true even when factors affecting international commerce and trade relations were found to exist.[122] The rationale for application of formula apportionment in these situations,

115. *Container*, 463 U.S. at 196-7.

116. *See New Unitary Approach Mulled in Wake of Treasury Decision*, 21 TAX NOTES 69 (1983) [hereinafter cited as *New Unitary Approach*].

117. *See* Westinghouse Elec. Corp. v. Tully, 55 N.Y.2d 364, 434 N.E.2d. 1044, 449 N.Y.S.2d 677 (1982), *prob. juris. noted*, 459 U.S. 1144 (1983).

118. *Alcan Aluminum Ltd. v. Franchise Tax Bd. of California*, 558 F. Supp. 624 (S.D.N.Y. 1983).

119. Shell Petroleum N.V. v. Graves, 570 F. Supp. 58 (N.D.Cal. 1983).

120. Shell Petroleum N.V. v. Graves, 709 F.2d 593, 595 (9th Cir. 1983).

121. *Id.*

122. *See Mobil*, 445 U.S. 425; *Exxon*, 447 U.S. 207; *Container*, 463 U.S. 159.

however, is much weaker. The only economic or constitutional justification for applying the formula apportionment method is based on the assumption that a dollar spent on sales, property or payroll in one jurisdiction will yield the same result if applied to the same use in another jurisdiction.[123] The assumption rarely holds true when applied to various states, but it is never true when applied to different nations, whose economies and societies are far from homogeneous. The costs of property, payroll and sales are usually much lower in foreign countries,[124] resulting in a disproportionate amount of income being attributed to the United States, and more specifically, the state applying the unitary tax method.[125]

Similar circumstances prompted Alcan to challenge California's imposition of tax on the unitary business it found to exist.[126] Alcan owned a subsidiary that conducted business in California. Although the subsidiary operated in the red, the formula attributed income to the California subsidiary since California combined the worldwide income of the Canadian parent corporation. The truth of the subsidiary's losses was substantiated by the fact that the Internal Revenue Service had investigated Alcan several times during the years in which California sought to assess taxes (1972-81), and it determined that section 482 adjustments[127] were necessary. That Alcan shut down its California operations further shows the truth of the subsidiary's unprofitability.[128] Foreign trading partners are understandably aggravated at the prospect of paying taxes on a business that is already losing money, merely because of its location within a unitary tax state, and threats of relocation and retaliation have followed.[129]

The foreign multinational corporation will not be able to protect its rights adequately when state taxing authorities impose a tax on its worldwide income simply because the corporation's subsidiary is located within a unitary tax state. Although the domestic subsidiary will be able to bring

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123. *See generally*, Smith, *supra* note 5.

124. Sony Corporation attested to this fact before the task force. *See infra* notes 149-159 and accompanying text. According to Sony, a disproportionate amount of income is attributed to the United States under the apportionment method because the costs of property, payroll, and sales are higher. Sony cited its specific problem to be the discrepancy in efficiency between its Japanese and Californian television manufacturing operations: even though its Japanese operations are more efficient, part of the income generated by the operation is attributed to California because the costs in California are higher. Most of the complaints lodged at the Nov. 16 task force hearing concerned the distortions of income in favor of the taxing state resulting from application of worldwide formula apportionment. Sheppard, *Unitary Group's Task Force Begins to Assess Proof of Harm*, 21 TAX NOTES 821 (1983).

125. Weissman, *supra* note 8, at 56. Another factor that will contribute to the distortion in income attributed to a jurisdiction is if the activities of two components of a unitary business are not matched; i.e., one is labor intensive while another is capital intensive. Also, fair attribution may be difficult due to fluctuating exchange rates.

126. *Alcan Aluminum Ltd. v. Franchise Tax Bd. of California*, 539 F. Supp. 512 (S.D.N.Y. 1982).

127. *See supra* note 74.

128. *Alcan*, 539 F. Supp. at 513-14.

129. *See generally* Smith, *supra* note 5.

suit in the state court to protest the imposition of a tax that has already been paid, that subsidiary cannot invoke a tax treaty between the U.S. and the country in whose territory its parent corporation is domiciled. This is true even though the spirit of the treaty is clearly violated. Similarly, the foreign parent will not be allowed to bring suit in the federal courts because it lacks standing. The parent can invoke the treaty rights; however, they are likely to be held inapplicable since the tax at issue was levied on the subsidiary—not the parent, and for matters of standing, the presence of "unitary business" will not be considered.[130]

V. CONGRESSIONAL/EXECUTIVE RESPONSE

As the phenomenon of unitary tax has burgeoned into an omnipresent onus on corporations, and the problems accompanying the method have become more and more visible, Congress has offered little solace.[131] Although Congress has been called upon to allay the difficulties, its response thus far has yielded only narrow legislation that falls far short of an adequate remedy.[132] On other occasions, Congress has feigned interest, evidenced by bills and hearings that, in the end, have yielded no legisla-

130. *See* Smith, *supra* note 5; *see generally Shell* 570 F. Supp. 58.

131. Congress did not exercise its commerce power to legislate in the state tax area until 1959. Hellerstein, *supra* note 1, at 131. *See, e.g.*, Act of June 3, 1964, ch. 106, § 41, 13 Stat. 111 (codified as amended, at 12 U.S.C. § 548 (1976)).

In 1959, Congress for the first time passed legislation limiting the power of the states to tax interstate commerce. *See* Act of Sept. 19, 1959, Pub. L. No. 86-272, 73 Stat. 555 (codified at 15 U.S.C. § 381 (1976)). This was a specific response to the Supreme Court's decision in Northwestern State Portland Cement Co. v. Minnesota, 358 U.S. 450 (1959). *Northwestern* held that a state could constitutionally impose a nondiscriminatory, fairly apportioned net income tax upon a foreign corporation engaged exclusively in interstate commerce in the taxing state. A mere seven months after *Northwestern*, Congress enacted legislation establishing a minimum threshold of intrastate activities that must be exceeded by a foreign corporation in a state before that state may subject such a corporation to a tax measured by net income. 15 U.S.C. § 381 (1976).

One of the other pieces of federal legislation limiting state tax authority under Congress' commerce powers was likewise a direct reaction to a Supreme Court decision. In Evansville-Vanderburgh Airport Auth. Dist. v. Delta Airlines, Inc., 405 U.S. 707 (1972), the Court upheld enplaning charges as reasonable amounts charged to defray the costs of building or maintaining airport facilities used by the passengers. Congress responded by prohibiting the states from imposing user charges in connection with carriage of persons in air commerce. 49 U.S.C. § 1513 (1976).

132. Some legislation has surfaced, though its scope is limited. Hellerstein, *supra* note 1, at 113 nn. 3 & 4. *See* 15 U.S.C. § 391 (1976) (prohibiting states from imposing electrical energy taxes discriminatorily against out-of-state purchasers); 15 U.S.C. § 78(d) (1976) (prohibiting states from imposing stock transfer taxes when only nexus between the state and the transaction is the presence of a transfer agency); 49 U.S.C. § 1513 (1976) (prohibiting states from imposing user charges in connection with the carriage of persons in air commerce); 49 U.S.C. § 11503 (1978) (prohibiting states from taxing railroad property more heavily than other industrial and commercial property); Motor Carrier Act of 1980, Pub. L. No. 92-296 § 3, 94 Stat. 793 (to be codified at 49 U.S.C. § 11503a) (prohibiting states from taxing motor carrier property more heavily than other industrial and commercial property).

tion.[133] In recent opinions,[134] the Supreme Court has invited Congress, if it is dissatisfied with the Court's laissez-faire approach, to enact meaningful legislation.[135] Bills have been introduced in Congress which propose to prohibit the states from using the worldwide unitary method,[136] but no hearings have yet been scheduled.[137]

A major problem with the proposed legislation is that, without clarification of the Administration's stance, it is doubtful whether the legislation can muster enough support.[138] The Executive Branch, which rarely involves itself in the area of state taxation, has been conspicuously active concerning the topic of unitary tax,[139] though its signals have been ambivalent and increasingly phlegmatic. The Administration filed an amicus curiae brief supporting the anti-unitary tax position in *Chicago Bridge & Iron Co. v. Caterpillar Tractor Co.*;[140] however, its failure to file one in *Container* despite urgings from corporate interests and foreign governments[141] might have been critical.[142] After the *Container* case had been decided, foreign representatives again approached the administration, urging that it file for Supreme Court rehearing of the case.[143] Great Brit-

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133. *Chairman's Report on the Worldwide Unitary Taxation Working Group Activities, Issues, and Recommendations*, 24 TAX NOTES 581 (1984)(hereinafter cited as *Chairman's Report*); *Additional Views of Worldwide Unitary Taxation Working Group Members*, 25 TAX NOTES 1043 (1984). *See infra* note 151.

134. *See* Moorman Mfg. Co. v. Bair, 437 U.S. 267, 280-81 (1978); *Washington Revenue*, 435 U.S. 734, 749 (1978).

135. The Court's decisions, however, have given states substantial leeway. *See Moorman*, 437 U.S. 267; *Washington Revenue*, 435 U.S. 734; National Geo. Soc'y v. State Bd. of Equilization, 430 U.S. 551 (1977); *Complete Auto*, 430 U.S. 274; Michelin Tire Corp. v. Wages, 423 U.S. 276 (1976).

136. Bernick, *Cabinet Council Recommends Anti-Unitary Position*, 20 TAX NOTES 901 (1983).

137. *Id.*

138. *Id.* Bob Ragland, Director of Taxation at the National Ass'n of Manufacturers, said that, without support from the Administration, supporters of anti-unitary tax legislation "aren't going to go out on a limb" for the legislation. *New Unitary Approach, supra* note 116, at 69.

139. *See, e.g., Japan Line* (U.S. filed a brief and argued as *amicus curiae*); *House Foreign Source Income Hearings on H.R.* 5076 at 38-55 (statement of Hon. Doland C. Lubick, Asst. Sec. of Treas. for Tax Policy); *Tax Treaties with the United Kingdom, the Republic of Korea, and the Republic of the Phillipines: Hearings Before the Senate Comm. of Foreign Relations*, 95th Congress, 1st Sess., 13-40 (1977) (statement of Hon. Laurence N. Woolworth, Asst. Sec'y of Treas. for Tax Policy) [hereinafter cited as *Hearings on Tax Treaties*].

140. *Appeal dismissed*, 463 U.S. 1220 (1983).

141. *New Unitary Approach, supra* note 116, at 69.

142. The Supreme Court did not find the failure to file a brief dispositive of the Administration's view, but concluded nonetheless that, in the Administration's view, federal interests were "not seriously threatened by California's decision to apply the unitary business concept and formula apportionment." *Container*, 463 U.S. at 196.

143. *Administration Seeks Unitary Method Compromise*, 20 TAX NOTES 1026 (1983). *See, e.g.,* Letter from Marc Lalonde, Canadian Minister of Finance, to Donald T. Regan, U.S. Secretary of the Treasure, (Aug. 8, 1983), *reprinted in* 20 TAX NOTES 684 (1983). Letter from Nigel Lawson, United Kingdom's Chancellor of the Exchequer, to U.S. Treasury Don-

ain's Prime Minister Margaret Thatcher was especially vocal.[144] Moreover, after a meeting of the Cabinet Council on Economic Affairs, top Reagan Administration officials recommended to President Reagan that the Administration oppose the worldwide unitary tax.[145] Reagan instead referred the issue back to the Cabinet Council,[146] an action that was seen as a stalling tactic.[147]

At the same time as President Reagan announced his intent not to file a petition for rehearing of the *Container* case, the Administration announced the creation of a working group[148] to study the international application of worldwide unitary taxation.[149] The working group held its first meeting in November, 1983.[150] Composed of representatives of the federal government, state governments, and the U.S. business community,[151] the group was assembled to consider: the definition of a unitary

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ald T. Regan, (July 12, 1983), *reprinted in* 20 TAX NOTES 450 (1983). Letter from James Q. Riordan, Senior Vice President of Mobil Corporation, to Donald T. Regan, U.S. Treasury Secretary, (Aug. 9, 1983), *reprinted in* 20 TAX NOTES 692 (1983). Representatives of the states' interests, while pleased that the administration failed to file an *amicus curiae* brief or to petition the court for rehearing in *Container*, were still not entirely satisfied. For example, James Rosapepe of the Multistate Tax Commission, indicated that the Administration's action "fell short of the pro-unitary position that the states were urging the Administration to adopt." *New Unitary Approach, supra* note 116, at 69.

144. *See, e.g.*, Shears, *Reagan Snubs Thatcher's Efforts to Halt U.S. Unitary Taxes*, The Daily Telegraph, Sept. 24, 1983, at 6.

145. Bernick, *supra* note 136, at 901.

146. Bernick, *Reagan Sends Back Cabinet Recommendation on Unitary Tax*, 20 TAX NOTES 965 (1983).

147. *Id.*

148. *Id.* This act, too, can be viewed as foot dragging. The creation of a working group was the least decisive of four options suggested and presented to the Cabinet Council by a Treasury Department option paper. The other options presented were as follows: First, it described the Conable-Mathias position, now contained in S. 1225 (H.R. 2196) that the states not be permitted to use the unitary method. Another option . . . was that it do nothing on the ground that no federal question is involved. A third option . . . was that the application of the unitary method be limited in the case of foreign corporations with U.S. subsidiaries. Sheppard, *Chapoton Labels Unitary Tax Method an Irritant in International Relations*, 21 TAX NOTES 439 (1983).

149. Reagan announced that the purpose of the working group was to study the unitary issue and to develop a federal policy on the unitary method that is "conducive to harmonious international economic relations, while also respecting the fiscal rights and privileges of individual states." *New Unitary Approach, supra* note 116, at 69. (citing press release of Donald T. Regan, Sept. 23, 1983).

150. Sheppard, *Unitary Method Group Tries to Define Problem*, 21 TAX NOTES 525 (1983).

151. The members of the Working Group, who were chosen by the Administration, are:
Phillip Caldwell, Ford Motor Co. & Business Roundtable
Owen L. Clarke, National Ass'n of Tax Administrators
Kent Conrad, Multistate Tax Commission
Gov. George Deukmejian, California
Clifton C. Garvin, Exxon Corp.
Robert E. Gilmore, Caterpillar Tractor Co.
Gov. Scott Matheson, Utah
Charles I. McCarty, BATUS, Inc.

business; application of the three-factor (payroll, sales, and property) apportionment formula in the international context; uniform rate setting and information sharing among the states; the desirability of federal legislation; and the possibility of information sharing between federal and state governments.[152] Each member of the working group in turn selected a representative to serve on the task force, whose purpose was to provide technical expertise in implementing the policies decided on by the working group.[153]

Representatives of states' interests have been particularly obstinate. They have refused to consider any options until some national harm has been demonstrated,[154] and have threatened to boycott if the alternative of federal legislation was not withdrawn.[155] They became a bit more amiable when it was pointed out that their very presence in the work group indicated that the Reagan Administration considered use by the states of the unitary tax harmful to national interests.[156] The states' representatives have also pushed for "full accountability," alleging that double taxation was rarely at issue, but that, instead, corporations had income on which they paid no tax.[157] Assuming that corporations do have income that is not required to be reported anywhere, the states would require that all income be reported somewhere, or a legitimate excuse be given for not reporting.[158] Although this approach seems more than slightly avaricious,

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Peter McGowan, Safeway Stores
Lee Moffitt, Florida
David E. Nething, National Conf. of State Legislatures
John R. Opel, International Business Machines
Norma Pace, American Paper Institute
Edmund T. Pratt, Jr., Pfizer, Inc.
Gov. James R. Thompson, Illinois
John B. Tucker, New Hampshire

Administration representatives included:

Donald T. Regan, Secretary of the Treasury
John E. Chapoton, Assistant Secretary of the Treasury for Tax Policy
Robert B. Hawkins, Jr., Advisory Commission on Intergovernmental Relations
Charles E. McLure, Jr., Deputy Assistant Secretary of the Treasury for Tax Analysis, Staff Director
John A. Svahn, Assistant to the President for Policy Development
W. Allen Wallis, Under Secretary of State for Economic Affairs

152. Sheppard, *supra* note 148, at 439.

153. Sheppard, *supra* note 150.

154. Sheppard, *supra* note 124, at 821.

155. Sheppard, *Federal Legislation Haunts Unitary Method Working Group*, 21 TAX NOTES 1011 (1983).

156. Sheppard, *supra* note 124, at 821. At the same time, Administration officials produced letters from eight countries evidencing dissatisfaction with the use of the unitary method. Among those countries were Australia, Switzerland, and the Netherlands. Moreover, it was assumed that other countries, such as Great Britain, were seeking to redress their grievances through the State Department.

157. Sheppard, *supra* note 150, at 525-26; Sheppard, *Unitary Task Force Seeks to Define Full Accountability*, 21 TAX NOTES 132 (1983).

158. Sheppard, *supra* note 157, at 132.

"full accountability" has been adopted as a goal of both the task force and the working group. States have said that they will consider an alternative to formula apportionment only if they are convinced that business investment and jobs are at stake, and they can be sure that they will lose no revenue.[159] Given the obstinance of the states and the equally firm positions of corporate interests, it is not surprising that the group's study has resulted in less than revolutionary findings and resolutions.

VI. CONCLUSION

For several reasons, states support the unitary tax method over the separate accounting method, the only apparent alternative.[160] The primary interest states have in the unitary method is the revenue its implementation generates. States also complain that the use of the separate accounting method would create serious administrative problems. States also argue from the vantage point of fairness, positing that they will be unable to accurately assess the tax liability of an enterprise if formal apportionment is disallowed. Tax burdens will be shifted inequitably to smaller businesses if the multinationals are allowed to avoid their tax burden. Proponents of the unitary method argue that concepts of state sovereignty require that they be allowed to employ formula apportionment and cite self-correcting forces, such as judicial supervision and state competition, as sufficient to prevent the occurrence of national harm.

The difficulties created by the use of separate accounting, however, are far less burdensome than those created by the use of the unitary method. Either method engenders administrative problems, but the burden seems much more appropriately placed on states, who can retrieve tax information from the federal tax authorities[161] than to burden corporations with massive paperwork with which they might be unable to comply.

Use of the unitary method in the international arena may have serious ramifications. Discontented trading partners may choose to trade with other countries rather than risk imposition of tax on the worldwide income of their own multinationals. The lack of tax harmonization may lead other countries to retaliate against United States interests operating in their territory and may lead to serious impairment of trade relations, including the inability to conclude tax treaties.[162]

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159. Sheppard, *supra* note 157.

160. Sheppard, *supra* note 150, at 525.

161. At least some of the information necessary to assess tax liability under the separate accounting method is already given to the states, since most states' laws require that the federal government report to the states when making a § 482 adjustment. Sheppard, *supra* note 124, at 822.

162. The United States is party to at least 30 tax treaties. In testimony before the Foreign Relations Committee of the U.S. Senate, Laurence Woodworth, the Assistant Secretary of the Treasury for Tax Policy, reported:

> We view tax treaties as an important element in the international economic

The problems arising out of states' use of formula apportionment demonstrate that, in the international arena, the unitary method should not be used. Each argument advanced by proponents of the unitary method is met by a problem that rises to the level of national harm and cannot be easily resolved. Unfortunately, a resolution does not seem forthcoming, since both the Judiciary and the Legislature await some definite signal from the Executive. The Executive Branch should abandon its stance of ambiguity and lethargy in favor of an affirmative position for international trade, for ultimately, the condition of relations with our foreign trading partners will affect the nation and the individual states much more than any problems proponents of the unitary tax can advance.

> policy of the United States. One of our fundamental objectives is to minimize impediments to free international flows of capital and technology and this objective is fostered by having the broadest possible network of income treaties.
>
> Among the major impediments to free capital and technology flows are the rules of national tax systems and their interaction with the systems of other countries. Tax treaties seek to eliminate, or at least mitigate the impact of these impediments.
>
> Treaties accomplish the minimization of impediments by a variety of means, the principal ones being the elimination or reduction of double taxation and the elimination, to the extent possible, of discriminatory tax rules which distinguish unreasonably between domestic and foreign investment.
>
> At the same time, tax treaties also serve other policy objectives—for example, the prevention of tax avoidance and evasion, and the fostering of international cooperation between the tax authorities of Contracting States.

Hearings on Tax Treaties, *supra* note 139, at 28 (Statement of Asst. Sec. of the Treas., Laurence Woodworth).

Chapoton, in a speech before the National Association of State Bar Tax Sections, in Washington, D.C., on Oct. 21, 1983, cited one instance of a country's refusal to continue tax treaty negotiation based on disapprobation of the unitary tax method. Sheppard, *supra* note 148, at 439.