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# Alcan Aluminium Limited v. Franchise Tax Board: State Unitary Apportionment of Foreign Parent Income Taxation Will Have to Go to State Court

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Apportionment of Foreign Parent Income Taxation Will Have to Go to  
State Court

**Cover Page Footnote**

International Law; Commercial Law; Law

# ***Alcan Aluminium Limited v. Franchise Tax Board:*** **State Unitary Apportionment of Foreign Parent** **Income Taxation Will Have to Go** **to State Court**

## **I. Introduction**

It is well-established that states cannot tax income earned outside their territorial borders.<sup>1</sup> Yet, because of the difficulty in accurately measuring the value earned by a corporation in a particular geographical area, states are constitutionally permitted to use apportionment formulas to determine taxable income.<sup>2</sup> California currently employs a controversial unitary apportionment formula known as worldwide combined reporting to measure corporate taxable income.<sup>3</sup> This formula has become a source of considerable tension between the United States and its major trading partners.<sup>4</sup>

An apportionment formula is a mathematical approximation of the taxable income properly attributable to a state from activities of a worldwide unitary business conducted within that state.<sup>5</sup> The approximation an apportionment formula provides depends on the extent of the activities included in the apportionable base. There are four types of apportionable bases used: separate entity base, water's edge accounting, domestic combined reporting, and worldwide combined reporting.<sup>6</sup> A formula using the separate entity apportionable base includes income only from activities conducted within the state.<sup>7</sup> The water's edge accounting method includes income from activities conducted within the United States. The domestic com-

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<sup>1</sup> *Container Corp. of America v. Franchise Tax Bd.*, 463 U.S. 159, 164 (1983) (citing *ASARCO Inc. v. Idaho State Tax Comm'n*, 458 U.S. 307, 315 (1982)).

<sup>2</sup> *Id.*

<sup>3</sup> CAL. REV. & TAX CODE §§ 25128-25137 (West 1979). Technically, California cannot be classified as a unitary state since it passed repeal legislation effective January 1, 1988, enabling qualified taxpayers to make a "water's edge" election. See *infra* notes 31-35 and accompanying text. Alaska and North Dakota also apply worldwide unitary taxation. ALASKA STAT. § 43.20.065 (1985); N.D. CENT. CODE §§ 57-38.1-01 to -21 (1972).

<sup>4</sup> Major trading partners include Japan, Canada, the United Kingdom, and most other members of the European Community. See *infra* notes 17-19 and accompanying text.

<sup>5</sup> See Note, *State Unitary Apportionment of Foreign Corporations' Worldwide Income: It's Time for the United States to Start Speaking With One Voice*, 5 B.U. INT'L L.J. 91, 92 (1987).

<sup>6</sup> See Note, *U.S. Perspectives on Worldwide Unitary Taxation*, 7 DICK. J. INT'L L. 213, 216-17 (1989).

<sup>7</sup> *Id.*

bined reporting method includes income from activities of the taxpayer corporation and its domestic subsidiaries and affiliates wherever conducted.<sup>8</sup> The "worldwide" method includes the income of foreign affiliates earned outside the United States.<sup>9</sup> The most commonly employed apportionment formula is:

$$\frac{\text{In-state property}}{\text{Total property}} + \frac{\text{In-state payroll}}{\text{Total payroll}} + \frac{\text{In-state sales}}{\text{Total sales}} \times \frac{\text{Total Corporate Income}}{\text{Total Income}} = \frac{\text{Taxable Income}}{\text{By State}}$$

All intracorporate transactions are eliminated in this formula.<sup>10</sup>

Some foreign parent corporations have attempted to contest the state tax assessment of their U.S. subsidiaries by suing for injunctive or declaratory relief in the federal courts. Until the Seventh Circuit's decision in *Alcan Aluminium Limited v. Franchise Tax Board*,<sup>11</sup> foreign parents had been denied standing to challenge a formula's constitutionality under the traditional rule that a shareholder may not initiate an action to enforce the rights of the corporation unless the corporation's management has refused to pursue the same action.<sup>12</sup> In *Alcan Aluminium*, the court held that the foreign parents had sustained injuries sufficiently "direct and independent of the injuries incurred by their subsidiaries to confer standing."<sup>13</sup> The Supreme Court, however, recently reversed that decision.<sup>14</sup> In reversing *Alcan*, the Court did not address the standing of foreign parent corporations. Without deciding whether the foreign parents would have standing, the Court held that the plaintiffs were nevertheless barred from bringing suit in federal court under the Tax Injunction Act.<sup>15</sup>

This Note begins with a synopsis of the reasons underlying the dispute over California's unitary apportionment formula and with a brief chronicle of the actions taken by the federal government and California in attempting to settle the controversy. An analysis of the Seventh Circuit's decision and the Supreme Court's reasoning for its subsequent reversal follows. The Note concludes with an examination of the likelihood of the formula's constitutionality should the Supreme Court hear one of several unitary tax cases currently proceeding in California state courts.

<sup>8</sup> *Id.*

<sup>9</sup> Hellerstein, *State Income Taxation of Multijurisdictional Corporations: Reflections on Mobil, Exxon, and H.R. 5076*, 79 MICH. L. REV. 113, 156-59 (1980).

<sup>10</sup> White & Nack, *State Tax Litigation After the Container Decision*, 20 TAX NOTES 771 (1983).

<sup>11</sup> 860 F.2d 688 (7th Cir. 1988), *rev'd*, 110 S. Ct. 661 (1990).

<sup>12</sup> 28 U.S.C. § 1341 (1988). *See infra* notes 52-54 and accompanying text.

<sup>13</sup> *Alcan Aluminium*, 860 F.2d at 690.

<sup>14</sup> *Alcan Aluminium*, *rev'd*, 110 S. Ct. 661 (1990).

<sup>15</sup> *See infra* notes 66-91 and accompanying text.

## II. Background

Since the Supreme Court's decision upholding the constitutionality of the worldwide apportionment method in *Container Corp. v. Franchise Tax Board*,<sup>16</sup> many trading partners have threatened<sup>17</sup> to curtail investment<sup>18</sup> in the United States or take retaliatory measures<sup>19</sup> against American corporations operating abroad. Foreign corporations and their domiciliary governments complain that the tax inaccurately reflects the income earned within a particular state.<sup>20</sup> In opposition to the worldwide unitary tax, it is argued that affiliated corporations subject to such a tax are allocated a higher portion of income than are affiliated corporations in other jurisdic-

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<sup>16</sup> 463 U.S. 159 (1983). The Court upheld California's application of worldwide combined apportionment to the worldwide income of domestic-based multinational corporations. However, the Court expressly left open the question of the constitutionality of the formula when applied to "domestic corporations with foreign parents or foreign corporations with either foreign parents or foreign subsidiaries." *Id.* at 189 n.26.

<sup>17</sup> Methods of protest include letters to the Treasury and State Departments, amicus curiae briefs filed in unitary apportionment cases, and actual or threatened implementation of retaliatory measures. See Note, *State Unitary Apportionment*, *supra* note 5, at 103-107. Sixteen countries filed amicus briefs against the unitary method in *Alcan Aluminium*.

<sup>18</sup> A letter to both the State and Treasury Departments from EEC countries, Japan, Canada, Australia, and Switzerland stated "[o]ur governments are deeply concerned about the use of the worldwide unitary basis of taxation. . . . [Federal restrictive action] would represent the removal of a serious obstacle to the further development of our trade and investment relationships." Letter to Donald T. Regan, U.S. Treasury Secretary, and Allen Wallis, Undersecretary of State (Jan. 27, 1984) (available in 22 Tax Notes Microfiche Data Base Doc. No. 84-1212 (Feb. 20, 1984)).

Keidanren, the Japanese Federation of Economic Organizations, also protested by sending a delegation to Washington, D.C. in 1984 to argue for the repeal of the state unitary tax laws. Seiki Tozaki, chair of C. Itoh & Co., Ltd. and leader of the delegation, announced that 40 Japanese companies who are heavily invested in the United States would not make any new or additional investments in unitary method states, and may leave them altogether. Meanwhile, Kyocera International, Inc., a U.S. subsidiary with a Japanese parent, sold two of its plants in California. See Sheppard, *Japan, Inc. Reinforces Complaints About the Unitary Method*, 22 TAX NOTES 653 (1984); see also *Worldwide Application of Unitary Tax: Hearings Before the Subcomm. on International Economic Policy of the Senate Foreign Relations Comm.*, 98th Cong., 1st Sess. 31 (1984).

<sup>19</sup> Britain's Parliament passed enabling legislation denying tax treaty benefits to certain United States-based corporations operating in Britain but incorporated or having their principle place of business in a unitary state. Finance Act, 1985, ch. 54, sched. 13 (Gr. Brit.), reprinted in 25 I.L.M. 735 (1986). See also Note, *State Unitary Apportionment*, *supra* note 5, at 106-07. However, following President Reagan's statement of his intent to propose federal legislation and California's passage of a repeal bill, the British government announced it would not take action under the retaliatory legislation for the time being. British Embassy Information Department, Press Release at 2 (Dec. 18, 1986) (available in 33 Tax Notes Microfiche Data Base Doc. No. 86-7934 (Dec. 22, 1986)).

<sup>20</sup> See Wallis Tells Working Group That Unitary Method Discriminates, 21 TAX NOTES 1219, 1219 (1983):

The essence of our trading partners' complaint is their sense that the unitary method is an inaccurate reflection of income earned within a jurisdiction, one at odds with the manner in which business is actually conducted. They feel that separate accounting more nearly approximates income earned and avoids the discriminatory burdens imposed by the unitary method on foreign businesses operating in the United States.

*Id.*

tions due to inflated payroll and property costs in the United States.<sup>21</sup> Foreign corporations also argue that the unitary method results in double taxation of their foreign-source income.<sup>22</sup>

Proponents of worldwide unitary apportionment retort that, in addition to ease of administration, use of the method prevents a multinational corporation from shifting income to affiliated companies in lower tax jurisdictions.<sup>23</sup> Since many multinational corporations are highly integrated with activities transcending geographic boundaries, unitary tax states argue that the method is a more accurate measure of the income properly attributable to them.<sup>24</sup> Finally, and probably most importantly, states allege they would lose a substantial amount of revenue if the method were repealed.<sup>25</sup>

In an attempt to ameliorate this deepening tension, President Reagan appointed a task force known as the Working Group to address the issue and formulate a compromise.<sup>26</sup> In its final report, the Working Group advocated three principles: (1) water's edge unitary combination for both U.S. and foreign companies; (2) increased federal administration assistance and cooperation with the states to promote full taxpayer disclosure and accountability; and (3) competitive balance for businesses.<sup>27</sup>

In 1985, after it became apparent that all states were not going to adopt the Working Group's suggestions, President Reagan proposed the incorporation of those principles into an act of Con-

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<sup>21</sup> Worldwide unitary apportionment assumes similar operating costs and economic conditions. If operating costs, such as payroll or raw materials, are higher in an American state than in a country where an affiliated company is located, it results in income being apportioned to the American state which is attributable to the other country. See also J. Hellerstein, *STATE TAXATION: CORPORATE INCOME AND FRANCHISE TAXES* 373-75 (1983); General Accounting Office, *KEY ISSUES AFFECTING STATE TAXATION OF MULTIJURISDICTIONAL CORPORATE INCOME NEED RESOLVING* 36-37 (July 1, 1982) [hereinafter GAO Report].

<sup>22</sup> See, e.g., GAO Report, *supra* note 21, at 35-36. If a state apportions income of a corporation to itself that is attributable to a foreign affiliate and the domiciliary country of the foreign affiliate does not provide a tax credit, the corporation is taxed twice on one source of income. *Id.* For an extensive discussion of the enhanced risk of multiple taxation in the foreign-based multinational corporation context, see Note, *State Worldwide Unitary Taxation: The Foreign Parent Case*, 23 *COLUM. J. TRANSNAT'L L.* 445, 462-66 (1985).

<sup>23</sup> GAO Report, *supra* note 21, at 35-36.

<sup>24</sup> See Note, *State Worldwide Unitary Taxation*, *supra* note 22, at 446-47; see also Keesling, *A Current Look at the Combined Report and Uniformity in Allocation Practices*, 42 *J. TAX'N* 106, 107 (1975).

<sup>25</sup> One commentator reports that under the proposed federal restrictions in 1986 North Dakota could possibly lose \$7.5 to \$9 million, and California \$80-\$150 million, whereas Alaska would absorb no loss at all. Note, *State Unitary Apportionment*, *supra* note 5, at 96 n.27.

<sup>26</sup> Ferguson, *Worldwide Unitary Taxation: The End Appears Near*, 4 *J. ST. TAX'N* 241, 242 (1986).

<sup>27</sup> *Id.* at 243; *Chairman's Report on the Worldwide Unitary Taxation Working Group: Activities, Issues and Recommendations*, 24 *TAX NOTES* 581, 581 (1984). The group was unable to reach an agreement on the treatment of foreign dividends or of corporations with 80% of their activities outside the United States. *Id.*

gress.<sup>28</sup> Accordingly, what was called the Unitary Tax Repealer Act<sup>29</sup> was introduced in the Senate. The proposal would "prohibit[] the use of worldwide unitary taxation in favor of a water's edge limitation, restrict[] state taxation of foreign source dividends, and require[] corporations to file a full disclosure spreadsheet report with the Internal Revenue Service."<sup>30</sup>

California has also taken steps to quiet this dispute. In 1986, California amended its franchise tax statute to allow a "unitary group" to make a "water's edge" election.<sup>31</sup> The advantage of this election is that a qualified taxpayer<sup>32</sup> is only required to take into account the income and apportionment factors of the members of its water's-edge group.<sup>33</sup> The foreign corporation still incurs a tax but only on activities conducted within the United States. Nevertheless, the extremely stringent requirements<sup>34</sup> for inclusion in the group often result ultimately in subjecting the corporation to worldwide unitary taxation.<sup>35</sup>

Many countries with investments in the United States remain dissatisfied despite the actions taken by the federal government and California.<sup>36</sup> Although only three states still employ<sup>37</sup> the unitary method, critics contend there is nothing to prevent other states from enacting it in the future.<sup>38</sup> Thus, many foreign countries and affected

<sup>28</sup> In a statement on November 8, 1985, President Reagan announced:

We hoped that by this time these principles would have been enacted by the various states that have unitary taxation. Since states have not universally accepted these principles, I am instructing the Secretary of the Treasury to initiate the process of crafting Federal legislation to incorporate these principles into law and work with the Congress for passage.

Ferguson, *supra* note 26, at 254.

<sup>29</sup> S. 1974, 99th Cong., 1st Sess., 131 CONG. REC. 17,975-78 (1985). Ultimately, no action was taken on this bill.

<sup>30</sup> Agostini, *U.S. Perspectives on Worldwide Unitary Taxation*, 7 DICK. J. INT'L L. 213, 224 (1989).

<sup>31</sup> 1986 Cal. Stat. ch. 660 (codified at CAL. REV. & TAX. CODE § 25110). Worldwide unitary taxation is still provided for in § 25101.

<sup>32</sup> Cal. Rev. & Tax. Code § 25110(b)(2).

<sup>33</sup> Cal. Rev. & Tax. Code § 25110(a). See Dushkes, *California's Unitary Tax System*, 16 BARRISTER 54, 55 (1989).

<sup>34</sup> Cal. Rev. & Tax. Code § 25110(a)(8)(A).

<sup>35</sup> See Note, *U.S. Perspectives on Worldwide Unitary Taxation*, *supra* note 6, at 225.

<sup>36</sup> See Note, *State Unitary Apportionment*, *supra* note 5, at 115.

<sup>37</sup> When President Reagan appointed the Working Group twelve states employed the worldwide unitary method. They included Alaska, California, Colorado, Florida, Idaho, Indiana, Massachusetts, Montana, New Hampshire, North Dakota, Oregon and Utah. Ferguson, *supra* note 26, at 242. Soon after the Working Group's final report was released in 1984, Oregon, Florida, Massachusetts, Idaho, Indiana, and Colorado repealed the method. *Id.* at 245. Since then, Montana, New Hampshire, and Utah have also relented.

<sup>38</sup> "[A] haphazard array of individually adopted State water's edge solutions replete with various 'election' fees and other objectionable provisions, will not provide an appropriate solution." Note, *State Unitary Apportionment*, *supra* note 5, at 116 n.181 (quoting *State Taxation of Multinational Business: Hearings Relating to the Description of S.113 and S.1974 Before the Subcomm. on Taxation and Debt Management of the Senate Committee on Finance*, 99th Cong., 2nd Sess. 4 (1986) (statement of Thomas H. Boggs, Jr., on behalf of Unitary Tax Campaign, Ltd.)). "Other objections include: (1) concern for a stable system since "without

foreign corporations continue to press for preemption by federal legislation or judicial disapproval by the Supreme Court.<sup>39</sup> Affected foreign corporations are, nevertheless, only able to litigate claims through their domestic subsidiaries in state court due to the Court's decision in *Alcan Aluminium Limited v. Franchise Tax Board*.<sup>40</sup>

### III. *Alcan Aluminium Limited v. Franchise Tax Board*

Alcan Aluminium Limited ("Alcan") and Imperial Chemical Industries ("Imperial") are foreign corporations with domestic subsidiaries doing business in California.<sup>41</sup> Alcan is a Canadian company and the sole stockholder in Alcan Aluminium Corporation ("Alcancorp"), an Ohio corporation.<sup>42</sup> Imperial is a British holding company which owns over 50% of ICI Americas, Inc. ("Americas"), a Delaware corporation.<sup>43</sup> California's Franchise Tax Board ("FTB") assessed franchise taxes against both Alcancorp and Americas under California's worldwide unitary apportionment formula.

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Federal legislation, States which act to limit worldwide unitary taxation may reverse such legislation decisions at any time;" and (2) need for "a consistent water's edge scheme which would increase certainty for business transactions and reduce the cost of complying with many widely varying State laws." *Id.*

<sup>39</sup> The Second and Ninth Circuits have both denied federal jurisdiction to foreign parents challenging the unitary tax. In *Shell Petroleum, N.V. v. Graves*, 709 F.2d 593 (9th Cir.), *cert. denied*, 464 U.S. 1012 (1983), the plaintiff was a Netherlands corporation seeking declaratory and injunctive relief from California's unitary method as applied to two of its American subsidiaries. The court denied jurisdiction because the "method of taxation that [the plaintiff] seeks to enjoin does not injure [the plaintiff] directly or independently of the corporation." *Id.* at 595. The court also held that the United States-Netherlands Treaty of Friendship, Commerce and Navigation does not confer standing on the Netherlands corporation because a domestic corporation would not have had standing to enjoin assessment of the tax. *Id.* at 596.

In *EMI Ltd. v. Bennett*, 738 F.2d 994 (9th Cir.), *cert. denied*, 469 U.S. 1073 (1984), the Ninth Circuit held on remand that EMI Ltd., a British corporation with American subsidiaries, had not sustained injuries directly or independently of the harm to its subsidiaries. Hence, the plaintiff lacked standing under the traditional shareholder standing rule. In addition, the treaty between the U.S. and the United Kingdom relied upon by EMI did not grant special status to stockholders which thereby conferred standing. *Id.* at 998.

Interestingly, the Ninth Circuit held that the Tax Injunction Act did not bar an action by the parent corporation. *Capitol Industries-EMI, Inc. v. Bennett*, 681 F.2d 1107, 1119 (1982). The court noted, however, that to allow "a parent corporation to bring an action in federal district court . . . could result in the circumvention of state remedial procedures that [the Tax Injunction Act] was intended to prevent." *Id.* at 1119 n.32.

The Second Circuit has also denied standing to a foreign parent. *Alcan Aluminium Ltd. v. Franchise Tax Bd.*, 742 F.2d 1430 (2d Cir. 1983), *cert. denied*, 464 U.S. 1041 (1984). Alcan first brought a nearly identical suit in the Southern District of New York. The district court stayed federal court action, including the standing issue, pending resolution of Alcan's claims in state administrative proceedings. Subsequently, the Second Circuit denied Alcan standing. The FTB did move to dismiss this action in the district court on collateral estoppel grounds but was unsuccessful. They failed to raise the issue on appeal thus the Seventh Circuit would not address it. *Alcan Aluminium Ltd. v. Franchise Tax Bd.*, 860 F.2d 688, 695 n.9 (7th Cir. 1988).

<sup>40</sup> 110 S. Ct. 661 (1990).

<sup>41</sup> *Alcan Aluminium*, 860 F.2d at 690.

<sup>42</sup> *Id.*

<sup>43</sup> *Id.*



Alcan and Imperial brought separate suits seeking declaratory and injunctive relief from the unitary apportionment method on the grounds that application of the method to domestic subsidiaries of foreign corporations violates the Foreign Commerce Clause<sup>44</sup> and inhibits the ability of the United States to speak with 'one voice' in matters of foreign policy. The district court found the plaintiffs were injured only in their capacity as shareholders and thus dismissed the suit for lack of standing.<sup>45</sup> The Seventh Circuit reversed.<sup>46</sup>

The Seventh Circuit began its analysis with an examination of the two restrictions on parties seeking access to the federal courts. In order to have standing, parties must overcome both constitutional and prudential limitations on the exercise of a federal court's jurisdiction to have standing.<sup>47</sup> The first restriction flows from article III, section 2<sup>48</sup> of the Constitution. The court stated that "the party who invokes the court's authority [must] show that he personally has suffered some actual or threatened injury as a result of the putatively illegal conduct of the defendant"<sup>49</sup> and that the injury "fairly can be traced to the challenged actions and is likely to be redressed by a favorable decision."<sup>50</sup> The court held that the direct harm the plaintiffs suffered as "participants in foreign commerce" satisfied the standing requirement in article III.<sup>51</sup>

The bulk of the opinion focused on the traditional shareholder rule encompassed in the prudential limitations on standing.<sup>52</sup> The court, agreeing with the FTB, acknowledged that long-settled equitable restrictions prevent shareholders from initiating a cause of action belonging to the corporation unless they have made a demand on the board of directors to pursue the cause which has been unjustly denied.<sup>53</sup> The court reasoned that these restrictions prevent shareholder suits from circumventing the limits on diversity jurisdiction or undermining managerial decisionmaking.<sup>54</sup> The court concluded that the facts in this case did not indicate a strike suit or an attempt

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<sup>44</sup> U.S. CONST. art. I, § 8, cl. 3.

<sup>45</sup> *Alcan Aluminium Ltd. v. Franchise Tax Bd.*, Nos. 84 C 6932, 84 C 8902, mem. op. at 8-10 (N.D. Ill. July 29, 1987) (1987 WL 15386).

<sup>46</sup> *Alcan Aluminium Ltd. v. Franchise Tax Bd.*, 860 F.2d 688 (7th Cir. 1988).

<sup>47</sup> *Id.* at 691.

<sup>48</sup> U.S. CONST. art. III, § 2, cl. 1.

<sup>49</sup> *Alcan Aluminium Ltd. v. Franchise Tax Bd.*, 110 S. Ct. 661, 663 (1990) (quoting *Gladstone, Realtors v. Village Bellwood*, 441 U.S. 91, 99 (1979)).

<sup>50</sup> *Id.* (quoting *Simon v. Eastern Kentucky Welfare Rights Org.*, 426 U.S. 26, 38, 41 (1976)).

<sup>51</sup> *Alcan Aluminium*, 860 F.2d at 692.

<sup>52</sup> "[P]rudential guidelines [are ones which] the Court [has] developed, for its own governance in the cases confessedly within its jurisdiction." *Id.* at 692 (quoting *Ashwander v. Tennessee Valley Auth.*, 297 U.S. 288, 346 (1936)).

<sup>53</sup> *Id.* at 693.

<sup>54</sup> *Id.* A strike suit in this context is a derivative action brought by the shareholder to elicit a lucrative settlement from management rather than to force them to pursue the cause.

to manipulate diversity jurisdiction.<sup>55</sup>

Despite its conclusion, the court questioned the "wisdom" of hearing the case.<sup>56</sup> The court reiterated the well-settled exception to the shareholder rule—namely, that a shareholder may bring suit if the shareholder has incurred injuries sufficiently direct and independent of the corporation even if the legal rights of the corporation are also implicated.<sup>57</sup> The plaintiffs argued that the double taxation of income and the increased cost of acquiring the additional information necessary to figure the tax are sufficiently direct injuries to confer standing. The court disagreed, characterizing the expenses as administrative costs experienced by the foreign parent "as shareholders in an enterprise faced with increased costs."<sup>58</sup>

Nevertheless, the court of appeals held that the shareholders of foreign parents do incur sufficiently direct injuries when their domestic subsidiaries are viewed as instrumentalities of foreign commerce.<sup>59</sup> The court reasoned that the unitary tax's potential to discourage ownership of American subsidiaries because of a tax burden higher than that of conducting business through independent contractors provided the plaintiffs' strongest argument for standing.<sup>60</sup> The court was careful to note it was not deciding the merits by holding that the burden on foreign commerce conferred standing.<sup>61</sup>

The defendants argued that the principles of comity and federalism, which have been partially codified in the Tax Injunction Act<sup>62</sup> should preclude the plaintiffs' action in federal court. The Tax Injunction Act prohibits federal interference with matters of state taxation where a state court remedy is available. The court dismissed the Act as inapplicable for lack of such remedy by the foreign parents.<sup>63</sup> In addition, principles of comity and federalism underlying the Act were not weighty enough to invoke the court's discretionary power to deny access to the federal courts in the absence of a state court remedy.<sup>64</sup> Interestingly, the court also relied on consider-

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<sup>55</sup> *Id.* at 694.

<sup>56</sup> *Id.* The court noted that "wise judicial administration" entails the "conservation of judicial resources and comprehensive disposition of litigation," and went on to state that "conservation of judicial resources can only in 'exceptional circumstances' justify the withholding of federal jurisdiction in spite of 'the virtually unflagging obligation of the federal courts to exercise the jurisdiction given them.'" *Id.*

<sup>57</sup> *Alcan Aluminium*, 860 F.2d at 693.

<sup>58</sup> *Id.* at 696.

<sup>59</sup> *Id.* at 697.

<sup>60</sup> *Id.* The court thought it important that the merits of the case have fueled an international controversy between the United States and its trading partners. *Id.* at 699.

<sup>61</sup> *Id.* at 697 n.10. "Evaluation of the constitutional significance of the threat in the particular circumstances presented by California's unitary tax must await the district court's assessment of the merits of this appeal. We decide only that the potential for constitutionally significant offense is sufficient to create standing." *Id.*

<sup>62</sup> 28 U.S.C. § 1341 (1988).

<sup>63</sup> *Alcan Aluminium*, 860 F.2d at 698.

<sup>64</sup> *Id.* at 699.

ations of international comity in its reasoning.<sup>65</sup> Apparently, the court felt that the implications of the tax on U.S. foreign relations weighed in favor of a federal court hearing the case. However, as noted above, the court said it was not deciding the merits. Ironically, the Tax Injunction Act is the precise ground on which the Supreme Court based its reversal.

In a rather short opinion the United States Supreme Court unanimously reversed the Seventh Circuit and held, without deciding the standing issue, that the plaintiffs' federal action was barred under the Tax Injunction Act.<sup>66</sup> To better understand the Court's decision, it is necessary to examine the Tax Injunction Act and the Court's interpretations in prior decisions.

The Tax Injunction Act provides that "[t]he district courts shall not enjoin, suspend or restrain the assessment, levy or collection of any tax under State law where a plain, speedy and efficient remedy may be had in the courts of such State."<sup>67</sup> The Supreme Court has interpreted this limitation broadly. In *Rosewell v. LaSalle National Bank*,<sup>68</sup> the Court held that a state court remedy will be considered "plain, speedy and efficient" so long as it meets "certain minimal procedural requirements."<sup>69</sup> Thus, if the state court procedure provides the taxpayer with a "full hearing and judicial determination of the controversy at which [he] may raise any and all constitutional objections to the tax," it is procedurally sufficient within the meaning of the Act.<sup>70</sup>

In *Rosewell*, the plaintiff, as beneficial owner of an apartment building, challenged the tax assessment of her property. After an unsuccessful administrative appeal, the plaintiff refused to pay the taxes and brought suit in federal court seeking injunctive relief on the grounds that the excessive tax deprived her of equal protection and due process under the Fourteenth Amendment.<sup>71</sup> The Supreme Court found that the Act barred federal jurisdiction because the Illinois refund procedure was a "plain, speedy and efficient remedy" despite a two year delay before the taxpayer would receive a refund.<sup>72</sup> The Court underscored the congressional awareness at the time of the adoption of the Act that most states provided refund procedures as a means of challenging an assessment. The Court felt that this awareness implied that Congress considered state court

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<sup>65</sup> The court stated that foreign governments view California's unitary method as a "serious injury to multinationals located within their borders and a threat to commercial relations with the United States." *Id.* at 698.

<sup>66</sup> *Alcan Aluminium Ltd. v. Franchise Tax Bd.*, 110 S. Ct. 661, 667 (1990).

<sup>67</sup> 28 U.S.C. § 1341 (1988).

<sup>68</sup> 450 U.S. 503 (1981).

<sup>69</sup> *Id.* at 512-15.

<sup>70</sup> *Id.*

<sup>71</sup> *Id.* at 506-07.

<sup>72</sup> *Id.* at 515. Moreover, no interest on the refund is paid for the two year delay.

remedies to satisfy this test.<sup>73</sup> The Court also emphasized that, as in 1937, the dependence of state budgets on the receipt of local tax revenues and the potential disaster on state tax administration compels federal noninterference in state tax issues.<sup>74</sup>

The Supreme Court has also held that the Tax Injunction Act prohibits actions for damages<sup>75</sup> and declaratory relief as well as injunctions. In *California v. Grace Brethren Church*,<sup>76</sup> the Court reasoned that prohibiting taxpayers from seeking injunctive relief in federal court while allowing them to seek a declaratory judgment would undermine the principal purpose of the Act because there is little practical difference between the two. The Court, citing *Rosewell*, reemphasized that the congressional intent in enacting the Tax Injunction Act was "to limit drastically federal district court jurisdiction to interfere with so important a local concern as the collection of taxes."<sup>77</sup>

In *Tully v. Griffin*,<sup>78</sup> the Court stressed that the "statute has its roots in equity practice, in principles of federalism, and in recognition of the imperative need of a State to administer its own fiscal operations."<sup>79</sup> In *Great Lakes Dredge & Dodge Co. v. Huffman*<sup>80</sup> and *Fair Assessment In Real Estate Association v. McNary*,<sup>81</sup> the Court, while declining to decide whether the Tax Injunction Act would necessitate the same result, denied federal jurisdiction in both cases under the principle of federalism. The Court in *McNary* held that "[t]he scrupulous regard for the rightful independence of state governments which should at all times actuate the federal courts, and a proper reluctance to interfere by injunction with their fiscal operations, require that such relief should be denied in every case where the asserted federal right may be preserved without it."<sup>82</sup>

The Supreme Court's decision in *Alcan Aluminium* seems consistent with the Tax Injunction Act's history of federal deference to state courts on matters of state tax; however, it is a rather broad interpretation of the Act's language. The Court acknowledged that the Act had not previously been construed so broadly as to deny federal jurisdiction to a "nontaxpayer who lacks a remedy in state court . . . on the ground that an affiliated taxpayer possesses adequate state

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<sup>73</sup> *Id.* at 523; see also H. R. REP. NO. 1503, 75th Cong., 1st Sess. 2 (1937).

<sup>74</sup> *Id.* at 527.

<sup>75</sup> See *Edelman v. Jordan*, 415 U.S. 651 (1974).

<sup>76</sup> 457 U.S. 393 (1982).

<sup>77</sup> *Id.* at 417 (quoting *Rosewell v. LaSalle Nat'l Bank*, 450 U.S. 503, 522 (1981)).

<sup>78</sup> 429 U.S. 68 (1976).

<sup>79</sup> *Id.* at 73.

<sup>80</sup> 319 U.S. 293 (1943).

<sup>81</sup> 454 U.S. 100 (1981).

<sup>82</sup> *Id.* at 111 (quoting *Great Lakes Dredge & Dock Co. v. Huffman*, 319 U.S. 293, 298 (1943)).

court remedies.”<sup>83</sup> The Court maintained, however, that allowing the respondents to bring an action in federal court when they directed and controlled a party having an adequate state court remedy would be to elevate form over substance.<sup>84</sup>

The Court also dismissed the respondents’ contention that they lacked an adequate state court remedy because their subsidiaries would not be permitted to raise a Foreign Commerce challenge to California’s unitary tax.<sup>85</sup> The respondents argued that the subsidiaries were not within the class of foreign investors protected by the Foreign Commerce Clause and therefore they could not adequately litigate their foreign parents’ claims.<sup>86</sup>

Previously, the Supreme Court has held that a remedy that is too uncertain or speculative is not “plain” within the meaning of the Tax Injunction Act and thus not sufficient to deny jurisdiction.<sup>87</sup> In *Alcan Aluminium*, the Court relied on the FTB’s reassurance that the “California courts would entertain and decide any issues the respondents desire to present.”<sup>88</sup> At first, this faith in the California courts appears rather speculative. However, the Court provided the caveat that, should California courts refuse to hear the argument, the result under the Tax Injunction Act “might well be different.”<sup>89</sup> In fact, the Court’s reliance in this instance was not misplaced because there are two cases<sup>90</sup> currently in the California courts involving plaintiff-subsidiaries that have *successfully* raised the foreign commerce challenge.

*Alcan Aluminium* is unusual because a decision on the procedural issue would largely influence the substantive issue.<sup>91</sup> By declining to decide the standing issue, the Supreme Court successfully avoided providing any insight on their opinion of the merits.

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<sup>83</sup> *Alcan Aluminium Ltd. v. Franchise Tax Bd.*, 110 S. Ct. 661, 666 (1990).

<sup>84</sup> *Id.* Cf. *South Carolina v. Regan*, 465 U.S. 367 (1984). *Regan* involved the Anti-Injunction Act, which prohibits the enjoining of the assessment or collection of any tax by any person whether or not such person is the one being assessed. The Court held that because South Carolina had no alternative remedy and could not be made to rely on a third party to raise its claim, it was not barred by the Anti-Injunction Act from challenging the Tax Equity and Fiscal Responsibility Act. In responding to Justice O’Connor’s concern that the decision would enable taxpayers to evade the Act by forming organizations to litigate their claims, thereby appearing not to have a remedy themselves, the Court stated that that would elevate form over substance to treat such organizations as if they did not possess alternative remedies. *Id.* at 381 n.19.

<sup>85</sup> *Alcan Aluminium*, 110 S. Ct. at 666-67.

<sup>86</sup> *Id.*

<sup>87</sup> See *Rosewell v. LaSalle Nat’l Bank*, 450 U.S. 503, 516-17 (1981); *California v. Grace Brethren Church*, 457 U.S. 393, 415 n.31 (1982).

<sup>88</sup> *Alcan Aluminium*, 110 S. Ct. at 667.

<sup>89</sup> *Id.*

<sup>90</sup> *Colgate-Palmolive Co. v. Franchise Tax Bd.*, No. 319715 Cal. Super. Ct. (Dec. 12, 1988); *Barclays Bank Int’l v. Franchise Tax Bd.*, 275 Cal. Rptr. 626, 225 Cal. App. 3d 1342 (1990). See *infra* notes 142-178 and accompanying text.

<sup>91</sup> Respondent *Alcan Aluminium* argued that the court could not decide the standing issue without also reaching the merits. See Sheppard, *Multinational Forum Shopping: Supreme Court Hears Alcan’s California Unitary Challenge*, 45 TAX NOTES 674, 676 (Nov. 6, 1989).

In 1983, the Court was faced with a strikingly similar case in *Container Corp. of America v. Franchise Tax Board*.<sup>92</sup> The Supreme Court upheld the constitutionality of California's unitary tax when applied to a domestic parent with foreign subsidiaries. Chief Justice Burger, Justice Powell and Justice O'Connor dissented, arguing that the formula violates the Foreign Commerce Clause.<sup>93</sup> Since Chief Justice Burger and Justice Powell have retired from the bench, there remains only one of the three dissenting justices in *Container Corp. of America v. Franchise Tax Board*. It is not possible to glean from the *Alcan Aluminium* decision whether four additional justices believe that California's method is unconstitutional when applied to a foreign parent with domestic subsidiaries.

#### IV. Foreign Commerce Clause Implications

Although the Supreme Court failed to reach the merits in *Alcan Aluminium*, most commentators agree that worldwide apportionment violates the Foreign Commerce Clause and should be declared unconstitutional.<sup>94</sup> The framework for analysis of this issue was established in two prior Supreme Court decisions:<sup>95</sup> *Japan Line, Ltd. v. County of Los Angeles*<sup>96</sup> and *Container Corp. v. Franchise Tax Board*.<sup>97</sup>

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<sup>92</sup> 463 U.S. 159 (1983).

<sup>93</sup> *Id.* at 197 (Powell, J., dissenting).

<sup>94</sup> See Note, *Foreign Multinationals and the Commerce Clause: Should the States Mind Their Own Business*, 41 TAX LAW. 785-801 (1988); Note, *The Container Aftermath: The Unconstitutionality of California's Unitary Corporate Tax Concept as Applied to a Foreign Parent Corporation*, 25 SANTA CLARA L. REV. 633, 639 (1985).

<sup>95</sup> In addition to *Container Corp. of America v. Franchise Tax Bd.* and *Japan Line, Ltd. v. County of Los Angeles*, the following cases are also relevant but do not add any significant insight to the analysis: *Wardair Canada, Inc. v. Florida Dep't of Revenue*, 477 U.S. 1 (1986) (Florida's tax on aviation fuel sold within the State to airlines regardless of whether the fuel was used to fly within or without the State, or whether the airline engaged in a substantial amount of business in Florida did not violate the Foreign Commerce Clause. The Supreme Court found that the federal government had affirmatively acted to approve a state tax on aviation fuel); *F.W. Woolworth Co. v. Taxation & Revenue Dep't*, 458 U.S. 354 (1982) (New Mexico's tax on a portion of the dividend received by a domestic parent from its foreign subsidiaries failed to meet due process standards because the parent and subsidiaries were not a unitary business); *ASARCO Inc. v. Idaho State Tax Comm'n*, 458 U.S. 307 (1982) (Idaho's attempt to tax interest and capital gains was a violation of due process because the parent and its subsidiaries were not a unitary business); *Mobil Oil Corp. v. Comm'r of Taxes*, 445 U.S. 425 (1980) (Vermont's application of an apportionment formula to foreign source dividend income of appellant received from its subsidiaries operating abroad did not violate the Due Process or Commerce Clauses. The Supreme Court found that taxation by apportionment did not produce a significantly greater tax burden than taxation by allocation.); *Moorman Mfg. Co. v. Bair*, 437 U.S. 267 (1978) (Iowa's single factor sales formula to apportion the income of an interstate business did not violate the Due Process or Commerce Clauses. Appellant was an Illinois corporation that sold goods manufactured in Illinois to Iowa customers through Iowa salesmen and warehouses. The Supreme Court held that the existence of duplicative taxation as between Illinois and Iowa was speculative.); *Exxon Corp. v. Wisconsin Dep't of Revenue*, 447 U.S. 207 (1980) (Wisconsin's application of an apportionment formula to appellant's total income did not violate the due process clause because Exxon's activities in Wisconsin were an integral part of a unitary business).

<sup>96</sup> 441 U.S. 434 (1979).

A. *Japan Line, Ltd. v. County of Los Angeles*

The validity of a state tax under the Commerce Clause is determined according to a four prong test. The four requirements of the test are that: (1) the tax is only applied to activities that have a substantial nexus with the taxing state; (2) the tax is fairly apportioned; (3) the tax does not discriminate against interstate or foreign commerce; and (4) the tax is fairly related to the services provided by the state.<sup>98</sup>

In *Japan Line, Ltd. v. County of Los Angeles*, the Supreme Court held that, in determining the constitutionality of a state tax imposed on an instrumentality of foreign commerce, two requirements in addition to the four prong test must be met. The tax must not: (1) create a "substantial risk of international multiple taxation;" or (2) prevent "the Federal Government from 'speaking with one voice' when regulating commercial relations with foreign governments."<sup>99</sup>

The facts of *Japan Line* involved an ad valorem property tax on Japanese cargo containers temporarily present in California.<sup>100</sup> The Court assumed, without deciding, that the tax met the four standard requirements, but held it did not satisfy either of the two additional conditions.<sup>101</sup>

First, because the containers were taxed at their full value in Japan, the California tax resulted in actual double taxation.<sup>102</sup> The Court relied on previous decisions requiring that taxes on interstate commerce "be apportioned among taxing jurisdictions, so that no instrumentality of commerce is subjected to more than one tax on its full value."<sup>103</sup> The Court recognized that neither the government nor the courts of the United States have the authority to correct malapportioned taxes imposed on foreign commerce by a foreign country.<sup>104</sup> Assuming it would be consistent with the custom of nations, a foreign country could also tax the entity or activity at its full value which would necessarily result in multiple taxation. Thus,

due to the absence of an authoritative tribunal capable of ensuring that the aggregation of taxes is computed on no more than one full value, a state tax, even though 'fairly apportioned' to reflect an instrumentality's presence within the State, may subject foreign commerce to the risk of a double tax burden to which [domestic] commerce is not exposed, and which the commerce clause forbids.<sup>105</sup>

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<sup>97</sup> 463 U.S. 159 (1983).

<sup>98</sup> *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274 (1977).

<sup>99</sup> *Japan Line*, 441 U.S. at 451.

<sup>100</sup> *Id.* at 436.

<sup>101</sup> *Id.* at 445-46.

<sup>102</sup> *Id.* at 447.

<sup>103</sup> *Id.*

<sup>104</sup> *Id.*

<sup>105</sup> *Id.* at 447-48.

The Court also held that the tax impeded the nation's ability to "speak with one voice" in its foreign relations and foreign trade.<sup>106</sup> The Court relied on the Customs Convention on Containers,<sup>107</sup> to which Japan and the United States are signatory, as establishing the need for uniformity in this area.<sup>108</sup> The Court also noted the asymmetry created by California's tax as well as the risk of international retaliation in evaluating the need for uniformity.<sup>109</sup>

*B. Container Corp. of America v. Franchise Tax Board*

In *Container Corp. of America v. Franchise Tax Board*, the Supreme Court upheld the validity of California's unitary method as applied to a U.S. corporation domiciled in the United States with foreign subsidiaries.<sup>110</sup> The Court reserved judgment, however, on whether the method would be constitutional with respect to "domestic corporations with foreign parents or foreign corporations with either foreign parents or foreign subsidiaries."<sup>111</sup>

The Court admitted four similarities between the facts of *Japan Line* and *Container Corp.*<sup>112</sup> First, in both cases the foreign entity was subjected to actual double taxation. Second, the double taxation flowed from "a serious divergence" in the tax practices adopted by California and those used by the foreign taxing authorities.<sup>113</sup> Third, there was congruity between the foreign tax practice and the internationally accepted method. Fourth, the federal government "seemed to prefer" the method employed internationally.<sup>114</sup>

Despite these similarities, the Court held that the unitary method applied in this context satisfied the additional conditions required under the Foreign Commerce Clause. The Court found the cases to be constitutionally different in three ways. First, *Japan Line* involved a property tax rather than an income tax.<sup>115</sup> The Court remarked that it had previously distinguished property taxes from income taxes in cases upholding apportionment formulas.<sup>116</sup>

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<sup>106</sup> *Id.* at 449.

<sup>107</sup> Customs Convention on Containers, May 18, 1956, United States-Japan, 20 U.S.T. 301, 304, T.I.A.S. No. 6634.

<sup>108</sup> *Japan Line*, 441 U.S. at 452.

<sup>109</sup> *Id.*

<sup>110</sup> 463 U.S. 159 (1983). The rationale of formula apportionment depends on the existence of a "unitary business." "A unitary business may be defined as a single business conducted both within and without the taxing state and whose tax base cannot be satisfactorily identified on a geographical basis." Hellerstein, *supra* note 9, at 122 n.50. Formula apportionment is constitutional only in the case of a unitary business. *Asarco, Inc. v. Idaho State Tax Comm'n*, 458 U.S. 307 (1982).

<sup>111</sup> *Container Corp.*, 463 U.S. at 189 n.26.

<sup>112</sup> *Id.* at 187.

<sup>113</sup> *Id.*

<sup>114</sup> *Id.*

<sup>115</sup> *Id.* at 187.

<sup>116</sup> *Id.*



Second, the Court found that the existing double taxation was “not the ‘inevitabl[e]’ result of the California taxing scheme,”<sup>117</sup> and thus did not meet the substantial risk of multiple taxation test. The Court held that the additional scrutiny required under the Foreign Commerce Clause must include “the context in which the double taxation takes place and the alternatives reasonabl[y] available to the taxing State.”<sup>118</sup> The Court reasoned that, depending on the facts of each case, California would not necessarily eliminate double taxation by adopting the “arm’s length” method. Accordingly, its apportionment formula did not create a substantial risk of multiple taxation.<sup>119</sup>

Finally, the Court reasoned that the legal incidence of the tax fell on a domestic corporation rather than a foreign entity, meaning that “such taxation was in reality of local rather than international concern.”<sup>120</sup> This factor weighed heavily in the Court’s conclusion that the tax did not violate the second requirement of *Japan Line*.

In analyzing the second requirement, the Court held that the one voice standard is violated if the tax “either implicates foreign policy issues which must be left to the Federal Government or violates a clear federal directive.”<sup>121</sup> The Court noted that one obvious foreign policy implication would be international retaliation against the United States as a whole. The Court recognized, however, that the judiciary has “little competence in determining precisely when foreign nations will be offended by particular acts, and even less competence in deciding how to balance a particular risk of retaliation against the sovereign right of the United States as a whole to let the States tax as they please.”<sup>122</sup> Accordingly, the Court, in finding foreign policy not implicated, used objective factors to analyze the threat of foreign retaliation. First, the tax did not create “automatic asymmetry in international taxation.”<sup>123</sup> Second, the tax was technically imposed on a domestic corporation rather than a foreign entity.<sup>124</sup> And third, California could produce the same economic result by simply raising its corporate tax rate.<sup>125</sup>

The Court also noted that the executive branch had failed to file an amicus brief in the case opposing the unitary method which raised doubts about whether there was any real concern that U.S. foreign

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<sup>117</sup> *Id.* (quoting *Japan Line Ltd. v. County of Los Angeles*, 441 U.S. 434, 447 (1979)).

<sup>118</sup> *Id.* at 189.

<sup>119</sup> The Court summarily dismissed the alternative of California not taxing the income of the foreign company at all, which was the result in *Japan Line Ltd. v. County of Los Angeles*, 441 U.S. 434 (1979).

<sup>120</sup> *Id.* at 196.

<sup>121</sup> *Id.*

<sup>122</sup> *Id.* at 195.

<sup>123</sup> *Id.*

<sup>124</sup> *Id.*

<sup>125</sup> *Id.*

policy was being seriously threatened.<sup>126</sup>

C. *Foreign Parent Corporations with Domestic Subsidiaries*

A case involving a foreign parent with domestic subsidiaries is constitutionally distinguishable from *Container Corp.* for several reasons. First, although the legal incidence of the tax still technically falls on a domestic corporation, it is the foreign parent corporation that incurs the economic consequences. Besides the fact that it is that company's income that is subjected to double taxation, the parent corporation will effectively be responsible for the tax as a parent company. Thus, the Court's reliance on the local nature of the concern in *Container Corp.* is inapplicable in this context. In light of its holding in *Alcan Aluminium* that the parent corporation and subsidiary corporation are in reality one entity with respect to an available remedy in state court, the Supreme Court could hardly hold that they are two separate entities for this purpose.

Second, unitary taxation as applied to foreign parent corporations with domestic subsidiaries interferes with the federal government's ability to "speak with one voice when regulating commercial relations with foreign governments."<sup>127</sup> In *Container Corp.*, the Court divided the "one voice" standard into two parts. The tax is unconstitutional if it: (1) "implicates foreign policy issues which must be left to the Federal Government;" or (2) "violates a clear federal directive."<sup>128</sup> The threatened retaliation of U.S. trading partners clearly implicates foreign policy.<sup>129</sup> The discontent of foreign trading partners has been expressed through letters from foreign nations to the Treasury and State Departments, actual and threatened reduction of investment in unitary states, and preliminary retaliatory legislation passed by one of the strongest allies of the United States.<sup>130</sup> Also, sixteen countries and the Justice Department<sup>131</sup> filed amicus briefs in *Alcan Aluminium* opposing the unitary tax method in California.<sup>132</sup> Amici from foreign countries emphasized that the tax is contrary to established principles of international taxation and a major impediment to investment in the United States.<sup>133</sup>

Finally, President Reagan's initiative in December 1985 promoting federal legislation which would prohibit worldwide unitary apportionment clearly demonstrates the executive branch's position on

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<sup>126</sup> *Id.*

<sup>127</sup> *Michelin Tire Corp. v. Wages*, 423 U.S. 276 (1976).

<sup>128</sup> *Container Corp.*, 463 U.S. at 194.

<sup>129</sup> *Id.*

<sup>130</sup> See *supra* notes 17-20 and accompanying text.

<sup>131</sup> See *Justice Takes Unusual Step By Filing Amicus Curiae Brief in California Unitary Tax Case*, 161 J. ACCT. 18 (1986).

<sup>132</sup> See Uhlfelder, *Sixteen Countries File Amicus Briefs Against Unitary Method; California Unitary Legislation Introduced*, 30 TAX NOTES 498 (Feb. 10, 1986).

<sup>133</sup> *Id.*

the issue.<sup>134</sup> Although the Commerce Clause states that "Congress shall have the power," it is understood that the executive branch shares control with Congress over foreign affairs.<sup>135</sup> Justice Powell in his dissent in *Container Corp.* questioned the majority's finding that the executive branch had not expressed a desire for a uniform policy when the Solicitor General had filed an amicus brief opposing a unitary formula in a case pending before the Supreme Court at the same time as *Container Corp.*<sup>136</sup>

Furthermore, although the analysis under the first prong of the test announced in *Japan Line* would be the same in the foreign parent case as in *Container Corp.*, the Court's reasoning behind its holding that California's unitary method satisfied this prong is questionable. The Court found that there was no substantial risk of multiple taxation because both methods could result in double taxation. The Court discounted the reality of double taxation resulting from the inherent inconsistency of unitary apportionment with international practices even though in *Japan Line* it had recognized the significance of the custom of nations in striking down California's ad valorem property tax.<sup>137</sup> As Justice Powell pointed out in his dissent, there is an inherent risk of multiple taxation in this context because formula apportionment is fundamentally different from the separate accounting or arm's length method used in many foreign jurisdictions.<sup>138</sup> Admittedly, as Justice Powell argues, there is a risk of multiple taxation due to differences in application even if California conformed to international practices.<sup>139</sup> However, the risk stems from the difference in application and not the inherent difference between the unitary method and the arm's length approach which can only be eliminated by changing the system itself.<sup>140</sup> Moreover, the Court ignored previous cases where it had stated that the validity of apportionment taxation lies in "[the court's] ability to enforce full apportionment by all potential taxing bodies."<sup>141</sup> The United States does not have the authority to ensure that foreign income is subjected to only one tax on its full value by foreign tax authorities.

#### D. California Lower Court Decisions

Currently, there are two cases proceeding through California state courts in which worldwide unitary apportionment has been de-

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<sup>134</sup> See *supra* notes 26-30 and accompanying text.

<sup>135</sup> See *Container Corp.*, 463 U.S. at 196.

<sup>136</sup> *Container Corp.*, 463 U.S. at 197 (Powell, J., dissenting).

<sup>137</sup> *Japan Line*, 441 U.S. at 453.

<sup>138</sup> *Container Corp.*, 463 U.S. at 198-99 (Powell, J., dissenting).

<sup>139</sup> *Id.* at 201 (Powell, J., dissenting).

<sup>140</sup> See Allen, *The Container Corp. Case: The Unitary Tax in the United States and as Perceived by the International Community*, 18 INT'L LAW. 127, 140 (1984).

<sup>141</sup> *Japan Line*, 441 U.S. at 447-48. Full apportionment ensures that no more than 100% of a corporation's income is apportioned and taxed.

clared unconstitutional. In *Barclays Bank International v. Franchise Tax Board*,<sup>142</sup> the California Court of Appeals affirmed the superior court's holding that California's income apportionment method violates the Foreign Commerce Clause when applied to the domestic operations of foreign based corporations. The court distinguished *Container Corp.* on the ground that it involved a domestic parent corporation with foreign subsidiaries.<sup>143</sup>

In another case, *Colgate-Palmolive Co. v. Franchise Tax Board*,<sup>144</sup> a California superior court held the worldwide method unconstitutional because it "impermissibly interfere[s] with the federal government's power to conduct foreign affairs."<sup>145</sup> The court found it highly significant that there was a showing of an express policy of the executive branch—evidenced by press releases and letters—that the worldwide unitary apportionment method should be limited.<sup>146</sup> It is interesting to note that the plaintiff in *Colgate-Palmolive* was a domestic corporation with foreign subsidiaries similar to *Container Corp.* The court distinguished *Container Corp.* by the clear and express policy the executive branch has since promulgated in condemning the worldwide unitary apportionment as detrimental to U.S. foreign policy.<sup>147</sup>

It does not appear that the Supreme Court would be able to uphold the decision in *Colgate-Palmolive* without overruling *Container Corp.* In *Container Corp.*, the Court relied heavily on the reasoning that the tax fell on a domestic entity and was therefore more of a local than international concern.<sup>148</sup> This is also true in *Colgate-Palmolive*.

Unlike *Colgate-Palmolive*, *Barclays* is an excellent opportunity for the Supreme Court to declare worldwide unitary apportionment unconstitutional in the foreign parent context.<sup>149</sup> The superior court in *Barclays* held that California's unitary method violated both the Due Process and Foreign Commerce Clauses.<sup>150</sup> The court did not expressly address the four prong Commerce Clause test under *Complete Auto Transit*, although as explained below the court effectively held

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<sup>142</sup> *Barclays Bank Int'l v. Franchise Tax Bd.*, 225 Cal. App. 3d 1342, 275 Cal. Rptr. 626 (1990).

<sup>143</sup> See *Unitary Method*, 35 TAX NOTES 1320 (1987).

<sup>144</sup> *Colgate-Palmolive*, No. 319715 (Cal. Super. Ct. Dec. 12, 1988).

<sup>145</sup> Hilker & Karalewitz, *Colgate-Palmolive: The Beginning of the End?*, 8 J. ST. TAX'N 89 (1989).

<sup>146</sup> See Newpol, *California Worldwide Reporting Stopped at Water's Edge*, 8 J. ST. TAX'N 92 (1989).

<sup>147</sup> Hilker & Karalewitz, *supra* note 145, at 91.

<sup>148</sup> *Container Corp.*, 463 U.S. at 196.

<sup>149</sup> *Barclays* does not face the procedural obstacles that other cases have faced in the past. See Note, *Foreign Multinationals and the Commerce Clause: Should the States Mind Their Own Business*, 41 TAX LAW. 785-801 (1988).

<sup>150</sup> *Barclays Bank Int'l*, No. 325059 (Cal. Super. Ct. June 16, 1987), reprinted in 1987 Cal. Tax Rep. (CCH) 24,917, 24,927-28, 24,929-30.

that it was not satisfied. Instead, the court first analyzed the additional conditions required under *Japan Line*.<sup>151</sup>

The court held that *Container Corp.* mandated the result under the first prong of the *Japan Line* test, which prohibits a "substantial risk of international multiple taxation."<sup>152</sup> Although there was actual double taxation in this case, the same arguments available here addressing multiple taxation were heard and rejected in *Container Corp.*<sup>153</sup> Thus, the method met the first requirement of the *Japan Line* test.<sup>154</sup>

The method failed, however, to pass the second part of *Japan Line*. The court found that the method implicated foreign policy in an area which required federal uniformity within the meaning of *Container Corp.*<sup>155</sup> The court recognized that the custom of nations was the arm's length method and concluded that, because California's method differed from the international practice, it necessarily implicated foreign policy.<sup>156</sup> The court found that the international community perceived the unitary method as an "arbitrary, unfair, and predatory measure of income taxation."<sup>157</sup> The court further stated that it was irrelevant whether the perception was justified or that the unitary method might actually be a more accurate measure than arm's length.<sup>158</sup> The court reasoned that if the international community holds this perception then the states are impermissibly conducting foreign affairs.<sup>159</sup> The court then created a presumption that when a foreign corporation's income is included in the income base for figuring formula apportionment then the corporation's domicile country will be offended, which thereby implicates foreign policy.<sup>160</sup> The court relied heavily on the fact that the tax impact falls on a foreign rather than domestic parent.<sup>161</sup>

On appeal, the California Court of Appeals affirmed the superior court's holding that the formula violated the Foreign Commerce Clause but declined to address the due process challenge.<sup>162</sup> The appeals court found that the worldwide combined reporting method failed to satisfy the second prong of the *Japan Line* test when applied to foreign parent corporations with foreign and domestic subsidiar-

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<sup>151</sup> *Id.* at 24,924-28.

<sup>152</sup> *Id.* at 24,928.

<sup>153</sup> *Id.*

<sup>154</sup> *Id.*

<sup>155</sup> *Id.* at 24,926-27.

<sup>156</sup> *Id.* at 24,927.

<sup>157</sup> *Id.* at 24,926.

<sup>158</sup> *Id.*

<sup>159</sup> *Id.*

<sup>160</sup> *Id.* at 24,928.

<sup>161</sup> *Id.* at 24,926.

<sup>162</sup> *Barclays Bank Int'l v. Franchise Tax Bd.*, 225 Cal. App. 3d 1342, 275 Cal. Rptr. 626, 646 (1990).

ies.<sup>163</sup> Although the application of the formula did not inevitably result in double taxation, it did implicate foreign policy issues as well as violate a clear federal directive.<sup>164</sup>

The court found the incessant protest letters from foreign nations and Great Britain's retaliatory legislation to be strong evidence of foreign policy implications.<sup>165</sup> In addition, the court found the three general factors present that the Supreme Court identified in *Container Corp.* as possibly leading to significant foreign retaliation.<sup>166</sup> First, the unitary method resulted in automatic asymmetry because no other country in the world employed this method.<sup>167</sup> Second, the court heavily relied on the fact that the legal incidence of the tax fell on a foreign rather than domestic corporation.<sup>168</sup> Third, the court found the tax burden was more a function of California's allocation method than its tax rate.<sup>169</sup> The court relied on the greater administrative burdens imposed on a foreign based corporation as evidence of foreign policy implications, but refused to hold that the increased compliance costs alone were sufficient to invalidate the method.<sup>170</sup>

The court also found that the worldwide combined reporting method violated a clear federal directive.<sup>171</sup> In finding the federal directive, the court relied on evidence showing that the executive branch has opposed the method for four administrations, the testimony of a senior career official at the Treasury Department, President Reagan's initiative in urging federal legislation, and Secretary of State Shultz's letter to the governor of California urging him to end California's use of the worldwide method.<sup>172</sup>

The court rejected the Franchise Tax Board's argument that the federal government had indicated its acquiescence in the states' using the worldwide combined reporting method through its treatment of the issue in treaty negotiations.<sup>173</sup> Specifically, the Board argued that the following five factors demonstrated an affirmative federal policy which therefore rendered a dormant commerce clause analysis unnecessary: "(1) the failure to consider state taxes in United States income tax treaties with foreign countries, except in nondiscrimination clauses; (2) the actions by the executive branch in adopting a Model Income Tax Treaty and in reserving its position on the Organization of Economic Cooperation and Development (OECD)

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<sup>163</sup> *Barclays Bank*, 275 Cal. Rptr. at 637.

<sup>164</sup> *Id.*

<sup>165</sup> *Id.* at 638.

<sup>166</sup> *Id.* at 638-41.

<sup>167</sup> *Id.* at 638.

<sup>168</sup> *Id.* at 639.

<sup>169</sup> *Id.*

<sup>170</sup> *Id.* at 640.

<sup>171</sup> *Id.* at 641-42.

<sup>172</sup> *Id.*

<sup>173</sup> *Id.* at 634-37.

Model Convention's application to subnational taxes; (3) Friendship, Commerce, and Navigation (FCN) Treaties to which the United States is a party do not require the states to use any particular method of tax accounting; (4) the absence of enacted congressional legislation prohibiting or restricting the states' use of [worldwide combined reporting]; and (5) the rejection by the United States Senate of article 9(4) in the United States-United Kingdom Tax Treaty, the only attempt by the executive branch to alter federal acquiescence in the states' use of [worldwide combined reporting]."<sup>174</sup>

The court reasoned that the treaties the Board relied on in factors (1) through (3) predated the application of worldwide combined reporting to foreign corporations and thus their failure to prohibit its application provided little support for federal acquiescence.<sup>175</sup> In response to the absence of federal legislation prohibiting worldwide combined reporting, the court refused to engage in "pure speculation" to determine the reason for congressional inaction.<sup>176</sup>

With respect to the fifth factor, the court explained that the executive branch had negotiated a tax treaty with the United Kingdom which included a provision that prohibited the states from using worldwide combined reporting.<sup>177</sup> The treaty was not ratified by the Senate, however, until that provision was removed. The Board argued that the Senate's refusal to ratify the treaty with the restriction indicated congressional approval. The court, however, refused to attribute the Senate's action to approval of states' using the worldwide combined reporting method.<sup>178</sup>

Neither the appeals court nor the superior court in *Barclays* had to go as far as they did to find California's unitary method unconstitutional. Rather, the method should be held unconstitutional because it discriminates against foreign commerce in violation of the four part test set forth in *Complete Auto Transit*. The superior court in *Barclays* did not expressly state that the method failed to satisfy the standard Commerce Clause test in *Complete Auto Transit*, although that is the effect of its holding.

California's method is unconstitutional because it discriminates between domestic and foreign based corporations. In California, the income from a foreign parent's foreign subsidiaries as well as the foreign parent itself is required to be included in figuring the base from which taxable income is calculated. The problem arises because foreign corporations maintain their records according to the appropriate accounting principles in their domicile countries which

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<sup>174</sup> *Id.* at 634.

<sup>175</sup> *Id.* at 634-35.

<sup>176</sup> *Id.* at 636.

<sup>177</sup> *Id.*

<sup>178</sup> *Id.* at 636-37.

are often not in accord with U.S. principles.<sup>179</sup> The information necessary to take advantage of tax reporting benefits under California's unitary method is not readily available to foreign parents and is extremely expensive to obtain.<sup>180</sup> Furthermore, for comparability purposes foreign corporations must translate their records from foreign currency into U.S. dollars.<sup>181</sup> This can be very complex and often requires "extensive effort."<sup>182</sup> The Franchise Tax Board admitted that literal compliance with California's worldwide unitary method was financially prohibitive for most foreign parents.<sup>183</sup> The appeals court noted that it would cost millions of dollars for Barclays to establish and maintain the information necessary to comply with California's unitary tax method.<sup>184</sup> The estimates ranged from \$6.4 million to \$7.7 million to establish a system and \$2 million to \$3.8 million to maintain it.<sup>185</sup> This amounts to economic protectionism because California is affording benefits to other corporations that foreign parents cannot take advantage of because of the costs associated with the information requirements. The federal government can employ economic protectionism policies against foreign countries; the individual states cannot.<sup>186</sup>

Impermissible discrimination is a stronger reason for finding the unitary method violative of the Foreign Commerce Clause. When a state's taxing scheme has the effect of disadvantaging foreign corporations to the advantage of domestic corporations, it is unconstitutional.<sup>187</sup> The purpose of the Commerce Clause is to ensure that the United States conducts its foreign affairs as one nation and not as fifty separate entities.<sup>188</sup> Just as one state could not directly impose an embargo or tariff on a foreign country, it cannot do so indirectly

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<sup>179</sup> See *Barclay's Bank*, 1987 Cal. Tax Rep. (CCH) at 24,928. See also *Comptroller General Report, Key Issues Affecting State Taxation of Multijurisdictional Corporate Income Need Resolving* 38, 40 (1982) [hereinafter 1982 GAO Report].

<sup>180</sup> 1982 GAO Report, *supra* note 179, at 37-40.

<sup>181</sup> *Id.* at 39-40.

<sup>182</sup> *Id.*

<sup>183</sup> *Barclay's Bank*, 275 Cal. Rptr. at 639.

<sup>184</sup> *Id.* at 640.

<sup>185</sup> *Id.*

<sup>186</sup> See *South-Central Timber Dev. v. Wunnicke*, 467 U.S. 82, 99-101 (1984) (foreign commerce burdened by embargo on export of unprocessed timber cut from state forests). See also *Board of Trustees of Univ. of Illinois v. United States*, 289 U.S. 48, 59 (1933) ("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.").

<sup>187</sup> See *Wardair Canada, Inc. v. Florida Dep't of Revenue*, 447 U.S. 1, 8 (1986) where the Court stated:

As in the context of cases alleging violations of the dormant interstate Commerce Clause, the concern in these Foreign Commerce Clause cases is not with an actual conflict between state and federal law, but rather with the policy of uniformity, embodied in the Commerce Clause, which presumptively prevails when the Federal Government has remained silent.

<sup>188</sup> See *id.*



through income taxation.<sup>189</sup>

The appeals court refused to hold that the compliance costs alone were sufficient to invalidate the worldwide combined reporting method as unconstitutionally discriminatory.<sup>190</sup> The court cited *Bibb v. Navajo Freight Lines*<sup>191</sup> for the proposition that cost alone is not enough to impermissibly burden interstate commerce. Apparently, the appeals court was persuaded that the statement that “[c]ost taken into consideration with other factors might be relevant in some cases to the issue of burden on commerce” indicated that cost is only sometimes relevant and in no case determinative.<sup>192</sup> Yet, in *Bibb*, the Supreme Court rejected appellants’ contention that no burden on interstate commerce is sufficient to invalidate local safety regulations absent some element of discrimination.<sup>193</sup> Furthermore, the Supreme Court drew a distinction between measures that place an unconstitutional burden on interstate commerce and measures which are unconstitutionally discriminatory.<sup>194</sup> The Supreme Court found that the costs of the Illinois safety statute requiring a specified type of rear fender mudguard placed an impermissible burden on interstate commerce even though the statute was nondiscriminatory. The statute applied to any motor vehicle of the second division.<sup>195</sup> It did not distinguish between out of state trucks and in state trucks. “This is one of those cases - few in number - where local safety measures that are nondiscriminatory place an unconstitutional burden on interstate commerce.”<sup>196</sup> Implicit in that statement is the notion that discriminatory safety measures are unconstitutional.

The discriminatory nature of the increased compliance costs for foreign based corporations distinguishes *Barclays* from *Bibb*. The unconstitutional element is not just the burden itself but the discriminatory nature of the burden. In *Hunt v. Washington Apple Advertising Commission*,<sup>197</sup> the Supreme Court held violative of the Commerce Clause a North Carolina statute requiring that all apples sold or shipped into North Carolina in closed containers be identified only by the applicable federal grade or the designation that the apples are

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<sup>189</sup> See *Halliburton Oil Well Co. v. Reily*, 373 U.S. 64, 70 (1963) (“Equality for the purposes of competition and the flow of commerce is measured in dollars and cents, not legal abstractions.”). See also *Boston Stock Exchange v. State Tax Comm’n*, 429 U.S. 318 (1977) (New York transfer tax on out-of-state securities transactions held to discriminate against interstate commerce in violation of the Commerce Clause). “No State, consistent with the Commerce Clause, may impose a tax which discriminates against interstate commerce . . . by providing a direct commercial advantage to local business.” *Id.* at 329.

<sup>190</sup> *Barclays Bank*, 275 Cal. Rptr. at 640.

<sup>191</sup> 359 U.S. 520 (1959).

<sup>192</sup> *Id.* at 526.

<sup>193</sup> *Id.* at 529.

<sup>194</sup> *Id.*

<sup>195</sup> *Id.* at 521 n.1.

<sup>196</sup> *Id.*

<sup>197</sup> 432 U.S. 333 (1977).

not graded. The Court found the statute impermissibly discriminated against Washington apple growers and dealers by increasing their costs of doing business in North Carolina while North Carolina growers and dealers remained unaffected.<sup>198</sup> Similarly, California's worldwide combined reporting method discriminates against foreign based corporations by increasing their compliance costs while leaving domestic based corporations unaffected.

In addition, striking down California's method as unconstitutionally discriminatory eliminates the need to evaluate what the possibility of foreign retaliation is and whether the Congress or executive branch has an implicit or explicit policy addressing the issue. In its decision, the *Barclay's* court appeared to rely heavily on the fact that the executive branch had disfavored the worldwide unitary method for four administrations in finding that the issue implicated foreign policy.<sup>199</sup> This analysis would not hold up if the next President suddenly favored the unitary method.

Moreover, the court in *Barclay's* attempted to perform a balancing which the Supreme Court has recognized as being inappropriate for the courts: weighing the possibility of foreign retaliation against a state's sovereignty interest.<sup>200</sup> The court heavily relied on evidence that there had been actual threats of foreign retaliation in concluding that there was a need for federal uniformity which outweighed the state's typically weighty sovereignty interest in areas of state taxation.<sup>201</sup> The court rejected the argument that much of the controversy surrounding the unitary tax had been contrived by the domicile country of the foreign parent corporation in this case (Great Britain) to create an apparent need for federal uniformity.

If the court had instead based its decision solely on the discriminatory nature of the method, it would not have to reach the question of whether the threatened retaliation was genuine or contrived.

## VI. Conclusion

Although the Supreme Court's interpretation of the Tax Injunction Act appears quite broad, it seems justified when considered in light of the federal policy not to interfere in state tax matters. Yet, the *Alcan Aluminium* decision does prevent foreign corporations from asserting a claim involving a state tax matter in which they are not technically the actual taxpayers and arguably creates another impediment to foreign investment in the United States. Foreign parent corporations will not want to invest in the United States via a subsidiary

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<sup>198</sup> *Id.* at 351.

<sup>199</sup> *Barclays Bank Int'l*, No. 325059 (Cal. Super. Ct. June 16, 1987), reprinted in 1987 Cal. Tax Rep. (CCH) 24,931, 24,925.

<sup>200</sup> *Id.* at 24,928. See also *Container Corp. v. Franchise Tax Bd.*, 463 U.S. 159, 194 (1983).

<sup>201</sup> *Barclays Bank Int'l*, 1987 Cal. Tax Rep. (CCH) at 24,926.

knowing they can only contest what is in essence a direct economic injury indirectly through their subsidiaries in a potentially biased state forum.

California's unitary tax frustrates the current United States philosophy of globalizing its capital markets and encouraging direct foreign investment. A foreign corporation may perceive its investment alternatives as mutually exclusive: either do business in California or not do business in the United States. If a foreign corporation knows that it will be financially prohibited from purchasing or creating a subsidiary company and participating in California's lucrative market because of the state unitary tax, it may become economically infeasible for the corporation to invest in the United States at all.

The worldwide unitary apportionment method should be declared unconstitutional because it violates the Foreign Commerce Clause. Although the issue was not squarely before the Court in *Alcan Aluminium*, it no doubt lies on its future agenda. It is hoped that the Supreme Court will seize the opportunity to settle this hotly contested legal, political, and economic issue.

RHONDA KAY SCHNARE

