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International and Interstate Approaches to Taxing Business Income

*David M. Hudson**
*Daniel C. Turner***

I. Introduction

Arriving at a reasonable, fair approach to the taxation of enterprises which are engaged in income producing activities in more than one jurisdiction has been a vexatious problem for the past century, both internationally and within the United States. The taxing entities are concerned about receiving their due from enterprises which enjoy the benefits of carrying on various activities within their borders; the enterprises are concerned about more than one jurisdiction taxing the enterprise's same tax base, whether it be property or net income. In the international setting, the pattern which has evolved for addressing the concerns of both sides is the ratification of treaties between two countries[1] to deal with these issues. The common approach is to treat an enterprise's business income earning activities within a particular country as if they were the activities of a separate enterprise, even though such activities actually may have been conducted by a mere branch of a foreign based enterprise.[2]

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[1] In the international context, it is customary to refer to sovereign nations as "states." *See, e.g.*, I. BROWNLIE, PRINCIPLES OF PUBLIC INTERNATIONAL LAW 73 (3d ed. 1979). Because this article discusses both nations and the states of the United States, however, to avoid confusion the term "states" will be used exclusively to refer to the members of the union of the United States of America.

[2] For a discussion of the separate entity approach, see *infra* notes 70-113 and accompanying text.

In the United States, the various states initially applied their respective taxes on, or measured their taxes by, corporate net income in the same manner as countries did, by utilizing the separate entity approach. In the 1920s, however, many states began to employ a different approach—formulary apportionment. States applied formulary apportionment to determine the tax base of a multijurisdictional enterprise engaged in a unitary business.[3] The approach proceeds from an economic, rather than geographic, perspective. It involves the notion that the overall net income (or loss) of a multijurisdictional enterprise is attributable, in part, to all of its property and activities, wherever they may be located. Therefore, states determined the net income tax base for a particular state by multiplying the overall net income by a fraction, the numerator being the quantity of income producing property and activities within that state, and the denominator being the total quantity of income producing property and activities.

Ideally, a system of fairly distributed tax burdens would have all taxing jurisdictions use a uniform approach to determine their fair share of a multijurisdictional enterprise's tax base. In the international setting, the League of Nations quickly dropped early proposals for a multilateral tax treaty addressing the problem of double taxation in favor of a series of bilateral treaties with the same objective. Differences in tax systems, languages, currencies and accounting principles did not lend themselves to multilateral treatment, but were best dealt with between two countries at a time in a bilateral treaty. The League of Nations, and, later the Organization for Economic Cooperation and Development proposed model treaties in an attempt to achieve uniformity, but deviations from the models always crept into the terms of each new bilateral treaty. Nonetheless, the ideal is a uniform, world-wide approach, agreed to by all countries in a multilateral treaty.

In the United States, many states have sought the objective of uniformity by enacting the Uniform Division of Income for Tax Purposes Act (UDITPA). In addition, many of those same states have entered into the Multistate Tax Compact (MTC). The salutary objective of both the UDITPA and the MTC is to provide uniform rules for the allocation and apportionment of income, in order to facilitate both compliance and enforcement, as well as to reduce the likelihood of double taxation. The promised uniformity, however, has been at the same time both illusive and elusive. Experience with the UDITPA and the MTC in the United States has demonstrated that a multilateral treaty would not achieve uniformity amongst the numerous sovereign countries of the world, primar-

[3] For a discussion of the unitary business concept see *infra* notes 267-76.

ily because there is no paramount supervisory body in the international arena. At the same time, uniformity could be achieved within the United States by pre-emptive federal legislation uniformly interpreted and applied to all of the states. The uniform application of an apportionment formula to distribute the tax base of a multijurisdictional unitary enterprise would avoid many of the problems of the separate entity approach, producing a fair, equitable determination of the tax base for state income taxes.

Part II of this article will examine the treatment of business income of multinational enterprises under tax treaties, and Part III discusses the determination of the tax base of such enterprises. Part IV examines the evolution of the law pertaining to state imposed taxes on, or measured by, the net business income of multistate unitary enterprises, the issues of jurisdiction and the determination of the tax base. Part V addresses various attempts to achieve uniformity in state taxation. Part VI suggests that in the international setting, the goal of uniformity is unlikely to be achieved by a multilateral treaty, but that within the United States, preemptive federal legislation should be enacted.

II. Jurisdiction To Tax Business Income Under Tax Treaties

The first bilateral tax treaty directed towards preventing double taxation was signed in Berlin on June 21, 1899, by representatives of Austria-Hungary and Prussia.[4] Although the United States did not become a party to a double taxation treaty until 1932,[5] the intervening three decades saw much activity in the field of international tax law.[6] Bilateral tax conventions became commonplace among the European countries.[7]

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[4] Treaty for the Prevention of Double Taxation, June 21, 1899, Austria-Hungary Prussia, 29 Martens Nouveau Recueil 407 (2d Ser.). Earlier treaties dealt with taxation, for example, the 1843 agreement between France and Belgium, which authorized the exchange of information to aid in the effective collection of taxes, is considered by some to be the first international tax agreement, but it was not concerned with double taxation. E. Seligman, Double Taxation and International Fiscal Cooperation 52-53 (1928).

[5] Convention concerning Double Taxation and protocol, April 27, 1932, United States-France, 49 Stat. 3145. T.S. No. 885.

[6] Actually, it was not until after World War I that treaty activity accelerated. Prior to that time, low tax rates and stable international commerce provided little impetus for concluding general income tax treaties. A. Ehrenzweig & F. Koch, Income Tax Treaties 6-7 (1949).

[7] *See* Carroll, *International Tax Law: Benefits for American Investors and Enterprises Abroad*, Part I, 2 Int'l Law. 692-93 (1968); Wang, *International Double Taxation of Income: Relief Through International Agreement*, 1921-1945, 59 Harv. L. Rev. 73, 102-07 (1945). In addition to bilateral conventions, a multilateral agreement was signed in 1922. Convention for the Purpose of Avoiding Double Taxation between Austria, Hungary, Italy, Poland, Rumania and the Kingdom of the Serbs, Croats and Slovenes, April 6, 1922, League of Nations, Doc. C.345 M.102 1928, II, at 73 (1928).

The League of Nations, with the cooperation of the International Chamber of Commerce,[8] followed a recommendation of the 1920 International Financial Conference[9] to undertake a study of the problems of international double taxation from an administrative and practical perspective.[10] The Financial Committee of the League of Nations designated a group of Technical Experts[11] to perform the study, and they presented their final report, including what was to be the first model bilateral treaty, to the Financial Committee in April of 1927.[12]

Because double taxation is a consequence of overlapping assertions of tax jurisdiction,[13] the solution to the problem lies in unravelling those competing jurisdictional claims, and delineating the circumstances under which one country or the other may impose its taxes. The two natural competing jurisdictional claimants are the country in which the taxpayer resides (country of residence)[14] and the country in which the income is derived (country of source). Although many factors are involved in negotiating the dividing lines, the problem may be viewed either with an eye on the type or nature of the tax to be levied, or on the item of income in question.

The first model bilateral tax treaty produced under the auspices of the League of Nations, in 1927, approached the problem by first considering the nature of the tax to be imposed.[15] The model convention di-

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8 Double Taxation and Tax Evasion, League of Nations Doc. C.115 M.55 1925 II (F.212), at 7-8 (1925).

9 Report presented by the Comm. of Technical Experts on Double Taxation and Tax Evasion, League of Nations, Doc. C.216 M.85 1927 II, at 5 (1927) [hereinafter cited as Report I].

10 A theoretical study of double taxation was undertaken by four economists at the direction of the Financial Committee of the League of Nations in 1923. Report on Double Taxation, League of Nations Doc. E.F.S. 73 F.19 (1923). For a thorough analysis by one of the economists who participated in that study, see E. SELIGMAN, *supra* note 4.

11 The experts were representatives appointed from Belgium, Czechoslovakia, France, Great Britain, Italy, the Netherlands and Switzerland. They were all high officials of the fiscal administrations of the respective countries, but were designated "technical experts" to make clear that they were not official government representatives, and thus were not constrained from expressing views contrary to their country's official policies. Double Taxation and Tax Evasion, L.N. Doc. C.115 M.55 1925 II (F.212) at 3, 6. Significantly, most of the members came from capital-importing or debtor countries, and the United States was not represented. E. SELIGMAN, *supra* note 4, at 141-42.

12 Report I, *supra* note 9. A preliminary report was submitted in 1925; see Double Taxation and Tax Evasion, *supra* note 8.

13 "*International Double Taxation* arises where various sovereign countries exercise their sovereign power to subject the same person to taxes of a substantially similar character on the same object." F. KOCH, THE DOUBLE TAXATION CONVENTIONS 3 (1947).

14 The "country of residence" is the modern concept. *See, e.g.*, Treasury Department's Model Income Tax Treaty of June 16, 1981, art. 4, 1 TAX TREATIES (CCH) ¶ 158. The early work of the League of Nations used the term "fiscal domicile," the place where an individual had his permanent home. *See, e.g.*, Double Taxation and Tax Evasion, *supra* note 8, at 20-21.

15 The Technical Experts who participated generally followed the report of the economists, but

vided direct taxes into two categories, impersonal or schedular taxes (*impôts réels*),[16] and personal or general taxes (*impôt personnel*).[17] The model convention did not attempt to define further the two categories of taxes, leaving to the contracting countries the determination of which of their taxes would fall into either category.[18] As general rules, however, impersonal taxes could be imposed by the country of source,[19] and personal taxes by the country of residence.[20]

Countries impose impersonal or schedular taxes (imôts réels), on income arising from specific sources, regardless of the nationality, residence, domicile, or other personal circumstances of the taxpayer; *impôts réels* are not imposed on the income of persons as such.[21] Because of the nature of *impôts réels*, the 1927 model treaty resolved double taxation principally by designating the source from which various items of income were derived. Under this regime, a country could tax income from immovable property where the property was situated;[22] a country in which the debtor resided could tax the debtor's interest income;[23] and the country where the "real centre of management" of a dividend-paying corporation was situated could tax the corporation's dividend income.[24] The country where the taxpayer maintained a "permanent establishment" could tax the taxpayers business profits.[25] This provision reflected an evolved acceptance of restricting a country's taxing jurisdiction until a

because of differing political backgrounds and lack of sophistication with the distinctions drawn by the economists, there were some differences. E. SELIGMAN, *supra* note 4, at 143-65.

16 Draft of a Bilateral Convention for the Prevention of Double Taxation, arts. 2-9 [hereinafter cited as Bilateral Convention], *reprinted in* Report I, *supra* note 9, at 10-11.

17 *Id.* arts. 10, 11-12. For a discussion of the classification of taxes, see E. SELIGMAN, *supra* note 4, at 58-87.

18 Report I, *supra* note 9, at 13.

19 Bilateral Convention, *supra* note 16, art. 2, at 10.

20 *Id.* art. 10, at 11.

21 The concept of *impôts réels* is difficult to understand for someone familiar with United States tax law because, like the United Kingdom's system, the United States tax system is based on the personal or general income tax, and *impôts réels* has no precise equivalent in the English language. Confusion may also arise for those familiar with the British "schedular" taxes. However, those schedules are only divisions for classifying income in computing the tax base; the British tax is a general or personal tax, not an *impôts réels*. Double Taxation and Tax Evasion, *supra* note 8, at 15; E. SELIGMAN, *supra* note 4, at 58-87.

22 Bilateral Convention, *supra* note 16, art. 2, at 10.

23 The general rule was modified "if such income [was] paid in one of the Contracting States to persons domiciled in the other Contracting State, the tax applicable thereto [was to be] refunded upon production of proper evidence. In such case the said income [could] be taxed in the State of domicile of the creditor." *Id.* art. 3, at 10.

24 *Id.* art. 4.

25 *Id.* art. 5, at 10-11. The term "business profits" is used in the text as a short-hand reference to the phrase in the treaty, "[i]ncome from any industrial, commercial, or agricultural undertaking and from any other trades or professions." *Id.*

significant level of taxpayer activity took place within the country. It was burdensome to transnational business if a nonresident incurred tax liability merely by selling its products in a country through an independent agent, or simply by sending salesmen into the country to solicit orders for acceptance or rejection by the head office. Instead, it became commonly accepted for countries to tax a nonresident's business profits only if the nonresident maintained some significant physical presence within the country as a fixed place of business.[26] The 1927 draft convention designated "real centres of management, affiliated companies, branches, factories, agencies, warehouses, offices, [and] depots" as permanent establishments, while not regarding activities of an independent agent such as a broker or commission agent as a permanent establishment of the nonresident.[27]

The 1927 model convention avoided double taxation of business income of a transnational enterprise by providing that if an enterprise maintained a permanent establishment in each of two treaty partner countries, "each of the two [should] tax the portion of the income produced in its territory."[28] Countries would determine the amount of income produced by each permanent establishment by reference to the enterprise's books and records, but "[i]n the absence of accounts showing [such] income separately and in proper form," designated authorities of the two countries were to confer and "come to an arrangement as to the rules for apportionment."[29] The convention itself contained no further guidance for the apportionment of business profits. The "Commentary" provided by the drafters simply noted that "[the] rules [would] vary essentially according to the undertakings concerned," and indicated that important factors for consideration might include "the amount of capital involved, . . . the number of workers, the wages paid, [and] receipts."[30]

The 1927 convention also addressed double taxation pertaining to personal taxes (*impôt personnel*). If an entity became subject to tax on its entire income by two countries, because it maintained a fiscal domicile in each, "the personal tax [was to] be imposed in each . . . in proportion to the period of stay during the fiscal year."[31] In addition, certain items of income might be taxed twice because of overlap between the personal tax imposed by the country of residence, and an impersonal tax imposed by

[26] For a discussion of the evolution of the "permanent establishment" concept, see Carroll, *supra* note 7, at 699-701.

[27] Bilateral Convention, *supra* note 16, art. 5.

[28] *Id.*

[29] *Id.*

[30] *Id.* Commentary to art. 5, at 15.

[31] *Id.* art. 11, at 12.

the country of source. If the country of residence did not levy impersonal taxes on its residents, then the country of residence would allow a tax credit[32] against the personal tax for impersonal taxes paid to the country of source. The Convention limited the amount of the credit to the lesser of the personal tax due to the country of residence, computed exclusively on items of income which the source country taxed or the tax paid to the country of source.[33]

In 1928, a conference of government experts took place in Geneva to discuss the 1927 draft convention.[34] The experts affirmed the general concepts of the 1927 draft, but the experts acknowledged that the draft was unsuited to the tax systems of some countries,[35] because the 1927 draft was designed primarily for countries imposing both personal and impersonal taxes.[36] In response, the conference of government experts proposed three model conventions for approval. The first, Draft No. I*a*, was essentially the same as the 1927 draft, since it retained the distinction between personal and impersonal taxes,[37] while the other two drafts made no such distinction.

Draft No. I*b* offered a model for conventions between two countries whose tax systems assert jurisdiction principally by residence.[38] Draft No. I*b* accorded primary authority to tax to the country of residence, the source country; only to tax certain specified categories of income, such as income from immovable property, and business profits attributable to a permanent establishment.[39] The second draft ameliorated double taxation in the same manner as the 1927 draft provided. If a taxpayer had a

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32 The Convention allowed the taxpayer a "deduct[ion] from its personal tax." *Id.* art. 10, at 11. The modern expression of this concept is "tax credit." *See, e.g.*, I.R.C. § 901 (1985).

33 The credit further may be limited by some agreed percentage of the residence country's personal tax to prevent a taxpayer from wholly escaping tax if all of his income is foreign source. Report I, *supra* note 9, at 17.

34 27 countries, including the United States, were represented at the conference. Report Presented by the General Meeting of Government Experts on Double Taxation and Tax Evasion, League of Nations Doc. C.562 M.178 1928 II. at 5 (1928) [hereinafter cited as Report II]. J. HERNDON, RELIEF FROM INTERNATIONAL INCOME TAXATION 175 (1932).

35 Some countries, such as Austria and Germany, had already signed treaties dividing tax jurisdiction according to rules which made no distinction between personal and impersonal taxes. Other countries, such as South Africa and the United Kingdom, did not impose impersonal taxes. Summary of the Observations Received by August 30th, 1928, from the Governments on the Report Submitted by the Committee of Technical Experts on Double Taxation and Tax Evasion, League of Nations Doc. C.495 M.147 1928 II (1928).

36 Report II, *supra* note 34, at 7.

37 Draft Convention No. I*a*, *reprinted in* Report II, *supra* note 34, at 7-9.

38 Draft Convention No. I*b*, *reprinted in* Report II, *supra* note 34, at 16-18. This draft had its genesis in proposals prepared by the American and British representatives. J. HERNDON, *supra* note 34, at 235.

39 Draft Convention No. I*b*, *reprinted in* Report II, *supra* note 34, arts. 1 & 2, at 16-17.

fiscal domicile in each country during the year, each country could impose a tax in proportion to the time the taxpayer spent there.[40] If a permanent establishment existing in each country earned business profits, "each [country could] impose [a] tax applicable to that part of the income produced on its territory."[41] Unlike the 1927 draft, however, neither Draft No. I*a* nor No. I*b* suggested the taxpayer's books and records be used in determining the portion of total profit to be attributable to each permanent establishment.[42] Instead, the 1928 drafts simply provided that "[t]he competent administrations of the two Contracting [countries should] come to an arrangement as to the basis of apportionment,"[43] the draft deliberately left open the question of the allocation of profits.[44]

Countries with tax systems differing in nature, but not fitting into the personal/impersonal mold, were to use Draft No. I*c*.[45] In contrast to Draft No. I*b*, this draft did not attempt to establish primacy of residence country jurisdiction. It simply listed certain categories of income and granted jurisdiction to the source country. As with the other two 1928 drafts, Draft No. I*c* provided that the country in which a permanent establishment was situated would tax the establishment's business profits, and if a taxpayer had permanent establishments in each country, each country was to "tax the portion of the income produced in its territory."[46] Also, this third draft left to the competent administrations of the two countries discretion to devise an appropriate basis for apportionment of profits between the two permanent establishments.[47]

The United States and various European countries widely used the three draft conventions produced at the 1928 conference as the basis for

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40 *Id.* art. 1, at 16.

41 *Id.* art. 2, at 16.

42 *Compare* Bilateral Convention, *supra* note 16, art. 5, at 11 *with* Bilateral Conventions for the Prevention of Double Taxation in the Special Matter of Direct Taxes, Draft Convention No. I*a*, art. 5, and Draft Convention No. I*b*, *reprinted in* Report II, *supra* note 34, art. 2(B), at 8, 16. The question of apportionment was discussed at some length by the delegates. Some felt that provisions for apportionment should be spelled out in the convention itself, while others believed such rules would conflict with their own domestic law and thus should not be included. J. HERNDON, *supra* note 34, at 203-05.

43 Draft Convention No. I*b*, *reprinted in* Report II, *supra* note 34, art. 2(B), at 16.

44 Fiscal Committee, Report to the Council on the Fourth Session of the Committee, League of Nations Doc. C.399 M.204 1933 II A, at 2 (1933) [hereinafter cited as Fiscal Report].

45 Draft Convention No. I*c*, *reprinted* in Report II, *supra* note 34, at 19-21. This draft had its genesis in proposals prepared by the French representative. J. HERNDON, *supra* note 34, at 235.

46 Draft Convention No. I*c*, art. 3, *reprinted in* Report II, *supra* note 34, at 19.

47 *Id.*

numerous bilateral tax treaties.[48] In the meantime, however, the League of Nations continued its work on the problems of double taxation. The Fiscal Committee of the League met again in 1931 and refined the 1928 model conventions. The Committee prepared two drafts, but in contrast to the earlier bilateral conventions, these drafts were in the form of multilateral conventions.[49] A fourth session of the Fiscal Committee took place in 1933 and the Committee prepared another multilateral draft convention.[50] While minor differences existed between the three multilateral drafts, they all possessed the common theme of according preference in jurisdiction to the country of residence, and continued the separate-entity/arm's-length approach of permitting the source country to tax the business income of the permanent establishment of a non-resident enterprise.

The drafters of the 1933 model convention were able to use information obtained from a survey[51] of the tax systems of over twenty nations, and the states of Massachusetts, New York and Wisconsin.[52] The survey's report and recommendations reflected the separate-entity/arm's-length approach for averting double taxation primarily because a majority of the tax systems surveyed employed this approach.[53]

At a conference in Mexico, in 1943, the Fiscal Committee produced the penultimate model convention drafted under the auspices of the League of Nations. Unlike earlier conferences, Latin and South American countries were heavily represented,[54] and they brought an economic

48 Rosenbloom & Langbein, *United States Tax Treaty Policy: An Overview*, 19 COLUM. J. TRANSNAT'L L. 359, 365 (1981).

49 These were referred to as Draft Plurilateral Conventions "A" and "B". Draft "A" attempted to resolve double taxation problems for both residents and non-residents, while Draft "B" only addressed non-residents. It was hoped that the plurilateral, or multilateral, conventions would encourage countries to alleviate double taxation by adopting uniform legislation, a method to be preferred over bilateral conventions. Report to the Council on the Work of the Third Session of the Committee, League of Nations Doc. C.415 M.171 1931 II A at 3, 13-16 (1931).

50 Fiscal Report, *supra* note 44. A revision of this convention was published by the Committee in Fiscal Committee, Report to the Council on the Fifth Session of the Committee, League of Nations Doc. C.252 M.124 1935 II A (1935) [hereinafter cited as Fiscal Report II].

51 The survey was conducted under the auspices of the League of Nations and was financed by a grant obtained by Professor Adams from the Rockefeller Foundation. 1 Taxation of Foreign and National Enterprises, League of Nations Doc. C.73 M.38 1932 II A at 3 (1932). The subtitle of this report was "A Study of the Tax Systems and the Methods of Allocation of the Profits of Enterprises Operating in More Than One Country."

52 Carroll, *supra* note 7, at 703-04. For a more anecdotal account of the survey, see generally M. CARROLL, GLOBAL PERSPECTIVES OF AN INTERNATIONAL TAX LAWYER (1978).

53 Carroll, *supra* note 7, at 704-05; Taxation of Foreign and National Enterprises, *supra* note 51, at 33-35, 53-55.

54 No Latin American country was represented at the 1928 conference, while at the Mexico conference, *all* of the countries represented (with the exception of Canada and the United States) were in Latin or South America. Carroll, *supra* note 7 at 707-08.

perspective very different from that of the United States and the industrialized countries of Europe. The model draft approved at the Mexico Conference[55] reflected that perspective by reversing the emphasis of the earlier models, by giving primacy of jurisdiction to the country of source, rather than the country of residence.[56] In addition, the 1943 convention found the concept of "permanent establishment" contained in the earlier models to be too narrowly drawn. The Mexico Draft provided that the country where the business of activity was carried out could tax industrial, commercial or agricultural profits, regardless of the existence of a permanent establishment.[57] When the full Fiscal Committee met for the final time in 1946, in London the Committee reversed this shift in perspective. The London Draft returned to emphasizing the taxing power of the country of residence, and to the country of source taxing business profits of an enterprise only if a permanent establishment was located there.[58]

After World War II, the Organization of Economic Cooperation and Development (OECD) picked up the development of model international tax treaties from the League of Nations.[59] The Fiscal Committee of the OECD published a draft double taxation convention in 1963,[60] and revised it in 1977.[61] In 1976, the United States, although basically satisfied with the OECD model, chose to promulgate a model convention for

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55 Model Bilateral Conventions for the Prevention of International Double Taxation and Fiscal Evasion, League of Nations Doc. C.2 M.2 1945 II A at 5 (1945).

56 Carroll, *supra* note 7, at 708; Wang, *supra* note 7, at 96. The Latin and South American preference for source country jurisdiction is seen today in the Model Convention for the Avoidance of Double Taxation Between Member Countries and Other Countries Outside the Andean Subregion (Andean Model), *reprinted in* Manual for the Negotiation of Bilateral Tax Treaties Between Developed and Developing Countries at 168-73 U.N. Doc. ST/ESA/94 (1979).

57 Carroll, *supra* note 7, at 708, 712-15. In addition, the Mexico Draft allocated profits from producing agricultural products, minerals and other natural resources to the country in which such items or materials were produced or extracted. "[I]f a corporation of one Contracting State [had] an establishment in the other which produce[d] raw materials which [were] sold at an establishment in the first State at world market prices the entire profit [was] to be allocated to the State where the raw materials were produced." *Id.* at 713.

58 London and Mexico Model Tax Conventions, Commentary and Text, League of Nations Doc. C.88 M.88 1946 II A (1946); Carroll, *supra* note 7, at 712-15.

59 The OECD was established in 1961 to replace the Organization for European Economic Cooperation (OEEC) which, in turn, had been established in 1948 by the countries which were recipients of the U.S. Marshall Aid program. B. TEW, THE EVOLUTION OF THE INTERNATIONAL MONETARY SYSTEM 20, 128 n.2 (2d ed. 1982).

60 Report of the OECD Fiscal Committee, 1963, Draft Double Taxation Convention on Income and Capital. *See* Kragen, *Double Income Taxation Treaties: The O.E.C.D. Draft*, 52 CALIF. L. REV. 306 (1964).

61 OECD Model Convention for Avoidance of Double Taxation with Respect to Taxes on Income and Capital, 1 TAX TREATIES (CCH) ¶ 151 (1977).

its use as a starting point in negotiations of bilateral tax conventions.[62] The United States model was oriented more closely than the OECD model to the United States Internal Revenue Code, but retained the basic thrust of according primary jurisdiction to the country of residence. The United States Model allowed a source country to tax business profits only if a permanent establishment could be found, and the source country was to measure the tax base by the separate-entity/arm's-length approach. The Treasury Department modified the 1976 United States model in 1977,[63] and published a revised, Proposed Draft, in 1981.[64]

The model conventions produced by the OECD and the United States were oriented toward negotiations between two countries with roughly equal flows of capital and income.[65] However, income and capital flows between developed and lesser developed countries are generally unequal, if not unidirectional. Treaty provisions producing fair results between equals may result in unfair treatment of unequals. In recognition of this, a Group of Experts, appointed by the Secretary General of the United Nations, issued guidelines in 1979 for the negotiation of tax treaties between developed and developing countries,[66] and in 1980, the United Nations published a model convention.[67] Though the U.N. model differs from the OECD and U.S. models in many respects; the primary difference is that it shifts the emphasis towards granting jurisdiction to tax certain items of income to the source country.[68] Notwithstanding these differences the U.N. model retains the familiar scheme for the taxation of business profits—the source country is granted jurisdiction only if a permanent establishment is present, and the source country measures the tax base by the separate-entity/arm's-length approach.[69]

62 Treasury Department's Model Income Tax Treaty, U.S. Treasury Press Release, May 18, 1976. For a comparative analysis of both model treaties, see Patrick, *A Comparison of the United States and OECD Model Income Tax Conventions*, 10 LAW & POL'Y INT'L BUS. 613 (1978).

63 Treasury Department's Model Income Tax Treaty of May 17, 1977, 1 TAX TREATIES (CCH) ¶ 153.

64 Treasury Department's Model Income Tax Treaty of June 16, 1981, *supra* note 14. For an analysis, see Burke, *Report on Proposed United States Model Income Tax Treaty*, 23 HARV. INT'L L.J. 219 (1983).

65 Rosenbloom & Langbein, *supra* note 48, at 392-93.

66 Manual for the Negotiation of Bilateral Tax Treaties Between Developed and Developing Countries, *supra* note 56. *See* Surry, *United Nations Group of Experts and the Guidelines for Tax Treaties Between Developed and Developing Countries*, 19 HARV. INT'L L.J. 1 (1978).

67 United Nations Model Double Taxation Convention Between Developed and Developing Countries, U.N. Doc. ST/ESA/102 (1980), 1 TAX TREATIES (CCH) ¶ 171 (1982).

68 Rosenbloom & Langbein, *supra* note 48, at 393.

69 Manual for the Negotiation of Bilateral Tax Treaties Between Developed and Developing Countries, *supra* note 56, at 53-58. This provision was explained in the "Observations" of the Group of Experts:

III. THE SEPARATE-ENTITY/ARM'S LENGTH APPROACH TO TAXING BUSINESS PROFITS OF A PERMANENT ESTABLISHMENT

As indicated in the previous section, the evolution of model and bilateral treaties to prevent double taxation began at a time when the general income tax was in its infancy.[70] The early treaties were therefore, mostly concerned with classifying various types of taxes a country might impose and assigning the power to impose a particular tax to the country of residence or country of source.[71] Countries did, however, impose taxes on, or measure taxes by, the income of business establishments, and the early model treaties addressed the potential for double taxation of business profits of a transnational enterprise by employing the "permanent establishment" concept.[72]

The concept of "permanent establishment" served two functions. First, it supplied a mutually agreed upon jurisdictional threshold. Unless the nonresident's business activities within a taxing country reached the level of a permanent establishment, no tax was imposed on business profits of the enterprise, even though the source of those profits was within the taxing country.[73] This function allowed transnational businesses to

> The most relevant question in international tax practice concerning business profits relates to the facts which make an enterprise liable to taxation on its profits in a foreign country. There is general acceptance of the so-called "arm's length" rule embodied in the OECD Draft Model Convention. According to this rule, the profits attributable to a permanent establishment are those which would be earned by the establishment if it were a wholly independent entity dealing with its head office as if it were a distinct and separate enterprise operating under conditions and selling at prices prevailing in the regular market. The profits so attributable are normally the profits shown on the books of the establishment. Nevertheless, this rule permits the authorities of the country in which the permanent establishment is located to rectify the accounts of the enterprise, so as to reflect properly income which the establishment would have earned if it were an independent enterprise dealing with its head office at arm's length.

Id. at 56.

[70] *See* E. SELIGMAN, THE INCOME TAX (2d ed. 1914). Indeed, the problems of double taxation are found primarily in the forms of taxation, such as the general income tax, which have been developed to suit modern economic conditions. E. SELIGMAN, *supra* note 4, at 11.

[71] The "classification and assignment" approach taken in the early work on double taxation by the League of Nations is considered by some to be the most significant aspect of its work, because of its pervasive and enduring influence in virtually all tax treaties up to the present. Rosenbloom & Langbein, *supra* note 48, at 366.

[72] For example, the League of Nations' first model convention provided: Income from any industrial, commercial or agricultural undertaking and from any other trades or professions shall be taxable in the State in which the persons controlling the undertaking or engaged in the trade or profession possess permanent establishments. Bilateral Convention, *supra* note 16, art. 5, at 10. Double taxation was still possible, however, if the country of fiscal domicile imposed a tax on all the profits of a taxpayer, including those which had been allocated to the source country. In such circumstances, double taxation was to be ameliorated by the residence country granting a credit in the amount of the lesser of the amount of tax imposed by the source country, or the amount of tax which would have been levied by the country of residence solely upon the items of income arising in the source country. *Id.* art. 10, at 11.

[73] This provision in a tax convention would effectively override domestic law which might pro-

expand more freely. For example, an enterprise could test the market for its products within a foreign country by arranging for sales through independent agents. If the enterprise found a sufficient market to exist, then the enterprise could expand operations in that country by opening a branch office, by sending in permanent employees, or by other means. In the meantime, the country in which the goods were sold would not tax the business profits generated by sales completed by the independent agents.[74]

The second function of the "permanent establishment" concept was in computing the tax base of the transnational enterprise in the nonresidence country where a permanent establishment was located. Again, early bilateral and model treaties reflected the prevailing economic theories of the time of imposing taxes either on property or identifiable transactions. If a country imposed taxes on an entity because of its relationship with the taxing state, the power to tax was supported either by some notion of benefit which the country provided to the taxpayer, or by some obligation the taxpayer owed to the country because of their special relationship.[75] A source country would properly impose income taxes on a transnational enterprise only to the extent the enterprise had profits clearly attributable to a permanent establishment within the taxing country.[76] From this perspective, for example, it made no difference to Italy whether a transnational enterprise domiciled in Germany had an overall loss during a tax year; if the enterprise's permanent establishment in Italy had a net profit, it would be subject to income tax by Italy.[77] The converse was true as well; if the Italian permanent establishment showed a loss, no Italian income tax would be imposed even though the overall enterprise had a net profit.

vide that the source of income from the sale of goods is where a contract of sale is concluded, and which imposes its income tax on all income with a source in its country. Carroll, *supra* note 7, at 700.

74 The League of Nations' first model convention established the precedent that an enterprise carrying on activities in a country solely through an independent agent should "not be held to [have] a permanent establishment in that country." Bilateral Convention, *supra* note 16, art. 5, at 11. This concept customarily is still included in treaties today. *See* Treasury Department's Proposed Model Income Tax Treaty of June 16, 1981, *supra* note 14, art. 5.

75 A. HARDING, DOUBLE TAXATION OF PROPERTY AND INCOME, 35-45 (1933); E. SELIGMAN, *supra* note 4, at 58-87.

76 Report I, *supra* note 9, at 15.

77 This approach was taken by most, but not all countries. For Spain, an enterprise's capacity to pay was properly measured by the total profit of the enterprise, with "a share of this total profit [being] attributed to the branches in Spain in accordance with their estimated relative economic importance to the enterprise as a whole." 5 Taxation of Foreign and National Enterprises, League of Nations Doc. C.425(c) M.217(c) 1933 II A, at 15 (1933). In addition, fractional apportionment was used in limited circumstances under the laws of France, Germany, the United Kingdom, and the United States. 1 Taxation of Foreign and National Enterprises, *supra* note 51, at 30-33.

Early model conventions reflected the view that it would be easy to determine whether and to what extent a permanent establishment had a gain or loss by referring to the transnational enterprise's books and records, if the books reflected separate accounting for the permanent establishment.[78] Such records were usually kept for the enterprise's own business purposes, and early model conventions deemed it appropriate for the taxing authorities to accept them.[79] Separate accounting was justified further in the international context by differences in language and currencies which served as economic boundaries making separate treatment reasonable.[80]

In 1933, after the completion of a study concerning appropriate methods for the allocation of profits,[81] the League of Nations approved a

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[78] The League of Nations' first model convention implied that the enterprise's records should be used by providing an alternative only "[i]n the absence of accounts showing [its] income separately and in proper form." Bilateral Convention art. 5, *supra* note 16, at 11. A later study noted that "[t]he normal procedure in Germany, Great Britain and the United States [was] to tax a branch of a foreign enterprise on the basis of its own accounts, provided they [were] satisfactory or [could] be properly adjusted." 1 Taxation of Foreign and National Enterprises, *supra* note 51, at 21.

[79] Gerstenberg, *Allocation of Business Income*, 24 NAT'L TAX ASS'N 301, 303 (1931).

[80] The National Tax Association, concluding that separate accounting was "best for international taxation," reasoned as follows:

> 1. Even where foreign undertakings are branches and not independent companies—independent companies are generally considered to be the prevailing system of organization for American international businesses—such branches, in practice, are treated from an accounting and administrative standpoint as separate companies.
>
> 2. The profit of the branches or establishments should be based on independent accounting to reflect the true financial results of the operation of each particular branch or establishment. Thus, a separate system of accounting for taxation conforms to the most appropriate method of keeping accounts for the business itself.
>
> 3. Separate systems of accounts for each branch or establishment reflect more truly the operating conditions of the branches, the efficiency of their management and like matters, than does any method of apportionment. Much of the complaint against double taxation would be obviated if reports for tax purposes could be taken directly from the accounts of the company constructed on a system intended primarily to contribute to the proper administration of the business.
>
> 4. By keeping the accounts separately, there is no necessity for transfers of currencies or for translations of accounting terms; the accounts for each country are kept in the language and in the currency of that country.
>
> 5. Inspections by tax officials are facilitated if the basis of the return is the local branch books.
>
> 6. The accuracy of the result is less subject to error.
>
> 7. Because of variations in rates of taxation among the independent sovereigns concerned in any given case, and because political and economic conditions vary from time to time, causing profits to vary irrespective of changes in investment or in gross sales or in any other item on which an artificial allocation of net income could be made, the only fair way of paying tax to a country in proportion to the net income derived from the country is on the basis of separate accounting.

Id.

[81] The survey, conducted by Mitchell B. Carroll, reviewed the tax systems of over twenty countries and the states of Massachusetts, New York and Wisconsin. The report was published in five volumes: 1-5 Taxation of Foreign and National Enterprises, League of Nations Doc. C.73 M.38 1932 II A (1932); C.425 M.217 1933 II A (1933); C.425(a) M.217(a) 1933 II A (1933); C.425(b) M.217(b) 1933 II A (1933); and C.425(c) M.217(c) 1933 II A (1933).

draft convention dealing specifically with the issue.[82] The convention endorsed the fundamental concepts of treating permanent establishments as independent taxable enterprises, and of determining an establishment's tax base by separate accounting.[83] The convention provided three alternative drafts, recognizing that a transnational enterprise might not keep its own books in a manner properly reflecting the independent separate entity treatment of permanent establishments.[84]

First, in order to enforce the separate entity approach, the convention authorized taxing authorities to change the treatment of items in the enterprise's books "to correct errors or omissions, or to re-establish the prices or remunerations entered in the books at the value which would prevail between independent persons dealing at arm's length."[85] The Convention preferred applying the arm's length standard to correct an enterprise's books, because the standard adhered to the separate entity treatment of permanent establishments. If the taxing authorities determined, however, that reconstruction of an enterprise's books by the arm's length approach was "impossible in practice,"[86] the Convention provided two alternatives: an empirical method, and fractional apportionment.

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82 Draft Convention Adopted for the Allocation of Business Income between States for the Purposes of Taxation, *reprinted in* Fiscal Report, *supra* note 44, at 3-6. This draft dealt generally with industrial and commercial enterprises, and included specific treatment of banking and financial enterprises.

83 If an enterprise with its fiscal domicile in one contracting state has permanent establishments in other contracting states, there shall be attributed to each permanent establishment the net business income which it might be expected to derive if it were an independent enterprise engaged in the same or similar activities under the same or similar conditions. Such net income will, in principle, be determined on the basis of the separate accounts pertaining to such establishment.

Id. art. 3, at 4.

84 The Commentary provided by the drafters indicated that "[i]f the taxpayer produce[d], in respect of that establishment, separate accounts in proper form which show[ed] its relations with the international enterprise to be normal and adequately reflect[ed] them, the fiscal authorities [would] take those accounts as a basis for the assessment." *Id.* Commentary to art. 3, at 6.

85 *Id.* art. 3, at 4. This provision dealt with a transnational enterprise with permanent establishments in more than one contracting state. Another article dealt with the same problem of the potential for transfer pricing manipulation in the context of transactions between economically related taxpayers which were not permanent establishments of a larger enterprise:

> When an enterprise of one contracting State has a dominant participation in the management of capital of an enterprise of another contracting State, or when both enterprises are owned or controlled by the same interests, and as a result of such situation there exists, in their commercial or financial relations, conditions different from those which would have been made between independent enterprises, any item of profit or loss which should normally have appeared in the accounts of one enterprise, but which has been, in this manner, diverted to the other enterprise, shall be entered in the accounts of such former enterprise, subject to the rights of appeal allowed under the law of the State of such enterprise.

Id. art. 5, at 5.

86 *Id.* Commentary to art. 3, at 6.

An empirical method for determining the tax base of a permanent establishment simply looked to gross sales, or inventory turnover, and allotted a percentage of the figure as taxable income. The percentage was determined by the nature of the business and comparisons with similar enterprises operating in the same country.[87] Empirical methods were inherently arbitrary, however, and therefore seldomly used.[88]

If the separate accounting and empirical approaches were "found to be inapplicable," the convention authorized a fractional apportionment method as follows:

> [T]he net business income of the permanent establishment [could] be determined by a computation based on the total income derived by the enterprise from the activities in which such establishment ha[d] participated. This determination [was] made by applying to the total income coefficients based on a comparison of gross receipts, assets, number of hours worked or other appropriate factors, provided such factors [were] so selected as to ensure results approaching as closely as possible to those which would be reflected by a separate accounting.[89]

The separate accounting and empirical approaches proceed from a geographical perspective; *viz.*, income can be given a geographical source by looking to the location where income producing activities took place. The fractional apportionment approach, by contrast, is based upon an economic perspective; all the activities of an enterprise contribute somewhat to its overall profit or loss, thus the tax base should be measured by net income, wherever earned.[90] If the theoretical foundation for the exercise of tax jurisdiction is that only income producing activities occurring within a country are taxable, with the tax base consisting solely of the profits generated by those activities, separate accounting rather than fractional apportionment is appropriate.[91] Nonetheless, the 1933 model

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87 *Id.* art. 3, at 4.

88 Gerstenberg, *supra* note 79, at 302, 306. Empirical methods were also noted as "sometimes unfair because they ignore the effect of circumstances peculiar to the foreign enterprise." 1 Taxation of Foreign and National Enterprises, League of Nations Doc. C.73 M.38 1932 II A at 54 (1932).

89 Draft Convention Adopted for the Allocation of Business Income between States for the Purposes of Taxation, art. 3, *supra* note 82, at 4.

90 G. HARLEY, INTERNATIONAL DIVISION OF THE INCOME TAX BASE OF MULTINATIONAL ENTERPRISE 8-11 (1981). The 1933 study of the methods of allocating taxable income noted:

> When the problem of taxing a foreign enterprise is viewed from the general principle that a State has jurisdiction only over persons within, property situated within, or transactions effected within its territory, it is obvious that, if the taxpayer resides in a foreign country, the State's jurisdiction over its income should be restricted to income from property or other source within its territory. The principle of permitting only the country of fiscal domicile to tax the total net income of the taxpayer is so generally accepted that it would appear inconsistent to incorporate in the regime a provision permitting any country in which the enterprise has a branch establishment to take jurisdiction over the total net income in order to determine what part thereof might be attributable to the local establishment.

4 Taxation of Foreign and National Enterprises, *supra* note 81, at 187-88.

91 5 Taxation of Foreign and National Enterprises, *supra* note 81, at 8.

convention recognized that separate accounting, while being theoretically sound, might be impractical or imperfect in operation. The problem with separate accounting is in dealing with transactions between a permanent establishment and other operations of an overall enterprise. Such transactions might involve transferring goods or providing services, and the problem is in establishing the "transfer pricing" at which such transactions take place.[92] For example, an enterprise might purchase goods in country A and sell the goods at retail in country B through a branch office constituting a permanent establishment. In computing the profits of the permanent establishment as a separate entity which Country B could tax, the nominal "transfer price" it paid for the goods must be determined. This situation permits the enterprise to manipulate its profits if the taxing authorities look to the enterprise's books and records as the source of the transfer price. The reason is that as the transfer price is increased, so too is the portion of the total profit attributable to the parent. Likewise, a lower transfer price shifts more of the overall profit to the branch office. If, in the above example, the enterprise purchase of the goods in Country A at a cost of $50, and sold the goods in Country B for $80, $10 of the profit would be attributed to Country A if the transfer price was $60, but $25 would be attributed to Country A if the transfer price is set at $75.

Because enterprises can easily manipulate transfer prices, most countries, and many tax treaties employing the separate accounting approach, impose an "arm's length" standard for measuring intra-enterprise transactions. The transfer price in the previous example for tax purposes must be the same price the enterprise would charge an unrelated purchaser in an otherwise identical transaction, assuming that the two parties were dealing at arm's length. In 1933, the arm's length standard for allocating the income among the various components of a transnational enterprise was first included in a model convention.[93] In 1921, Congress amended the internal revenue laws of the United States to authorize taxing authorities to "consolidate the accounts of . . . related trades and businesses [if necessary] for the purpose of making an accu-

[92] For a discussion of various theories of transfer pricing, see S. PLASSCHAERT, TRANSFER PRICING AND MULTINATIONAL CORPORATIONS (1979); Lamont, *Multinational Enterprise, Transfer Pricing, and the 482 Mess*, 14 COLUM. J. TRANSNAT'L L. 383, 389-93 (1975). The magnitude of the problem is reflected by a recent study which indicated that during the 1970's for all exports roughly 50% from the United States, 30% from the United Kingdom, 29% of Swedish exports and 59% from Canada represented intra-group transactions, and, hence, transfer pricing. Messere, *OECD: Report on Transfer Pricing and Multinational Enterprises*, 1979 INTERTAX, at 288 n.1.

[93] Draft Convention Adopted for the Allocation of Business Income Between States for the Purposes of Taxation, art. 3, *supra* note 81, at 4.

rate distribution or apportionment of gains, profits, income, deductions, or capital between or among [the] related trades or businesses."[94] The statute did not specify any particular method for making the authorized adjustments. In 1934, the United States followed the League of Nations' example in international transactions by promulgating regulations adopting the arm's length standard.[95] In 1962, the House of Representatives approved legislation which would have deviated from the arm's length approach in certain circumstances, but the bill failed to pass the Senate.[96] In 1968, Congress amended the regulations, reinforcing the arm's length approach and providing examples of how it should apply in various factual circumstances.[97]

There are two problems with the hypothetical arm's length standard. First, the determination of a transfer price under the standard is often truly hypothetical because comparable actual transactions rarely exist. A recent study of how the Internal Revenue Service applies the standard found that only three percent of the recommended adjustments were based on actual comparable arm's length prices.[98] This result may be attributable to many factors, including, the nature of the business, goods or services involved, or the quantity of goods the enterprise has transferred.[99] Even if an enterprise treats each of its foreign permanent establishments as separate entities on its books, and supplies transfer prices among them for internal purposes, the potential remains great for manipulating the geographical source of income by adjusting the transfer

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94 Act of Nov. 23, 1921, ch. 136, sec. 240(d), 42 Stat. 227, 260. This statute was modified in 1928, Act of May 29, 1928, ch. 852, sec. 45, 45 Stat. 791, 806, and appears today, substantially unchanged, as I.R.C. § 482 (1985). *See* 7 MERTENS, LAW OF FEDERAL INCOME TAXATION, § 38.61.

95 Comptroller General, IRS Could Better Protect U.S. Tax Interests in Determining the Income of Multinational Corporations, Rep. No. GGD-81-81 at 2-3 (Sept. 30, 1981) [hereinafter cited as Comptroller Report].

96 H.R. 10650, 87th Cong., 2nd Sess., § 6 (1962), *reprinted in* 1962-3 C.B. 537. The legislation pertained to sales of tangile personal property between U.S. corporations and their foreign subsidiaries—the classic situation for transfer pricing manipulation. The bill authorized an apportionment formula, rather than an arm's length review of transfer prices. Comment, *Multinational Corporations and Income Allocation Under Section 482 of the Internal Revenue Code,* 89 HARV. L. REV. 1202, 1211-14 (1976) [hereinafter cited as *Multinational Corporations*].

97 Treas. Reg. § 1.482-1, -2 as amended by T.D. 6952, *reprinted in* 1968-1 C.B. 218. *See* Jenks, *Treasury Regulations Under Section 482,* 23 TAX LAW. 279 (1970); *Multinational Corporations, supra* note 96, at 1212.

98 Comptroller Report, *supra* note 95, at 27. *See also* R. GORDON, TAX HAVENS AND THEIR USE BY UNITED STATES TAXPAYERS—AN OVERVIEW 129-32 (1981); Burns, How IRS Applies the Intercompany Pricing Rules of Section 482: A Corporate Survey, 52 J. TAX'N 308 (1980); Fuller, *Problems in Applying the 482 Intercompany Pricing Regs. Accentuated by DuPont Case,* 52 J. TAX'N 10 (1980).

99 Abrutyn, *The Quest for Comparables in Section 482 Cases,* 2 INT'L TAX J. 318 (1976).

prices. The incentive to set transfer prices for favorable tax consequences is even greater when the tax rates of the countries involved differ substantially. This is especially true when a country imposes little or no tax, *i.e.*, a tax haven. In the example above, an enterprise might create a permanent establishment in a tax haven country, country C. Instead of transferring the goods directly from country A to the permanent establishment in country B, the goods could be routed through the permanent establishment in country C. If the goods purchased for $50 in country A are transferred at a transfer price of $50 to the permanent establishment in country C, no gain is attributable to country A. The goods could then be transferred to the permanent establishment in country B at a transfer price of $80. If the goods are ultimately sold to the consumer in country B for $80, no gain is attributed to country B; the entire profit of $30 would be attributed to, and be taxable (although not necessarily *taxed*) by country C.[100]

The second problem with the hypothetical arm's length approach is that each of the two countries having jurisdiction to tax might determine different transfer prices for the same transaction. If there is no mechanism for coordination, double taxation may result. In the original example, the tax authorities of country A might determine that the proper transfer price to the permanent establishment in country B was $70, so that when the goods are sold at retail for $80, $20 would be taxable by country A. The remaining $10 would be attributable to the permanent establishment in country B and taxable there. Country B's taxing authorities, however, might determine the proper transfer price from country A to be only $65. If so, $15 of the total profit would be taxable by country B, and $15 by country A. If both determinations governed, the two countries would tax the enterprise on a total of $35, even though the enterprise's actual profits were only $30. Because of this potential for double taxation, most modern bilateral tax conventions provide for coordinating redetermination of transfer prices and include some type of mechanism to resolve conflicts.[101]

The Internal Revenue Service may be precipitating an additional problem by its redetermination of transfer prices. In the United States, the unilateral approach to ameliorating double taxation, whether as a consequence of the redetermination of transfer prices or otherwise, is the

100 The figures used in the example are a blatent illustration of the "pig theory" in operation. In actual practice, some of the overall profit would probably have been left attributable to countries A and B.

101 *See, e.g.*, Treasury Department's Proposed Model Income Tax Treaty of June 16, 1981, *supra* note 14, art. 9.

foreign tax credit.[102] In general, income of a United States person[103] which has a foreign source and has been subject to foreign income tax may nonetheless also be taxed by the United States.[104] The Internal Revenue Service will permit a credit against the United States income tax liability, in the amount of the foreign taxes paid, limited by a fraction in which the numerator is the taxpayer's foreign source taxable income and the denominator is the taxpayer's worldwide taxable income.[105] If the Internal Revenue Service redetermines a transfer price, attributing more income to the United States operations, and less to foreign sources, the above fraction becomes smaller, resulting in less of the foreign tax paid being creditable. The foreign country, on the other hand, might not have a tax treaty with the United States. The country might not agree with the redetermination made by the Internal Revenue Service, with the result that more than 100% of the enterprise's income might be subject to taxation.[106]

The United States and the OECD are closely scrutinizing transfer prices due to the problems inherent with the practical application of the arm's length standard to transfer pricing. In 1981, the Comptroller General of the United States issued a report concluding that "the theory on which [the arm's length approach] rests no longer corresponds to the realities of intercorporate transactions."[107] The report recommended that consideration be given to reformulating section 482 regulations to permit formula apportionment as an alternative to the separate-account-

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[102] I.R.C. § 901 (1985). For a thorough discussion of the foreign tax credit, *see* P. POSTLEWAITE, INTERNATIONAL CORPORATE TAXATION 81-126 (1980).

[103] A "United States person" is defined for purposes of the Internal Revenue Code as "(A) a citizen or resident of the United States, (B) a domestic partnership, (C) a domestic corporation, and (D) any estate or trust (other than a foreign estate or foreign trust, within the meaning of section 7701(a)(31))." I.R.C. § 7701(a)(30) (1985).

[104] Gross income includes "all income from whatever source derived . . . ." I.R.C. § 61 (1985). *See* Treas. Reg. § 1.1-1(b).

[105] I.R.C. § 904 (1985).

[106] For example, a domestic corporation might report to the taxing authorities of both the U.S. and country X that it had $200 of taxable income, of which $100 was from country X. Based on those figures, it might pay $30 of income tax to country X. The limiting foreign tax credit fraction under I.R.C. § 904(a) would be 100/200, or 50%. If the U.S. makes an adjustment under I.R.C. § 482 with the effect of shifting the source of $20 of taxable income from country X to the U.S. (now $120 U.S. source and $80 sourced in country X), it might have two effects on the taxpayer. First, the full $30 of tax paid to country X might not be considered a creditable foreign income tax payment. Treas. Reg. § 1.901-2(e)(5). Second, the limiting fraction under I.R.C. § 904(a) would drop to 80/200, or 40%. The $20 of taxable income which was recharacterized as U.S. source would have been taxed both by country X and by the U.S., without the benefit of an offsetting credit for foreign income tax paid.

[107] Comptroller Report, *supra* note 95, at 27.

ing/arm's-length approach.[108] The Commissioner of the Internal Revenue, however, brushed aside this recommendation of the report, suggesting that the United States is in good company with the O.E.C.D. in retaining the arm's length standard.[109]

In Europe, the OECD studied the problems of transfer pricing, and issued a report in 1979.[110] Because the arm's length approach is so deeply embedded in the OECD Model Tax Conventions, the report did not consider alternatives; its objective being "to set out as far as possible the considerations to be taken into account and to describe, where possible, generally agreed practices in determining transfer prices for tax purposes."[111] The report did note in passing, however, its awareness of proposals for formulary apportionment, but the report rejected this method as arbitrary and unworkable. The report deemed the method to be arbitrary because it disregarded both market conditions, and an enterprise's circumstances and allocation of resources.[112] The report believed that formulary apportionment was unworkable in practice, because taxing authorities, especially of a foreign country, would not have access to information concerning the world-wide activities of a transnational enterprise.[113]

IV. State Tax Jurisdiction and Division of Multistate Enterprises' Business Income

A. Early History

State imposed income taxes date from the 1840's, when six states turned to them as a source of revenue.[114] Some twenty years later, during the Civil War period, the pressures of financing the war caused six

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108 *Id.* at 53.

109 *Id.* at 83.

110 OECD Committee On Fiscal Affairs, *Transfer Pricing and Multinational Enterprises* (1979) [hereinafter cited as OECD Report]. For a summary of the report and a discussion of some of the more important issues involved, *see* Messere, *supra* note 92. A briefer summary is in Fuller, *supra* note 98, at 12.

111 OECD Report, *supra* note 110, at 9.

112 *Id.* at 14-15. The report discusses formulary apportionment and other alternatives to the arm's length approach under the collective heading, "Global Methods."

113 *Id.* In addition, the different accounting systems and legal requirements of various countries were believed to present further problems.

114 The six states were, in order of adoption, Pennsylvania, Maryland, Virginia, Alabama, Florida and North Carolina. Special Subcomm. on State Taxation of Interstate Commerce of the House Comm. on the Judiciary, State Taxation on Interstate Commerce, H.R. Rep. No. 1480, 88th Cong., 2d Sess. 100 n.2 (1964) [hereinafter cited as 1964 Report on State Taxation]. This Report is popularly referred to as the Willis Report because Willis was the chairman of the special subcommittee on state taxation.

additional states[115] and the federal government to adopt income taxes.[116] Following the Civil War, enthusiasm for income taxation waned,[117] but in 1894, the federal government again enacted an income tax, modeled after that of the Civil War period.[118] The court in *Pollock v. Farmers' Loan & Trust Co.*,[119] interpreted this legislation as imposing a direct tax upon property and held it to be unconstitutional because the tax was not required to be apportioned by population.

In 1909, Congress took two steps in an attempt to circumvent the decision in *Pollock*. First, Congress submitted a joint resolution calling for an amendment to the Constitution authorizing federal taxes to be imposed on income without apportionment.[120] Second, Congress imposed a federal excise tax, measured by net income, on entities doing business in a corporate form.[121] The states ratified the Sixteenth Amendment in February, 1913, and the Supreme Court upheld the corporate tax as not requiring apportionment, because it was interpreted to be an indirect excise tax on the privilege of doing business in a corporate capacity, not an income tax.[122]

The dichotomy between direct income and indirect excise taxes was important for state taxes as well, because many state constitutions prohibited direct taxes.[123] With public expenditures increasing, and traditional revenue sources becoming less attractive and unable to provide sufficient revenues, income taxes became increasingly popular. However, state constitutional prohibitions against direct taxes presented the states

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115 The six states were Georgia, Missouri, Texas, Louisiana, West Virginia and Kentucky. *Id.* at 100 n.3.

116 Act of August 5, 1861, ch. 45, §§ 49-51, 12 Stat. 292, 309-11 (repealed 1862). Before any taxes were collected under this Act, it was repealed and replaced by an 1862 Act. Act of July 1, 1862, ch. 119, §§ 89-93, 12 Stat. 432, 473-75 (repealed 1864); *See* Bennett v. Hunter, 76 U.S. (9 Wall.) 326, 333 (1869). Between 1862 and 1872, two additional federal income tax statutes were passed. Act of June 30, 1864, ch. 173, § 116-23, 13 Stat. 223, 281-85 (repealed 1870); Act of July 14, 1870, ch. 255, 16 Stat. 256 (repealed 1872).

117 T. FROST, FEDERAL INCOME TAX LAW 1 (1913) (federal income tax); 1964 REPORT ON STATE TAXATION, *supra* note 114, at 100 (state income tax).

118 Act of August 27, 1894, ch. 349, §§ 27-37, 28 Stat. 509, 553-60.

119 157 U.S. 429, 583, *reh'g* 158 U.S. 601, 637 (1895). The *Pollock* holding came as a surprise because earlier decisions were believed to have established precedent for finding income taxes to be indirect taxes, not requiring apportionment. *E.g.*, Springer v. U.S., 102 U.S. 586 (1880); Hylton v. U.S., 3 U.S. (3 Dall.) 171 (1796). Lower courts had found the Civil War income taxes constitutional. *E.g.*, Clarke v. Sickel, 5 F. Cas. 981 (E.D. Pa.) (No. 2,862). *See also* Brushaber v. Union Pacific R.R. Co., 240 U.S. 1 (1916).

120 S.J. Res. 40, 61st Cong., 1st Sess., 36 Stat. 184 (1909).

121 Act of August 5, 1909, ch. 6, § 38, 36 Stat. 11, 112-17 (repealed 1913). President Taft had advocated both the constitutional amendment and the enactment of a corporate excise tax. 44 CONG. REC. 3344-45 (1909).

122 Flint v. Stone Tracy Co., 220 U.S. 107, 151 (1910).

123 1964 REPORT ON STATE TAXATION, *supra* note 114, at 100-01.

with the same alternatives earlier faced by the federal government, either amend their constitutions to allow direct income taxes, or enact a form of indirect exise tax measured by income.[124] In 1911, Wisconsin enacted what is considered to be the first modern state income tax, imposed at graduated rates on personal and corporate income.[125] Other states quickly followed suit, imposing taxes on corporations, either as direct taxes on income, or as indirect excise or franchise taxes measured by income, until by the early 1930's a majority of states imposed such taxes.[126]

B. Federal Constitutional Restrictions on State Corporate Income Taxes

Like sovereign nations, states have inherent sovereign powers, including the power to tax. However, states have agreed to restrictions on their powers by ratifying the U.S. Constitution,[127] and it is the Due Process and the Commerce Clauses which are of paramount importance.[128]

1. Due Process Clause

"In determining [state] tax liability, the threshold question for every business which crosses state lines is that of jurisdiction."[129] A state's jurisdiction extends to persons and subjects with *some* degree of connection or involvement with the state.[130] The issue is one of degree, not kind—how much connection with a state is needed to meet the federal constitutional test that no state may "deprive any person of life, liberty,

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124 *Id.*

125 The Territory of Hawaii had enacted an income tax imposed on corporations in 1901. The tax was imposed at a flat rate of 2% on personal and corporate net income, patterned after the 1894 federal legislation which had been found unconstitutional, but it was not until Wisconsin's 1911 legislation that state income taxes became popular. *Id.*

126 By 1920, Connecticut, Montana, New York and Massachusetts enacted franchise taxes measured by net income, while Mississippi, Virginia, Missouri and North Dakota joined Wisconsin and Hawaii imposing direct income taxes. *Id.* at 103. As of December 31, 1981, 45 states imposed taxes on or measured by corporate net income. GENERAL ACCOUNTING OFFICE, COMPTROLLER GENERAL REPORT TO THE CHAIRMAN, HOUSE COMMITTEE ON WAYS AND MEANS, *Key Issues Affecting State Taxation of Multijurisdictional Corporate Income Need Resolving* Rep. No. 1, GGD-82-38, 53, 59-67 (July 1, 1982) [hereinafter cited as GAO REPORT].

127 Shaffer v. Carter, 252 U.S. 37, 50 (1920).

128 Other federal constitutional provisions have played a lesser role. *See, e.g.*, Pensacola Tel. Co. v. Western Union Tel. Co., 96 U.S. 1, 12-13 (1887) (Privileges and Immunities Clause); Almy v. California, 65 U.S. (24 How.) 169 (1860); Container Corp. of America v. Franchise Tax Board, 463 U.S. 159 (1983) (Foreign Commerce Clause).

129 1964 REPORT ON STATE TAXATION, *supra* note 114, at 594.

130 *See* Morgan v. Parham, 83 U.S. (16 Wall.) 471 (1872); Hays v. Pacific Mail S.S. Co., 58 U.S. (17 How.) 596 (1854).

or property, without due process of law."[131]

State jurisdiction in matters of taxation involves a mixture of *in personam* and *in rem* deliberations.[132] The Supreme Court held at an early date that states have plenary power to tax residents and domestic corporations on income derived outside the state,[133] so long as the tax is not "palpably arbitrary or unreasonable."[134] The rationale for such expansive power was that with respect to its residents, a state provides protection and privileges, including the right to receive and enjoy income.[135] In *New York v. Graves*, the Supreme Court held that the State of New York could tax a resident on income derived exclusively from sources located outside the state.[136] The fact of domicile itself affords a basis for tax jurisdiction, and the enjoyment of privileges of residency and protection of state laws require residents to share the costs of government. "Taxes are what we pay for civilized society."[137]

Nonresident individuals and foreign corporations may be subject to state income taxation, but the issue is where the jurisdictional line should be drawn.[138] In *Shaffer v. Carter*,[139] and *Travis v. Yale & Towne Mfg. Co.*,[140] companion cases decided in 1920, the Supreme Court upheld a state tax on income derived from a business or an occupation which a nonresident within the taxing state engaged in.[141] The Court was explicit

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131 U.S. CONST. amend. XIV, § 1. Corporations, both foreign and domestic are protected by this amendment. Kentucky Fin. Corp. v. Paramount Auto Exch. Corp., 262 U.S. 544, 555 (1923). The application of the Due Process Clause to issues of state taxation of interstate commerce itself has had a questioned history. It was not until 35 years after adoption of the Fourteenth Amendment that a state tax was struck down on Due Process grounds. Louisville & Jeffersonville Ferry Co. v. Kentucky, 188 U.S. 385 (1903). However, the Court did not give any explanation for resting commerce considerations upon Due Process reasoning. *E.g.*, Union Refrigerator Transit Co. v. Kentucky, 199 U.S. 194, 211 (1905); Delaware, Lackawanna & Western R.R. Co. v. Pennsylvania, 198 U.S. 341 (1905). Notwithstanding the uncertain genesis, however, the Due Process Clause has since competed with the Commerce Clause over protection of interstate commerce from state taxation. Central R.R. Co. of Pennsylvania v. Pennsylvania, 370 U.S. 607, 619-23 (1962) (Black, J., concurring).

132 Shaffer v. Carter, 252 U.S. 37, 49 (1920); State Tax on Foreign-Held Bonds, 82 U.S. (15 Wall.) 300, 319 (1872).

133 Kirtland v. Hotchkiss, 100 U.S. 491, 498 (1879). *See* State Tax on Foreign-Held Bonds, 82 U.S. (15 Wall.) 300, 319 (1872).

134 Lawrence v. State Tax Comm'n of Mississippi, 286 U.S. 276, 279-80 (1932).

135 *Id.* at 281.

136 300 U.S. 308 (1937).

137 *Id.* at 313 (quoting Compañia General de Tabacos v. Collector, 275 U.S. 87, 100 (1927) (Holmes, J., dissenting)). *See* Guaranty Trust Co. v. Virginia, 305 U.S. 19 (1938).

138 The issues of who is a resident or a nonresident, and what is a domestic corporation or a foreign corporation give rise to factual distinctions. *See* Arredoñdo v. Brockette, 648 F.2d 425, 431 (5th Cir. 1981) (residence has many meanings in the law, largely determined by statutory context).

139 252 U.S. 37 (1920).

140 252 U.S. 60 (1920).

141 *Schaffer*, 252 U.S. at 53-56.

that the state tax jurisdiction was not *in personam*, but was based on the rights granted to the nonresident to carry on business within the state, and thus be provied with state protections.[142] The tax could be levied "as a necessary consequence" of a state's sovereign power in such circumstances.[143] *Shaffer* involved a nonresident individual operating an extensive oil and gas business in the taxing state while *Yale & Towne* involved a foreign corporation conducting an ongoing business with many employees resident in the taxing state. After these decisions, questions continued to arise in various factual situations as to whether a state could tax the income of nonresidents with fewer contacts with the state.

Over the years, courts announced various tests in attempting to demarcate the jurisdictional boundary. Short-hand labels such as "taxable event" and "business situs" evinced a type of rational process in decisions, but in operation their application proved merely conclusory. In 1940, the Supreme Court set forth a new standard. *Wisconsin v. J.C. Penney Co.*,[144] dealt with a tax on a Delaware corporation, whose principal offices and all major stockholder and administrative proceedings were located outside Wisconsin, but which did substantial business in Wisconsin. The Court upheld the tax, reasoning that constitutional jurisdictional "nexus" is based on the quality of the relationship existing between the nonresident and the state. A state's power to tax depends upon the state's granting of opportunities, protections, and benefits to the nonresident. The simple Due Process standard is "whether the state has given anything for which it can ask return."[145]

In 1959, the Supreme Court considered five cases involving state net income taxes imposed on interstate business activities.[146] Of these, two were consolidated for hearing and full opinion in *Northwestern States Portland Cement Co. v. Minnesota* and *Williams v. Stockham Valves & Fittings, Inc.*[147] In *Northwestern States*, an Iowa corporation manufac-

142 *Id.* at 53.

143 *Id.* at 52.

144 311 U.S. 435 (1940).

145 *Id.* at 444. Later the Court gave a different phrasing of the Due Process standard, requiring "some definite link, some minimum connection, between a state and the person, property or transaction it seeks to tax." Miller Brothers Co. v. Maryland, 347 U.S. 340, 344-45 (1954). But the change in phrasing is not a difference in substance. *See* Northwestern States Portland Cement Co. v. Minnesota, 358 U.S. 450, 464-65 (1959).

146 Northwestern States Portland Cement Co. 358 U.S. 450, 464-65; Williams v. Stockham Valves & Fittings, Inc., (argued together) 358 U.S. 450, 464-65 (1959); Brown-Forman Distillers Corp. v. Collector of Revenue, 359 U.S. 28 (1959), *dismissing appeal from and denying cert. to* 234 La. 651, 101 So. 2d 70 (1958); E.T. & W.N.C. Transp. Co. v. Currie, 359 U.S. 28 (1959), *aff'g per curiam* 248 N.C. 560, 104 S.E.2d 403 (1958); International Shoe Co. v. Fontenot, 359 U.S. 984 (1959), *denying cert. to* 236 La. 279, 107 So. 2d 640 (1958).

147 358 U.S. 450 (1959).

tured and sold cement at a plant located in Iowa. In Minnesota, the corporation regularly and systematically solicited orders for the sale of its products through eligible dealers, however, all orders were subject to acceptance, filling and delivery at the Iowa plant. As part of its operations, the corporation leased an office in Minnesota which a "district manager" supervised and the corporation hired two employee salesmen and a secretary to work at the office. The corporation had no bank accounts, real property, or warehouse of inventory in Minnesota.[148]

In *Stockham Valves & Fittings* Georgia imposed income tax on a Delaware corporation which had its principal office and manufacturing plant in Alabama. The corporation sold its manufactured products in Georgia through established local dealers. The Corporation maintained in Atlanta a sales-service office, serving five states. One commissioned salesman who solicited orders in Georgia, and a salaried secretary worked in the Atlanta office. Other than office supplies and equipment, the corporation had no other property, bank accounts or merchandise in Georgia. The sales-service office in Atlanta forwarded orders for goods solicited in Georgia to the home office for acceptance, and the taxpayer shipped goods directly from the Birmingham plant to customers in Georgia.[149]

Notwithstanding the taxpayer's Due Process arguments, the Court upheld the taxes in both cases. The Court applied the standard from *J.C. Penney*, finding that the "substantial income producing activity" by both corporations established the minimum connection or "nexus" with the taxing state to conclude that the states had given something "for which it [could] ask return."[150]

The second aspect of Due Process considerations regarding state income taxes imposed on multistate business enterprises is that there must be a rational relationship between the in-state activities of the enterprise and the income which the state taxed.[151] Generally, a state may not impose a tax on income earned outside the state by a nonresident.[152] The tax base, taxable income, of a nonresident, however, may include out-of-state income, if the tax base is "fairly apportioned among the States for tax purposes by [a formula] utilizing in-State aspects of interstate affairs."[153] If the method of apportioning combined in-state and out-of-

148 *Id.* at 453-55.

149 *Id.* at 455-56.

150 *Id.* at 464-65.

151 Mobil Oil Corp. v. Comm'r of Taxes, 445 U.S. 425, 436-37 (1980); Morrman Mfg. Co. v. Bair, 437 U.S. 267, 272-73 (1978).

152 Connecticut General Life Ins. Co. v. Johnson, 303 U.S. 77 (1938).

153 *Northwestern States Portland Cement Co.*, 358 U.S. at 460 (1959).

state income results in combined income being "fairly apportioned." the "rational relationship" Due Process requirement will be satisfied.[154]

2. *Commerce Clause*

The Constitution grants Congress the power "[t]o regulate Commerce . . . among the several States . . . ."[155] Early Supreme Court decisions gave the Commerce Clause a restrictive interpretation in the context of a state's power to tax an enterprise engaged in interstate commerce. In the *Case of the State Freight Tax*,[156] the Court held that a state tax imposed on an enterprise engaged in interstate commerce would constitute a burden on interstate commerce, and because Congress had not authorized the tax, it was invalid.

The belief that a state could not impose a tax on the privilege of engaging in interstate commerce without express authorization by the Congress hardened to the view that a state could not levy a general franchise tax, imposed on domestic and foreign corporations alike, in a nondiscriminatory fashion.[157] The Court, however, was willing to draw a distinction between taxes *on* interstate commerce, and taxes merely *affecting* interstate commerce.[158] Under this distinction, the Court upheld ad valorem taxes that states imposed on property owned by enterprises engaged in interstate commerce.[159] Similarly, the Court upheld a nondiscriminatory tax on net income derived from interstate commerce under the theory that the tax was "but a method of distributing the cost of government, like a tax upon property . . . [and thus] . . . it constitutes one of the ordinary and general burdens of government, from which persons and corporations otherwise subject to the jurisdiction of the states are not exempted by the Federal Constitution because they happen to be engaged in commerce among the states."[160]

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[154] Mobil Oil Corp. v. Comm'r of Taxes, 445 U.S. 425, 436-37 (1980). The Supreme Court has not prescribed any single apportionment formula or method, but has sanctioned various formulas as applied to the facts of specific cases. *See* Underwood Typewriter Co. v. Chamberlain, 254 U.S. 113 (1920); Hans Rees' Sons, Inc. v. North Carolina, 283 U.S. 123 (1931); and Butler Bros. v. McColgan, 315 U.S. 501 (1942).

[155] U.S. CONST. art. I, § 8, cl. 3.

[156] 82 U.S. (15 Wall.) 232 (1872); *See* Hellerstein, *State Franchise Taxation of Interstate Business*, 4 TAX L. REV. 95 (1948); Hellerstein & Hennefield, *State Taxation in a National Economy*, 54 HARV. L. REV. 949 (1941); and J. HELLERSTEIN & W. HELLERSTEIN, STATE AND LOCAL TAXATION, 237-390 (4th ed. 1978).

[157] Cheney Bros. Co. v. Commonwealth, 246 U.S. 147 (1918); Alpha Portland Cement Co. v. Commonwealth, 268 U.S. 203 (1925); Welton v. Missouri, 91 U.S. 275 (1875) (taxes which discriminated against interstate commerce were also held invalid).

[158] The Delaware Railroad Tax, 85 U.S. (18 Wall.) 206 (1873).

[159] Cleveland, Cincinnati, Chicago & St. Louis Ry. Co. v. Backus, 154 U.S. 439 (1894).

[160] United States Glue Co. v. Town of Oak Creek, 247 U.S. 321, 329 (1918).

The Court began to view the Commerce Clause restrictions on state taxing power in a different light by the late 1930's. The Court discarded the view that "[i]nterstate commerce cannot be taxed at all, even though the same amount of tax should be laid on domestic commerce, or that which is carried on solely within the state."[161] Instead, the test of whether a state tax violated the Commerce Clause by imposing a "burden" on interstate commerce depended upon whether the tax made interstate commerce potentially subject to *multiple* taxation.[162] If a tax was properly apportioned to the in-state activities of a multistate enterprise, then the court would not strike it down.[163]

By 1951, the composition of the Supreme Court had changed and so had its interpretation of the Commerce Clause. *Spector Motor Service, Inc. v. O'Connor*,[164] involved Connecticut's franchise tax, which the state imposed on both domestic and foreign corporations for the privilege of doing business within the state. Even though the tax did not discriminate against interstate activities[165] and even though the tax was apportioned to the enterprise's activities within the state,[166] the Court held that the tax was invalid as applied to a foreign corporation engaged exclusively in interstate commerce. Because the incidence of the tax, as applied to the Spector Motor Service company, was on the privilege of engaging in exclusively interstate commerce, it was invalid under the Commerce Clause.[167] If income derived from exclusively interstate business is made subject to a state tax, the state tax is unconstitutional under the Commerce Clause "no matter how fairly it is apportioned to business done within the state."[168]

The Court soon receded from its restrictive interpretation of the Commerce Clause which it delineated in *Spector Motor Service*. In 1959, the Court rendered its landmark decision in *Northwestern States Portland Cement Co. v. Minnesota*,[169] upholding a nondiscriminatory tax imposed on net income. The tax base included income derived from an exclusively interstate business, but net income was apportioned according to the percentage of the taxpayer's sales, tangible property, and payroll within Minnesota. The Court recalled the distinction between a tax

161 Robbins v. Shelby County Taxing District, 120 U.S. 489, 497 (1887).
162 Western Live Stock v. Bureau of Revenue, 303 U.S. 250 (1938).
163 Memphis Natural Gas Co. v. Stone, 335 U.S. 80 (1948).
164 340 U.S. 602 (1951).
165 *Id.* at 607.
166 *Id.* at 606.
167 *Id.* at 609-10.
168 *Id.* at 609.
169 358 U.S. 450 (1959).

which imposes a *direct* burden on interstate commerce, and a tax which merely constitutes an *indirect* burden.[170] The Court distinguished the holding in *Spector Motor Service* on the grounds that the incidence of Connecticut's tax was the privilege of engaging in interstate commerce, while the incidence of the tax in *Northwestern States* was activities which took place within the taxing state. The Court upheld the tax even though the in-state activities which gave rise to taxable income involved exclusively interstate commerce.[171]

The United States Supreme Court in 1975 upheld Louisiana's tax on an enterprise engaged exclusively in interstate commerce.[172] An earlier version of the state law imposed a tax "for the privilege of carrying on or doing business" within the state; but the state courts determined that the tax violated the Commerce Clause, relying on the United States Supreme Court decision in *Spector Motor Service.*[173] The Louisiana Legislature reformulated its tax,[174] to levy it on "[t]he qualification to carry on or do business in [Louisiana] or the actual doing of business within [Louisiana] *in a corporate form.*"[175] This permitted the Supreme Court to conclude that

> [t]he tax cannot be said to be imposed upon appellant merely or solely for the privilege of doing interstate business in Louisiana. It is, rather, a fairly apportioned and nondiscriminatory means of requiring appellant to pay its just share of the cost of state government upon which appellant necessarily relies and by which it is furnished protection and benefits.[176]

In 1977 the Court in *Complete Auto Transit, Inc. v. Brady* finally discarded the approach taken in *Spector Motor Service.*[177] The state lev-

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170 *Id.* at 459, *citing* United States Glue Co. v. Town of Oak Creek, 247 U.S. 321 (1918).

171 358 U.S. at 463-64. The absurdity of the formalistic approach taken by the Court in applying the Commerce Clause during this era became apparent in two cases involving the Railway Express Agency and Virginia's taxes involving gross receipts. In 1954, the tax was denominated a license tax for the privilege of doing business in the state, and was held invalid as applied to an enterprise engaged exclusively in interstate commerce. Railway Express Agency, Inc. v. Virginia, 347 U.S. 359 (1954). By 1959, the Virginia Legislature reformulated its tax, making it a franchise tax, laid on intangible property of express companies, in lieu of all other intangible property taxes, but to be measured by gross receipts, fairly apportioned to activities within the state. This levy was upheld, although the Court took pains to sanctimoniously caution, "[t]his is not to say that a legislature may effect a validation of a tax, otherwise unconstitutional, by merely changing its descriptive words." Railway Express Agency, Inc. v. Virginia, 358 U.S. 434, 441 (1959).

172 Colonial Pipeline Co. v. Traigle, 421 U.S. 100 (1975).

173 Colonial Pipeline Co. v. Mouton, 228 So. 2d 718 (La. Ct. App. 1969), *cert. denied*, 231 So. 2d 393 (La. 1970).

174 The Louisiana Legislature no doubt had taken its cue from the Virginia Legislature's successful response to Railway Express Agency, Inc. v. Virginia, 347 U.S. 359 (1954). *See supra* note 170.

175 421 U.S. at 103 (emphasis added).

176 *Id.* at 114.

177 430 U.S. 274 (1977).

ied a tax, measured by gross receipts and fairly apportioned to the state, "for the privilege of engaging or continuing in business or doing business within" Mississippi.[178] The Court recounted that it was consistent with the Commerce Clause for a state to tax an enterprise engaged in interstate commerce, if the tax is fairly apportioned, nondiscriminatory, and fairly related to services which the taxing state provided. Only the formalistic application of *Spector Motor Service* would cause a tax to be struck down, even though the state could achieve the same objective by chosing its statutory language carefully. "Under the present state of the law, the *Spector* rule, as it has come to be known, has no relationship to economic realities. Rather it stands only as a trap for the unwary draftsman."[179] The Court noted that there were "no real economic differences" between the two Virginia taxes which the Railway Express Agency assailed in the 1950's,[180] and that the Louisiana tax which the Supreme Court upheld in *Colonial Pipeline* differed from the predecessor tax which the state court had struck down only because the Louisiana Legislature had "recogniz[ed] that it had run afoul of a rule of words rather than a rule of substance . . . ."[181] Rather than engaging further in sophistry, Justice Blackmun delivered the unanimous opinion of the Court:

> [W]e now reject the rule of *Spector Motor Service, Inc. v. O'Connor*, that a state tax on the "privilege of doing business" is *per se* unconstitutional when it is applied to interstate commerce, and that case is overruled.[182]

Although *Completed Auto Transit* focused on the Commerce Clause, the Court melded Due Process concerns with those of the Commerce Clause in describing a tax which may be imposed on the net income of a foreign corporation engaged in interstate business. A tax is valid "when the tax is applied to an activity with a substantial nexus with the taxing state, is fairly apportioned, does not discriminate against interstate commerce, and is fairly related to the services provided by the State."[183]

V. UNIFORMITY IN STATE TAXATION

A. General Demand for Tax Uniformity Among States

Federal constitutional restrictions on the exercise of state taxing

178 *Id.* at 275.
179 *Id.* at 279.
180 *Id.* at 284; *see also supra* note 170.
181 *Id.* at 286.
182 *Id.* at 288-89.
183 *Id.* at 279.

power eroded with the Supreme Court granting the states broad discretion in fashioning rules for determining tax base and the "fair apportionment" of income. As a result, multistate business enterprises felt increasingly defenseless and at the mercy of state legislation. Consequently, the business community began to push for some uniformity in the rules both for asserting state tax jurisdiction and for measuring the tax base.[184]

In determining the amount of income attributable to a taxing state, two elements must be clearly distinguished. The first is the definition of net income. Clearly, if states use disparate definitions of net income, no uniform rule for the division of net income could guarantee equality because net income in one state might include items of gross income excluded by another state, or deductions might be allowed in one state and disallowed in another. A uniform approach to measuring the tax base seemed possible in the early days of state income taxes because many states incorporated the tax base used for federal income tax purposes.[185] By the early 1960's, however, most states diverged to some degree from the federal income tax definition of taxable income, favorably emphasizing local concerns.[186] The deviations from federal law were generally minor, and substantial conformity with a major portion of the federal approach remained, especially in the states which taxed the apportioned total net income of unitary businesses.[187] Consequently, multistate business enterprises were more concerned with the rules for dividing income for tax purposes.

When Wisconsin became the first state to enact a corporate income tax in 1911, it provided three methods of dividing the income of a multistate enterprise: separate accounting, specific allocation, and formula apportionment.[188] Separate accounting starts with the premise that income from a multistate entity can be segregated so that separate net incomes can be determined for the activities conducted within each state.[189] Early state statutes favored this method, but increasing interrelationships among subunits of large corporations made it virtually impossible to ascribe specific items of income and deductions to any specific state, and

[184] *See generally* Beale, *Jurisdiction to Tax*, 32 HARV. L. REV. 587 (1919); Beale, *The Situs of Things*, 28 YALE L.J. 525 (1919); Powell, *Taxation of Things in Transit*, 7 VA. L. REV. 167, 245, 429, 497 (4 pts.) (1920-21).

[185] 1964 REPORT ON STATE TAXATION, *supra* note 114, at 109.

[186] *Id.* at 255-56.

[187] *Id.* at 279.

[188] *Id.* at 113; *See supra* notes 70-113 and accompanying text.

[189] 1964 REPORT ON STATE TAXATION, *supra* note 114, at 115.

the method lost support.[190]

Specific allocation and formula apportionment are generally related. Under specific allocation, a state assigned or allocated to a particular state certain items of income, usually derived from intangibles, for taxation, without further division.[191] The state divided or apportioned the remaining net income of the enterprise among states according to a formula. The formula may be composed of a single factor, or numerous factors with varying weight given to each. Early state statutes often used a single factor of sales or property, but multifactor formulas became widespread, with the most popular being a three-factor formula based on property, payroll and sales, with each factor being given equal weight. Under the three-factor formula, a state combines an enterprise's intrastate property, payroll and sales to form the numerator of a fraction, the denominator being a combination of these same factors of the enterprise from whatever source. The state then multiplied the fraction by the tax base, composed of net income from all sources, to arrive at the portion of the tax base subject to taxation by that state.[192]

Because each state is free to adopt an apportionment formula which will withstand constitutional scrutiny if it produces "fair apportionment," myriad differences in apportionment formulas have arisen, and nonuniformity in state taxation prevails.[193] Experience has shown that states will adopt a particular formula which is in their own economic self-interest, while the potential of multiple taxation of multistate business enterprises encourages businesses to push for uniform rules of apportionment.[194]

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190 *Id.*

191 *Id.* at 118. Although specific allocation is generally applied in conjunction with formulary apportionment; one commentator has stated that specific allocation is really a special case of separate accounting. W. BEAMAN, PAYING TAXES TO OTHER STATES 3.6 (1963).

192 *See generally*, 1964 REPORT ON STATE TAXATION, *supra* note 114, at 118-22.

193 *Id.*; Cohen, *State Tax Allocation and Formulas Which Affect Management Operating Decisions*, 1 J. TAX'N (No. 2) 2 (1954); Silverstein, *Problems of Apportionment in Taxation of Multistate Business*, 4 TAX L. REV. 207 (1949).

194 1964 REPORT ON STATE TAXATION, *supra* note 114, at 123 states:

> The formulae presently employed by the various states for the apportionment of multi-state income, generally speaking, were enacted by state legislatures for revenue purposes only, and without any thought to uniformity with the laws of other states. Factors of formulae, and the components thereof have been weighted to meet local interests peculiar to the state, and with no interstate cooperation in view. This has resulted in many inequities, some of gross proportions. In the enactment of apportionment laws, too much regard has been given to the need for revenue, and not enough to the welfare of the taxpayer; too much to circumventing court decisions by legislative gymnastics, and not enough to the clear intent of the Constitution.

Statement of Fred L. Cox, Director of Income Tax Unit, State of Georgia, *reprinted in Industry Critical of Uniform Act for Dividing Income Between States, Survey Shows*, 36 TAXES 533, 534 (1958).

A multistate entity challenging a state apportionment formula has a heavy burden to overcome,

B. State-Level Attempts at Uniformity

1. National Tax Association

It was not long after states first enacted income taxes that multijurisdictional enterprises began encountering problems of compliance and multiple taxation. In 1916, the National Tax Association (NTA)[195] began work on a uniform model state income tax law.[196] Over the next forty-five years, the NTA appointed no less than seven committees to study the approaches to achieve uniformity at a state level,[197] and another three committees to study state-federal intergovernmental approaches.[198] Although some of the best tax minds in the country served on these committees, and they spent considerable time and energy in the effort, no meaningful results were achieved. Nonetheless, the NTA activity did focus attention on the problems of lack of interstate uniformity, and did provide some foundation for later action taken in drafting a uniform state law.[199]

2. Uniform Division of Income for Tax Purposes Act

As the NTA strived to achieve uniformity in state taxation of multistate business enterprises, other groups also addressed the issues.[200] In 1953, the Governors' Conference requested the Council of State Govern-

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either showing the formula is void on its face, or by clear and cogent evidence in practical operation it is oppressive to the taxpayer. Butler Bros. v. McColgan, 315 U.S. 501, 507 (1942); Norfolk & W. Ry. Co. v. North Carolina, 297 U.S. 682, 684, 688 (1936). *See Factors that Make a Business Unitary and thus Subject To Apportionment*, 11 J. TAX'N 240 (1959).

195 The NTA, an organization of tax officials from the various states, held its first annual conference in Columbus, Ohio in 1907. *Opening Proceedings*, NAT'L TAX ASSOC. (1909). In 1973 the NTA merged with the Tax Institute of America, and the organization is now referred to as the NTA-TIA. *By-laws of National Tax Association—Tax Institute of America*, 66 NAT'L TAX. ASS'N xxi (1973).

196 *See*, Gerstenberg, *Standardization and Simplification of Business Taxes: Report of Committee of the National Tax Association*, 20 NAT'L TAX ASS'N 323-24 (1927). It was suggested that the initial NTA impetus on the subject of state taxation of multistate business started with the paper by Professor Bullock at the 1916 National Conference. Bullock, *The State Income Tax and the Classified Property Tax*, 10 NAT'L TAX ASSOC. 362 (1916). At the time of the 1916 conference, only five states imposed corporate taxes relating to income. 1964 REPORT ON STATE TAXATION, *supra*, note 114, at 103.

197 The first committee was formed in 1916; the seventh committee, in 1955.

198 In 1933, the first intergovernmental committee was appointed; the third such committee was appointed in 1953.

199 *See infra* notes 200-214 and accompanying text.

200 Other organizations such as the American Bar Association, the National Association of Attorneys General, the National Association of Tax Administrators, the Advisory Commission on Intergovernmental Relations, and the Conference of Commissioners of Uniform State Laws had worked towards state income tax uniformity. *See* A.B.A. Comm. on State and Local Taxes, *Recommendations*, 22 TAX LAW. 1041, 1056 (1959) [hereinafter cited as *A.B.A. Recommendations*].

ments to study the problem of uniformity,[201] and soon afterwards, the National Conference of Commissioners on Uniform State Laws (National Conference)[202] began preparation of proposed drafts.[203] In July of 1957 the National Conference approved a final draft, entitled the Uniform Division of Income for Tax Purposes Act (UDITPA).[204] Within a week, the UDITPA was approved by the House of Delegates of the American Bar Association.[205]

The primary objective of the UDITPA was to provide a state-level solution to a uniform approach to the division of a multistate enterprise's income.[206] Under the UDITPA all income of a multistate enterprise is initially divided into two categories, nonbusiness income and business income.[207] With respect to the former, the UDITPA identifies four types of nonbusiness income: rents and royalties from real and tangible personal property, capital gains and losses from sales of real and personal property, interest and dividends, and patent and copyright royalties.[208] These four categories correspond to traditional state legislation which requires that one hundred percent of such items be allocated to a specific state.[209] An exception to prevailing state laws called for income to be allocated to the taxpayer's home state when the taxpayer was not taxable (*e.g.*, because of insufficient nexus with the state) in the state to which a specific item of income would otherwise be allocated under the general rules.[210]

UDIPTA defines business income as "income arising from transactions and activities in the regular course of the taxpayer's trade or busi-

201 *Industry Critical of Uniform Act for Dividing Income Between States, Survey Shows*, *supra* note 194, at 534.

202 For general information on the National Conference of Commissioners on Uniform State Laws, see Council of State Governments: The Book of the States 14 (1956-57).

203 A tentative draft entitled "Uniform Allocation and Apportionment of Income Act" was submitted in 1956. *See* Handbook of the National Conference of Commissioners on Uniform State laws and Proc., Ann. Conference Sixty-Fifth Year 89, 270 (1956); Lynn, *Formula Apportionment of Corporate Income for State Tax Purposes: Natura Not Facit Saltum*, 18 OHIO ST. L.J. 84, 95 (1957).

204 *See* Lynn, *The Uniform Division of Income for Tax Purposes Act*, 19 OHIO ST. L.J. 41 (1958); Lynn, *New Uniform Act for Dividing Income Between States Approved*, 35 TAXES 631 (1957). The UDITPA is currently contained in 7A UNIFORM LAWS ANNOTATED 391 (1978).

205 2 American Bar News 3 (1957); see generally Lynn, *The Uniform Division of Income for Tax Purposes Act*, *supra* note 204.

206 *See generally*, Lynn, *supra* note 204; Pierce, *The Uniform Division of Income for State Tax Purposes*, 35 TAXES 747 (1957). The UDITPA was also aimed at simplifying compliance with state tax acts. *Industry Critical of Uniform Act for Dividing Income Between States, Survey Shows*, *supra* note 194, at 534.

207 7A Uniform Laws Annotated §§ 1(a), 1(e), 4, 9 (1978).

208 *Id.* §§ 5, 6, 7, 8.

209 *See* Pierce, *supra* note 206, at 749.

210 7A Uniform Laws Annotated §§ 5, 6, 8 (1978).

ness and includes income from tangible and intangible property if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations."[211] Income which is not within the definition of business income is defined as nonbusiness income.[212] The UDITPA apportions a multistate enterprise's total business income by the popular formula utilizing a property factor, a payroll factor, and a sales factor, giving equal weight to each factor.[213] UDIPTA expressly exempts three major classes of taxpayers: individuals to the extent of personal service income, financial organizations, and public utilities.[214]

3. *Multistate Tax Compact*

In 1964, the Committee, headed by Congressman Willis, completed its exhaustive study of state taxation of interstate commerce, and published a report (popularly referred to as the Willis Report) containing recommendations for limiting state taxing power.[215] The Willis Report paid special attention to past state-level efforts to achieve uniformity, especially those of the NTA,[216] and the recently adopted UDITPA.[217] The Willis Report traced the efforts of the NTA, noting the gradual shift from pure state-level approaches to some form of congressional solution.[218] In addition, it noted that while the UDITPA represented the first genuine state-level proposal, only three of the thirty-eight states imposing an income tax had adopted it, and only one of the three had en-

[211] *Id.* § 1(a).

[212] *Id.* § 1(e).

[213] The property factor is a fraction, with the average value of the taxpayer's property used in the state during the tax year in the numerator; the denominator is the average value of such property wherever located. *Id.* § 10. Similar fractions are computed for the payroll factor, *id.* § 13, and the sales factor, *id.* § 15. The final apportionment fraction is the sum of the property, payroll and sales factors divided by three. *Id.* § 9.

[214] *Id.* § 2. *See* Pierce, *supra* note 206, at 748-49.

[215] 1964 REPORT ON STATE TAXATION, *supra* note 114. Subsequent reports were issued in 1965. H.R. REP. NO. 565, 89th Cong., 1st Sess. (1965); H.R. REP. NO. 952, 89th Cong., 1st Sess. (1965). *See* Taylor, *Willis Report on Interstate Taxation: New Laws to Make Sweeping Changes*, 23 J. TAX'N 374 (1965); Taylor, *House Study Finds State Taxation of Interstate Commerce Burdensome and Unfair*, 21 J. TAX'N 120 (1964); Note, *State Taxation of Interstate Business—Looking Toward Federal-State Cooperation*, 23 VAND. L. REV. 1217 (1970) [hereinafter cited as *Cooperation*.] Prior to the Willis Report, reliable economic data for evaluating the problem of multiple taxation of multistate business was nonexistant. Hellerstein, *An Academician's View of State Taxation of Interstate Commerce*, 53 NAT'L TAX ASS'N 201, 207 (1960).

[216] 1964 REPORT ON STATE TAXATION, *supra* note 114, at 128-32. See NTA discussion *supra* notes 194-98 and accompanying text.

[217] 1964 REPORT ON STATE TAXATION, *supra* note 114, at 132-33. See also UDITPA discussion *supra* notes 200-14 and accompanying text.

[218] 1964 REPORT ON STATE TAXATION, *supra* note 114, at 129-32.

acted it verbatim.[219] In light of this paucity of state action, the subcommittee joined by leading advocates of state power[220] vigorously endorsed full-scale federal intervention.[221] Representative Willis introduced legislation in 1965 to effectuate the Willis Report's recommendations,[222] but Congress adjourned before final passage.[223]

Sensing forthcoming federal legislation and fearing loss of local control over state taxation, numerous state tax administators began a full-scale state-level response.[224] In January of 1966, the National Association of State Tax Administrators Association met to formulate a strategy to head off federal action. The Association formed a special committee to prepare a model multistate tax statute, and on December 20, 1966, the Committee issued the Multistate Tax Compact (MTC).[225] The MTC became effective on August 4, 1967, when the seventh state adopted it,[226]

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219 The three states were Alaska, Arkansas and Kansas, with only Kansas adopting the UDITPA verbatim. *Id.* at 133.

220 The report concluded:

> Fifty years ago, as the first of the states adopted the income tax, forward-looking tax men warned of the dangers of each State taxing interstate commerce in its own way. For 50 years State tax administrators have been discussing ways of achieving simplicity and uniformity. One proposal after another has been formulated, discussed, revised, and in spite of the expenditure of enormous efforts, discarded. And, today, the States appear to be as far from a solution as they have ever been. In short, the history of 50 years of State income taxation leaves no room for optimism that the States will be any more successful in the future than they have been in the past.
>
> Certainly, the problems presented are not easy problems, but they are important problems. They are important to the States and they are important to the vitality of the American common market. Congress has a responsibility to both, and it is time for it to seek a solution.

Id. at 599.

221 F.L. Cox, leading spokesman for state and intergovernmental level solutions testified before the subcommittee that "we have now arrived at a point that I have frequently warned the States they would arrive at, when it would be necessary for Congress to act independently of the States." *Id.* at 133 (footnote omitted).

222 H.R. 11798, 89th Cong., 2d Sess. (1966) (THE "INTERSTATE TAXATION ACT"), *reprinted in* 19 A.B.A. TAX. SECTION 11-12 (1965). For a discussion of this Act, see Bishop & Taylor, *H.R. 11798: Reform or Ruin?—The Proposed Interstate Taxation Act*, 29 TEX. B.J. 247, 307 (1966).

223 Cellar, *The Development of a Congressional Program Dealing with State Taxation of Interstate Commerce*, 36 FORDHAM L. REV. 385, 390 (1968). Originally H.R. 11798 would have imposed a mandatory two-factor apportionment formula, and required federal administration and adjudication of state taxes, but the bill was amended during hearings making the formula optional and eliminating direct federal control. *Cooperation, supra* note 215, at 1320.

224 For an example of the Texas response to H.R. 11798, see *Resolution on No. 4*, 29 TEX. B.J. 660, 662, 890 (1966); *Referendum Results*, 29 TEX. B.J. 890 (1966); Taylor, *Multistate Tax Compact: Texas' Exciting Answer in the Battle With Proponents of Federal Control Over State Taxation of Interstate Commerce*, 30 TEX. B.J. 773 (1967).

225 MULTISTATE TAX COMPACT, *reproduced in* State Tax Guide, All States (CCH)) ¶ 35 (1974) [hereinafter cited as MULTISTATE TAX COMPACT]; *Cooperation, supra* note 215, at 1321 n.24.

226 The first seven states in order of adoption were Kansas, Washington, Texas, New Mexico, Illinois, Florida and Nevada. Sharpe, *State Taxation of Interstate Businesses and the Multistate Tax Compact: The Search for a Delicate Uniformity*, 11 COLUM. J.L. & SOC. PROBS. 231, 244 n.50 (1975). The stated purposes of the MTC were to:

and by January 13, 1970, there were nineteen member states.[227]

A chief feature of the MTC is the formation of a Multistate Tax Commission (Commission), composed of one representative from each member state, and charged with administering the MTC and adopting uniform regulations and tax forms.[228] More importantly, the Commission is granted the authority, upon request or on its own initiative, to conduct a consolidated audit of the records of a multistate enterprise.[229] Another significant feature of the MTC is the incorporation of the provisions of the UDITPA. Under, the MTC, a state may utilize whatever apportionment formula it desires, but upon application of a taxpayer, the UDITPA approach must be employed.[230]

Although the MTC represented the first comprehensive state-level attempt to generate uniformity in state taxation, the effort failed to stave off congressional movement towards a solution.[231] Both in 1967-68[232] and in 1969[233] the House passed legislation, but the Senate failed to do so.[234]

Shortly after the creation of the MTC, movement began for Congressional sanctioning of the MTC because of concern that absent Congressional approval, the MTC was in violation of the Compact Clause.[235]

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1. Facilitate proper determination of state and local tax liability of multistate taxpayers including the equitable apportionment of tax bases and settlement of apportionment disputes;
2. Promote uniformity or compatibility in significant components of tax systems;
3. Facilitate taxpayer convenience and compliance in the filing of tax returns and in other phases of tax administration;
4. Avoid duplicative taxation.

MULTISTATE TAX COMPACT, *supra* note 225, art. I, *reprinted also in* United States Steel Corp. v. Multistate Tax Comm'n, 417 F. Supp. 795, 799 (S.D.N.Y. 1976) *aff'd* 434 U.S. 452 (1978).

227 By December, 1983, there were twenty-one member states (including the District of Columbia), and ten associate member states. 1983 MULTISTATE TAX COMM'N REV. 3 (1983). For a discussion of associate membership status, see MULTISTATE TAX COMM'N, 6 ANN. REP. NO. 12 (1973).

228 MULTISTATE TAX COMPACT, *supra* note 225, art. VI, §§ 1(a), (f).

229 *Id.* art. VIII. The overall effectiveness of the consolidated audit is open to debate, with some taxpayers contesting the Commission's authority. Krol, *Taxpayers Balking at Submitting to Audits of Multistate Tax Commission,* 43 J. TAX. 364 (1975); Sharpe, *supra* note 226 at 245-46, nn.56-57. *See also* Cappetta, *Joint Audit Program of the Multistate Tax Commission,* 33 INST. ON FED. TAX'N 961 (1975).

230 MULTISTATE TAX COMPACT art. IV.

231 Hellerstein, *State Taxation Under the Commerce Clause: An Historical Perspective,* 29 VAND. L. REV. 335, 341 (1976).

232 H.R. 2158, 90th Cong., 1st Sess. (1967).

233 H.R. 7906, 91st Cong., 1st Sess. (1969), *reprinted in A.B.A. Recommendations, supra* note 200, at 1045-53.

234 *Cooperation, supra* note 215, at 1320 n.20. Subsequent legislative proposals have also failed to be enacted, *e.g.,* S.2084, 94th Cong., 1st Sess. (1975); S.2092, 93d Cong., 1st Sess. (1973); S.1245, 93d Cong., 1st Sess. (1973).

235 Taylor, *supra* note 224, at 774. The Compact Clause provides that "[n]o State shall, without the consent of Congress . . . enter into any Agreement or Compact with another State." U.S.

In 1972, the United States Steel Corporation filed a declaratory action against the MTC challenging its validity.[236] In February 1978, however, the Supreme Court upheld the MTC in *United States Steel Corp. v. Multistate Tax Comm'n*.[237]

Although the laudable objective of the MTC was to achieve state-level uniformity in state taxation of multistate enterprises, it has remained elusive. Even though more than half of the states are full or associate members of the MTC,[238] the member states are free to supply their own administrative and judicial interpretations of the provisions of the MTC.[239] The regulations which MTC authorized the Commission to promulgate are advisory only; members may adopt, reject or amend the regulations as they see fit.[240] Without uniform interpretation of the statutory allocation and apportionment provisions, uniform application and results are not possible.

C. Federal-Level Attempts at Uniformity

1. Public Law No. 86-272

Although Congress has not acted to impose uniform rules of allocation and apportionment of a multistate enterprise's income the Supreme Court has addressed the threshold for asserting state tax jurisdiction. During the 1950's, Supreme Court decisions, culminating with *Northwestern States Portland Cement Co. v. Minnesota* and *Williams v. Stockham Valves & Fittings, Inc.*, increasingly narrowed the scope of Due Process and Commerce Clause limitations on a state's power to tax nonresident corporations engaged in interstate commerce.[241] The Supreme Court upheld the taxes in both cases, holding

> that net income from the interstate operations of a foreign corporation may be subjected to state taxation provided the levy is not discriminatory and is properly apportioned to local activities within the taxing State forming sufficient nexus to support the same.[242]

Const. art. I, sec. 10, cl. 3. "Many attempts were made to obtain Congressional consent from 1966 thru 1973, but none were successful." United States Steel Corp. v. Multistate Tax Comm'n., 434 U.S. 452, 458 n.8 (1978).

236 United States Steel Corp. v. Multistate Tax Comm'n, 417 F. Supp. 795 (S.D.N.Y. 1976), *aff'd*, 434 U.S. 452 (1978).

237 434 U.S. 452 (1978).

238 *See supra* note 226 and accompanying text.

239 Interview with Eugene F. Corrigan, Executive Director, Multistate Tax Commission, in Boulder, Colorado (May 2, 1983).

240 MULTISTATE TAX COMPACT, *supra* note 225, art. VII; United States Steel Corp. v. Multistate Tax Comm'n., 434 U.S. 452, 457 (1978).

241 358 U.S. 450 (1959); see discussion, text and *supra* notes 146-50.

242 358 U.S. at 452.

The Court did not explore the "nexus" issue to any great extent. The Court merely noted that substantial income had been "derived from the taxing State's sales which are shown to be promoted by vigorous and continuous sales campaigns run through a central office located in the State."[243] A week later, however, the Court dismissed the appeal in *Brown-Forman Distillers Corp. v. Collector of Revenue*.[244] Brown-Forman was a Kentucky corporation engaged in the business of distilling and packaging alcoholic beverages, and it had less contact with the taxing state (Louisiana) than had the taxpayers in *Northwestern States* or *Stockham Valves & Fittings*. The taxpayer in Brown-Forman did not have a sales office nor did it maintain a warehouse or stock of goods in Louisiana; its activities in the taxing state were "limited to the presence of 'missionary men' who call upon wholesale dealers and who, on occasion, accompany the salesmen of these wholesalers to assist them in obtaining a suitable display" or merchandise at retail outlets.[245] Orders for goods which the missionary men solicited from in-state wholesalers were subject to approval by the home office in Kentucky; the manufacturer shipped goods directly to customers from Kentucky, and customers rent payment to the home office.[246] The Supreme Court of Louisiana upheld the apportioned income tax, finding no Due Process or Commerce Clause infirmity. The U.S. Supreme Court affirmed the decision.

As the constitutional restraints on state income tax jurisdiction eroded, many small- and medium-sized enterprises engaged in interstate business activity became concerned about the low threshold of activity which might subject them to a state's income tax, and the attendant burdens and costs of compliance. The Senate Finance Committee held hearings in July, 1959, to consider proposals to limit state income tax jurisdiction.[247] Congress subsequently enacted Public Law No. 86-272 on September 14, 1959.[248]

Public Law No. 86-272 imposes a minimum jurisdictional threshold which must be crossed before a state may impose an income tax on a nonresident's income derived within the state. Such a tax may not be imposed if the *only* business activities of the nonresident carried on within the state are the solicitation of orders for the sale (by the nonresident or a prospective client or customer of the nonresident) of tangible

243 *Id.* at 465.

244 359 U.S. 28 (1959), *dismissing appeal from* 234 La. 651, 101 So. 2d 70 (1958).

245 101 So. 2d at 70.

246 *Id.*

247 S. REP. NO. 658, 86th Cong., 1st Sess. 2, *reprinted in* 1959 U.S. CODE CONG. & AD. NEWS 2548-49.

248 Pub. L. No. 86-272, 73 Stat. 555 (codified as amended at 15 U.S.C. §§ 381-84 (1976)).

personal property, if the orders are subject to approval outside the state, and are filled by the shipment or delivery of goods from outside the state. Either employees or independent agents may solicit orders within this safe harbor, and if independent agents are used, sales may be completed within the state, and a sales office may be maintained for their use.[249] If employees of the nonresident, rather than independent contractors, maintain the sales office, that constitutes activity which goes beyond the mere solicitation of orders, and removes the nonresident from the safe harbor protection of Pub. L. 86-272.[250]

The United States Supreme Court has not directly addressed the constitutional validity of Pub. L. No. 86-272, although it did deny certiorari review of a Louisiana case in which the state Supreme Court upheld the Act as a valid exercise of power reserved to the Congress by the Commerce Clause.[251] The Supreme Court of Missouri,[252] the Supreme Court of Oregon,[253] and the Supreme Court of Oklahoma[254] have upheld the validity of Pub. L. 86-272.

More recently, the United States Supreme Court decision in *Container Corp. of America v. Franchise Tax Board*[255] has precipitated Congressional activity directed towards the determination of the tax base of a multistate enterprise. The Supreme Court rendered the *Container Corp.* decision in June, 1983, and on September 6, 1983, the Cabinet Council on Economic Affairs voted to recommend that the President take a public position against the worldwide unitary approach.[256] On September 23, 1983, the Secretary of the Treasury announced the formation of a working group of representatives from the Federal and state governments and the business community to study the issues raised by the worldwide unitary approach.[257] In addition, Senator Mathias and

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249 Pub. L. 86-272, Title I, § 101, 73 Stat. 555 (codified as amended at 15 U.S.C. § 381 (1976)).

250 Jantzen, Inc. v. District of Columbia, 395 A.2d 29 (D.C. App. 1978); *see also* Goldberg v. State Tax Comm'n, 618 S.W.2d 635 (Mo. 1981); Hartman, *Solicitation and Delivery Under Public Law 86-272: An Uncharted Course*, 29 VAND. L. REV. 354 (1976).

251 International Shoe Co. v. Cocreham, 246 La. 244, 164 So. 2d 314 (1964), *cert. denied*, 379 U.S. 902 (1964).

252 State ex rel. Ciba Pharmaceutical Products, Inc. v. State Tax Comm'n, 382 S.W.2d 645 (Mo. 1964).

253 Smith Kline & French Laboratories, Inc. v. State Tax Comm'n, 241 Or. 50, 403 P.2d 375 (1965).

254 Oklahoma Tax Comm'n v. Brown-Forman Distillers Corp., 420 P.2d 894 (Okla. 1966). For an analysis of Pub. L. 86-272, its history and effects, see 1964 REPORT ON STATE TAXATION, *supra* note 114.

255 Container Corp. of America v. Franchise Tax Bd., 463 U.S. 159, (1983); *see infra* note 278 and accompanying text.

256 Tax Notes, Sept. 12, 1983 at 901.

257 Tax Notes, Oct. 3, 1983 at 69; *see* Lewin, *Unitary Tax Scope Widens*, N.Y. Times, Oct. 18,

Representative Conable have introduced legislation to prohibit states from using the worldwide unitary method.[258]

2. *Case Law*

The imposition of a minimum jurisdictional standard by Public Law No. 86-272 did little to settle the problem of potential double taxation of a multistate enterprise clearly doing business in more than one state.[259] In such situations, the main constitutional issue is whether a state's method of apportionment is fair.[260] In the years immediately following *Northwestern States*, attention was initially directed towards apportionment formulas, but more recently the emphasis has shifted to consideration of the tax base which is subject to apportionment.

In 1965, the Supreme Court handed down the first major decision following *Northwestern States* regarding the measure of a state income tax. In *General Motors Corp. v. District of Columbia (General Motors II)* the Court struck down an apportionment formula composed of the single factor of sales, but did so on the ground that the formula, which had been promulgated by administrative regulation, was not authorized by statute.[261] However, in dicta, the Court again sanctioned the familiar three-factor formula.[262]

Because of *General Motors II*'s seeming disdain for any formula other than the three-factor formula, and the incorporation of the UDITPA by the MTC, most states moved to a three-factor apportionment formula. By 1978, forty-four of forty-six states imposing corporate income taxes were using the three-factor apportionment formula.[263]

1983, at 28, col. 1. For a discussion of the unitary business concept, see *infra* notes 267-79 and accompanying text.

258 H.R. 2918, 98th Cong., 1st Sess. (1983), sponsored by Rep. Conable, and S. 1225, 98th Cong., 1st Sess. (1983), sponsored by Sen. Mathias.

259 Hellerstein, *State Taxation Under the Commerce Clause: An Historical Perspective*, 29 VAND. L. REV. 335, 339-40 (1976). For general criticism of Public Law No. 86-272, see Wagner & Del Duca, *Uniformity or Preferential Tax Immunity for Multi-State Firms*, 48 A.B.A. J. 532 (1962).

260 *See supra* notes 153-82 and accompanying text.

261 380 U.S. 553, 561 (1965). There was also some hesitation by the Court as to whether a sales-factor formula adequately measured the source of income or reflected the social cost of government. *See* Hellerstein, *State Tax Discrimination Against Out-of-Staters*, 30 NAT'L TAX J. 113, 120-23 (1977).

262 380 U.S. at 559-61.

263 Brief, Amicus Curiae, Committee on State Taxation of the Council of State Chambers of Commerce at 168-69, Moorman Mfg. Co. v. Bair, 437 U.S. 267 (1978), *reprinted in* 10 Law Reprints, Tax Series No. 10 (1977/78 Term). While this tremendous uniformity was occurring on a surface level, however, a submovement was begun as Florida, Massachusetts, New York and Wisconsin modified their particular three-factor formulas giving double weight to the sales factor. *Id.* at 178. The effect of this modification reduced taxes of local business at the expense of instate sales of foreign business enterprises. Hellerstein, *supra* note 261, at 123, 132 n.98.

Iowa continued to apportion interstate income according to a formula using the single factor of sales, and the Court in *Morrman Mfg. Co. v. Bair*[264] upheld this approach. The Court clarified its decision in *General Motors II*, stating that it had been decided purely upon statutory grounds, and that the Court had taken no position in that case on the constitutionality of a single sales-factor formula. Thus the Iowa statute would be measured by traditional Due Process and Commerce Clause standards.[265] After examining the pre-*Northwestern States* line of cases, the Court upheld the Iowa formula because the taxpayer failed to present affirmative proof demonstrating actual multiple taxation. The strong presumptive validity of the state statute prevailed, and in conclusion, the Court noted that the traditional constitutional analysis would be applied on a case-by-case basis "until Congress prescribes a different rule."[266]

After the *Morrman* decision, the Supreme Court turned its attention to the state tax base and the concept of a unitary business. Two decisions in early 1980 addressed the issue of "unitary business." The first, *Mobil Oil Corp. v. Commissioner of Taxes*,[267] involved Vermont's corporate income tax which Vermont imposed on a foreign corporation. The state employed the common three-factor formula, but included in the taxpayer's apportionable tax base, dividends received from subsidiary corporations, which is normally a type of income subject to specific allocation rather than apportionment. The Court found that the taxpayer's network of divisional entities constituted a "unitary business," and thus the dividend income could properly be included in the tax base subject to apportionment. The nature of an item of income is not determinative; a taxpayer must show that an item of income is attributable exclusively to out-of-state business in order to keep it out of the apportionable tax base.[268] The corporation attempted to demonstrate that the dividend in-

264 437 U.S. 267 (1978).

265 *Id.* at 275, *citing General Motors II*, 380 U.S. at 561.

266 *Id.* at 275-76, 281. Justices Brennan, Blackmun and Powell vehemently dissented arguing that the Court should be mindful of the regressive effect the decision would have upon attempts at generating state tax uniformity and should look to possible multiple taxation from the use of diverse formulas. *Id.* at 281-82 (Brennan, J., dissenting), 282-84 (Blackmun, J., dissenting), and 283-97 (Powell, Blackmun, J.J., dissenting).

267 445 U.S. 425 (1980).

268 The unitary business method takes into account:

> contributions to income resulting from functional integration, centralization of management, and economies of scale. Because these factors of profitability arise from the operation of the business as a whole, it becomes misleading to characterize the income of the business as having a single identifiable "source." . . . [T]he linchpin of apportionability in the field of state income taxation is the unitary-business principle. In accord with this principle [the taxpayer] must show, in order to establish that its [income] is not subject to [apportionment], that the income was earned in the course of activities unrelated to [instate business].

Id. at 438-39 (footnotes and citations omitted).

come had been earned outside the state by presenting accounting records, but the Court rejected the evidence, holding the tax violated neither the Due Process Clause nor the Commerce Clause.[269]

The second case decided in 1980, *Exxon Corp. v. Wisconsin Department of Revenue*,[270] also dealt with what items of income could be included in the tax base subject to apportionment. The focus was not on any particular item of income, but on whether the taxpayer's total operating income could be apportioned, although only marketing activities occurred in the state. The Court found that the taxpayer was engaged in a unitary business, notwithstanding the fact the taxpayer's books reflected "functional," as opposed to "geographic" accounting, with income being attributable to various functional units of the organization.[271] Because the evidence showed "a highly integrated business which benefited from an umbrella of centralized management and controlled interaction," internal accounting and source of income was irrelevant.[272]

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269 *Id.* The unitary business method of income division applied in *Mobil* was not a new concept, being traceable to preincome tax cases. ASARCO Inc. v. Idaho State Tax Comm'n, 458 U.S. 307 n.14 (1982). But *Mobil* was important in highlighting the modern elements of the "factors of profitibility" (functional integration, centralization of management and economies of scale) which the Court considered relevant in finding a unitary business. Over the years the Court had been criticized for failing to adequately define a unitary business. For a discussion of various aspects of the unitary business method, see G. ALTMAN & F. KEESLING, ALLOCATION OF INCOME IN STATE TAXATION 101 (2d ed. 1950); Dexter, *The Unitary Concept in State Income Taxation of Multistate-Multinational Business*, 10 URBAN LAW. 181 (1978); Hellerstein, *Recent Developments in State Tax Apportionment and the Circumscription of a Unitary Business*, 21 NAT'L TAX J. 487 (1968); Keesling & Warren, *The Unitary Concept in the Allocation of Income*, 12 HASTINGS L.J. 42 (1960); Palestin, *Interstate Taxation: Non-Unitary Corporation—Should Statutory Apportionment Yield to Separate Accounting?* 58 NAT'L TAX ASS'N 531 (1965); Rudolph, *State Taxation of Interstate Business: The Unitary Business Concept and Affiliated Corporate Groups*, 25 TAX L. REV. 171 (1970); Comment, *State Taxation of a Unitary Business*, 8 FORDHAM L.J. 819 (1980); and C. McClure, Jr., Defining Unitary Business: An Economist's View (Nat'l Bureau of Economic Research Working Paper No. 1125, 1983).

270 447 U.S. 207 (1980).

271 *Id.* at 223 nn.7-8.

272 *Id.* at 224. Needless to say, the expansion of formulary apportionment in *Mobil* and treatment of the separate accounting method in *Exxon* set off another round of reaction to the laxing Supreme Court protection of interstate commerce from state taxation. *See, e.g.*, Dexter, *Tax Apportionment of the Income of a Unitary Business: An Examination of Mobil Oil Corp. v. Commissioner of Taxes of Vermont*, 1981 B.Y.U.L. REV. 107; Keesling, *The Impact of the Mobil Case on Apportionment of Income*, 1981 B.Y.U.L. REV. 87 (*Mobil* "is a landmark case in the area of tax law relating to the allocation and apportionment of income for state tax purposes"); Note, *State Taxation of Multistate and Multinational Businesses, 34* TAX LAW. 431 (1981). There have been repeated calls for some definite congressional legislation to clarify the area. *E.g.*, Killefer, *State Taxes on Commerce: Mobil Oil Corp. v. Commissioner of Taxes of Vermont*, 8 J. CORP. TAX. 3, 18 (1981); Nachenson & Feinschreiber, *The Unitary Method of State Taxation after Mobil and Exxon*, 11 TAX ADVISER 708, 716 (1980); Comment, *Constitutional Law—State Taxation of Foreign Source Dividend Income*, 11 MEM. ST. U.L. REV. 267, 278 (1981). The decisions also excited the international community. *E.g.*, Kocot, *State Taxation of Foreign Source Divided Income*, 12 LAW & POL'Y INT'L BUS. 1023 (1980);

Just as it appeared that *Mobil* and *Exxon* would give states an expansive license to tax multijurisdictional enterprises, two companion cases which the Supreme Court decided in 1982 closed the door somewhat. *ASARCO Inc. v. Idaho St. Tax Comm'n,*[273] and *F.W. Woolworth Co. v. Taxation and Revenue Department*[274] questioned whether the respective states of Idaho and New Mexico could include in the apportionable tax base of foreign corporations items of intangible income received from their respective subsidiaries which had no business activities in the state. Each state Supreme Court had upheld the respective tax after finding that the taxpayer was engaged in a unitary business, on the authority of *Mobil* and *Exxon*.[275] The taxpayers presented evidence showing that the intangible income in question was attributable exclusively to foreign business, thereby satisfying the evidenciary standard of *Mobil*. Consequently, the Supreme Court held that the income was not unitary business income subject to apportionment, and the Supreme Court reversed both cases.[276]

Neither *Mobil, Exxon, ASARCO,* nor *Woolworth* addressed the constitutionality of worldwide combined reporting, which includes income from sources outside the United States in the tax base of a unitary busi-

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Taxation: Inclusion of Foreign Source Dividend Income in State Apportionment Formula, 22 HARV. INT'L L.J. 491 (1981).

273 458 U.S. 307 (1982).

274 458 U.S. 354 (1982).

275 Taxation and Revenue Dep't v. F.W. Woolworth Co., 95 N.M. 519, 526-29, 624 P.2d 28, 35-38 (1981), *rev'd* 458 U.S. 354 (1982); American Smelting & Refining Co. v. Idaho State Tax Comm'n, 102 Idaho 38, 624 P.2d 946 (1981), *rev'd* 458 U.S. 307 (1982).

276 For a general discussion, see *The Supreme Court 1981 Term: State Corporate Income Taxation*, 96 HARV. L. REV. 1, 86-96 (1982), and Hellerstein, *State Income Taxation of Multijurisdictional Corporations, Part II: Reflections on ASARCO and Woolworth*, 81 MICH. L. REV. 157 (1982). In *ASARCO*, the Court attempted to distinguish *Mobil* when applying its evidenciary standard by focusing on the independent operations of the parent and subsidiaries. 458 U.S. at 315-20. But the holding undoubtedly was influenced by Idaho's concession that the case did not involve a classic single unitary business, but attempted to redefine the principal to encompass "corporate *purpose*." 458 U.S. at 326. Consequently, the case was criticized for failing to adequately address the definition of unitary business. Floyd, *The 'Unitary' Business in State Taxation: Confusion at the Supreme Court?*" 1982 B.Y.U.L. REV. 465-66; Hellerstein, *supra* at 172-73. The decision was also heavily criticized by the dissenting justices for failing to take into account the economic realities in the receipt of income by the parent. 458 U.S. at 331-53.

As for *Woolworth*, the Court criticized the lack of preparation by the state on the issue of determining the existence of a unitary business. 458 U.S. at 360 ("[r]egrettably, it needs to be said that the State did a very poor job of inquiring into and developing the facts in this case"). The state was content to rest the constitutionality of its statute on the presumption of correctness in state taxation and the taxpayer's "potential" for operating its company as a unitary business. *Id.* at 360-61. *See* Floyd, *supra* at 477-78. Due to the lack of evidence presented by the state, the Court examined the taxpayer's evidence, and concluded that there was not a unitary business "on the basis of undisputed facts." 458 U.S. at 369.

ness.[277] In June, 1983, the Supreme Court upheld the constitutionality of California's worldwide combined reporting in *Container Corp. of America v. Franchise Tax Bd.*[278] California's franchise tax was imposed on a Delaware corporation engaged in the manufacture of paperboard packaging both within and outside California. Although the taxpayer's operations were largely domestic, a number of controlled subsidiaries were engaged in similar business activities in foreign countries. California included income earned from these overseas subsidiaries in the total state tax base subject to apportionment. The corporation argued that the subsidiaries were not part of a unified business, and that *ASARCO* and *Woolworth* precluded inclusion of the income in its tax base. But the Court disagreed, finding the facts more in accord with *Mobil* and *Exxon*, and holding that the entire worldwide operations formed a single unitary business, the total income of which was subject to apportionment.[279]

VI. SOLUTIONS TO MULTIPLE TAXATION

A. International Business

Because international and interstate taxation of multijurisdictional business enterprises each requires resolution of competing jurisdictional claims, and proper determination and division of income to avoid multiple taxation, the tendency to compare State and Federal systems of taxation is natural. Interestingly, this tendency dates back to early discussions of multiple taxation from both international and interstate

277 Specifically, the inclusion of foreign income is referred to as "worldwide combined reporting." "Under combined reporting, the separate corporate elements of a unitary business prepare a single report which sums the results of their individual activities and assigns the appropriate portion of profit or loss to the individual corporate elements and states on the basis of an apportionment formula." A combined report is not synonymous with a consolidated tax return provided under the Internal Revenue Code, I.R.C. § 1501, but merely represents an information report. GAO REPORT, *supra* note 126, at 5. A combined report aggregates the total net income of a multijurisdictional enterprise, eliminating intercompany transactions required under I.R.C. § 482. Note, *State Taxation of Foreign-Source Income: Mobil Oil Corp. v. Commissioner of Taxes*, 66 CORNELL L. REV. 805, 815 n.56 (1981).

278 463 U.S. 159 (1983). For a general discussion of the history and operation of combined reporting in California, see Keesling, *A Current Look at the Combined Report and Uniformity in Allocation Practices*, 42 J. TAX'N 106 (1975).

279 463 U.S. at 180, 184. As of July 1, 1982, thirteen states applied worldwide combined reporting. GAO REPORT, *supra* note 126, at 66. Following the decision in *Container Corp.*, a number of states adopted the approach. *E.g.*, FLA. STAT. ANN. § 220.135 (West 1985 Supp.).

The Container Corporation was a domestic corporation which was required to include foreign subsidiary corporations under California's worldwide combined reporting approach. Still to be resolved is the issue of whether a non-U.S. corporation with operations in the U.S. can be required by a state to include its non-U.S. operations in a combined report. *See* Javaras & Browne, *Litigation Prospects After Container: The Foreign Parent Issue*, Tax Notes, Dec. 19, 1983 at 1027.

perspectives.[280]

As discussed in Part II, the League of Nations, with encouragement from the International Chamber of Commerce, began a movement to foster international cooperation to minimize double taxation, and produced a report in 1923 which four leading international economists, including Professor Seligman prepared.[281] During this period, the NTA commenced its efforts to achieve interstate uniformity,[282] and because Professor Seligman was a former president of the NTA,[283] his views on double taxation undoubtedly influenced the search for a single procedure at both the interstate and international levels of government.[284] Another past-president of the NTA, Professor Adams of Yale University, who was also involved in the international arena, representing the United States at international conferences on double taxation,[285] presented his views at the 1929 NTA conference.[286] After giving a brief history of the efforts of the League and the progress achieved, with some twenty bilateral treaties having been concluded, he predicted that within a short period Europe would have a network of bilateral conventions virtually eliminating double taxation problems for international enterprises operating in the region.[287] Because countries have conflicting and selfish economic and political interests, however, Adams did not believe that a bilateral treaty network could be spread worldwide; the only means of resolving the problem would be for nations to adopt one uniform multilateral convention along the lines of the model treaties which the League prepared.[288] Adams also recommended that the NTA encourage the American states to follow the lead set by the League by adopting a uniform law.[289]

The comparison of international and interstate jurisdictional and

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280 For an international perspective, see Carroll, *Allocation of Business Income: The Draft Convention of the League of Nations*, 34 COLUM. L. REV. 473, 489 (1934), and for an interstate perspective, see Adams, *International and Interstate Aspects of Double Taxation*, 22 NAT'L TAX ASS'N 193 (1929).

281 *See supra* notes 10-33 and accompanying text.

282 *See supra* notes 15-19 and accompanying text.

283 Seligman was President of the NTA from 1913-15. Mattersdorf, *The National Tax Association—Places of Meetings and Officers*, 63 NAT'L TAX ASS'N 455, 460 (1970).

284 *See* Adams, *supra* note 280, at 193. *See also* Carroll, *Observations of Report of the Committee of the National Tax Association on Uniformity and Reciprocity in State Tax Legislation, Especially with Regard to the Allocation of Income of International Enterprises*, 24 NAT'L TAX ASS'N 333-45 (1931).

285 *Reciprocity in Inheritance Taxation—Report of Committee of the National Tax Association*, 22 NAT'L TAX ASS'N 200, 226 (1929). Professor Adams was President of the NTA from 1922-23. Mattersdorf, *supra* note 283, at 460.

286 Adams, *supra* note 280.

287 *Id.* at 193-94.

288 *Id.* at 194, 196.

289 *Id.* at 196-97.

double taxation problems continued at the 1930 annual NTA conference. A year earlier the International Chamber of Commerce had proposed a series of principles which would aid in mitigating international double taxation.[290] The NTA's Third Committee studied these principles and in its annual report, the Committee addressed these principles with item-by-item committee comment as to whether each principle would apply in the interstate setting; however, the Committee did not draw any ultimate conclusions.[291]

During the next year, members of the Third Committee devoted extensive consideration to whether the interstate and international problems of double taxation could be governed by the same principles. In its 1931 report, the Third Committee listed six major differences between international and interstate conditions and relations, and concluded that similar principles could not be applied.[292] As the myriad of futile attempts to reach state-level interstate uniformity demonstrated, voluntary conformity by independent sovereign states is impossible. Only some type of forced compliance, applicable to all taxing jurisdictions, can provide the vehicle necessary for broad uniformity. Forced compliance would require the devolution of some of an independent state's sovereign powers such as is found with a federal-constitutional authority.

Under a federal system, states surrender a portion of their individual sovereignty to a central authority through a constitutional compact, and laws made pursuant to such constitution form the supreme law, notwithstanding any conflicting state law or constitution.[293] The most comprehensive international institution is the United Nations (UN),[294] however,

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290 *See* Edmonds, *Report of the Committee of the National Tax Association on Uniformity and Reciprocity in State Taxing Legislation*, 23 NAT'L TAX ASS'N 338, 352 (1930).

291 *Id.* at 353-56.

292 The six differences were:

1. differences in language in international business necessitating generally differences in the financial records of the foreign divisions of a business;
2. differences in methods of conducting foreign businesses and interstate commerce;
3. the different theories of profit realization upon which foreign branches and domestic branches are likely to be based;
4. tariff laws which may affect international but not interstate income taxation;
5. differences in the competitive objectives and motives in domestic and foreign businesses involving in the case of international business frequently such real but intangible elements as race or historical prejudices;
6. differences in constitutional limitations on the power to tax.

Gerstenberg, *Allocation of Business Income, Report of the Committee of the National Tax Association on Uniformity and Reciprocity in State Taxation legislation*, 24 NAT'L TAX ASS'N 294, 302 (1931).

293 McCulloch v. Maryland, 17 U.S. (4 Wheat.) 316, 406 (1819).

294 G. SCHWARZENBERGER, 3 INTERNATIONAL LAW 7 (1976).

it is not a centralized government. The UN Charter[295] sets forth various purposes and principles, and provides a framework for a potential international constitution, but it is not by any means the equivalent of the United States Constitution.[296] Since the Charter provisions lack an effective enforcement mechanism its provisions are seen by some as providing only inspirational messages to guide international relations.[297] Member nations of the UN are inclined towards complying with the Charter primarily out of a sense of world opinion, although arguably by some concession of sovereignty. Unlike with a constitutional system, political issues, such as are involved in determinations of taxation of multinational enterprises, lie outside the reach of the UN because it lacks an effective system of authority and enforcement.[298] Due to the absence of an international constitutional system,[299] and the low probability of voluntary national movement, hope appears dim for an international multilateral treaty for solving multiple taxation problems. If a multilateral treaty is unlikely, the question arises whether *any* means is available for ameliorating multiple taxation on an international level. Professor Adams suggested in 1929 the use of model bilateral treaties. Although total uniformity might be unobtainable, continued improvement and worldwide acceptance of such treaties appears as the optimum approach to minimizing international double taxation.

The objective of improving upon a model bilateral treaty was the guiding principal behind the first recommendations made by the Organization for European Economic Cooperation (OEEC) on February 15, 1955.[300] At that time there existed 70 bilateral treaties patterned after the model treaties of the League of Nations.[301] Increasing international economic interdependence provided an impetus for even greater progress to be achieved, and consequently the Organization for Economic Cooperation and Development (OECD) and the United States pursued the model bilateral treaty approach.[302] The model bilateral treaties have met

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295 L. GOODRICH, E. HAMBRO & A.P. SIMONS, CHARTER OF THE UNITED NATIONS: COMMENTARY AND DOCUMENTS (3d and revised ed. 1969).

296 J. HALDERMAN, THE UNITED NATIONS AND THE RULE OF LAW 1-7 (1966).

297 G. SCHWARZENBERGER, *supra* note 294, at 136.

298 J. HALDERMAN, *supra* note 296, at 215-16.

299 The original intention of the United Nations was directed towards a constitutional form, but the goal has been generally dismissed. *Id.* at 1-2. Obviously, if the United Nations, a recognized international institution, is unable to achieve unity among nations, *a fortiori*, any extant or proposed ad hoc international organization designed to deal directly with the issues of multiple taxation likewise will confront failure.

300 Model Double Taxation Convention on Income and on Capital, Report of the OECD Committee on Fiscal Affairs 7 (1977).

301 *Id.*

302 *See supra* notes 59-64 and accompanying text.

with considerable success, and this appears the proper direction for easing double taxation on the international level, rather than devoting fruitless efforts towards a multilateral convention.[303] As for division of income, the model treaties apply the separate-entity/arm's-length approach,[304] which international tax authorities have recommended as the best approach on the international level.[305]

B. Interstate Business

Over the years, various committees of the National Tax Association have advocated five general approaches for achieving uniformity in interstate taxation; two strictly state-level, two state-federal hybrid methods, and one strictly federal-level.[306] As for the two purely state-level approaches, one calls for a voluntary uniform national state tax system, while the other proposes regional unity. The NTA has long supported the national approach, but its long history of futility illustrates the practical impossibility of attaining such a system.[307] Two state-level efforts, the UDITPA and the MTC, have brought some semblance of conformity to the area, but neither has been truly successful.[308] Although regional uniformity has not had the same concerted attention,[309] difficulties similar to those faced by national efforts exist for concluding regional agreements.[310]

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303 The OECD has considered the feasibility of a model multilateral convention, but has rejected the idea, concluding that "great difficulties" would be met. Model Double Taxation Convention on Income and on Capital, Report of the OECD Committee on Fiscal Affairs 7 (1977).

304 *See supra* notes 69-112 and accompanying text.

305 *E.g.*, Carroll, *supra* note 280, at 494; Carroll, *supra* note 284, at 333. The reason this method is optimum for international commerce has been explained by the Supreme Court as follows:

> Although consistent application of the fair apportionment standard can generally mitigate, if not eliminate, double taxation in the domestic context, "neither this Court nor this Nation can ensure full apportionment when one of the taxing entities is a foreign sovereign. If an instrumentality of commerce is domiciled abroad, the country of domicile may have the right, consistently with the custom of nations, to impose a tax on its full value. If a state should seek to the tax the same instrumentality on an apportioned basis, multiple taxation inevitably results . . . [d]ue to the absence of an authoritative tribunal capable of ensuring that the aggregation of taxes is computed on no more than one full value.

Container Corp. of America v. Franchise Tax Bd., 463 U.S. 159, 186 (1983), *quoting* Japan Line, Ltd. v. County of Los Angeles, 441 U.S. 434, 447-48 (1979).

306 *See* Ratliff, Jr., *State Taxation of Interstate Commerce: The Case for Federal Control*, 55 NAT'L TAX ASS'N 513, 518-20 (1962); *Cooperation*, *supra* note 215, at 1335.

307 For the NTA history, see *supra* notes 195-99 and accompanying text.

308 Although the vast majority of states having corporate income taxes use the equally weighted three-factor formula, GAO REPORT, *supra* note 126, at 61, patterned after the UDITPA, much diversity still exists. *See supra* notes 200-240 and accompanying text.

309 *See supra* notes 229-30 and accompanying text.

310 The regional approach attempts to encourage states within a certain economic network to adopt the same tax system thereby generating uniformity among that block of states. There are at least four problems with this approach. First, there is the difficulty of defining an economic region.

The two state/federal hybrid methods suffer similar complaints. The first hybrid method, which Cox advocated at the 1953 NTA conference,[311] calls for a national convention of states, with the federal government relegated to the role of a neutral moderator. Consequently, some Committee workers criticized this approach as another form of state-level approach, subject to the same defects as the other forms.[312] The second method urges an intergovernmental solution, recommending formation of an independent state-federal fiscal agency directly authorized to mediate a national state tax system.[313] But the committees which the NTA appointed over the years to search for an intergovernmental approach experienced the identical frustrations as the committees searching for a state-level approach did, and there is little to suggest that future intergovernmental efforts would be successful.

With state-level and state/federal hybrid approaches unfeasible, the remaining hope for national uniformity of state taxation rests in pre-emptive federal action. For the very reason a multilateral treaty is unfeasible on an international level,[314] a single uniform federal law is possible on the interstate level; the former lacks a constitutional system while the latter does not. Over the years a number of commentators and congressmen have advocated federal legislation as the only means of achieving uniformity.[315] Two questions, however, stand out as obstacles to a feder-

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Of course there are various states dependent upon certain predominate industries, but this does not mean those states depend exclusively upon one industry for revenue. Second, a regional formula would have to take into account differences between states as would a national formula. Third, the problem of resolving national differences remains, with analysis merely shifting from state-level to a more abstract level of finding an acceptable uniform formula applicable across regional lines. The regional formula would not relieve multijurisdictional business enterprises from multiple taxation, the group most in need of a unified system. Finally, and perhaps most critically, the regional approach is viewed as an interim measure, but as such, it diverts attention from the central issue of achieving national uniformity. *See* 51 NAT'L TAX ASS'N 372 (1958).

311 Cox, *Congressional Action to Achieve Uniformity in Interstate Allocation of Income*, 46 NAT'L TAX ASS'N 262, 264 (1953).

312 Leo Mattersdorf, Chair of the NTA's Fifth Committee, was extremely skeptical whether such Congressional input would be helpful. When a question was addressed to Mattersdorf whether the NTA had ever appointed a committee to recommend a model allocation formula, he responded, "[w]e have had about six committees, I think. Each recommended a different formula, and none of them has ever been adopted." Mattersdorf, *Should the States Adopt Withholding*, 46 NAT'L TAX ASS'N 271, 283 (1953). While sympathizing with the Cox proposal, Mattersdorf questioned whether it was conceivable that states would "get together any faster under the impetus of a resolution of Congress than they ha[d] in the past." *Id.* at 285. After briefly presenting his views, Mattersdorf concluded, "while I am in favor of what Mr. Cox recommends, I think it will not work and that a resolution of Congress will not help the matter one iota." *Id.* at 286.

313 *See* Martin, *Federal-State Tax Cooperation*, 34 NAT'L MUNICIPAL REV. 21 (1945).

314 *See supra* notes 293-99 and accompanying text.

315 *E.g.*, GAO REPORT, *supra* note 126, at 16-67; 1964 REPORT ON STATE TAXATION, *supra* note 114, at 599; *see supra* note 220. As early as 1939, the U.S. Department of Agriculture noted that

ally imposed, nationally uniform state taxation system; one is constitutional, the other political.

Politically, the question is whether Congress can find a solution states would be willing to accept. Income taxes are a vital source of revenue for states, and states naturally become very defensive against anything which would threaten existing state prerogatives.[316] The answer depends on whether Congress can compose unified legislation without intruding too much upon existing state law which, in turn, requires examination of the three elements of state law—subject matter, measure, and rate.

With respect to what activities may be subject to tax, a 1981 federal study (GAO Report) found the various income tax states used ten different criteria for determining jurisdiction over foreign corporations.[317] While this seems to evidence wide divergence, the diversity is more semantic than real. States are permitted to tax interstate commerce, and Public Law No. 86-272 already imposes a uniform *minimum* jurisdictional level. Thus, the path seems clear for Congress to impose a *maximum* jurisdictional level applicable to all states.

As for the measure of the tax, three subissues must be addressed. The first deals with the appropriate mode of computing net income subject to division. The second concerns the proper criteria to apply in establishing a unitary or worldwide combined business for inclusion of total business income in the tax base subject to division. Third, there must be a solitary apportionment formula. Although there are many variations among the states regarding each of these subissues, there is

"[t]he difficulty of making appreciable progress through voluntary state adoption of broad reciprocity agreements suggest the alternative of Federal action." U.S. Department of Agriculture, Barriers to International Trade in Farm Products 54 (U.S. Government Printing Office, Washington, DC 1939), *reprinted in* Kahn, *Federal Limitations Upon State Motor Carrier Taxation and Regulation*, 32 TEMP. L.Q. 61, 78 (1958). The American Bar Association began study of federal legislation covering state taxation of multistate business in 1956, making specific suggestions in 1969. *A.B.A. Recommendations*, *supra* note 200, at 1041-53 (1959). A minority report severly criticized the resolutions as committing the A.B.A. to a strictly political issue. *Id.* at 1054-62. The same criticism had been voiced earlier by the A.B.A. House of Delegates to a 1967 resolution calling for federal action. *Id.* at 1054-55.

316 Such a defensive reaction helps explain the early state resistance to UDITPA. One main problem in the history of double taxation lies with interstate business itself. Instead of being content with being subject to state tax upon one hundred per cent of net income, many businesses had devised means to shelter portions of income from tax by creating "nowhere income," and have raised the specter of "double taxation" when such was not an issue. Corrigan, *Interstate Corporate Income Taxation—Recent Revolutions and a Modern Response*, 29 VAND. L. REV. 423 (1976).

317 GAO REPORT, *supra* note 126, at 59-60. For criticism of the GAO Report, see Roemer, *The States View of GAO Report*, 75 NAT'L TAX ASS'N 152 (1982); Committee on Interstate Commerce of the N.Y. Bar Ass'n, Congress and the Taxation of Multijurisdictional Corporations, Tax Notes, Nov. 7, 1983 at 451.

nonetheless a large degree of conformity.[318]

Finally, a federal statute need not, and should not, address the issue of the rate at which states may impose their income tax. Uniform federal law regarding jurisdiction and determination of the tax base should eliminate the possibility of double taxation of net income, and the revenue needs and overall fiscal policy of each state would determine the rate of tax.[319]

From the political perspective, the stage seems set for a nationally uniform state income tax system; some states have even called for federal legislation.[320] Opposition, however, will undoubtedly come from advocates of strong states' rights and from some powerful business interests which find the lack of uniformity to be to their advantage.

The primary constitutional issue is whether the Congress has authority to fully pre-empt issues involving state taxation of interstate commerce. Because Public Law No. 86-272 represents the solitary instance of congressional control over state income taxation,[321] and this law has not had constitutional review by the Supreme Court, no genuine gauge of the constitutional question is available. The reasoning of the state court decisions upholding Public Law No. 86-272, however, seems sound,[322] and federal preemptive legislation should be valid.[323]

The movement towards uniformity begun by the UDITPA and the MTC has demonstrated the desirability of uniformity and the weaknesses of anything less than a federally imposed approach. The constitutional objections to federal legislation seem insubstantial; the political objections may, however, prove to be insurmountable.

VII. CONCLUSION

An organized search for solutions to the problems of double taxa-

318 The GAO REPORT found 75% of the taxing states based state taxable income upon federal taxable income. GAO REPORT, *supra* note 126, at 60-61. A large percentage of states also use the equally weighted three-factor formula, as well as individual treatment in the three factors of property, payroll and sales. *Id.* at 61-65. Finally, there was general agreement over income division and unitary business. *Id.* at 65-66.

319 States could adjust tax rates to offset any loss due to the change over to the national system. Likewise, businesses could lobby individual states to alter rates or provide credits for the benefit of particular business interests.

320 Brief for Appellants, Jurisdictional Statement at 22-23, United States Steel Corporation v. Multistate Tax Comm'n, 434 U.S. 452 (1978), 10 Law Reprints, Tax Series No. 1 (1977/78 Term).

321 *Cf.* Aloha Airlines, Inc. v. Director of Taxation of Hawaii, 464 U.S. 7 (1983) (state tax on gross income of airlines operating within the state was preempted by federal law).

322 *See supra* notes 251-54 and accompanying text.

323 See P. HARTMAN, STATE TAXATION OF INTERSTATE COMMERCE 247-56 (1953); Hellerstein, *The Power of Congress to Restrict State Taxation of Interstate Commerce*, 12 J. TAX'N 302, 303-05 (1960).

tion of multijurisdictional enterprises has been underway for more than a century at both the international and the interstate levels. A network of bilateral tax treaties has evolved as the solution at the international level, because even though a widely adopted multilateral treaty has strong theoretical appeal, it has proven to be impractical. Instead, the search has been for a general framework, in the form of model treaty provisions, which can bring a common theme, if not uniformity, to bilateral tax treaties. The general scheme of these treaties is to establish standards for the assertion of taxing jurisdiction, and, if those standards are met, to treat the business activities within the taxing state as a separate entity, dealing at arm's length with other elements of the enterprise of which it is a part. Although it is difficult to administer and ensure compliance with the separate-entity/arm's-length approach, efforts to refine the concepts involved in the measure of the tax base have been helpful in resolving many of the troublesome areas. Total uniformity in the international arena does not seem possible the best that can be hoped for is improving the existing approach.

Multijurisdictional enterprises have also been troubled by the specter of double taxation within the United States. Unlike in the international arena, however, the United States Constitution has provided some protections here. The Due Process and Commerce Clause have imposed some constraints on the states' exercise of their taxing powers, but not to a degree which requires the states to adopt uniform criteria for jurisdiction and the determination of a taxpayer's tax base. Therefore, double taxation may still result, but the burden is on the taxpayer to demonstrate actual double taxation, rather than the likelihood of it because of the interplay of conflicting states' rules. Also in contrast with the international arena, it is possible to achieve uniformity within the United States. The existence of a governmental structure which has powers superior to those of the individual states permits the Congress to enact legislation, binding on all the states, which would provide uniform rules for asserting tax jurisdiction, and for determining a taxpayer's tax base. Equally important is that the uniform rules, the statutes, would be subject to uniform interpretation and application in each of the states. Voluntary efforts by the states to adopt uniform rules have been largely unsuccessful, and recent Supreme Court decisions have given the states broad discretion to structure their income tax systems. Interstate uniformity can only be achieved by Congressional action.