Mississippi College Law Review

Volume 16
Issue 1 *Vol. 16 Iss. 1*

Article 14

1996

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16 Miss. C. L. Rev. 247 (1995-1996)

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IS A STATE'S TAXATION OF FOREIGN CORPORATIONS CONSTITUTIONALLY LIMITED TO U.S. WATER'S EDGE: APPLICATION OF WORLDWIDE COMBINED REPORTING

Barclays Bank PLC v. Franchise Tax Board of California

114 S. Ct. 2268 (1994)

Raymond G. Russell

I. INTRODUCTION

The Supreme Court handed down in *Barclays Bank PLC v. Franchise Tax Board of California*,[1] on June 20, 1994, a 7-2 decision upholding California's assessment of corporate franchise taxes[2] on Barclays Bank PLC,[3] based on an apportionment of its income which was calculated as including the income of its worldwide subsidiaries.[4] In a companion case, *Colgate-Palmolive Co. v. Franchise Tax Board of California*,[5] the Court considered, in the context of a domestic parent, similar issues.

Few United States tax policy controversies have created as much international commotion as the disputes revolving around the *Barclays* case. The taxing authority of the State of California was upheld despite an onslaught of amici briefs from foreign trading partners[6] expressing their disdain for the worldwide

1. 114 S. Ct. 2268 (1994).
2. *Id.* at 2278.
3. Actually, the petitioner in this case, Barclays Bank PLC, succeeds in interest in the tax refund claims of Barclays Bank of California (Barcal) and Barclays Bank International Limited (BBI). *Id.* at 2274. BBI was a United Kingdom corporation which wholly owned the California banking corporation Barcal. *Id.* BBI carried on business in the United Kingdom and in thirty-three other countries and territories. *Id.* Barcal and BBI were members of the United Kingdom based Barclays Group, a multinational banking enterprise. *Id.* The Barclays Group is composed of over 220 corporations doing business in some sixty nations; no more than three of those entities did any business in the United States. *Id.* at 2274, 2279.
4. *Id.* at 2271. Various other states apply a version of worldwide combined reporting, including Alaska, Colorado, Florida, Idaho, Montana, New Hampshire, North Dakota, and Utah. J. William McArthur, Jr. & Kendall L. Houghton, *In Barclays, U.S. Supreme Court Finds for California, Which was Banking on It*, 81 J. TAX'N 176, 178 (1994). Thirteen states filed or participated in amici briefs supporting California's use of worldwide combined reporting. These states were Alaska, Arkansas, Colorado, Hawaii, Idaho, Kansas, Maine, Montana, New Hampshire, New Mexico, North Dakota, Oregon, and Rhode Island. Nicholas S. Freud & Walter M. Kolligs, *U.S. Supreme Court Upholds Worldwide Reporting and Unitary Taxation*, 5 J. INT'L TAX'N 340, 341 n.3 (August 1994).
5. 114 S. Ct. 2268 (1994).
6. The governments of the United Kingdom, Belgium, Denmark, France, Germany, Greece, Ireland, Italy, Luxembourg, the Netherlands, Portugal, Spain, Australia, Austria, Canada, Finland, Japan, Norway, Sweden, and Switzerland submitted amici briefs in support of Barclays. *Id.* at 2284. This group comprises most of the United States' trading partners. *Id.* at 2289. Diplomatic notes complaining about the use of the worldwide combined reporting method by the states have been received by the Department of State from nearly every developed nation in the world. *Id.* at 2290. The parliament of the United Kingdom has gone so far at to enact retaliatory legislation that would tax dividends received from subsidiaries located in the United Kingdom to the United States corporations which owned them. *Id.*

combined reporting method,[7] as well as pressure from the Executive Branch.[8] The Court, while reaffirming that the Due Process and Commerce Clauses of the Constitution prevent states from imposing taxes on nonresidents based on the income earned beyond the taxing state's border,[9] upheld California's use of a worldwide combined reporting method.[10] The majority opinion, applying a case-by-case analysis derived from *Complete Auto Transit, Inc. v. Brady*,[11] *Container Corp. v. Franchise Tax Board*,[12] and *Japan Line, Ltd. v. County of Los Angeles*,[13] determined that the taxation method as applied by the State did not prevent the federal government from "speaking with one voice" in international tax treaties and in international commerce,[14] and, thus, that the method did not violate the "dormant" or "negative" Commerce Clause.[15] The Court also did not agree with petitioners' contention that the Due Process Clause was violated because the "reasonable approximations" mechanism for reducing the compliance burden was standardless.[16]

This Note will discuss the difference between the separate accounting scheme applied by the federal government and the worldwide combined reporting method; the factual background and procedural history of the instant case; the more recent developments involving the authority of the states to tax corporations operating within the states' borders in the manner they choose; the holdings of the instant case, and the differing views of the justices in *Barclays*. In addition, this Note will examine the effects of the *Barclays* decision on the Dormant Commerce Clause as a limitation on the states' taxing power, the potential of continued or expanded use by the states of worldwide combined reporting, and the possible adoption by Congress of the worldwide combined reporting method as the method of taxation to be applied to international corporations by the federal government.

II. SEPARATE ACCOUNTING VS. WORLDWIDE COMBINED REPORTING

Before a thorough understanding of the Court's holding in Barclays can be reached, one must understand the basic distinctions between a separate accounting method and a worldwide combined reporting method as well as the possible ramifications of those distinctions. Although there are differing views on the

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7. *Id.* at 2289-90.

8. *Id.* at 2285. The Court held that Executive Branch communications could espouse federal policy, but that they "lack[ed] the force of law" and could not render California's use of worldwide combined reporting unconstitutional. *Id.* at 2286.

9. *Id.* at 2272.

10. *Id.* at 2286.

11. 430 U.S. 274, 279 (1977).

12. 463 U.S. 159, 185 (1983).

13. 441 U.S. 434, 450 (1979).

14. Barclays Bank PLC v. Franchise Tax Bd. of Cal., 114 S. Ct. 2268, 2281 (1994) (quoting Michelin Tire Corp. v. Wages, 423 U.S. 276, 285 (1976)).

15. *Id.* at 2276. The Court stated that there was a self-executing aspect of the Commerce Clause which prohibits discrimination against interstate (or foreign) commerce and that the Court's jurisprudence deems this aspect to be the "dormant" or "negative" Commerce Clause. *Id.*

16. *Id.* at 2278.

potential ramifications of the use of one method over the other,[17] the following discussion should prove to be a useful distillation of the basic functioning of the methods and the distinctions involved.

A. Separate Accounting Method

The United States imposes its income tax on a corporate income based method of "separate accounting."[18] All major developed nations use this method of apportioning income among taxing sovereigns.[18]

"Separate accounting is a technique of carving out of the overall business of the taxpayer the activities taking place, the property employed in, and the income derived from, sources within a single State, and by accounting analysis ascertaining the profits attributable to that portion of the business."[20] The separate accounting method, in contrast to worldwide combined reporting, treats each corporate entity singularly to determine income tax liability.[21] This method, when it can be and is appropriately applied, taxes entities operating within the taxing body's jurisdiction only on the income recognized on their own books.[22] A foreign corporation, under the Internal Revenue Code, only reports income sufficiently connected with the entity's engagement of a United States trade or business and income derived from a United States source.[23] A domestic corporation reports all income, whether foreign or domestic, and receives a credit for the payment of qualifying taxes to foreign sovereigns.[24]

One risk associated with determining tax liability based on separate accounting is that a multinational conglomerate will manipulate transfers of value among its subsidiaries or components to reduce the conglomerate's total tax liability.[25] To retard such manipulation, a taxing jurisdiction must ensure that such transactions, or transfers of value, are returned based on an "arm's length" value.[26] A taxing jurisdiction must therefore ensure that such transfers of value are reported

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17. *See, e.g.*, Kenneth W. Gideon & William J. Wilkins, *Memorandum to Congress: You Wouldn't Like Worldwide Formula Apportionment*, 65 TAX NOTES 1259, 1265 (Dec. 5, 1994); Benjamin F. Miller, *None Are So Blind As Those Who Will Not See*, 66 TAX NOTES 1023, 1024 (Feb. 14, 1995).

18. *Barclays*, 114 S. Ct. at 2273. Separate accounting is also often referred to as the "arm's-length" approach. Container Corp. of Am. v. Franchise Tax Bd., 463 U.S. 159, 184 (1983).

19. *Barclays*, 114 S. Ct. at 2273.

20. 1 J. HELLERSTEIN & W. HELLERSTEIN, STATE TAXATION: CORPORATE INCOME AND FRANCHISE TAXES, ¶ 8.03 (2d ed. 1993).

21. *Barclays*, 114 S. Ct. at 2273.

22. *Id.* The Court in *Container Corp.* described the effects of separate accounting as follows:

> Under the "arm's length" approach, every corporation, even if closely tied to other corporations, is treated for most—but decidedly not all—purposes as if it were an independent entity dealing at arm's length with its affiliated corporations, and subject to taxation only by the jurisdictions in which it operates and only for the income it realizes on its own books.

Container Corp., 459 U.S. at 184.

23. *Barclays*, 114 S. Ct. at 2273.

24. *Id.*

25. *Id.*

26. *Id.*

to reflect true market value.[27] Some commentators, as well as the Court, adopt the view that the result is somewhat arbitrary in any event.[28]

B. Worldwide Combined Reporting

The worldwide combined reporting method is, basically, a variation of the "unitary method."[29] It is another means of determining the portion of the income of a multi-jurisdictional entity that can be taxed by a jurisdiction. The unitary method:

> rejects geographical or transactional accounting, and instead calculates the local tax base by first defining the scope of the "unitary business" of which the taxed enterprise's activities in the taxing jurisdiction form one part, and then apportioning the total income of that "unitary business" between the taxing jurisdiction and the rest of the world on the basis of a formula taking into account objective measures of the corporation's activities within and without the jurisdiction.[30]

Basically, a business is unitary if it "exhibits functional integration, centralization of management, and economies of scale."[31] Stated differently, "[i]f the operation of the portion of the business done within the state is dependent upon or contributes to the operation of the business without the state, the operations are unitary."[32]

The worldwide combined reporting method can be seen as being comprised of two components or aspects: a unitary business and formula apportionment.[33] Once there is a determination that an entity is a part of a unitary business, and which other entities comprise the unitary business, a jurisdiction must then apply a formula which apportions the income of that business within and without the jurisdiction.[34] The formula commonly applied by the states using a unitary method is called the "three-factor" formula.[35] The formula is based generally in

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27. *Id.*

28. "Rules governing international multijurisdictional income allocation have an inescapable imprecision given the complexity of the subject matter." Barclays Bank PLC v. Franchise Tax Bd. of Cal., 114 S. Ct. 2268, 2279 (1994). "The problem with this method is that formal accounting is subject to manipulation and imprecision, and often ignores or captures inadequately the many subtle and largely unquantifiable transfers of value that take place among the components of a single enterprise." Container Corp. of Am. v. Franchise Tax Bd., 463 U.S. 159, 164 (1983). *See also* 1 J. HELLERSTEIN & W. HELLERSTEIN, STATE TAXATION: CORPORATE INCOME AND FRANCHISE TAXES ¶ 8.03 (2d ed. 1993) (identifying three "inherent defects" of separate accounting as a method of dividing the income of a unitary business: compliance expense, difficulty of arriving at "arm's length" prices, and the problems of treating an interdependent entity as independent).

29. *Barclay's*, 114 S. Ct. at 2272. "A final point that needs to be made about the unitary business concept is that it is not, so to speak, unitary: there are variations on the theme, and any number of them are logically consistent with the underlying principles motivating the approach." *Container Corp.*, 463 U.S. at 167.

30. *Container Corp.*, 463 U.S. at 165.

31. *Barclays*, 114 S. Ct. at 2272 n.1 (quoting Allied-Signal, Inc. v. Director, Div. of Tax'n, 504 U.S. 768 (1992)).

32. *Id.* (quoting Edison Cal. Stores, Inc. v. McColgan, 183 P.2d 16, 21 (Cal. 1947)).

33. *See Container Corp.*, 463 U.S. at 164.

34. *Id.*

35. *Id.*

equal parts,[36] on the "proportion of a unitary business's total payroll, property, and sales which are located in the taxing state."[37]

Under a worldwide combined reporting method, as applied by California, a "unitary business" is construed broadly[38] and then the "three-factor" formula is applied to arrive at the amount of income that can be attributed to the unitary business's operations in the jurisdiction.[39] A jurisdiction then taxes the income of all the entities comprising the worldwide unitary business based on the percentage derived from the three-factor formula.[40]

III. FACTS AND PROCEDURAL HISTORY OF THE INSTANT CASE

The first of these two consolidated cases, *Barclays*, traveled a long road to reach the Court. This refund suit was brought by two members of the Barclays Group, a United Kingdom based multinational banking enterprise which transacts business in sixty nations and includes 220 corporations.[41] One of the two taxpayers, Barclays Bank of California (Barcal), was a California banking corporation owned wholly by the second taxpayer, Barclays Bank International Limited (BBI).[42] BBI, a United Kingdom corporation, had business which reached thirty-three other countries and territories outside of the United Kingdom.[43] The two companies were doing business in California and were thus subject to California's franchise tax.[44]

Barcal computed its 1977 California franchise tax based only on the income generated by its operations.[45] BBI assumed that it was a participant of a unitary business composed of itself and its subsidiaries.[46] BBI did not include the income generated by its parent corporation nor the income generated by the parent's other subsidiaries.[47]

The California Franchise Tax Board (Tax Board), Respondent here, audited the 1977 income year franchise tax returns of Barcal and BBI.[48] The Tax Board, determining that BBI and Barcal were a part of the worldwide unitary business of the Barclays Group, assessed additional tax liability to BBI and Barcal.[49] The

36. Barclays Bank PLC v. Franchise Tax Bd. of Cal., 114 S. Ct. 2268, 2273 (1994). California, in 1993, modified its "three-factor" formula to double the weight of the sales factor. *Id.*

37. *Container Corp.*, 463 U.S. at 170.

38. *Barclays*, 114 S. Ct. at 2273. Generally, this would require the taxpayer to aggregate the income of both affiliates operating outside of the United States and those operating within the United States. *Id.*

39. *Id.*

40. *Id.* "Thus, if a unitary business had 8% of its payroll, 3% of its property, and 4% of its sales in California, the State took the average—5%—and imposed its tax on that percentage of the business' total income." *Id.*

41. *Id.* at 2274.

42. *Id.*

43. *Id.*

44. *Id.*

45. *Id.*

46. *Id.*

47. *Id.*

48. *Id.*

49. *Id.*

additional tax assessed for the 1977 income year was $1678 for BBI and $152,420 for Barcal.[50]

BBI and Barcal both paid the additional assessments and then brought suits for refunds.[51] Barclays Bank, PLC (Barclays), the Petitioner in this case, is the successor in interest to the tax refund claims of both BBI and Barcal.[52]

Barcal and BBI prevailed in the superior court of California[53] by challenging the constitutionality of the additional tax assessed under the Due Process and Commerce Clauses of the United States Constitution.[54] The California Court of Appeals also determined that the California unitary tax method of worldwide combined reporting was unconstitutional under the Foreign Commerce Clause when applied to foreign multinational businesses forming a unitary group.[55] The court made this determination because the method "not only implicates foreign policy issues which must be left to the federal government but violates a clear federal directive as well."[56] Barcal's and BBI's fortunes were reversed by the California Supreme Court[57] which held that the worldwide combined reporting method of taxation did not impair the federal government's ability to "speak with one voice" in the realm of foreign commerce regulation.[58] After reversing on the Dormant Commerce Clause issue, the California Supreme Court remanded the case to the Court of Appeals for further consideration of Barclays' claim that the burden of compliance with the worldwide combined reporting method violated both the Due Process Clause and the nondiscrimination requirement of the Commerce Clause when applied to foreign-based multinationals.[59] The compliance burden issues were then decided against Barclays by the Court of Appeals.[60] The California Supreme Court denied further review,[61] and the United States Supreme Court then granted certiorari.[62]

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50. *Id.*
51. *Id.*
52. *Id.*
53. *Id.*
54. *Id.* After a lengthy trial, BBI and Barcal prevailed in 1987 and the Tax Board appealed. Eric J. Coffill, *Supreme Court in Barclays Upholds California's Use of Worldwide Unitary Method Involving Foreign Parent Corporations*, 64 TAX NOTES 371, 372 (July 18, 1994).
55. Barclays Bank Int'l Ltd. v. Franchise Tax Bd., 275 Cal. Rptr. 626, 627 (Cal. Ct. App. 1991).
56. *Id.* at 645. In determining that worldwide combined reporting implicated foreign policy issues which must be left to the federal government, the court noted that "[t]he most obvious foreign policy implication of a state tax is the *threat it might pose* of offending our foreign trading partners and leading them to retaliate against the Nation as a whole." *Id.* at 637 (quoting Container Corp. of Am. v. Franchise Tax Bd., 463 U.S. 159, 194 (1983)). The court further stated:

> In 1985, Britain passed retaliatory legislation withdrawing a tax advantage for U.S.-based corporations doing business in both Britain and a unitary tax state. Though Britain stopped short of pulling the procedural trigger to fully implement this legislation, the law had a retroactive provision that impelled many American companies into preimplementation compliance. Moreover, Britain canceled a trade mission to Florida because that state applied WWCR to foreign-based multinationals. And there were other similar cancellations. There was also evidence the United States has had problems in negotiating treaties because of objections to WWCR.

Id. at 638.
57. Barclays Bank PLC v. Franchise Tax Bd. of Cal., 114 S. Ct. 2268, 2274 (1994).
58. *Id.*
59. *Id.*
60. *Id.*
61. *Id.*
62. *Id.*

Colgate's consolidated case[63] also traveled a long road to reach the Court. Colgate is a Delaware corporation headquartered in New York.[64] It owned some seventy-five subsidiary corporations that operated entirely outside of the United States.[65] Colgate and its subsidiaries operating within the United States, as well as the seventy-five subsidiaries operating outside of the United States, principally engaged in the manufacture and distribution of personal hygiene and household products.[66] Colgate, like Barclays, conceded for the purposes of this litigation, that for the years in question, its worldwide business was unitary.[67] Colgate, therefore, was deemed a domestic based multinational enterprise.[68]

Colgate filed California franchise tax returns based on its 1970 through 1973 income.[69] The income it reported from its foreign subsidiaries was based on a separate accounting basis,[70] rather than based on worldwide combined reporting.[71] The Tax Board, upon determining that the taxes should have been computed on the basis of worldwide combined reporting, assessed a four-year deficiency of $604,765.[72] Colgate brought a refund suit after paying the additionally assessed tax.[73]

Colgate began its suit, as Barclays had, in the California Superior Court, which found that the worldwide combined reporting method had been condemned by the federal government as being impermissively intrusive of the federal government's authority to regulate foreign commerce uniformly.[74] The Court of Appeals, deciding that the evidence of the Executive Branch's dislike of the worldwide combined reporting method was insufficient to find it unconstitutional, reversed the lower court.[75] Colgate then sought consideration by the California Supreme Court which returned the case to the Court of Appeals to be reconsidered in light of its then recent decision in *Barclays*.[76] The Court of Appeals again decided against Colgate and in favor of the Tax Board.[77] The California Supreme Court declined to review the case further, and the United States Supreme Court granted certiorari.[78]

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63. Colgate-Palmolive Co. v. Franchise Tax Bd. of Cal., 114 S. Ct. 2268 (1994).
64. Barclays Bank PLC v. Franchise Tax Bd. of Cal., 114 S. Ct. 2268, 2275 (1994).
65. *Id.*
66. *Id.*
67. *Id.*
68. *Id.* at 2271.
69. *Id.* at 2275.
70. *Id.* *See infra* notes 20-24 and accompanying text.
71. Barclays Bank PLC v. Franchise Tax Bd. of Cal., 114 S. Ct. 2268, 2275 (1994).
72. *Id.*
73. *Id.*
74. *Id.*
75. *Id.*
76. *Id.*
77. *Id.*
78. *Id.*

IV. HISTORY OF THE TAXING AUTHORITY OF THE STATES

The United States Constitution expressly delivers to Congress the power to "regulate Commerce with foreign Nations, and among the several States."[79] The Due Process and Commerce Clauses of the Constitution prevent states from imposing an income tax on nonresidents which taxes value earned outside of the imposing state's borders.[80] Thus, a state must only tax the income derived from within its borders.[81] However, when there is a unitary business operating in and deriving income from more than one state or jurisdiction, "arriving at precise territorial allocations of 'value' is often an elusive goal, both in theory and in practice."[82] The Court has therefore repeatedly held that there is no singular formula imposed on the states by the Constitution for determining the income which was derived from that state and that a taxpayer must show by clear and cogent evidence that the tax imposed results in taxation of values earned outside the borders of the taxing state before the taxing scheme will be held to violate the Due Process and Commerce Clauses.[83]

The Court in *Complete Auto*[84] was presented with a Mississippi tax imposed on interstate corporations for the privilege of doing business in the state.[85] The tax provided that

> [t]here is hereby levied and assessed and shall be collected, privilege taxes for the privilege of engaging or continuing in business or doing business within this state to be determined by the application of rates against gross proceeds of sales or gross income or values, as the case may be, as provided in the following sections.[86]

The taxpayer, Complete Auto Transit, Inc., was a Michigan corporation which transported motor vehicles by motor carrier for General Motors Corporation.[87] The vehicles were assembled outside of the state by General Motors and then shipped by rail to Jackson, Mississippi.[88] Once the vehicles had arrived in Jackson, they were then loaded onto the taxpayer's trucks and transported to the Mississippi dealers.[89]

The Mississippi Tax Commission assessed a three-year deficiency against Complete Auto Transit, Inc. in the amount of $122,160.59 for the sales of trans-

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79. U.S. CONST. art. I, § 8, cl. 3.
80. ASARCO Inc. v. Idaho State Tax Comm'n, 458 U.S. 307, 315 (1982) (citing Connecticut Gen. Life Ins. Co. v. Johnson, 303 U.S. 77, 80-81 (1938)).
81. *Id.*
82. Container Corp. of Am. v. Franchise Tax Bd., 463 U.S. 159, 164 (1983).
83. *Id.*
84. Complete Auto Transit, Inc. v. Brady, 430 U.S. 274 (1977).
85. *Id.*
86. *Id.* (quoting MISS. CODE ANN. § 10105 (1942 & 1972 Supp.) which is now codified at MISS. CODE ANN. § 27-65-13 (1990)).
87. *Id.* at 276.
88. *Id.*
89. *Id.*

portation services for the period from August 1, 1968, to July 31, 1971.[90] Another deficiency was assessed for the period from August 1, 1971, to July 31, 1972, in the amount of $42,990.89.[91]

The taxpayer paid the assessments under protest and sued for a refund,[92] asserting that "its transportation was but one part of an interstate movement, and that the taxes assessed and paid were unconstitutional as applied to operations in interstate commerce."[93]

The Court rejected the assertion that a state tax on the privilege of doing business is unconstitutional *per se* when applied to interstate commerce and overruled *Specter Motor Service, Inc. v. O'Connor*[94] which had so held.[95] The Court then considered the practical effects of the statute and applied a test which would sustain a tax against a challenge under the Commerce Clause 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."[96] The taxpayer had made no other argument than that the tax was unconstitutional *per se* because it imposed a tax for the privilege of doing business which was interstate.[97] The Court therefore upheld the tax imposed by Mississippi on the taxpayer engaged in interstate trade and established the test for deciding a challenge of such a tax under the Commerce Clause.[98]

The issue of taxation by a state of a multi-jurisdictional corporation was before the Court in a somewhat different context in *Japan Line, Ltd. v. County of Los Angeles*.[99] The question before the Court was "whether a State, consistently with the Commerce Clause of the Constitution, may impose a nondiscriminatory ad valorem property tax on foreign-owned instrumentalities (cargo containers) of international commerce."[100]

The taxpayers were six Japanese shipping companies.[101] Each of the companies was incorporated under the laws of Japan, and each had its principal place of business and domicile in Japan.[102] The cargo containers sought to be taxed by the State of California were owned by the taxpayers and were used exclusively for the transportation of cargo in foreign commerce.[103] It was stipulated on appeal that "[e]ach container is in constant transit save for time spent undergoing

90. *Id.* at 277.
91. *Id.*
92. *Id.*
93. *Id.*
94. 340 U.S. 602 (1951).
95. Complete Auto Transit, Inc. v. Brady, 430 U.S. 274, 288 (1977).
96. *Id.* at 279.
97. *Id.* at 289.
98. *Id.*
99. 441 U.S. 434 (1979).
100. *Id.* at 435-36.
101. *Id.* at 436.
102. *Id.*
103. *Id.*

repair or awaiting loading and unloading of cargo"[104] and that all of the containers were subject to Japan's property tax, and were in fact taxed there.[105]

The containers, in the course of international commerce, passed through the jurisdiction and some were there at any given time; the average stay of a container in the state was less than three weeks.[106] The containers were used in no intrastate or interstate transportation of cargo which was not a continuation of the international transportation.[107] Any period of nonmovement or movement was inseparable from the container's use in foreign commerce.[108]

The ad valorem property tax was imposed on property present in California on March 1 of any year.[109] The average presence of containers during each year was determined, and California assessed $550,000 on the value of the containers determined to be present on the lien dates in 1970, 1971, and 1972.[110] The taxpayers paid the taxes under protest and sued for a refund challenging the constitutionality of the taxes imposed.[111]

The Court first reaffirmed that there was no immunity from taxation conferred by the Constitution and that the fair share of State tax burden must be borne by interstate commerce.[112] Therefore, if the *Complete Auto* test was met, there would be no impermissible burden imposed on interstate commerce.[113] The Court then determined that if the containers were only interstate commerce instrumentalities, the *Complete Auto* test would be applied and satisfied, and the Commerce Clause inquiry would be concluded.[114]

However, the Court determined that the relevant analysis was not the same if, as was the case here, foreign commerce was involved.[115] Congress' power to regulate foreign commerce required "a more extensive constitutional inquiry."[116] It was determined that a Court must also inquire into whether the tax, notwithstanding apportionment, creates a "substantial risk of international multiple taxation," and whether the taxing scheme precludes the federal government from "speaking with one voice when regulating commercial relations with foreign governments."[117]

In support of its first additional inquiry, the enhanced risk of multiple taxation, the Court stated that "[i]t is a commonplace of constitutional jurisprudence that multiple taxation may well be offensive to the Commerce Clause."[118] The Court

104. *Id.*
105. *Id.*
106. *Id.* at 437.
107. *Id.*
108. *Id.*
109. *Id.*
110. *Id.*
111. *Id.*
112. *Id.* at 444.
113. *Id.*
114. *Id.* at 445.
115. *Id.* at 446.
116. *Id.*
117. *Id.*
118. *Id.*

has required apportionment so that there would be no multiple taxation, "so that no instrumentality is subject to more than one tax on its full value."[119] The basis of approval of apportioned property taxation was the Court's ability to "enforce full apportionment by all potential taxing bodies"; an ability which is absent when one of the taxing jurisdictions is a foreign sovereign.[120] Thus, if a foreign sovereign imposes a tax on the full value of the property, any tax imposed by a state will inevitably result in multiple taxation.[121] It was also noted by the Court that there was no authoritative tribunal with the capacity to ensure that multiple taxation did not occur when there was a foreign sovereign involved.[122]

As to the second additional inquiry, allowing the federal government to speak with one voice, the Court reasoned that "a state tax on the instrumentalities of foreign commerce may impair federal uniformity in an area where federal uniformity is essential"[123] and that foreign commerce is "preeminently a matter of national concern."[124] One of the primary problems the Court foresaw was that "[i]f a novel state tax creates an asymmetry in the international tax structure, foreign nations disadvantaged by the levy may retaliate against American-owned instrumentalities present in their jurisdictions."[125]

The Court then determined that the tax in question met neither of the additional inquiries. Japan had already levied a tax on the full value of property and any further tax applied by a state, even if apportioned, would result in inevitable double taxation.[126] Also, since both the United States and Japan had signed the Customs Convention on Containers under which American owned containers were not taxed in Japan and Japanese owned containers would not be taxed by the federal government, the imposition of a tax by California would create an acute risk of retaliation by Japan and would prevent the federal government from "speaking with one voice."[127] Therefore, it was held that the tax sought to be imposed on foreign commerce by California was unconstitutional under the Commerce Clause[128] with the Court stating that "[e]ven a slight overlapping of tax — a problem that might be deemed *de minimis* in a domestic context — assumes importance when sensitive matters of foreign relations and national sovereignty are concerned."[129]

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119. *Id.* at 447.
120. *Id.*
121. *Id.*
122. *Id.*
123. *Id.* at 448.
124. *Id.*
125. *Id.* at 450. The Court further stated that

> [s]uch retaliation of necessity would be directed at American transportation equipment in general, not just that of the taxing State, so that the Nation as a whole would suffer. If other States followed the taxing State's example, various instrumentalities of commerce could be subjected to varying degrees of multiple taxation, a result that would plainly prevent this Nation from "speaking with one voice" in regulating foreign commerce.

Id. at 450-51.
126. *Id.* at 452.
127. *Id.* at 453.
128. *Id.* at 454.
129. *Id.* at 456.

The Court was again called upon to determine the states' authority to tax multi-jurisdictional corporations in *Container Corp. of America v. Franchise Tax Board*.[130] The controversy again arose in California, but this time, in contrast to *Japan Line*, the Court was faced with a tax on income and not a tax on tangible property.

The taxpayer, Container Corporation of America, was a Delaware corporation headquartered in Illinois which had operations in California and other states as well as a number of foreign subsidiaries incorporated in the countries in which they operated.[131] During the years 1963, 1964, and 1965, the taxpayer had twenty foreign subsidiaries engaging in business.[132] Additional franchise taxes were assessed against Container Corporation in 1969.[133] The contention of the Tax Board was that the taxpayer should have included its overseas subsidiaries as part of its unitary business instead of as passive investments.[134] When the Tax Board calculated the tax liability as including the income of the subsidiaries, the tax liability increased for each of the three years in question.[135] Container Corporation paid the additional amounts under protest and sued for a refund.[136]

There were three questions presented for consideration by the Court: whether the state courts were correct in determining that the taxpayer and its subsidiaries composed a unitary business; whether the three-factor formula as applied to the unitary business was so inaccurate as to violate the constitutional requirement of "fair apportionment"; and whether California had an obligation under the Foreign Commerce Clause to apply a separate accounting method (arm's length analysis) as used by the federal government and most foreign sovereigns.[137] The Court decided against the taxpayer on each of these issues.

As to the first issue involving the trial court's determination that the taxpayer and its subsidiaries composed a unitary business, the Court stated that it would, if reasonably possible, defer to the decision of the state courts in determining whether a particular set of circumstances gives rise to a "unitary business."[138] Thus, the Court would not interfere in the state court's decision if the determination of a unitary business was within "the realm of possible judgment."[139] Since

130. 463 U.S. 159 (1983). The clash of the amici briefs was on again as well. Many states submitted briefs urging affirmance of the authority to use the worldwide combined reporting method; these included Idaho, Utah, Illinois, Montana, New Mexico, New York, North Dakota, Oregon, Alaska, Connecticut, Delaware, Indiana, Kansas, Massachusetts, Michigan, Minnesota, Missouri, Nebraska, New Hampshire, and North Carolina. The National Governors' Association and the National Farmers' Union also urged affirmance. *Id.* at 162. Urging the Court to reverse the use of worldwide combined reporting were the Government of the Kingdom of the Netherlands, the Canadian Imperial Bank of Commerce, the Committee on Unitary Tax, the Confederation of British Industry, Gulf Oil Corporation, International Bankers Association in California, Phillips Petroleum Company, Shell Petroleum, Sony Corporation, and the Union of Industries of the European Community, among others. *Id.*

131. *Id.* at 163.

132. *Id.* at 171.

133. *Id.* at 174.

134. *Id.*

135. *Id.*

136. *Id.* at 175.

137. *Id.* at 163.

138. *Id.* at 175.

139. *Id.* at 176.

there was here a substantial intertwining of activities, such as technical and expansion assistance rendered to the subsidiaries by the taxpayer, the Court left the trial court's decision undisturbed.[140]

There was then a consideration of whether the formula applied to the unitary business, the three-factor formula,[141] fairly attributed the income derived within the state.[142] The taxpayer had the burden of proving that the income attributed to California was "out of all appropriate proportion to the business transacted" by the taxpayer in that state.[143] The Court determined that both separate accounting and formula apportionment were inexact when applied[144] and that the three-factor formula was widely approved because the combination of payroll, property, and sales "appear in combination to reflect a very large share of the activities by which value is generated."[145] Thus, the formula applied by California was determined to provide a fair apportionment of income.[146]

The Court then turned to whether the Foreign Commerce Clause required the state to apply a separate accounting scheme.[147] The additional inquiries to *Compete Auto* that *Japan Line* established provided the applicable standard.[148]

In consideration of the first additional area of scrutiny, the enhanced risk of multiple taxation, the presence of several similarities to *Japan Line*, in which the Court concluded that the tax imposed was unconstitutional under the Foreign Commerce Clause, were noted.[149] Such similarities included that the tax imposed here, as in *Japan Line*, had resulted in actual double taxation,[150] that the double taxation stems from the substantial divergence in taxing schemes used by California from the methods applied by the foreign taxing jurisdictions, that the taxing method adopted by the foreign sovereigns is consistent with international practice, and that the federal government, to the degree it has spoken, prefers the international method (separate accounting).[151]

However, the Court also found that there were several ways in which this case could be clearly distinguished from *Japan Line*. The first difference was that the controversy here involves a tax imposed on income rather than on tangible property.[152] Also, the double taxation that occurred here was not the "inevitable"

140. *Id.* at 179-80.
141. The three-factor formula is composed of payroll, property, and sales. *Id.* at 183.
142. *Id.* at 180.
143. *Id.* at 181 (quoting Hans Rees' Sons, Inc. v. North Carolina *ex. rel.* Maxwell, 283 U.S. 123, 135 (1931)).
144. *Id.* at 182.
145. *Id.* at 183.
146. *Id.*
147. *Id.* at 185.
148. *Id.* The two additional considerations when a state seeks to tax foreign commerce are the "enhanced risk of multiple taxation," and the possibility that the taxing scheme will prevent the federal government from speaking with one voice in foreign commerce matters. *Id.* at 185-86.
149. *Id.* at 187.
150. *Id.* "[I]n the sense that some of the income taxed without apportionment by foreign nations as attributable to appellant's foreign subsidiaries was also taxed by California as attributable to the State's share of the total income of the unitary business of which those subsidiaries are a part." *Id.*
151. *Id.*
152. *Id.* at 188.

result of the taxing scheme, as it was in *Japan Line*.[153] Finally, the third difference was that the tax fell on a domestic corporation rather than on a foreign parent.[154]

One very relevant consideration in the Court's decision was that California would have had trouble avoiding double taxation even if it had adopted a separate accounting scheme.[155] This effect was attributed to the difference between a tax on income and a tax on tangible property.[156] The Court stated that "[a]llocating income among various taxing jurisdictions bears some resemblance, as we have emphasized throughout this opinion, to slicing a shadow."[157] The determination was then made that it would be perverse to require California to give up its taxing scheme and require it to use another which would also sometimes result in double taxation.[158]

The Court then turned to the "one voice" consideration which it determined to be essentially another species of pre-emption analysis.[159] Several factors were deemed to be important in the inquiry involved. The tax in this case did not create an automatic "asymmetry" in international taxation, and it was imposed on a domestic entity as opposed to a foreign entity.[160] Also, there was no explicit preemption of this area by federal law.[161] The agreements in the international treaties involved were found not to be applicable to the states.[162]

Thus, the State's taxing scheme was upheld by the Court here,[163] though it reserved the question of the "constitutionality of combined apportionment with respect to state taxation of domestic corporations with foreign parents or foreign corporations with either foreign parents or foreign subsidiaries" for another day.[164]

In *Wardair Canada, Inc. v. Florida Department of Revenue*,[165] the Court considered a Florida tax imposed on the sale of fuel to airlines.[166] Florida had taxed the sale of fuel to airlines based on a prorated mileage figure so that the portion of tax payable by the airline was equal to the "ratio of its Florida mileage to its worldwide mileage for the previous fiscal year."[167] This dispute arose when the

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153. The Court further elaborated that

> [t]he "arm's-length" approach divides the pie on the basis of formal accounting principles. The formula apportionment method divides the same pie on the basis of a mathematical generalization. Whether the combination of the two methods results in the same income being taxed twice or in some portion of income not being taxed at all is dependent solely on the facts of the individual case.

Id.

154. *Id.*
155. *Id.* at 192.
156. *Id.*
157. *Id.*
158. *Id.*
159. *Id.* at 193.
160. *Id.* at 195.
161. *Id.* at 196.
162. *Id.*
163. *Id.* at 197.
164. *Id.* at 189 n.26.
165. 477 U.S. 1 (1986).
166. *Id.* at 3.
167. *Id.*

tax law was amended to establish a flat rate of five percent on a deemed price per gallon.[168] The airlines were thus liable for the full amount of the fuel tax regardless of the portion of the fuel that was used outside of the state and regardless of whether the airline did only a nominal amount of business within the borders of the state.[169] This amendment to the tax law substantially increased the tax liability of foreign airlines with operations mainly outside the State of Florida.[170] Thus, another challenge to the taxing authority of the states was begun.

The taxpayer contended that this area of the law was completely pre-empted by federal law and that the tax was unconstitutional under the Foreign Commerce Clause.[171] The Court quickly determined that this area of the law was not pre-empted by federal law and turned to the Foreign Commerce Clause issue.[172]

The Court stated that when there is a Dormant Commerce Clause issue, whether foreign or domestic, and there has been no affirmative action by the federal government, "it is the responsibility of the judiciary to determine whether action taken by state or local authorities unduly threatens the values the Commerce Clause was intended to serve."[173]

The taxpayer conceded that the state tax met the four requirements of the *Complete Auto* test[174] and that there was no threat of multiple taxation in this instance.[175] Thus, the determination would hinge on whether the Florida tax prevented the federal government from "speak[ing] with one voice."[176] It was determined that the law in its current state acquiesced in the taxation by states of fuel because the bilateral agreements[177] between the United States and other countries only foreclosed taxation by the federal government and not by the states.[178] Thus, the Court construed silence to equal acquiescence and determined that the Florida tax did not prevent the federal government from speaking with one voice.[179] Florida was allowed to retain its method of taxation.[180]

V. THE INSTANT CASE

The majority, in an opinion authored by Justice Ginsburg, determined first that the worldwide combined reporting method as applied by California easily met

168. *Id.* at 4.
169. *Id.*
170. *Id.*
171. *Id.*
172. *Id.* at 7.
173. *Id.*
174. *See supra* note 96 and accompanying text.
175. Wardair Can. Inc. v. Florida Dep't of Revenue, 477 U.S. 1, 8-9 (1986).
176. *Id.*
177. *Id.* at 10.
178. *Id.* The Court went on to note that

> [t]axation by political subdivisions of either the United States or Canada are not mentioned, an omission which must be understood as representing a policy choice by the contracting parties, especially in the light of the fact that the Resolution addressed this concern eight years before the United States and Canada entered into the Agreement.

Id. at 11.
179. *Id.* at 12.
180. *Id.* at 13.

three of the four criteria set forth in *Complete Auto*.[181] The nexus requirement was met because Barcal, BBI, and Colgate all did business in California during the years at issue.[182]

The fair apportionment standard was found to be satisfied since neither Colgate nor Barclays established that the income attributed to California was out of "all appropriate proportion" to the amount of business transacted by the taxpayers in that state or the absence of a "rational relationship between the income attributed to the state and the intrastate values of the enterprise."[183] Also, since the state had provided "protection, opportunities[,] and benefits" to the taxpayers, the tax was fairly related to the benefits provided by the state.[184]

However, Barclays, but not Colgate, vigorously contended that the worldwide combined reporting method of taxation violated the antidiscrimination component of the *Complete Auto* test.[185] Barclays contended that a foreign parent of a domestic taxpayer would be "forced" to convert the financial and accounting records of its subsidiaries worldwide into the currency, language, and accounting principals of the United States and that the expense of such conversion would be prohibitive.[186] It asserted, and the trial court found, that setting up a system with the capacity of reporting the information required of its holdings worldwide would cost $5 million and more than $2 million a year to maintain.[187] Thus, the argument continued, the prohibitive burden of implementing and maintaining such a system on a foreign parent gave a competitive advantage to the domestic enterprise and therefore constituted "economic protectionism."[188]

The Court found these arguments to be unpersuasive and held that the claim of unconstitutional discrimination against foreign commerce failed.[189] In reaching this conclusion, the Court reasoned that the factual underpinnings of the contention were infirm.[190] The tax regulations provided that the Tax Board was to "consider the effort and expense required to obtain the necessary information" and that it could accept reasonable approximations.[191] In fact, Barclays had been allowed to make use of these provisions. It made computations based on reasonable approximations and avoided the expense of which it complained.[192] The Court of Appeals additionally determined that the actual compliance costs suffered by Barclays were relatively modest in the years immediately preceding those in issue, with the costs ranging from $900 to $1250.[193] Thus, the Court

181. Barclays Bank PLC v. Franchise Tax Bd. of Cal., 114 S. Ct. 2268, 2276 (1994). *See supra* note 96 and accompanying text.
182. *Id.*
183. *Id.* at 2277 (quoting Container Corp. of Am. v. Franchise Tax Bd., 463 U.S. 159, 180-81 (1983)).
184. *Id.* (quoting Wilson v. J.C. Penny Co., 311 U.S. 435, 444 (1940)).
185. *Id.*
186. *Id.*
187. *Id.* at 2277 n.11.
188. *Id.* at 2277.
189. *Id.* at 2278.
190. *Id.* at 2277.
191. *Id.*
192. *Id.* at 2278.
193. *Id.* at 2278 n.13.

determined that Barclays had not established that the taxing scheme, with its system of reasonable approximations, systematically overtaxed BBI or Barcal in particular or foreign enterprises in general.[194]

With the determination that the *Complete Auto* test was met, the Court next considered the companion issue asserted by Barclays that the "reasonable approximations" method of compliance with the taxing scheme violated due process.[195] Without any showing of an approximation that the Tax Board rejected as unreasonable, Barclays asserted that foreign multinationals faced continuing peril when filing tax returns because there was no standard for determining which "reasonable approximations" would be accepted by the Tax Board.[196] Thus, Barclays contended that it was the grant of "standardless discretion" which violated due process.[197]

In addressing the due process contention, the Court first noted that "reasonableness" is a time-honored standard permitting effective judicial review in a "myriad" of situations.[198] It also noted that taxpayers were permitted to seek an advance determination of the tax consequences of potential future courses of action from the Tax Board.[199]

The Court then stated that "[r]ules governing international multijurisdictional income allocation have an inescapable imprecision given the complexity of the subject matter" and held the taxing scheme was no more violative of due process than it was of the antidiscrimination component of the Commerce Clause standard.[200]

Having determined that the worldwide combined reporting method of taxation was "proper and fair" under the *Complete Auto* test, the Court proceeded to address the two additional areas of scrutiny required when a state seeks to impose a tax upon foreign commerce.[201] Arguments asserting the first of these, the enhanced risk of multiple taxation, had previously been rejected by the Court in *Container Corp.* in the context of a charge that the application of California's worldwide combined reporting scheme unconstitutionally exposed the foreign subsidiaries of a domestic parent to a risk of multiple international taxation.[202] The Court noted that in *Container Corp.*, even though there was actual double taxation, it was held that California's worldwide combined reporting method was not unconstitutional under the Foreign Commerce Clause because multiple taxation was not the inevitable result of the taxing scheme and because the reasonable alternative available to the state (separate accounting) "could not eliminate the risk of double taxation."[203]

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194. *Id.* at 2278.
195. *Id.*
196. *Id.*
197. *Id.*
198. *Id.*
199. *Id.*
200. *Id.*
201. *Id.*
202. *Id.* *See supra* notes 155-158 and accompanying text.
203. Barclays Bank PLC v. Franchise Tax Bd. of Cal., 114 S. Ct. 2268, 2280 (1994) (quoting Container Corp. of Am. v. Franchise Tax Bd., 463 U.S. 159, 191 (1983)).

Barclays' argument hinged on the assertion that the instant situation should compel a different outcome since application of the worldwide combined reporting method to foreign multinational corporations creates a more "aggravated" risk of multiple international taxation than existed in the context of a domestic parent.[204] The Court again refused to "require California to give up one allocation method that sometimes results in double taxation in favor of another allocation that also sometimes results in double taxation" and decided to adhere to the precedent set forth in *Container Corp.*[205]

The Court then turned to the issue "ultimately and most energetically" asserted, that the worldwide combined reporting method as applied to Barcal, BBI, and Colgate impaired federal uniformity "in an area where federal uniformity is essential."[206] The decisions in *Container Corp.* and *Wardair* were the principle guides to the Court in reaching its decision.[207] The "one voice" issue was considered in these cases only after the state method of taxation was deemed to be otherwise constitutional.[208]

Earlier in the opinion it had been noted that the dormant or negative Commerce Clause had a self-executing aspect which had long been understood to provide protection from a state's interference in foreign commerce even when Congress had not acted.[209] The Court found that the idea that Congress may passively indicate that certain action by a state does not "impair federal uniformity in an area where federal uniformity is essential" was an underlying premise of both *Wardair* and *Container Corp.*[210] It was further stated that Congress "need not convey its intent with the unmistakable clarity required to permit state regulation that discriminates against interstate commerce or otherwise falls short" under the requirements of *Complete Auto.*[211]

Having thus framed the Foreign Commerce Clause issue as one of the effects of congressional silence, the Court declared that there was no specific congressional intent indicated to bar the state action at issue.[212] Contrarily, the Court viewed its 1983 decision of *Container Corp.* as having "left the ball in Congress' court."[213] In the eleven years following the *Container Corp.* decision, Congress could have enacted legislation requiring the states to apply the separate accounting method.[214] However, Congress had failed to enact numerous bills which would have prohibited the taxing method involved in this dispute.[215]

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204. *Id.* at 2279.
205. *Id.* at 2280 (quoting *Container Corp.*, 463 U.S. at 193).
206. *Id.* at 2281 (quoting Japan Line, Ltd. v. County of Los Angeles, 441 U.S. 434, 448 (1979)).
207. *Id. See supra* notes 130-180 and accompanying text.
208. *Id.* at 2282.
209. *Id.* at 2276.
210. *Id.* at 2282 (quoting *Japan Line*, 441 U.S. at 448).
211. *Id.*
212. *Id.* at 2283.
213. *Id.*
214. *Id.*
215. *Id.* at 2284.

To shore up its position, the Court, as in *Container Corp.*, also discussed the Senate action on a United States/United Kingdom tax treaty. The history of the treaty showed that it, as originally negotiated, would have precluded the states from applying the worldwide combined reporting method to United Kingdom controlled taxpayers.[216] The Senate refused to adopt this version of the treaty.[217]

The Court therefore determined that the taxing method applied by California did not prevent the federal government from speaking with one voice since Congress was willing to tolerate the state's application of the worldwide combined reporting method.[218]

In quick succession, the Court also disregarded several other complaints. The assertion that the worldwide combined reporting method was unconstitutional because it was likely to provoke retaliatory action by foreign sovereigns, as evidenced by a large quantity of amici briefs, was discarded as directed to the wrong forum.[219] In response to the argument that the federal government has continuously expressed a preference for the arm's length method, the Court stated that such a preference does not render a state's contrary method unconstitutional.[220]

Finally, the assertion by Colgate that several Executive pronouncements constituted a "clear federal directive" was answered by the Court's statement that such communications lacked the force of law and could not render California's otherwise valid and congressionally condoned method of taxation unconstitutional.[221] In conclusion, Justice Ginsburg stated that Congress' voice in the area of foreign commerce is the voice of the Nation, and neither the Court nor the Executive Branch may intrude into its domain.[222]

VI. ANALYSIS

A. Commerce Clause Limitations on a State's Taxing Authority

After the decision in *Barclays* it seems clear that there is little room for challenging, on Foreign Commerce Clause grounds, a state's use of a worldwide combined reporting method. In the absence of some indication of congressional disapproval of the method, its use will be upheld regardless of the threatened international reaction. The Court determined that, after *Container Corp.* and *Wardair*, silence by Congress, when it could otherwise prohibit a state's use of the taxing scheme, is implicit to inferring congressional permission for the use of the method and that therefore federal uniformity is not impaired in an area in which federal uniformity is essential.[223] It seems inferential that the other

216. *Id.*
217. *Id.*
218. *Id.*
219. *Id.* at 2285.
220. *Id.*
221. *Id.* at 2286.
222. *Id.*
223. *Id.* at 2282.

requirements of *Complete Auto* and of *Japan Line*, after the Court's brisk treatment in *Barclays*, will pose little threat to a state's application of the worldwide combined reporting method to a foreign multinational corporation. As to Colgate, a domestic parent, the Court was unanimous in upholding California's application of the worldwide combined reporting method, a result which is not surprising in light of its previous decision in *Container Corp.*

However, there are two areas under which a taxpayer might still challenge such a taxing scheme after the decision in this case. These two areas are the unity of the business involved and distortion.

The cases discussed in this Note do not change the fact that before a unitary method, such as worldwide combined reporting, can be applied, there must be a factual finding that the enterprise in question constitutes a unitary business.[224] Unity was not an issue in the instant case, as both Barclays and Colgate had submitted on this point and stipulated that the entities involved were part of a worldwide unitary business.[225]

Under the Due Process and Commerce Clauses of the Constitution, a state is not allowed to impose a tax on income arising out of operations carried on outside of that state.[226] The burden is on the taxpayer to show by "clear and cogent evidence" that the taxing scheme applied by a state results in such a taxation of extraterritorial income.[227] Also, the Court will defer, when reasonably possible, to the determination of the state courts when deciding whether a business in a particular set of circumstances constitutes a unitary business.[228] Thus, in order to contend for less than worldwide treatment, a taxpayer, whether a domestic or foreign corporation, would have to dispute a finding that its business exhibited "functional integration, centralization of management, and economies of scale."[229]

The other area of possible contention for future taxpayers is that of distortion. The Court has stated in *Container Corp.* that the three-factor formula applied to a unitary business is appropriate because "payroll, property, and sales appear in combination to reflect a very large share of the activities by which value is generated."[230] Even so, the Court also notes that the formula is "necessarily imperfect."[231] The weight given to each factor is essentially arbitrary, the three factors do not include all of the factors arguably relevant to income from operations, and the relationship between the factors and income is not exact.[232]

"The underlying assumption of formula apportionment is that each dollar of payroll, property, and sales produces an equal amount of income or an equal

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224. *See supra* notes 29-40 and accompanying text.
225. Barclays Bank PLC v. Franchise Tax Bd. of Cal., 114 S. Ct. 2268, 2274, 2275 (1994).
226. Container Corp. of Am. v. Franchise Tax Bd., 463 U.S. 159, 165 (1983).
227. *Id.* at 175.
228. *Id.*
229. *Barclays*, 114 S. Ct. at 2272 n.1.
230. Container Corp. of Am. v. Franchise Tax Bd., 463 U.S. 159, 183 (1983).
231. *Id.*
232. *Id.* at 184.

quantity of product."[233] While this assumption seems to be at least roughly correct as between the states in the United States, and in the context of jurisdictions in which the taxpayer's unitary business operates that have at least somewhat comparable taxing and economic conditions, the comparability it assumes probably does not exist on a worldwide basis.[234] Thus, while the three-factor apportionment formula has generally been upheld, there may be some room left for a taxpayer to challenge such apportionment based on its distortive effect, in that the three-factor formula as applied to a foreign multinational corporation creates a situation in which the income apportioned to the state is "out of all appropriate proportion to the business transacted by the appellant in that State."[235]

Such a distortive effect has been found to be grounds for reversal, if the distortion is great enough.[236] Thus, a corporation could possibly show such a distortion if in one of the jurisdictions an equal amount of income was derived as in the taxing jurisdiction, but was based on unequal units of payroll, property, and sales.[237] The Court has also recognized this weakness in the assumption underlying the three-factor formula:

> The assumption has admitted weakness: an enterprise's willingness to invest simultaneously in two jurisdictions with very different true rates of return might be adequately explained by, for example, the difficulty in shifting resources, the decreasing marginal value of additional investment, and portfolio-balancing considerations.[238]

Therefore, as an example, assume that a foreign-based corporation (FB), which only does business outside of the United States, wholly owns a domestic corporation (DB) which only does business inside the United States.[239] Also, assume that DB operates in a state which applies the three-factor formula of apportionment and that FB and DB are part of a unitary business. The companies generate an equal amount of income from the same proportion of inputs (payroll, sales, and property). In such a situation, part of the combined income of the unitary business would be attributable to the domestic state. If DB and FB had total inputs of 50 units each in payroll, property, and sales, the amount of their com-

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233. Coffill, *supra* note 54, at 372. Such assumption has been stated by the Court as

> [t]he three-factor formula, as applied to horizontally linked enterprises, is based in part on the very rough economic assumption that rates of return on property and payroll—as such rates of return would be measured by an ideal accounting method that took all transfers of value into account—are roughly the same in different taxing jurisdictions.

Container Corp, 463 U.S. at 183.

234. Coffill, *supra* note 54, at 378.

235. *Container Corp.*, 463 U.S. at 181 (quoting Hans Rees' Sons, Inc. v. North Carolina *ex. rel.* Maxwell, 283 U.S. 123, 135 (1931)).

236. *Hans Rees' Sons, Inc.*, 283 U.S. at 135 (disallowing the use of an apportionment method when the distortive effect, or percentage increase in taxable income attributable to the state, of focusing on one factor was more than 250%).

237. *See* Coffill, *supra* note 54, at 378.

238. *Container Corp.*, 463 U.S. at 183 n.20.

239. The following example is based on a similar example found in Coffill, *supra* note 54, at 378.

bined income to be taxed by the state could be expressed as 1/3(50/100 + 50/100 + 50/100) or as fifty percent (50%).

However, if DB's payroll cost were substantially higher than FB's, while income and all other factors remained constant, a distortion could occur. If it is assumed that DB requires 600 units of payroll to generate the same income as FB, the percentage of income taxed by the domestic state could be expressed as 1/3(600/650 + 50/100 + 50/100) or as sixty-four percent (64%).

Therefore, while DB is generating the same percentage of the combined income, fifty percent (50%), the domestic state is now taxing sixty-four percent (64%) of the income of the combined business (DB + FB). The result is distorted because the facts do not follow the basic economic assumption underlying the three-factor formula, that a business will only operate where the cost of payroll, property, and sales are at roughly equally efficient levels. As the Court recognized in the previous excerpt from *Container Corp.*,[240] this economic assumption might have weak underpinnings in an international business. However, this Commentator believes that any affront on the three-factor formula, revealing less than a dramatic distortion, will be met with substantial resistance, and be disregarded by the Court.[241]

B. Potential Ramifications of Barclays

Barclays is a clear victory for the use of a worldwide combined reporting method by a state. The decision leaves few legal impediments in the way of a state wishing to adopt such a method of taxation. However, it is this Commentator's belief that the worldwide combined reporting method will not be widely embraced by the states, nor Congress, as a revenue generating tool.

Following the 1983 decision in *Container Corp.*, several states reviewed the possibility of adopting a worldwide combined reporting method.[242] In response to that decision by the Court and the following review by the states, the business community became quite galvanized and took the fight to the legislatures.[243] They argued that the adoption or continued use of the method would be disastrous to a state's economic well-being.[244] The strength of the anti-worldwide combined reporting movement caught the attention of the legislatures, and many states not using the worldwide combined reporting method began expounding their non-use in hopes of exploiting a perceived advantage in marketing their states for economic development.[245] The effects were fairly dramatic, and within a short period of time the states that applied the method overhauled their taxing

240. *See supra* note 238 and accompanying text.

241. *See Container Corp.*, 463 U.S. at 184 (disregarding a fourteen percent increase in taxable income attributable to the state because of its application of the three-factor method).

242. J. William McArthur, Jr. & Kendall L. Houghton, *In Barclays, U.S. Supreme Court Finds for California, Which Was Banking on It*, 81 J. TAX'N 176, 178 (1994).

243. *Id.*

244. *Id.*

245. *Id.*

schemes to allow for some form of water's-edge limitation on reporting.[246] Thus, even though a state attempting to adopt the worldwide combined reporting method will not face many legal impediments, it would probably meet an immediate back-lash from a galvanized business community.

It should be stressed, however, that interest in combined reporting still exists. In Louisiana, for instance, it is reported that the Louisiana Department of Revenue and Taxation has begun "a study of combined unitary reporting as an alternative to Louisiana's current income tax regime."[247] Also of future interest will be the stirrings of interest that are beginning in a Congress desperate to generate funds for everything from health care to the revenues lost from trade treaties to deficit reduction. The Foreign Tax Compliance Act of 1994 was introduced as a bill in the House of Representatives by Congressman Richard Gephardt.[248] This bill proposes that the federal government abandon its use of separate accounting and implement a worldwide unitary system similar to the one used by California.[249] Adoption by the federal government of the now constitutionally approved method of taxation would have wide-ranging effects indeed.[250]

VII. CONCLUSION

In one of the more far-reaching and important tax decisions in recent memory, the Court, extending the principles enunciated in *Japan Line* and *Container Corp.*, has now indicated a clear "hands-off" approach to the states' authority to implement unitary taxing methods. In particular, the worldwide combined reporting method applied by California and its underlying three-factor apportionment scheme seems to be becoming the standard by which the Court measures other taxing methods. The decision is a clear victory for the proponents of the worldwide combined reporting method, though the effect of such victory will likely have limited ramifications mainly due to a galvanized business and international community. However, the recent developments in Congress and in the legislatures of some states may prove to bear interesting future implementations of such taxing schemes.

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246. *Id.*

247. Christopher J. Dicharry, *Expanding Louisiana's Corporate Income Tax Base*, 41 LA. BUS. J. 416, 418 (Feb. 1994).

248. Jeremy Kahn, *Congress Ponders Change in Foreign Company Tax*, FINANCIAL TIMES, Aug. 2, 1994, at 4.

249. *Id.*

250. Consider the potential effects of federal adoption as compared to the response to the adoption by California. *See supra* note 6.