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The Supreme Court Upholds Worldwide Unitary Taxation by the States of Multinational Corporate Income: *Container Corporation of American v. Franchise Tax Board*

Ettore A. Santucci

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CASENOTES

The Supreme Court upholds worldwide unitary taxation by the states of multinational corporate income: *Container Corporation of America v. Franchise Tax Board*.¹ Many states in the United States have adopted the unitary business concept as a method for estimating their fair share of the income tax base of a multijurisdictional — multistate or multinational — enterprise.² For corporate income taxation purposes, the unitary business concept considers affiliated groups of firms as a single business divided into purely formal, separately incorporated subsidiaries for reasons of legal convenience.³ Relying on this approach, several states have developed a two-step technique⁴ in order to tax their fair share of the worldwide unitary income of a multinational enterprise.⁵ First, these states require combined reporting⁶ of the net income of all the affiliated corporations

¹ 103 S. Ct. 2933 (1983), *reh'g denied*, 52 U.S.L.W. 3292 (U.S. October 10, 1983).

² See *infra* notes 350-52 and accompanying text.

³ Note, *Multinational Corporations and Income Allocation Under Section 482 of the Internal Revenue Code*, 89 HARV. L. REV. 1202, 1205 (1976) [hereinafter cited as Note, *Multinational Corporations*]. See also Dexter, *The Unitary Concept in State Income Taxation of Multistate-Multinational Businesses*, 10 URB. LAW. 181, 182-83 (1978) [hereinafter cited as Dexter, *The Unitary Concept*]; J. Hellerstein, *Recent Developments in State Tax Apportionment and the Circumscription of Unitary Business*, 21 NAT'L. TAX J. 487, 487 (1968) [hereinafter cited as J. Hellerstein, *Recent Developments*]; W. Hellerstein, *State Income Taxation of Multi-jurisdictional Corporations and the Supreme Court*, 35 NAT'L. TAX J. 401, 401-02 (1982) [hereinafter cited as W. Hellerstein, *State Income Taxation*]; Keesling, *A Current Look at the Combined Report and Uniformity in Allocation Practices*, 42 J. TAX'N. 106, 107 (1975) [hereinafter cited as Keesling, *A Current Look*].

⁴ See *infra* notes 17-21 and accompanying text.

⁵ Multinational firms have been defined as a "cluster of corporations of diverse nationality joined together by ties of common ownership and responsive to a common management strategy." Note, *Multinational Corporations*, *supra* note 3, at 1202 (quoting Vernon, *Economic Sovereignty at Bay*, 47 FOREIGN AFF. 110, 114 (1968)). Although the subsidiary corporations in a multinational firm are legally separate, in fact the parent company, which exercises ultimate managerial authority, tends to view them as parts of a single global system. Note, *Multinational Corporations*, *supra* note 3, at 1202. The overall success of the entire affiliated group, rather than that of any individual component, is considered critical. *Id.*

⁶ A *combined report* must be distinguished clearly from a *consolidated return*. Whereas the combined report is not a tax return, the consolidated return is a tax return. Corrigan, *Mobil-izing Interstate Taxation*, 13 TAX NOTES 803, 804 n.3 (Oct. 12, 1981) [hereinafter cited as Corrigan, *Mobil-izing*]; Keesling, *A Current Look*, *supra* note 3, at 108. By using a consolidated report, income is not only computed as a unit, but also taxed as a unit. Keesling, *A Current Look*, *supra* note 3, at 108. The combined report is merely an "informational" return, used to determine the tax liability of a corporation by reference to the activities of other corporations which are part of a unitary business with the taxpayer corporation.

Combined reporting is a technique developed by the states to respond to the multi-corporate structure of modern conglomerates. *Id.* Originally the states had to deal only with single corporations consisting of multiple divisions located in various taxing jurisdictions. *Id.* Thus, the entire unitary business coincided with a single taxpayer. *Id.* Corporations, however, evolved their structure into a constellation of subsidiary and affiliated corporations under the leadership and control of a parent holding company. *Id.* Each separate corporation is technically a separate taxpayer, but the unitary business consists of all the subsidiaries and affiliates together. *Id.* If apportionment of income were limited to the component parts of a single-corporate unitary business, its purpose might be easily frustrated by organizing the functional or regional divisions of a business into separate subsidiary or affiliated corporations. *Id.* This risk is eliminated by requiring commonly owned or controlled corporations constituting a unitary business to file a *combined report* detailing the profits or losses and the property, payroll, and sales factor for each related corporation. *Id.* All intercompany items and

composing a multinational firm, if any one of the components of the firm does business within the state.⁷ Second, the states apportion such combined taxable income among the various jurisdictions where the firm does business according to an index of the real economic contribution of each component corporation to the production of the overall profits of the entire group.⁸ The applicable index is normally determined by a formula that takes into account the geographical distribution of the factors of production — labor and capital — and of sales.⁹ This technique is generally referred to as worldwide combined formula apportionment. The unitary business concept and formula apportionment disregard formal corporate distinctions and look at the underlying economic realities of a multijurisdictional enterprise.

Two fundamental purposes justify the adoption of worldwide unitary taxation. On the one hand, a state's worldwide unitary treatment of multijurisdictional firms prevents arbitrary income shifting on the part of the latter from jurisdictions with high tax burdens to others with more favorable income taxation.¹⁰ On the other hand, formula apportionment allows the states to allocate taxable income more fairly when separate accounting cannot satisfactorily isolate the profits attributable to particular component parts of a multijurisdictional conglomerate.¹¹

transactions, including intra-unitary business dividends, must be eliminated to avoid double counting of a portion of gross income. *Id.* Combined unitary income is apportioned to the taxing jurisdiction by application of the combined apportionment formula to the combined net income of the entire multicorporate enterprise. *Id.* at 107.

⁷ Keesling, *A Current Look*, *supra* note 3, at 108.

⁸ Note, *Multinational Corporations*, *supra* note 3, at 1206-07. The alternative approach available to state tax authorities for determining their jurisdiction's fair share of the income tax base created by a multi-jurisdictional enterprise is the separate accounting approach, which regards each affiliated corporation as a separate and independent entity. *Id.* at 1205. If the separate accounting approach is used, taxable income is allocated to the separate corporate entity to which it formally belongs. *Id.* Such allocation, however, is subject to transfer price review and eventual adjustment of intercompany transactions so as to make them conform to the results of bargaining which would have been negotiated between unrelated parties, dealing at arm's length in similar goods and services and in similar circumstances. *Id.* See generally Musgrave, *International Tax Base Division and the Multinational Corporations*, 27 PUB. FIN. 394 (1972).

⁹ See *infra* note 20 and accompanying text. The most widely used apportionment formula is the so-called "three factor formula," which takes into account property, payroll and sales, and attributes equal weight to each factor. Government Accounting Office, *Key Issues Affecting State Taxation of Multijurisdictional Corporate Income Need Resolving*, 17 TAX NOTES 159, 160 (July 12, 1982). Some jurisdictions take into account only one or two of these factors or incorporate entirely different factors in their formula. *Id.* Different jurisdictions attribute different weight to different factors. *Id.* Apportionment formulas often change for the same jurisdiction depending on the type of industry involved and, sometimes, depending on the particular circumstances of a specific taxpayer firm.

¹⁰ Note, *Multinational Corporations*, *supra* note 3, at 1203. Income shifting is possible because multinational parents and subsidiaries, unlike truly separate corporations dealing at arm's length, are largely free from market constraints in setting transfer prices for intercompany transactions in goods and services within the affiliated group. *Id.* The level of transfer prices has a direct effect on the amount of net income of each component corporation and on the distribution of overall profits within the group. *Id.* The amount of each component's income liability in the states or nations where it operates may therefore be easily manipulated. *Id.*

¹¹ *Id.* at 1215. Separate accounting may be inappropriate to allocate the tax base because economic interrelations among affiliated corporations may give rise to a variety of synergistic effects, which alter the costs and benefits of transacting intercompany business. *Id.* Whenever commonly controlled entities directly contribute either horizontally or vertically to a single production-distribution cycle, opportunities for cost savings through economies of scale and reduced transaction

California was the first state to adopt the unitary approach to taxation of corporate income and has consistently expanded and improved application of this approach to both multistate and multinational affiliated groups of corporations.¹² California's treatment of a multinational firm doing business within the state was at issue in *Container Corporation of America v. Franchise Tax Board*,¹³ where the taxpayer claimed that the California statute violated the due process and commerce clauses of the United States Constitution. In deciding this case, the United States Supreme Court, for the first time, upheld a state's worldwide unitary taxation of the combined income of a multinational enterprise through formula apportionment.¹⁴

California imposes a corporate franchise income tax.¹⁵ The California statute employs the unitary business principle and formula apportionment¹⁶ in applying the tax to corporations doing business both within and without the state.¹⁷ When a multijurisdictional corporation has income from business activity which is taxable both within and without the state, the California statute determines the share of the tax base attributable to the state.¹⁸ The statute defines apportionable income as business income¹⁹ and pro-

costs may result. See generally F.M. SHERER, *INDUSTRIAL MARKET STRUCTURE AND ECONOMIC PERFORMANCE* 72-103 (1970); Musgrave, *supra* note 8, at 403. Even where no direct transfers are made, centralized management may result in increased efficiency and lower costs of operation. See Keesling & Warren, *The Unitary Concept in the Allocation of Income*, 12 *HASTINGS L.J.* 42, 51-52 (1960). Diversification of risks and increased political and economic power may also increase long-run profits. See Musgrave, *supra* note 8, at 403-04. Since the benefits of synergy result from the cooperation of numerous affiliates, the income of each should include a share of the increased profits, even though they are not recorded by separate accounting. See Note, *Multinational Corporations*, *supra* note 3, at 1216.

From an economic viewpoint, unitary treatment is justified when (1) there is a substantial volume of transactions among affiliated firms, so that transfer price manipulation is possible; or (2) there is complete vertical integration among affiliated firms so that savings in transaction costs and economies in production can be achieved; or (3) there is horizontal interdependence among affiliated firms, but one is not the customer of the other. MCLURE, *DEFINING A UNITARY BUSINESS: THE ECONOMIST'S VIEW* (National Bureau of Economic Research, Working Paper No. 1125, 1983). Horizontal interdependence may involve both economies of scale and scope and the difficulties of transferring proprietary information. *Id.*

¹² See *infra* notes 81-92 and accompanying text; Note, *Multinational Corporations*, *supra* note 3, at 1224-25.

¹³ 103 S. Ct. 2933 (1983).

¹⁴ *Id.* at 2946.

¹⁵ CAL. REV. & TAX. CODE, §§ 23101-23364a (West 1979 & Supp. 1983).

¹⁶ CAL. REV. & TAX. CODE, §§ 25101-25140 (West 1979 & Supp. 1983). In the words of the Supreme Court, California "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." 103 S. Ct. at 2940.

¹⁷ *Id.* at 2942.

¹⁸ CAL. REV. & TAX. CODE §§ 25101-25140 (West 1979 & Supp. 1983). Sections 25130 through 25140 of the California statute reproduce, with only minor variations, the Uniform Division of Income for Tax Purposes Act (UDITPA), approved by the National Conference of Commissioners on Uniform State Laws and by the House of Delegates of the American Bar Association in 1957. UNIF. DIVISION OF INCOME FOR TAX PURPOSES ACT, 7a U.L.A. 91 (1979 & Supp. 1983). UDITPA has been adopted substantially by 23 states, including California. *Id.*

¹⁹ CAL. REV. & TAX. CODE § 25120(a) (West 1979 & Supp. 1983). The California statute, like UDITPA, distinguishes between "business" income, which is apportionable, and "non-business"

vides that a portion of this income shall be allocated to the state by application of a formula based on property, payroll and sales.²⁰ In order to apply the unitary business/formula apportionment method to affiliated groups of corporations, as well as to single corporate enterprises, California requires "combined reporting" of multicorporate unitary businesses.²¹ *Container Corporation of America v. Franchise Tax Board* arose out of California's taxation of an American corporation with subsidiaries located in foreign countries.²²

Container Corporation of America (Container), a vertically integrated²³ manufacturer of paperboard packaging, is a Delaware corporation, headquartered in Illinois and doing business in a number of states including California.²⁴ In 1963, 1964 and 1965, the years at issue in this case, Container directly or indirectly owned between 66.7 percent and 100 percent of twenty foreign subsidiaries.²⁵ Most of the foreign subsidiaries were engaged in the same business as Container and were vertically integrated as well.²⁶ Sales from Container to the foreign subsidiaries were insignificant.²⁷ The subsidiaries were relatively autonomous with respect to matters of personnel and day-to-day management, both of which were in the hands of foreign local executives.²⁸ Personnel transfers from Container to its subsidiaries were rare.²⁹ Container had one senior vice-president and four other officers in charge of overseeing the foreign subsidiaries' operations, setting standards of professionalism and profitability, solving major problems, and making long-term decisions.³⁰ Local decisions regarding capital expenditures by the subsidiaries had to receive the consent of the parent.³¹ A number of Container appointees sat on the

income, which is not. *Id.* Business income is defined in section 25120(a) as income earned in the regular course of the multijurisdictional corporation's trade or business. *Id.* Non-business income is defined in section 25120(d) as any income other than business income. *Id.* at § 25120(d). Non-business income, including rents and royalties, capital gains, interest, and dividends, *id.* at § 25123, is allocated entirely to one state, on the basis of either the corporation's commercial domicile or the state where the asset is used or located. *Id.* at §§ 25124-25127.

²⁰ *Id.* at § 25128. This section defines the apportionment formula as a fraction, the numerator of which is the property factor plus the payroll factor plus the sales factor, and the denominator of which is three. *Id.* The respective factors are the amount of the corporation's property, payroll and sales within the state over the amount of the multijurisdictional corporation's property, payroll and sales everywhere. *Id.* at §§ 25129-25136.

²¹ *Id.* at § 25102.

²² 103 S. Ct. at 2945.

²³ Vertical integration denotes the control by a single firm of different stages in the same productive process. F.M. SHERER, *supra* note 11, at 72-103. Typical examples of vertical integration are: control by a single enterprise of the manufacture and sale of a product; the production, refining and retail distribution of raw materials; or the manufacture of component parts and their assembly into final consumer products. *Id.* Some courts and commentators use the term "integration" loosely to describe a firm's expansion into related, but not connected, productive processes or the pattern of geographical expansion of a single enterprise.

²⁴ 103 S. Ct. at 2939 (1983).

²⁵ *Id.* at 2943. The subsidiaries were located in Colombia, Mexico, Venezuela, Panama, Austria, Germany, Holland, and Italy. *WhiteNack, State Tax Litigation After the Container Decision*, 20 TAX NOTES 771, 772 (September 5, 1983).

²⁶ 103 S. Ct. at 2943.

²⁷ *Id.*

²⁸ *Id.*

²⁹ *Id.* at 2943-44. While foreign employees occasionally visited Container's plants, there was no formal training program in the United States. *Id.* at 2944.

³⁰ *Id.* at 2944.

³¹ *Id.* at 2944, 2948 n.19.

subsidiaries' board of directors but were not usually active in local management.³² Container either held directly or guaranteed approximately one-half of the subsidiaries' long-term debt.³³ Container also provided its subsidiaries with manufacturing techniques, technical assistance, insurance and cost accounting consultation, either by contract or by uncompensated, informal agreement.³⁴ Container sometimes sold used equipment to its subsidiaries or acted as their purchasing agent.³⁵

In its 1963, 1964 and 1965 California Franchise Tax Returns, Container included its own corporate net earnings, but did not include any income of its foreign subsidiaries.³⁶ In calculating the share of its net income apportionable to California under the three-factor payroll, property and sales formula, Container omitted all of its foreign subsidiaries' payroll, property and sales.³⁷ In 1969, the California Franchise Tax Board issued notices of additional assessment to the corporation on the grounds that Container should have treated its foreign subsidiaries as part of its unitary business, rather than as passive investments.³⁸ Container paid the additional amounts under protest and then sued in California Superior Court for a refund.³⁹ The trial court upheld the state board's assessments.⁴⁰ The California Court of Appeals affirmed.⁴¹ The California Supreme Court refused to exercise discretionary review.⁴² The United States Supreme Court heard the case on mandatory appeal and affirmed the judgment below.⁴³

In a five to three opinion⁴⁴ delivered by Justice Brennan, the Supreme Court approved California's formula apportionment of the worldwide combined income of multinational conglomerates for state corporate income tax purposes.⁴⁵ The Court held that the California statute when applied to tax the income of a multinational enterprise consisting of a United States parent company and foreign subsidiaries and affiliates violates neither the due process clause nor the commerce clause of the United States Constitution.⁴⁶ The Court first held that the lower court had properly found Container

³² *Id.* at 2944. In its review of *Container's* structure, the Supreme Court noted that decentralization of management decisions and the parent's "hands off" attitude prevailed both in its domestic and foreign operations, and was largely mandated by the realities of the packaging industry. *Id.* at 2944 n.8.

³³ *Id.* at 2944.

³⁴ *Id.*

³⁵ *Id.*

³⁶ *Id.*

³⁷ *Id.* at 2945.

³⁸ *Id.* at 2944. Income received from merely *passive* investments is not apportionable. See *infra* text accompanying note 132. Including the overseas subsidiaries in Container's unitary business increased the apportionable unitary income and decreased the percentage of that income attributable to California. *Id.* The net effect was a higher tax liability for Container. *Id.* at 2945, 2945 nn.11 & 12.

³⁹ *Id.* at 2945.

⁴⁰ *Container Corp. of America v. Franchise Tax Board* (City & County of San Francisco Superior Court No. 673492).

⁴¹ *Container Corp. of America v. Franchise Tax Bd.*, 117 Cal. App. 3d 988, 173 Cal. Rptr. 121 (1981).

⁴² 103 S. Ct. at 2945.

⁴³ *Id.*

⁴⁴ *Id.* at 2939. Justice Brennan was joined by Justices White, Marshall, Blackmun, and Rehnquist. *Id.* Justice Powell filed a dissenting opinion, in which the Chief Justice and Justice O'Connor joined. *Id.* at 2957. Justice Stevens took no part in the consideration or decision of the case. *Id.*

⁴⁵ 103 S. Ct. at 2939, 2946, 2957.

⁴⁶ *Id.*

and its foreign subsidiaries to constitute a unitary business for state income tax purposes.⁴⁷ The Court also held that California's use of the standard three-factor formula to apportion the income of such unitary business was fair.⁴⁸ Finally, the Court found that the foreign commerce clause⁴⁹ does not require California to adopt the separate accounting method — often referred to as the "arm's length"⁵⁰ approach — in evaluating the tax consequences of intercorporate relationships, even though this is the method used by the federal government and most foreign nations.⁵¹

Container Corporation of America v. Franchise Tax Board represents the first time the Supreme Court has approved application of the unitary business principle and formula apportionment to state taxation of enterprises doing business outside the United States or beyond the "water's edge."⁵² The Court also approved California's requirement of combined reporting by multinational groups of affiliated corporations, at least in the context of an American parent company with foreign subsidiaries and affiliates.⁵³ In upholding the decision of the California tax authorities, the Court in *Container* followed the trend toward giving the states broader discretion in the field of income taxation of multijurisdictional corporations. Consistent with its recent decisions in this field, the Court once more demonstrated its reluctance to scrutinize closely state division-of-income practices.⁵⁴ The Court's deferential attitude toward state actions and its repeated references to Congress' power to legislate in this area are likely to generate a powerful momentum for the achievement of national uniformity with respect to state division-of-income rules for corporate income taxation purposes.⁵⁵

Although the *Container* decision is a clear step toward the recognition of worldwide unitary taxation of multinational enterprises, the Supreme Court expressly reserved judgment on the application of the unitary business/formula apportionment method to a foreign parent company with United States subsidiaries and affiliates.⁵⁶ This apparent

⁴⁷ *Id.* at 2939.

⁴⁸ *Id.* at 2946, 2948-50.

⁴⁹ U.S. CONST., art. 1, § 8, cl. 3.

⁵⁰ See *infra* notes 248-52 and accompanying text. See, Harley, *International Division of the Income Tax Base of Multinational Enterprise: An Overview*, 13 TAX NOTES 1563, 1564 (Dec. 28, 1981); Surrey, *Reflections on the Allocation of Income and Expenses Among National Tax Jurisdictions*, 10 L. & POLICY INT'L. BUS. 409, 413-14 (1978); Note, *Multinational Corporations*, *supra* note 3, at 1205-08 (1976). Under the separate accounting or arm's length approach the tax authorities respect formal corporate lines and treat each affiliated corporation as a separate entity. Harley, *supra*, at 1564. Inter-corporate transactions are judged by the standard of the arrangements which would have been made between unrelated parties, dealing at arm's length. *Id.* If the intragroup transactions differ from those arrangements, then an adjustment which applies the arm's length criterion is made.

⁵¹ 103 S. Ct. at 2955-56.

⁵² *Id.* at 2946.

⁵³ See *infra* notes 340-47 and accompanying text.

⁵⁴ See *infra* notes 356-59 and accompanying text.

⁵⁵ See *infra* notes 360-63 and accompanying text.

⁵⁶ 103 S. Ct. at 2952 n.26. See *infra* notes 261-64 and accompanying text. In the Court's words "we have no need to address in this opinion 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," 103 S. Ct. at 2952 n.26, and again, "we recognize that the fact that the legal incidence of a tax falls on a corporation whose formal corporate domicile is domestic might be less significant in the case of a domestic corporation that was owned by foreign interests. We need not decide here whether such a case would require us to alter our analysis." *Id.* at 2956 n.32.

dichotomy between foreign and United States parents leaves a gap in the definition of the constitutional boundaries to state income taxation of multinationals.⁵⁷

This casenote discusses the worldwide unitary taxation of the combined income of multinational corporations by the states. Part I of the article outlines the development of the unitary business concept and formula apportionment for state income tax purposes through the analysis of significant Supreme Court decisions.⁵⁸ In Part II, the Court's decision in *Container* is presented and the constitutional limitations on state division-of-income rules are examined separately.⁵⁹ In Part III, the *Container* opinion is analyzed in detail in light of the preceding case law and numerous scholarly commentaries on the subject of unitary taxation.⁶⁰ Finally, in Part IV, the impact of the *Container* decision is evaluated.⁶¹ This casenote submits that the Court's attitude of judicial deference toward state tax practices and toward any eventual congressional enactment in this area creates a propitious climate for the development of a uniform solution to division-of-income problems, either through a negotiated compromise among the states, business and the federal government or through federal legislation.⁶²

I. DEVELOPMENT OF THE UNITARY BUSINESS CONCEPT AND FORMULA APPORTIONMENT FOR STATE TAX PURPOSES

A. Early Property Tax Cases

The unitary business principle has its roots in the "unit rule" of taxation, which first emerged in the state *ad valorem* property tax cases involving railroads, express companies and other transportation businesses.⁶³ In *Adams Express Co. v. Ohio State Auditor*,⁶⁴ the Supreme Court held that a state may value the property of a company operating in several states as a *unit* and tax a fair and proper share of such property.⁶⁵ The *Adams Express* Court stated that physical unity is not necessary, nor is unity of ownership sufficient to justify treating property as a unit for tax purposes.⁶⁶ The Court held that unity of use and management of property located in different states to carry on the business is the proper test for a "unit" of property.⁶⁷ According to the *Adams Express* Court, unitary treatment of property contained within and without a state is justified when, given the nature of the business, property located in one state possesses a value only in combination with and from use in connection with the property located elsewhere.⁶⁸ The *Adams Express* case indicates that in applying the unitary business concept, a state may apportion intangible values to those states where the business activity of the

⁵⁷ See *infra* notes 348-49 and accompanying text.

⁵⁸ See *infra* notes 63-203 and accompanying text.

⁵⁹ See *infra* notes 207-301 and accompanying text.

⁶⁰ See *infra* notes 302-49 and accompanying text.

⁶¹ See *infra* notes 350-64 and accompanying text.

⁶² See *infra* notes 360-62 and accompanying text.

⁶³ Dexter, *The Unitary Concept*, *supra* note 3, at 184; J. Hellerstein, *Recent Developments*, *supra* note 3, at 488.

⁶⁴ 165 U.S. 194 (1897).

⁶⁵ *Id.* at 220-21.

⁶⁶ *Id.* at 222.

⁶⁷ *Id.*

⁶⁸ *Id.*

corporation is carried on through its use of tangible property and other income producing activities.⁶⁹

A number of later property tax cases further shaped the concept of unitary taxation.⁷⁰ These cases allowed a state to determine the in-state property or income subject to taxation by reference to the total property or income of the entire multijurisdictional enterprise. This method of arriving at the state's tax base is appropriate regardless of whether the enterprise conducts its business in a single or multiple corporate form, so long as the business is unitary.⁷¹

B. Early State Income Tax Cases

The concept of unitary taxation developed in the property tax cases was carried further beginning in 1920 in a number of cases dealing with state income taxes on manufacturing and mercantile businesses. In *Underwood Typewriter Co. v. Chamberlain*,⁷² the Supreme Court upheld Connecticut's apportionment of the income of a multistate corporation through a formula employing the location of corporate property as the sole factor.⁷³ The Underwood Company conducted all its manufacturing operations in Connecticut, but had branch offices and inventories in other states.⁷⁴ The Supreme Court found that the corporation's profit was generated by a series of transactions beginning with manufacturing in one state and ending with sales in other states.⁷⁵ According to the Court, this made it impossible for state tax authorities to allocate specifically the profits earned within each state.⁷⁶ The Court concluded that formula apportionment was an appropriate method to determine the corporation's fair share of the burden of taxation.⁷⁷

The Supreme Court considered another application of formula apportionment in *Bass, Ratcliff & Gretton, Ltd. v. State Tax Commissioner*.⁷⁸ In that case the Court upheld New York's application of a two-factor formula based on property and sales to the income of a British manufacturer importing beer into the United States through a New York office.⁷⁹ In *Bass, Ratcliff*, as in *Underwood*, the Court stated that the taxpayer corporation has the burden of showing that the statutory method of apportionment is arbitrary and unreasonable.⁸⁰

⁶⁹ *Id.* at 223. Dexter, *The Unitary Concept*, *supra* note 3, at 187-88.

⁷⁰ See, e.g., *Wallace v. Hines*, 253 U.S. 66 (1920) (out-of-state property not apportionable unless it "adds to the value" of in-state property); *Union Tank Line Co. v. Wright*, 249 U.S. 275 (1919) (Court found application of track mileage formula unreasonable in the particular circumstances of the case); *Fargo v. Hart*, 193 U.S. 490 (1904) (property not associated with company's unitary business cannot be apportioned); *Cleveland, Cincinnati, Chicago & St. Louis Railway Co. v. Backus*, 154 U.S. 439 (1894) (ownership of single railway system by separate corporations does not defeat unitary concept); *Commonwealth v. Southern Railway Co.*, 193 Ky. 474, 237 S.W. 11 (1921) (in-state railroad owned and operated by out-of-state parent resulted in taxation of parent); see generally, Dexter, *The Unitary Concept*, *supra* note 3, at 188-90.

⁷¹ *Id.* at 189-90.

⁷² 254 U.S. 113 (1920).

⁷³ *Id.* at 120-21.

⁷⁴ *Id.* at 119.

⁷⁵ *Id.* at 120.

⁷⁶ *Id.* at 121.

⁷⁷ *Id.*

⁷⁸ 266 U.S. 271 (1924).

⁷⁹ *Id.* at 282.

⁸⁰ *Id.* at 283-84; *Underwood*, 254 U.S. at 121.

The unitary business test for state income tax purposes was developed primarily from cases arising from California tax practices. In *Butler Bros. v. McColgan*,⁸¹ an Illinois corporation engaged in the wholesale dry goods business, operated several independent distributing houses in various states, including California.⁸² Through the operation of a central buying division the corporation was able to obtain lower prices for the goods sold by all the houses and thereby achieved significant economies of scale.⁸³ The Supreme Court, relying on a finding of unity of ownership, management and use among the independent distributing houses located in different states, held that the existence of economies of scale was sufficient to make the business unitary.⁸⁴ The Court thus adopted the so called "three-unities test" articulated by the California Court of Appeals below in its *Butler Bros.* opinion.⁸⁵ The California court developed a classic formulation of the determinative factors to be considered under this test: "(1) unity of ownership; (2) unity of operation, as evidenced by central purchasing, advertising, accounting and management divisions; (3) unity of use in its centralized executive force and general system of operation."⁸⁶

The test for unitariness was further developed in *Edison California Stores, Inc. v. McColgan*,⁸⁷ another case arising under California tax law. In *Edison* the California Court of Appeals developed the "three-unities test," stating that if the portion of the business conducted within the state is "dependent upon or contributes to" the portion of the business conducted without the state, the operation within and without the state are unitary.⁸⁸ The "three-unities test" and the "contribution and dependence" test may be considered complementary.

Some state courts have taken a very expansive view of the unitary business principle and have stretched the above tests so far as to cover almost unrelated activities carried on by separate parts of a firm in different states. In *Superior Oil Co. v. Franchise Tax Board*,⁸⁹ for example, the California Court of Appeals held that the in-state operations of a nonintegrated oil company contributed substantially to and were substantially dependent upon its out-of-state operations. In *Superior Oil Co.* the company engaged in no interstate sales, but its California headquarters handled accounting, purchases of equipment, and insurance matters for the entire enterprise, within and without the state.⁹⁰ The taxpayer in *Superior Oil* sought unitary treatment in order to offset in-state profits with out-of-state

⁸¹ 315 U.S. 501 (1942).

⁸² *Id.* at 504.

⁸³ *Id.* at 506.

⁸⁴ *Id.* at 508-09. The Court was satisfied that the corporation's separate accounting system, whereby all goods were billed at cost to the regional offices and overhead and operating expenses of the central office were shared as well, was accurate and fair. *Id.* at 504-05. The Court noted, however, that it "need not impeach the integrity of [the separate] accounting system" to uphold formula apportionment, because "accounting practices . . . may vary considerably according to the problem at hand." *Id.* at 507. The Court's finding of unity of ownership and management, functional integration, and economies of scale supported the state's reliance on property, payroll, and sales to reflect the relative contribution of the activities in the various states to the production of the total unitary income. *Id.* at 509.

⁸⁵ 17 Cal. 2d 664, 111 P.2d 334 (1941).

⁸⁶ *Id.* at 678, 111 P.2d at 341.

⁸⁷ 30 Cal. 2d 472, 183 P.2d 16 (1947).

⁸⁸ *Id.* at 481, 183 P.2d at 21.

⁸⁹ 60 Cal. 2d 406, 386 P.2d 33 (1963).

⁹⁰ *Id.* at 415-16, 386 P.2d at 39.

losses.⁹¹ The Court granted this treatment.⁹² Other state courts have taken an unduly restrictive view of the unitary business principle.⁹³

The progressive consolidation and expansion of unitary taxation of multijurisdictional corporations has not gone unchallenged. While the Supreme Court, as well as state courts, generally have shown a significant degree of deference to state division-of-income practices, taxpayers have at times succeeded in attacking the constitutional validity of a state's apportionment formula. In *Hans Rees' Sons, Inc. v. North Carolina*,⁹⁴ a company manufactured leather goods in one state and sold them in other states and abroad.⁹⁵ The evidence showed that while the in-state manufacturing operations generated an average of seventeen per cent of the profits, approximately eighty per cent of the profits was allocated by the manufacturing state to itself through formula apportionment.⁹⁶ The Supreme Court found that although the taxpayer's business was unitary, formula apportionment operated unreasonably and arbitrarily because it attributed to the taxing state a percentage of income "out of all appropriate proportion" to business transacted in the state.⁹⁷ The Court, therefore, struck down the state's application of the formula apportionment method.⁹⁸

The tests developed in the early cases have meaning only in light of the particular facts of each individual case. For this reason, modern courts, in applying those tests, consider all of the facts and circumstances in determining whether the taxpayer's business was unitary or whether apportionment resulted in the taxation of extraterritorial values.⁹⁹ It has always been clearly understood, however, that the burden is on the taxpayer to introduce clear and cogent evidence that unitary taxation is inappropriate.¹⁰⁰

C. Recent Refinements of the Constitutional Doctrines Affecting Unitary Taxation

Since 1978, the Supreme Court has addressed the constitutional limitations on state income taxation of multijurisdictional corporations in a number of cases. In the landmark case of *Mobil Oil Corporation v. Commissioner of Taxes of Vermont*,¹⁰¹ the Court held that formula apportionment does not violate the due process and commerce clauses of the Constitution so long as the taxpayer's business is unitary, even though formal corporate distinctions are disregarded for tax purposes.¹⁰² In the subsequent cases of *ASARCO, Inc.*

⁹¹ *Id.* at 408, 386 P.2d at 34. This case was somewhat out of the ordinary. Normally the taxpayer seeks to avoid unitary treatment. Here, however, unitary taxation decreased the taxpayer's tax liability in California, and the state tax authorities tried to deny that taxpayer's business was unitary. *Id.* In this unusual role, the state tried to limit the scope of the "contribution and dependence test" by arguing that "the employment of an allocation formula is justified only when the various local operations are so essential to the overall operations that it is impossible to make separate accounting computations." *Id.* at 413, 386 P.2d at 37. The Court explicitly rejected this position. *Id.* at 414, 386 P.2d at 38.

⁹² *Id.* at 415, 386 P.2d at 38.

⁹³ See, e.g., *Skelly Oil Co. v. Comm'r of Taxation*, 269 Minn. 351, 131 N.W.2d 632 (1964) (integrated oil company's marketing and production operations held *not* unitary).

⁹⁴ 283 U.S. 123 (1931).

⁹⁵ *Id.* at 126-27.

⁹⁶ *Id.* at 127-28.

⁹⁷ *Id.* at 135.

⁹⁸ *Id.*

⁹⁹ See, e.g., *Container*, 103 S. Ct. at 2947-48.

¹⁰⁰ *Norfolk & Western Ry. Co. v. North Carolina*, 297 U.S. 682, 688 (1935).

¹⁰¹ 445 U.S. 425 (1980).

¹⁰² See *infra* notes 129-32 and accompanying text.

*v. Idaho State Tax Commission*¹⁰³ and *F. W. Woolworth Co. v. Taxation and Revenue Department of the State of New Mexico*,¹⁰⁴ however, the Court showed that the requirements set forth in *Mobil* were effective limitations on the states' application of unitary taxation. In these two cases, the Court held that actual integration and control must be found before the different parts of a firm may be held to constitute a unitary business.¹⁰⁵ Furthermore, in the 1979 case of *Japan Lines, Ltd. v. County of Los Angeles*,¹⁰⁶ the Court held that the risk of international double taxation and the need for federal uniformity in matters of foreign relations are additional considerations that limit the availability to the states of unitary taxation in the case of multinational corporations, when international commerce is involved.¹⁰⁷

1. The Outlines of Unitary Taxation of Multijurisdictional Corporate Income

The Supreme Court signaled its renewed interest in state division-of-income problems in 1978. In *Moorman Manufacturing Co. v. Bair*,¹⁰⁸ the Court upheld Iowa's single-factor sales formula for apportioning income. This decision laid the foundation and set the tone for subsequent Supreme Court decisions in this area of the law.¹⁰⁹

Moorman involved an Illinois corporation that manufactured animal feed in Illinois and sold about twenty per cent of its production in Iowa, where it had over five hundred salespeople and six warehouses.¹¹⁰ In upholding Iowa's tax treatment of this corporation, the Court held that states have wide latitude in the selection of apportionment formulas.¹¹¹ Moreover, the Court stated it would interfere only when the taxpayer has proved by clear and cogent evidence¹¹² that formula apportionment has led to a "grossly distorted result."¹¹³ The Court insisted that actual double taxation must be established on the record, or it will be viewed as "speculative."¹¹⁴ The Court further indicated that even assuming some overlap in the taxation of a multistate corporation's income, it would not invalidate formula apportionment in the absence of federal legislation.¹¹⁵ The Court refused to engage in "extensive judicial lawmaking" and referred dissatisfied taxpayers to

¹⁰³ 102 S. Ct. 3103 (1982).

¹⁰⁴ 102 S. Ct. 3128 (1982).

¹⁰⁵ See *infra* notes 158-61, 171-76 and accompanying text.

¹⁰⁶ 441 U.S. 434 (1979).

¹⁰⁷ See *infra* notes 195-201 and accompanying text.

¹⁰⁸ 437 U.S. 267 (1978).

¹⁰⁹ *Id.* at 281.

¹¹⁰ *Id.* at 269.

¹¹¹ *Id.*

¹¹² *Id.* at 274 (citing *Butler Bros. v. McCollgan*, 315 U.S. 501, 507 (1942)).

¹¹³ *Id.* at 274 (citing *Norfolk & Western Ry. Co. v. State Tax Comm'r*, 390 U.S. 317, 326 (1968)).

¹¹⁴ 437 U.S. at 276. The Court distinguished the case of *General Motors Corp. v. District of Columbia*, 380 U.S. 553 (1965), where it had stricken down a single-factor sales formula, as based on the requirements of the D.C. statute, not the U.S. Constitution. 437 U.S. at 274-75. The *General Motors* opinion contains some *dicta* to the effect that a single state's use of a single-factor formula when the vast majority of states apportion income on the basis of a three-factor formula would ordinarily result in multiple taxation of corporate income. *General Motors*, 380 U.S. at 556-57. The majority in *Moorman*, however, disregarded the allegation that Iowa's single-factor formula provided a direct commercial advantage to local business by discriminating against out-of-state manufacturers selling their products within the state. *Moorman*, 437 U.S. at 276. Justices Powell and Blackmun, in dissent, raised the issue of state protectionism. *Id.* at 282, 283-84.

¹¹⁵ 437 U.S. at 278-79.

Congress.¹¹⁶ The *Moorman* decision stresses three recurring themes that underlie the Court's decisions on state division-of-income rules: 1) wide latitude for the states in apportioning the income of multijurisdictional firms; 2) self-restraint by the Court in scrutinizing state practices; and 3) deference to Congress as the appropriate source of uniform rules in this area.¹¹⁷

The taxation of income from intangible property, particularly of dividends received by multistate or multinational corporations from their out-of-state affiliates, was a very controversial issue for states adopting the unitary method because of the contention that intangible income is inherently nonapportionable.¹¹⁸ In *Mobil Oil Corp. v. Commissioner of Taxes of Vermont*,¹¹⁹ the Supreme Court extended the application of the unitary business principle to dividends received by a corporation from its foreign subsidiaries and

¹¹⁶ *Id.* at 280. The Court refused to hold that the commerce clause itself, without implementing legislation by Congress, prohibits any overlap in the computation of taxable income by the states. *Id.* at 278. The Court noted that some overlap is likely to result whenever a multistate firm does business in states having different division-of-income rules. *Id.* A constitutional requirement of precisely apportioned income, in the Court's opinion, would be tantamount to a requirement of national uniform division-of-income rules. *Id.* at 279. The Court observed, however, that uniformity is a matter of political and economic judgment and that the Constitution is neutral with respect to the content of any uniform rule. *Id.* The Court noted that only Congress has the power and the authority to dictate uniform rules. *Id.* at 280.

¹¹⁷ W. Hellerstein, *State Income Taxation*, *supra* note 3, at 404. See also Schwartz, *Commerce, the States, and the Burger Court*, 74 N.W. U.L. REV. 409, 436 (1979).

¹¹⁸ See Dexter, *Taxation of Income from Intangibles of Multistate-Multinational Corporations*, 29 VAND. L. REV. 401, 401-03 (1976) [hereinafter cited as Dexter, *Taxation of Income from Intangibles*]. The main issue was whether such income should be apportioned or allocated specifically to the state of its putative source. *Specific allocation* has in general been largely rejected because of the inherent difficulties in identifying the particular source of income. See W. Hellerstein, *State Income Taxation*, *supra* note 3, at 401-02. The great bulk of the intangible income of corporations in the United States is derived from investments in affiliated corporations. Dexter, *Taxation of Income from Intangibles*, *supra*, at 402. Originally taxpayers took the position that intercorporate dividends should be exempt from state taxation since they have no "source" apart from the underlying income-producing activities of the payor corporation. *Id.* *A fortiori* "foreign source" dividends from a foreign affiliate should not be subject to state taxation at all. *Id.* at 404-05. As a compromise position, taxpayers later conceded that domestic intercorporate dividend income from unaffiliated corporations could be attributed to the commercial domicile of the payee corporation, while all other dividend income should be exempt. *Id.* On the other hand, the states argued that dividends received from affiliates and subsidiaries, either domestic or foreign, constituting an integral part of the taxpayer's unitary business should be apportioned among the states where the taxpayer carries on its business activities. *Id.*

Before *Mobil Oil Corp. v. Comm'r of Taxes of Vermont*, 445 U.S. 425 (1980), the issues were: (1) the extent to which dividend income and other intangible income should be exempt or specifically allocated to the commercial domicile of the taxpayer corporation; (2) whether foreign source dividends should be treated differently from domestic source dividends; and (3) whether income from intangibles could be subject to the apportionment rules that generally applied to other classes of income. Dexter, *Taxation of Income from Intangibles*, *supra*, at 405. According to Dexter, the four basic alternatives available were:

(1) assign the income to the payor source from which the intangible income is derived; (2) attribute the income to the commercial domicile of the payee corporation; (3) apportion the income among the states in which the payee corporation carries on its business activities; or (4) apportion the income among the states concerned by taking into account in the formula some or all of the property, payroll, and sales of the payor as well as the payee corporation.

Id.

¹¹⁹ 445 U.S. 425 (1980).

affiliates.¹²⁰ Mobil Oil Corporation, commercially domiciled in New York, was engaged in a vertically integrated multinational petroleum business.¹²¹ Mobil's activities in Vermont were limited to marketing.¹²² The corporation derived a large portion of its income in the form of dividends from subsidiaries and affiliates operating abroad.¹²³ The state of Vermont imposed an income tax on corporations doing business within the state and adopted the unitary business/formula apportionment method to tax multijurisdictional corporations.¹²⁴ Mobil excluded its foreign source dividends in reporting its apportionable income, claiming that these dividends were taxable exclusively in the state of Mobil's commercial domicile.¹²⁵ Vermont disagreed and sought to include foreign source dividends in the apportionable tax base.¹²⁶ The Supreme Court upheld the state's claim to tax the dividends received from foreign affiliates.¹²⁷

The Court stated in *Mobil* that the "linchpin" of apportionability in the field of state income taxation is the unitary business principle.¹²⁸ The Court held that in order to exclude its dividend income from the apportionable tax base, a taxpayer corporation must show that the income was earned in the course of activities unrelated to its activities within the taxing state.¹²⁹ According to the Court, dividends from subsidiaries and affiliates fall within the parent's apportionable income base when they reflect profits derived from a functionally integrated enterprise.¹³⁰ The Court looked at the "underlying economic realities" rather than the "form of investment" or the "form of business organization," thereby disregarding formal corporate lines.¹³¹ The Court noted, however, that dividend income received from merely *passive* investments is not apportionable where the business activities of the dividend payor have "nothing to do" with the activities

¹²⁰ *Id.* at 449.

¹²¹ *Id.* at 428.

¹²² *Id.*

¹²³ *Id.* at 430.

¹²⁴ *Id.* at 429. VT. STAT. ANN., tit. 32, §§ 5811(18), 5833(a) (1981).

¹²⁵ 445 U.S. at 430, 433.

¹²⁶ *Id.* at 431-32.

¹²⁷ *Id.* at 449. The Court's decision turned on the resolution of *procedural* as well as *substantive* issues. 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, 107 (1981) [hereinafter cited as *Dexter, Tax Apportionment*]. Mobil did not contend that the apportionment formula operated *unfairly* by attributing to Vermont more net income than was reasonably related to Mobil's activities there. 445 U.S. at 434. It did not argue, until it was too late, that combined reporting should be allowed. *Id.* at 434 n.11. Nor did Mobil, in the Court's opinion, offer evidence that its dividends and stock investments were unrelated to its unitary business. *Id.* at 439. Mobil instead claimed that dividends from a "foreign source" by their very *nature* are not apportionable income. *Id.* at 434. The Court was then able to narrow the issues to "whether there is something about the character of income earned from investments in affiliates and subsidiaries operating abroad" that makes dividends therefrom non-apportionable. *Id.* at 434-35. The Court concluded that there was not. *Id.* at 439.

¹²⁸ 445 U.S. at 439.

¹²⁹ *Id.*

¹³⁰ *Id.* at 440.

¹³¹ *Id.* at 441. Mobil, in its reply brief, tried to argue that Vermont's failure to require "combined apportionment" violated the due process clause. *Id.* at 441 n.15. The Court refused to address this argument, as it was untimely, unsupported by the record and "an afterthought." *Id.* See generally Nackenson & Feinschreiber, *The Unitary Method of State Taxation After Mobil and Exxon*, 11 TAX ADVISER 708 (1980). Justice Stevens, in dissent, disagreed. 445 U.S. at 460. He believed that a challenge to the apportionable income tax base *necessarily* implied a challenge to the apportionment formula. *Id.* at 460-61 (Stevens, J., dissenting). His opinion clearly supported worldwide combined reporting of unitary enterprises. *Id.*

of the recipient in the taxing state.¹³² The Court dismissed Mobil's complaint of duplicative taxation, finding it unsupported by the record.¹³³

The principles set forth in *Mobil* were reaffirmed by the Supreme Court in *Exxon Corp. v. Wisconsin Department of Revenue*.¹³⁴ Exxon, an integrated oil company operating worldwide, limited its activities in Wisconsin to the marketing of petroleum products.¹³⁵ Wisconsin imposed a corporate income tax using a three-factor apportionment formula.¹³⁶ Exxon's internal system of functional accounting separated its income into three distinct categories: marketing, exploration and production, and refining.¹³⁷ Exxon introduced evidence that each one of its functional departments was organized as a separate unit, independently responsible for its own performance¹³⁸ and, therefore, did not constitute a unitary business for state income tax purposes.¹³⁹ Transfers of products and raw materials among the three functional departments were theoretically based on competitive wholesale market prices.¹⁴⁰ Exxon, however, was a single corporate entity with a centralized corporate staff providing a wide range of critical services to the entire corporation.¹⁴¹ The Court held that Exxon was a highly integrated business which benefited from an "umbrella of centralized management and controlled interaction."¹⁴² The Court concluded that the taxpayer's business was unitary,¹⁴³ reasoning that the taxpayer's internal accounting system was not binding on the state for tax purposes.¹⁴⁴

2. Effective Limitations of the States' Discretion to Apply the Unitary Concept

The Court's decisions in *Mobil* and *Exxon* indicated an attitude of judicial restraint and willingness to allow the states wide discretion in their division-of-income practices. In both cases, the Court expanded the notion of unitary business, focusing on the actual interdependence of the taxpayer's subsidiaries and affiliates or divisions, as evidenced by

¹³² 445 U.S. at 441-42.

¹³³ *Id.* at 444. The Court said, in *dicta*, that even assuming the state of commercial domicile has the authority to lay some tax on dividend income, there is no reason why that power should be exclusive when the dividends reflect income from a unitary business, part of which is conducted in other states. *Id.* at 446-47. The Court stated that there is "nothing talismanic about the concept of 'business situs' or 'commercial domicile'." *Id.* at 445. Ultimately, however, the Court refrained from clarifying the multiple taxation issue other than to say that such an issue would not be decided on the "vagaries" of the state of commercial domicile's tax policy towards dividend income. *Id.* at 444. See generally Dexter, *Tax Apportionment*, *supra* note 127, at 114.

¹³⁴ 447 U.S. 207 (1980).

¹³⁵ *Id.* at 212-13.

¹³⁶ *Id.* at 213-14; WIS. STAT. § 71.07(2) (1969 & Supp. 1983-1984).

¹³⁷ 447 U.S. at 210.

¹³⁸ *Id.* at 212. Taxpayer's departments were actually in competition with each other and with outsiders for company resources, capital and business opportunities. *Id.*

¹³⁹ *Id.*

¹⁴⁰ *Id.*

¹⁴¹ *Id.* at 213. Such services included centralized purchasing, interdepartmental coordination to achieve operating efficiencies, nationwide distribution, uniform brand names, advertising, and credit cards. *Id.*

¹⁴² *Id.* at 224.

¹⁴³ *Id.*

¹⁴⁴ *Id.* at 221. It has been noted that after *Exxon* only "the most sanguine taxpayer would harbor the hope that the Supreme Court may still be moved by separate accounting evidence to invalidate the application of a three-factor apportionment formula to the income of a unitary business." W. Hellerstein, *State Income Taxation*, *supra* note 3, at 412.

integration of the operating functions, centralization management, economies of scale and, of course, common ownership and control.¹⁴⁵ The Supreme Court reversed this expansive trend in *ASARCO, Inc. v. Idaho State Tax Commission*¹⁴⁶ and in *F. W. Woolworth Co. v. Taxation and Revenue Department of New Mexico*.¹⁴⁷ In these cases, the Court applied the same doctrines it had used in *Mobil* and *Exxon*, but found the taxpayers' business non-unitary.¹⁴⁸ In *ASARCO* and *Woolworth*, the Court took a more active role in scrutinizing state division-of-income practices and turned the unitary business principle into a constitutional restraint on state taxation powers.¹⁴⁹

ASARCO, Inc., a New Jersey corporation headquartered in New York, was principally engaged in mining, smelting and refining.¹⁵⁰ It conducted roughly 2.5 per cent of its business in Idaho.¹⁵¹ ASARCO owned between 34 per cent and 52.7 per cent of five subsidiaries, from which it collected dividends and other income from intangible property.¹⁵² None of these subsidiaries conducted business in Idaho. Idaho imposed a corporate income tax upon multijurisdictional corporations, derived from the state's version of the Uniform Division of Income for Tax Purposes Act (UDITPA).¹⁵³ ASARCO sought to exclude income from its five subsidiaries from its apportionable tax base, arguing that these subsidiaries were not part of its unitary business.¹⁵⁴ The state maintained that dividend income from these five subsidiaries was properly included in the apportionable tax base, regardless of whether the links between the subsidiaries and ASARCO were sufficient to justify unitary treatment, because ASARCO's receipt of dividends from each subsidiary constituted apportionable "business" income to ASARCO.¹⁵⁵ The Supreme Court held that Idaho's efforts to tax ASARCO's foreign source income violated the due process prohibition against extraterritorial taxation.¹⁵⁶

The issue in *ASARCO* was whether income received by a nondomiciliary corporation, doing business within the state, from corporations with which it was *not* vertically integrated should be included in the apportionable tax base, when the taxpayer held "substantial ownership interests in and enjoyed a variety of working relationships with such

¹⁴⁵ See generally Casenote, *State Taxation of Nondomiciliary Corporations*, 40 WASH. & LEE L. REV. 191 (1983).

¹⁴⁶ 102 S. Ct. 3103 (1982).

¹⁴⁷ 102 S. Ct. 3128 (1982).

¹⁴⁸ *Woolworth*, 102 S. Ct. at 3139; *ASARCO*, 102 S.Ct. at 3112.

¹⁴⁹ Casenote, 96 HARV. L. REV. 62, 87 (1982).

¹⁵⁰ 102 S. Ct. at 3105.

¹⁵¹ *Id.*

¹⁵² *Id.* at 3105, 3106 and n.2. ASARCO owned 52.7 percent of M.I.M. Holdings, Ltd., a publicly owned corporation engaged in mining, smelting, and refining in Australia and in the United Kingdom; 34 percent of General Cable Corp. and 34 percent of Revere Copper and Brass, Inc., both publicly owned United States corporations which make cable and copper wares, respectively; 49 percent of ASARCO Mexicana, S.A., a widely held Mexican company which mines and smelts lead and copper; and 51.5 percent of Southern Peru Copper Corp., a company owned by four shareholders. *Id.* at 3106 and n.2. Besides dividends, ASARCO received interest income from convertible debentures and notes and realized capital gains on sales of stock from its subsidiaries. *Id.* at 3106. See also Casenote, *Taxation: State Taxation of Multinational Corporations — ASARCO, Inc. v. Idaho State Comm'n.; F.W. Woolworth Co. v. Taxation and Revenue Dept.*, 23 HARV. INT'L. L.J. 480, 480-81 nn.2-5 (1983) [hereinafter cited as Casenote, *ASARCO and Woolworth*].

¹⁵³ Idaho Code § 63-3027 (1976 & Supp. 1982-83); see *supra* note 18 and accompanying text.

¹⁵⁴ 102 S. Ct. at 3107-08.

¹⁵⁵ *Id.* at 3108.

¹⁵⁶ *Id.* at 3116.

corporations."¹⁵⁷ The Court disagreed with the state's argument that intangible income should be included in the apportionable tax base if the intangible property is acquired, managed or disposed of for purposes relating to or contributing to the taxpayer's own business.¹⁵⁸ According to the Court, the meaning of the unitary business concept would be destroyed if a finding of unitariness were based on the mere fact that investment in a subsidiary benefits the parent company.¹⁵⁹ The Court reasoned that the more limited elements of integration and control were better indicators in determining whether a business is unitary.¹⁶⁰ Applying this narrower test to the facts of the case, the Court held that ASARCO had sustained the burden of proving that the subsidiaries at issue were "discrete business enterprises" and not part of its unitary business.¹⁶¹ Consequently, due process prohibited unitary taxation of ASARCO.¹⁶² Three justices dissented in ASARCO, eschewing the Court's narrow view and accusing the Court of substituting an "oversimplified test" of active operational control and functional integration for the "multifaceted analysis" used in *Mobil* and *Exxon* to determine whether a business was unitary.¹⁶³

In *F. W. Woolworth Co. v. Taxation and Revenue Department of the State of New Mexico*,¹⁶⁴ a companion case of the ASARCO decision, the Court also found that a state's effort to tax an apportionable share of dividends¹⁶⁵ from foreign subsidiaries violated the due process clause of the fourteenth amendment.¹⁶⁶ Woolworth, a New York corporation, was engaged in the general retail merchandise business throughout the United States, including New Mexico.¹⁶⁷ It wholly owned three foreign subsidiaries and owned 52.7 percent of a fourth, all of which engaged in chain store retailing operations independent from those of Woolworth.¹⁶⁸ Woolworth sought to exclude from its apportionable income tax base the substantial dividends received from its four foreign subsidiaries, but the state of New Mexico disagreed.¹⁶⁹ The Supreme Court sustained the taxpayer's position.¹⁷⁰ The Court found that Woolworth's business was not unitary, because Woolworth had chosen *not* to exercise its potential for controlling its foreign subsidiaries.¹⁷¹ The Court stated that, when dividend-paying subsidiaries operate as discrete business enterprises, they should

¹⁵⁷ *Id.* at 3107. See also W. Hellerstein, *State Income Taxation*, *supra* note 3, at 415.

¹⁵⁸ 102 S. Ct. at 3114.

¹⁵⁹ *Id.* The Court found that the business of a corporation requires that it earn money to continue operation and yield profits. *Id.* Consequently, *all* of its operations, including any investment made, contribute or relate to the *corporate purpose*. *Id.*

¹⁶⁰ *Id.* at 3112-13. The integration test permits apportionment when transactions between in-state and out-of-state operations, or shared costs and benefits, allow local activities to contribute to out-of-state income. Casenote, 96 HARV. L. REV. 62, 92-93 (1983). The *control* test recognizes that apportionment is inappropriate unless the division of benefits and burdens between the in-state and out-of-state activities is not at arm's length and is, therefore, inherently suspect. *Id.*

¹⁶¹ 102 S. Ct. at 3111. A commentator noted that the Court's decision may be due more to its view of the facts, than to its definition of a unitary business. W. Hellerstein, *Income State Taxation*, *supra* note 3, at 418.

¹⁶² 102 S. Ct. at 3116.

¹⁶³ 102 S. Ct. at 3123. Justice O'Connor's dissent was joined by Justices Blackmun and Rehnquist. *Id.* at 3117.

¹⁶⁴ 102 S. Ct. 3128 (1982).

¹⁶⁵ N.M. STAT. ANN. §§ 7-4-1 to 7-4-21 (1983).

¹⁶⁶ 102 S. Ct. at 3139.

¹⁶⁷ *Id.* at 3131.

¹⁶⁸ *Id.*

¹⁶⁹ *Id.* at 3132.

¹⁷⁰ *Id.* at 3139.

¹⁷¹ *Id.* at 3134, 3138.

not be treated as unitary with the parent company merely because of the latter's potential to operate them as divisions of a single integrated enterprise.¹⁷² In evaluating the relationship of Woolworth to its four dividend-paying foreign subsidiaries, the Court found little functional integration, centralization of management, or economies of scale.¹⁷³ The Court drew a clear distinction between a retail merchandising business and the kind of multinational business in which refined, processed, or manufactured products may be produced in one or more countries and marketed in various countries.¹⁷⁴ In the former case, a flow of international trade, an interchange of personnel, and substantial mutual interdependence are lacking.¹⁷⁵ The Court therefore concluded that the state was attempting to reach extraterritorial values, wholly unrelated to the in-state business of the taxpayer, in violation of due process standards.¹⁷⁶

In essence, the *ASARCO* Court found that "uncontrolled integrated affiliates" are not a unitary business.¹⁷⁷ The *Woolworth* decision indicated that "unintegrated controlled affiliates" are not unitary.¹⁷⁸ In both cases, the Supreme Court found that a portion of investment income is taxable in a jurisdiction if, and only if, the business activities of the issuer of the securities are unitary with those of the security holder.¹⁷⁹

The *ASARCO* and *Woolworth* decisions support taxpayer challenges to state division-of-income rules under the due process clause.¹⁸⁰ The long-term impact of these decisions has been debated widely. One commentator praised the Supreme Court's "new attitude of judicial vigilance" as opposed to its prior "detached judicial tolerance" and "hands-off attitude."¹⁸¹ Others have criticized the Court's approach as too narrow and have argued for a limited interpretation of these two cases.¹⁸²

Commentators from both sides, however, agree that the *ASARCO* and *Woolworth* opinions do not necessarily prohibit a state from apportioning income from intangibles received from an out-of-state payor with which the payee is *not* conducting a unitary business.¹⁸³ The general rule is that long-term portfolio investments *unrelated* to the payee's day-to-day operations are ordinarily nonapportionable. This is not true, however, for *short-term* investments of working capital.¹⁸⁴ Moreover, an exception must be

¹⁷² *Id.* at 3134.

¹⁷³ *Id.* at 3135-38.

¹⁷⁴ *Id.* at 3138-39.

¹⁷⁵ *Id.* at 3139.

¹⁷⁶ *Id.*

¹⁷⁷ Casenote, 96 HARV. L. REV. 62, 90 (1982).

¹⁷⁸ *Id.*

¹⁷⁹ *Id.* at 93.

¹⁸⁰ Casenote, *Due Process and the Unitary Principle of State Taxation: ASARCO, Inc. v. Idaho State Tax Commission; F.W. Woolworth Co. v. Taxation and Revenue Department of New Mexico*, 36 TAX LAW 460, 468 (1982).

¹⁸¹ Hellerstein, *State Income Taxation*, *supra* note 3, at 422-23.

¹⁸² Greene, *ASARCO and Woolworth: Anomalous Anachronisms with Limited Precedential Value*, 18 TAX NOTES 795, 795 (March 7, 1983); *see also*, Lathrop, *Due Process Considerations and the Apportionment of Dividend Income: A Dissent from the ASARCO and Woolworth Decisions*, 16 TAX NOTES 3, 3 (July 5, 1982). One author termed *ASARCO* and *Woolworth* an "anomalous anachronism with limited precedential value." Greene, *supra*, at 795.

¹⁸³ Greene, *supra* note 182, at 801; W. Hellerstein, *State Income Taxation*, *supra* note 3, at 416-17, 421.

¹⁸⁴ Greene, *supra* note 182, at 801; W. Hellerstein, *State Income Taxation*, *supra* note 3, at 416-17, 421. Dividends from temporary or short-term investment of working capital or other current funds for ordinary operating uses generally have been held to be apportionable without any requirement

made for income from intangibles covered by the *Corn Products* doctrine, dealing with the capital gain-ordinary income division between investment and business for federal income taxation purposes.¹⁸⁵ It is also important to note that the Court in *ASARCO* and *Woolworth* did not depart from or overrule its prior decisions in unitary business cases.¹⁸⁶ The Court, instead, explicitly relied on these decisions and merely shifted the emphasis toward the analysis of the facts of the case in *ASARCO* and *Woolworth*. Indeed, the Court repeatedly cited *Mobil* as the leading authority in the area, clearly showing no intention to depart from it.¹⁸⁷

3. Additional Restraints for Cases Involving International Commerce

The due process standards articulated by the Court in *ASARCO* and *Woolworth* are adequate for domestic corporations operating in several states. When, however, multinational corporations are subjected to unitary taxation by the states, additional constitutional issues arise under the foreign commerce clause, because state action is then likely to affect international commerce and foreign relations. In this context, the case of *Japan Line, Ltd. v. County of Los Angeles*¹⁸⁸ furnished multinational firms with what many hailed at the time as an important new avenue for attacking apportionment of income from foreign sources.¹⁸⁹

In *Japan Line*, the Supreme Court addressed the issue of whether instrumentalities of foreign commerce which are owned, based and registered abroad and which are used exclusively in international commerce may be subjected to apportioned *ad valorem* property taxation by a state.¹⁹⁰ Six Japanese shipping companies operated vessels, based in Japan, for the purpose of transporting cargo containers owned and registered in Japan.¹⁹¹ The containers were subject to property tax in Japan and were, in fact, taxed there.¹⁹² The county of Los Angeles imposed a property tax on the foreign containers on the basis of their average presence in California.¹⁹³ The Supreme Court held that Los

of functional integration between payor and payee. J. Hellerstein, *Allocation and Apportionment of Dividends and the Delineation of the Unitary Business*, 14 TAX NOTES 155, 159 (Jan. 25, 1982) [hereinafter cited as J. Hellerstein, *Allocation and Apportionment*].

¹⁸⁵ J. Hellerstein, *Allocation and Apportionment*, *supra* note 184, at 159. See generally S. SURREY, W. WARREN, P. MCDANIEL & H. AULF, FEDERAL INCOME TAXATION, 1063-74 (1972). In *Corn Products Refining Co. v. Commissioner*, 350 U.S. 46 (1955), the Supreme Court held that the gains and losses incurred by a manufacturer of corn products from its purchase and sale of corn futures gave rise to ordinary income and losses, rather than capital gains and losses, because the purchases and sales constituted "an integral part of its manufacturing business," *id.* at 51, rather than "transactions in property which are not the normal source of business income." *Id.* at 52. As a result of the Supreme Court's decision in *Corn Products*, the general rule that capital stock held by a corporation constitutes a capital asset and, consequently, generates capital gains or losses on sale or other disposition, has been qualified in various circumstances in which stock is bought and kept not for investment purposes, but only as an incident to the conduct of the taxpayer's business. J. Hellerstein, *Allocation and Apportionment*, *supra* note 184, at 159-60.

¹⁸⁶ Greene, *supra* note 182, at 801.

¹⁸⁷ See, e.g., *Woolworth* 102 S. Ct. at 3135; *ASARCO* 102 S. Ct. at 3109.

¹⁸⁸ 441 U.S. 434 (1979).

¹⁸⁹ J. Hellerstein, *Allocation and Apportionment*, *supra* note 184, at 156.

¹⁹⁰ 441 U.S. at 444.

¹⁹¹ 441 U.S. at 436-37.

¹⁹² *Id.*

¹⁹³ *Id.* at 437. Property present in California on March first of any year is subject to *ad valorem* property tax. CAL. REV. & TAX CODE §§ 117, 405, 2192 (West 1970 & Supp. 1983). In *Japan Line*, California taxed all the containers actually present in Los Angeles on any March first on their entire

Angeles could not impose such a tax.¹⁹⁴

The Court distinguished cases involving international commerce from cases involving domestic interstate commerce only.¹⁹⁵ In the latter situation, the Court noted that it need only address the minimal nexus, fair apportionment and nondiscrimination questions.¹⁹⁶ In the former case, however, the Court stated that two additional standards are important in determining the validity of a state's action.¹⁹⁷ In the *Japan Line* decision, the Court first examined whether the tax, notwithstanding apportionment, created a substantial risk of international multiple taxation.¹⁹⁸ Second, the Court considered whether the tax prevented the federal government from "speaking with one voice" when regulating commercial relations with *foreign* countries.¹⁹⁹ The Court stated that the risk of double taxation in the international context is more serious than in the domestic context, because of the absence of an authoritative tribunal capable of ensuring the cumulative tax burden is computed on no more than one full value, when one of the taxing authorities is a foreign sovereign.²⁰⁰ The Court also reasoned that the impairment of federal uniformity on matters of foreign commerce may give rise to international disputes and lead foreign nations disadvantaged by the levy to retaliate against American-owned businesses operating in those countries.²⁰¹

Although *Japan Line* created additional constraints on state division-of-income rules dealing with multinational firms, the holding was expressly limited to the taxation of foreign-owned instrumentalities used exclusively in international commerce.²⁰² The Court did not consider the constitutionality of a state tax on foreign-owned instrumentalities used in interstate commerce or domestically-owned instrumentalities used in international commerce.²⁰³

value, as if those same containers were present in the state for the whole year. 441 U.S. at 437. Each container actually remained in California only for an average of three weeks out of every year for loading, unloading, repair, and transit to final destination. *Id.* at 436-37. While any particular Japanese container was present only temporarily in California, a fairly constant number of containers occupied space on wharves and in warehouses in Los Angeles throughout the year. *Id.* Since the number of containers actually within the state on March first approximated the average number of containers within the state on any random date, this "average presence tax" was approximately the same as if *each* container entering California during the year were taxed at a value proportionate to the fraction of the year it was actually present in the taxing jurisdiction. *Id.* at 437. *See also* Note, *Commerce Clause Limits on Direct Taxation of Foreign Containers: Japan Line, Ltd. v. County of Los Angeles*, 14 J. INT'L. L. & ECON. 153, 154 (1979).

¹⁹⁴ 441 U.S. at 451.

¹⁹⁵ *Id.* at 446.

¹⁹⁶ *Id.* In *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274 (1977), involving a state tax on the sale of intrastate transportation services for articles of interstate commerce, the Supreme Court held that the commerce clause does not bar state taxation of instrumentalities of interstate commerce. *Id.* at 277. The Court applied a four pronged test under the domestic commerce clause, under which it looks at whether: (1) the activity taxed has a sufficient nexus with the taxing state; (2) the tax is non-discriminatory with regard to interstate commerce; (3) the tax is fairly apportioned; and (4) the tax is related to the benefits and protection provided by the taxing state. *Id.* at 279.

¹⁹⁷ 441 U.S. at 446.

¹⁹⁸ *Id.*

¹⁹⁹ *Id.* at 448. *See* *Michelin Tire Corp. v. Wages*, 423 U.S. 276, 285 (1976).

²⁰⁰ 441 U.S. at 447.

²⁰¹ *Id.* at 449-50.

²⁰² *Id.* at 445-46, 446 nn.9 & 10.

²⁰³ *Id.* at 444 n.7.

4. The Status of the Law Prior to *Container*

In the *Mobil* and *Exxon* decisions, the Court reaffirmed the unitary business concept as the basis and prerequisite for formula apportionment.²⁰⁴ In the *ASARCO* and *Woolworth* decisions, the Court held that actual integration and control are the tests of a unitary business.²⁰⁵ In *Japan Line*, the Court held that multiple taxation and federal uniformity are additional concerns when unitary taxation affects international commerce.²⁰⁶ After these cases, the constitutional requirements for state unitary taxation of multijurisdictional enterprises were fairly well settled, at least for United States corporations involved in domestic interstate commerce. Unitary taxation by the states of multinational enterprises, whether based in the United States or abroad, doing business in the United States, either directly or through subsidiaries and affiliates, was the next logical area of expansion for state division-of-income rules.

II. THE *Container* DECISION: WORLDWIDE UNITARY TAXATION OF MULTINATIONAL CORPORATE INCOME UPHELD

In *Container Corporation of America v. Franchise Tax Board*²⁰⁷ the Supreme Court confronted the issue of worldwide unitary taxation by a state of a multinational enterprise. Container was a United States corporation with several foreign subsidiaries operating abroad.²⁰⁸ All the subsidiaries were engaged in the same line of business as Container and entertained a variety of working relationships with the parent company.²⁰⁹ The Supreme Court upheld California's worldwide unitary tax and combined formula apportionment as applied to a United States-based multinational enterprise.²¹⁰

A. *The Majority Opinion*

In the first part of the opinion, the Court reviewed briefly the constitutional standards applicable to state taxation of multijurisdictional entities. First, after reaffirming the constitutional prohibition against extraterritorial taxation by the states,²¹¹ the Court stated that the due process and commerce clauses of the Constitution require a "minimal connection" between the interstate activities of the taxpayer and the taxing state, as well as a "rational relationship" between the income attributed to the state and the intrastate values of the enterprise.²¹² The Court reaffirmed the principle that the burden is on the taxpayer to show by clear and cogent evidence that there was extraterritorial taxation.²¹³ After briefly reviewing the conceptual differences between separate accounting, either

²⁰⁴ See *supra* notes 129-32 and accompanying text.

²⁰⁵ See *supra* notes 158-61, 171-76 and accompanying text.

²⁰⁶ See *supra* notes 195-201 and accompanying text.

²⁰⁷ 103 S. Ct. 2933 (1983), *reh'g denied*, 52 U.S.L.W. 3292 (U.S. October 10, 1983).

²⁰⁸ See *supra* notes 23-26 and accompanying text.

²⁰⁹ See *supra* notes 27-35 and accompanying text.

²¹⁰ 103 S. Ct. at 2950, 2954-55.

²¹¹ *Id.* at 2939.

²¹² *Id.* at 2940. The Court noted that these standards at least require that the in-state and out-of-state activities of the taxpayer constitute a unitary business and that they share or exchange values not capable of precise identification or measurement. *Id.*

²¹³ *Id.* at 2939-40.

geographical or functional, and the unitary approaches.²¹⁴ The Court noted that there are numerous variations of the unitary business principle consistent with these constitutional requirements.²¹⁵ One such variation, the Court said, is combined reporting of affiliated groups of corporations²¹⁶ whose application to multinational conglomerates, like Container Corporation of America, was at issue in this case.²¹⁷ Second, the Court reaffirmed that under both the due process and commerce clauses an apportionment formula must be fair.²¹⁸ Third, the Court restated that under the commerce clause an apportionment formula must not result in discrimination against either interstate or foreign commerce.²¹⁹

The first issue to be considered by the Court was the unitary character of Container and its subsidiaries.²²⁰ The Court, however, was unwilling to take an active role in deciding this issue for fear of spawning a great deal of further litigation on the intricate factual issues relating to unitariness.²²¹ Consequently, the Court stated that it will, whenever reasonably possible, defer to the state courts' determinations of the unitary character of an enterprise, so long as they are "within the realm of permissible judgment."²²² According to the Court, it is the sole responsibility of the federal government, not of the United States Supreme Court, to achieve uniformity in the definition of a unitary business.²²³

In reviewing the lower court's finding that Container and its subsidiaries constitute a unitary business, the Supreme Court, unlike the California Court of Appeals below,²²⁴ did not refer to any of the formalized tests of unitary business, such as the "three-unities test"²²⁵ or the "contribution and dependence test."²²⁶ Instead, the Court chose to rely

²¹⁴ *Id.* at 2940. The Court appeared to favor the state's use of the latter approach by noting 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." *Id.*

²¹⁵ *Id.* at 2941.

²¹⁶ *Id.* See CAL. REV. & TAX CODE § 25102 (West 1979 & Supp. 1983).

²¹⁷ 103 S. Ct. at 2941-42. The Court was careful to point out that while a state might decide to "respect formal corporate lines and treat the ownership of a corporate subsidiary as *per se* a passive investment," this approach was "not constitutionally required." *Id.* at 2941. In accepting combined reporting as a permissible method, the Court quoted *dicta* from the *Mobil* case: "[s]uperficially, intercorporate division might appear to be an . . . attractive basis for limiting apportionability. But the form of business organization may have nothing to do with the underlying unity or diversity of business enterprise." *Id.* (quoting *Mobil Oil v. Comm'r of Taxes of Vermont*, 445 U.S. 425, 440 (1980)). See *supra* notes 101-07 and accompanying text.

²¹⁸ 103 S. Ct. at 2942. The Court noted that there are two components of fairness: *internal consistency*, which requires that the formula must be such that, if applied by every jurisdiction, it would result in no more than all of the unitary business' income being taxed, and *external consistency*, which requires that the factor or factors used in the apportionment formula actually reflect a reasonable sense of how income is generated. *Id.*

²¹⁹ 103 S. Ct. at 2943.

²²⁰ *Id.* at 2945.

²²¹ *Id.* at 2945-46.

²²² *Id.*

²²³ *Id.* at 2956. See *infra* notes 356-57 and accompanying text.

²²⁴ See *Container Corp. of America v. Franchise Tax Bd.*, 117 Cal. App. 3d 988, 995, 1000, 173 Cal. Rptr. 121, 125, 129 (Ct. App. 1981).

²²⁵ For a detailed discussion of the three unities test, see *supra*, notes 84-86 and accompanying text.

²²⁶ For a detailed discussion of the contribution and dependence test see *supra*, notes 87-88 and accompanying text.

on a series of factors contained in the record and concluded that all such factors "taken in combination" were sufficient to support the lower court's finding of a unitary business.²²⁷ The Court explicitly refused to decide whether any particular factor would be sufficient or conclusive in determining whether the taxpayer's business is unitary.²²⁸

One of the factors considered by the Court was that Container Corporation and its subsidiaries were engaged in the same line of business.²²⁹ Like the Court below,²³⁰ the Supreme Court endorsed the "administrative presumption" that corporations engaged in the same line of business are unitary, at least as long as this presumption is only one element among many in a court's finding of a unitary enterprise and its use is reasonably limited.²³¹ The Court declined to set out any bright-line test of unitariness. In particular, the Court refused to follow the suggestion of a leading scholar²³² in requiring a substantial flow of goods among the component parts of a mercantile or manufacturing enterprise as a prerequisite to a finding of a unitary business.²³³ The Court reasoned that unitariness is predicated upon a "flow of *value*, not a flow of *goods*," as evidenced by functional integration, centralization of management, and economies of scale.²³⁴

After finding that the lower court's determination of the unitary character of Container was within the realm of permissible judgment,²³⁵ the Court addressed the issue of fair apportionment. The Court held that Container failed to sustain the burden of proving that the income attributed to California bore "no rational relationship to the in-state values" of the firm, and was "out of all appropriate proportion to the business transacted" there.²³⁶ Container challenged formula apportionment on two factually and theoretically related grounds.²³⁷ The first ground was that its foreign subsidiaries were significantly more profitable than its domestic operations, so that apportionment by formula systematically distorted the true allocation of income between Container and its

²²⁷ 103 S. Ct. at 2948. The factors considered by the Court included: Container's assistance to its foreign subsidiaries in obtaining used and new equipment and in filling personnel needs; Container's substantial role in loaning funds to the subsidiaries and guaranteeing loans provided by others; the "considerable interplay" between Container and the subsidiaries in the area of corporate expansion; Container's technical assistance to its subsidiaries; and the supervisory role played by Container's officers in providing general guidance to the subsidiaries. *Id.* at 2947.

²²⁸ *Id.* at 2948.

²²⁹ *Id.* at 2947.

²³⁰ *Container Corp. of America v. Franchise Tax Bd.*, 117 Cal. App. 3d 988, 1000, 173 Cal. Rptr. 121, 129 (Ct. App. 1981). Based on the administrative regulations implementing the California tax statute, CALIFORNIA ADMINISTRATIVE CODE, title 18, Section 25120(b), the California Court of Appeals noted that "a strong inference of a unitary business exists where the taxpayer is engaged in the same type of business as its subsidiaries." *Container Corp. of America v. Franchise Tax Bd.*, 117 Cal. App. 3d 988, 1000, 173 Cal. Rptr. 121, 129 (Ct. App. 1981). The Court showed great deference for this administrative construction of the California tax laws. *Id.*

²³¹ 103 S. Ct. at 2947. The Court noted that investment in affiliates engaged in a business truly distinct from the taxpayer's main line of business often serves the primary function of diversifying the corporate portfolio and reducing the risks inherent in being tied to one industry's business cycle. *Id.* When, however, a corporation invests in a subsidiary engaged in the same line of work as itself, the Court believes its purpose is typically increased efficiency and profitability through economies of scale, operational integration and sharing of expertise. *Id.*

²³² J. Hellerstein, *Recent Developments*, *supra* note 3, at 501-02.

²³³ 103 S. Ct. at 2947 and n.17.

²³⁴ *Id.* at 2947.

²³⁵ *Id.* at 2948.

²³⁶ *Id.*

²³⁷ *Id.* at 2948-49.

subsidiaries.²³⁸ Container's second ground for objecting to formula apportionment was that the costs of production in foreign countries were generally significantly lower than in the United States, primarily as a result of the lower wage rates abroad, and that, because wages are one of the three factors in the formula, apportionment unfairly inflated the amount of income attributed to California, where wages are higher.²³⁹ The Court found these arguments unpersuasive and upheld California's use of formula apportionment.²⁴⁰

The Court did not set out to show that these arguments were unsupported by the evidence produced.²⁴¹ The Court, instead, pointed out that even if the taxpayer's complaints against the distortions caused by unitary taxation were verified in reality, it would not automatically follow that the taxpayer should prevail.²⁴² The Court in fact acknowledged that both separate geographical accounting and formula apportionment are "imperfect proxies for an ideal which is not only difficult to achieve in practice, but also difficult to describe in theory."²⁴³ Perfect accuracy is not to be expected regardless of what approach is adopted. Accordingly, the Court did not maintain that the use of a three-factor formula is an absolute guarantee against distortive effects.²⁴⁴ The Court noted, however, that the three-factor formula has been widely adopted by the states, including California, because the elements that it takes into account — payroll, property, and sales — appear, in combination, to reflect most of the factors by which value is generated.²⁴⁵ Consequently, while the Court implied that Container's evidence as to relative profitability and disparate costs of production might be sufficient to substantiate Container's complaints, such evidence did not in fact demonstrate the gross distortions in the amount of income attributed to California, that are necessary to strike down unitary taxation in any particular case.²⁴⁶ More importantly, however, the Court stated that even if Container's complaints accurately reflected reality, they would not in theory impeach the rationale underlying formula apportionment.²⁴⁷

Although the Court found California's method of taxation in and of itself proper and fair, the Court admitted that the method used by California is quite different from that employed by the federal government and the vast majority of foreign nations.²⁴⁸ The internationally recognized approach to income taxation of multijurisdictional enterprises is a version of the separate accounting approach, often called *the arm's length standard*.²⁴⁹ Under the arm's length standard, each corporation, even if closely related to other corporations within an affiliated group, is treated as a separate entity.²⁵⁰ If, the Court indicated, intra-group transactions differ from arm's length transactions, then an adjust-

²³⁸ *Id.* at 2948.

²³⁹ *Id.* at 2949.

²⁴⁰ *Id.*

²⁴¹ *Id.*

²⁴² *Id.*

²⁴³ *Id.*

²⁴⁴ *Id.*

²⁴⁵ *Id.*

²⁴⁶ *Id.* at 2949-50. The Court found that the difference in the amount of income taxable by California as computed by Container from that computed by state authorities was 14 percent, "a figure certainly within the substantial margin of error inherent in any method of attributing income among the components of a unitary business." *Id.* at 2950.

²⁴⁷ *Id.* at 2949. See *infra* notes 326-30 and accompanying text.

²⁴⁸ *Id.* at 2950.

²⁴⁹ *Id.*

²⁵⁰ *Id.*

ment is required in order to reallocate income among related taxpayers.²⁵¹ The Court stated that for federal income tax purposes, the arm's length approach is articulated in section 482 of the Internal Revenue Code.²⁵²

California's departure from the internationally accepted method of taxation raised a constitutional issue because of Container's multinational character. The Court noted that if Container's unitary enterprise were entirely domestic, the application of different methods of taxation in different states would raise no commerce clause issue.²⁵³ Given the firm's multinational character, however, the Court stated that its inquiry under the *foreign* commerce clause must be more searching than in the case of a domestic multistate corporation.²⁵⁴ Under the standards developed by the Supreme Court in *Japan Line*,²⁵⁵ the Court looked at whether California's worldwide unitary tax (1) created a substantial risk of multiple taxation; and (2) impaired federal uniformity in an area where federal uniformity is essential.²⁵⁶

In applying these standards, the Court admitted that the *Container* case was similar to *Japan Line* in that there was proof of actual double taxation, stemming from California's adoption of a method of taxation different from and inconsistent with that adopted by the federal government and accepted by the international community.²⁵⁷

Nevertheless the Court distinguished *Japan Line* from *Container* on three grounds. First, *Container* involved a tax on income, rather than on property.²⁵⁸ Second, the double taxation in *Container*, although real, was not the "inevitable" result of the California taxing scheme.²⁵⁹ The occurrence of multiple taxation depended solely on the *facts* of the particular case.²⁶⁰ Third, the tax in *Container* fell on a corporation domiciled and headquartered in the United States, rather than on the foreign owners of an instrumentality of foreign commerce.²⁶¹ Because *Japan Line* specifically excepted from its holding the case of

²⁵¹ *Id.* at 2953. The Court recognized that under the arm's length approach, transactions among related corporations are closely scrutinized to avoid income shifting. *Id.* Intragroup transfer prices for goods and services are equated to the price levels that would result among unrelated parties dealing at arm's length in comparable situations, products, and markets. *Id.* The Court noted that the rationale behind the arm's length approach is that, for a variety of reasons, businesses sharing a common economic interest, typically a parent corporation and its subsidiaries, often find it advantageous to engage in transactions on terms different from those which would result if either party were dealing with an unrelated person. *Id.*

²⁵² *Id.* at 2953. I.R.C. § 482 (1983) provides that:

In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Secretary may distribute, apportion, or allocate gross income, deductions, credits or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades or businesses.

Id.

²⁵³ 103 S. Ct. at 2950. Elsewhere in the opinion, the majority noted that in the interstate commerce context the commerce clause has not in practice required much more than fair apportionment. *Id.* at 2943.

²⁵⁴ *Id.* at 2950.

²⁵⁵ For a discussion of *Japan Line*, see *supra* notes 188-203 and accompanying text.

²⁵⁶ 103 S. Ct. at 2951.

²⁵⁷ *Id.* at 2951-52.

²⁵⁸ *Id.* at 2952.

²⁵⁹ *Id.*

²⁶⁰ *Id.* On this point the disagreement between the majority and the dissenters is at its maximum. For a detailed analysis, see *infra* notes 331-39 and accompanying text.

²⁶¹ 103 S. Ct. at 2952.

domestically owned instrumentalities engaged in foreign commerce,²⁶² the Court did not have to narrow or overrule that case in deciding *Container*.²⁶³ Based on the facts before it, the Court expressly refused to decide whether worldwide combined apportionment as applied by a state to a domestic corporation with foreign parents or to foreign corporations with either foreign parents or foreign subsidiaries is constitutional.²⁶⁴

In analyzing the issue of double taxation, the Court pointed out that, although even a slight overlapping of tax in the international context raises a constitutional issue, there is no "absolute prohibition" on state-induced multiple taxation.²⁶⁵ A state tax, the Court stated, must be looked at in its context and in light of the alternatives reasonably available to the taxing state.²⁶⁶ In the *Container* situation, the Court noted, there was no alternative available to California that would assure elimination or even amelioration of the double taxation problem, short of the state's foregoing any tax on *Container's* income.²⁶⁷ The Court said that even if California were to adopt some version of the arm's length standard, there would be no guarantee that the international double taxation problem would be eliminated.²⁶⁸ This is due to the likelihood of substantial differences in the precise rules whereby the various national jurisdictions implement such a standard.²⁶⁹

Having resolved that no undue risk of multiple taxation was involved in the case, the Court confronted the issue of whether California's worldwide unitary tax impaired federal uniformity.²⁷⁰ The Court stated that when a state tax implicates foreign affairs, it must be held unconstitutional if it either implicates matters of foreign policy within the exclusive power of the federal government or violates a clear federal directive.²⁷¹

Under the first prong of the above test — whether the California tax implicated foreign policy — the Court considered the risk that worldwide unitary taxation would offend United States foreign trading partners and lead them to retaliate against the nation as a whole.²⁷² The Court, however, was reluctant to engage in a factual investigation or a balancing between the risk of retaliation and the freedom of the states.²⁷³ Foreign policy, the Court stated, is the province of the Executive Branch and of Congress.²⁷⁴ In accord with this position, the Court took notice of the Administration's

²⁶² *Japan Line, Ltd. v. County of Los Angeles*, 441 U.S. 434, at 444 n.7 (1979).

²⁶³ 103 S. Ct. at 2952.

²⁶⁴ *Id.* at 2952 n.26.

²⁶⁵ *Id.* at 2953. The Court stated that "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." *Id.* (quoting *Japan Line, Ltd. v. County of Los Angeles*, 441 U.S. 434, 456 (1979)).

²⁶⁶ 103 S. Ct. at 2953.

²⁶⁷ *Id.*

²⁶⁸ *Id.* at 2954.

²⁶⁹ *Id.* The Court concluded that "in the absence of a central coordinating authority, absolute consistency, even among taxing authorities whose basic approach to [division of income among various taxing jurisdictions] is quite similar, may just be too much to ask . . ." *Id.*, and that therefore "it would be perverse . . . to require California to give up one allocation method that sometimes results in double taxation in favor of another allocation method that also sometimes results in double taxation." *Id.* at 2954-55.

²⁷⁰ *Id.* at 2955.

²⁷¹ *Id.*

²⁷² *Id.*

²⁷³ *Id.* In the absence of explicit congressional action and given its unwillingness to make policy judgments, the Court noted it was left with "objective standards" and "general observations" regarding the imperatives of international law and economics. *Id.*

²⁷⁴ *Id.* at 2956.

decision not to file an *amicus curiae* brief in opposition to the state tax.²⁷⁵ The Court considered the Executive Branch's unwillingness to take a strong position on the issues of this case as at least some indication that the foreign policy of the United States was not "seriously threatened" by California's action.²⁷⁶

The Court indicated that foreign retaliation against the United States was both unlikely and inapposite because in *Container* the "legal incidence" of the state tax fell on a domestic corporation, rather than on a foreign entity, even though, in a sense, California reached for foreign income.²⁷⁷ Because *Container Corp.* was "in one way or another" taxable in California, the Court reasoned, foreign nations had no reason to retaliate, no matter how theoretically objectionable they might find California's approach.²⁷⁸

Considering the second prong of its test — whether the California tax violated federal law — the Court was unable to find any specific indication of Congressional intent contrary to California's practice.²⁷⁹ The Court concluded that neither the federal tax statutes nor the network of tax treaties to which the federal government was a party provided the necessary pre-emptive force.²⁸⁰ The Court found that although many treaties require the federal government to adopt the arm's length approach in taxing domestic income of multinational enterprises, that requirement is normally waived with respect to the taxes imposed by the signatory nations on their own domestic corporations.²⁸¹ Moreover, all such treaties exempt the taxing activity of "sub-national governmental units" such as the states.²⁸² As to congressional legislation in the field of state

²⁷⁵ *Id.* The Court was careful to point out that "the lack of such a submission was by no means dispositive." *Id.* The Court, however, noted that the Solicitor General had submitted a brief opposing worldwide formula apportionment in *Caterpillar Tractor Co. v. Lenckes*, 84 Ill. 2d 102, 417 N.E. 2d 1343 (1981), *appeal dismissed, sub. nom. Chicago Bridge & Iron Co. v. Caterpillar Tractor Co.*, 51 U.S.L.W. 3937 (1983). 103 S. Ct. at 2956 n.33. In *Container* the Court stated that "although there [was] no need for us to speculate as to the reasons for the Solicitor General's decision not to submit a similar brief in the [*Container* case], . . . there [was] no indication that the position taken by the government in *Chicago Bridge & Iron* still represent[ed] its views. . . ." *Id. Chicago Bridge & Iron* involved issues almost identical to *Container* and was pending before the Supreme Court at the same time as *Container*. There the taxpayer sought to be treated as a worldwide unitary business to offset in-state profits with out-of-state and foreign losses. *Caterpillar Tractor Co. v. Lenckes*, 84 Ill. 2d 102, 107-08, 417 N.E. 2d 1343, 1347 (1981). The state disagreed and a number of corporations intervened to oppose use of worldwide combined formula apportionment. *Id.* at 112, 417 N.E. 2d at 1349. Following the *Container* decision, *Chicago Bridge & Iron* was dismissed for want of a substantial federal question. *Chicago Bridge & Iron Co. v. Caterpillar Tractor Co.*, 51 U.S.L.W. 3937 (1983).

²⁷⁶ 103 S. Ct. at 2956.

²⁷⁷ *Id.* at 2955-56. The majority called attention to *Container* Corporation's status as a United States company *twice* in the opinion. See *supra* note 56 and accompanying text.

²⁷⁸ *Id.* at 2956. To make its point clearer, the Court pointed out that the amount of tax a domestic corporation pays in California is "much more the function of California's tax rate than of its allocation method." *Id.* Therefore, the Court believed foreign nations have no more reason to retaliate if a state adopts worldwide combined apportionment than if it raises its general tax rate to achieve the same economic result. *Id.* In both cases, the Court maintained, foreign nations might at best complain of an "attenuated," non-injurious offense. *Id.*

²⁷⁹ *Id.*

²⁸⁰ *Id.*

²⁸¹ *Id.* (citing UNITED STATES DRAFT MODEL INCOME TAX TREATY, art. 7(2) & 1(3) (June 16, 1981), reprinted in TAX TREATIES (P-H) ¶ 1022 [hereinafter cited as *Model Treaty*]).

²⁸² 103 S. Ct. at 2956. In its opinion the Court referred to the only proposal ever made to insert in a tax treaty a provision limiting the states' freedom to depart from the arm's length standard, which did not receive the consent of the Senate. *Id.* For details of the proposed treaty provision, see

taxation of multijurisdictional corporations, the Court recognized the long history of proposals, bills and debates, but noted that so far Congress had failed to enact any legislation addressing the problem.²⁸³

In sum, the Court concluded that the California tax authorities' treatment of Container Corporation violated neither the due process clause nor the commerce clause of the Constitution, under the standards developed in *Mobil* and its progeny. In particular, the Court held that the additional tests developed by the Court in *Japan Line* for the states' unitary taxation of multinational enterprises were satisfied in the *Container* case and the *foreign* commerce clause was not violated.

B. *The Dissenting Opinion*

Justice Powell, joined in his dissent by Chief Justice Burger and Justice O'Connor, did not address the issues of unitariness and fair apportionment, but limited his opinion to the foreign commerce aspects of the *Container* case.²⁸⁴ The dissenters found *Japan Line* controlling and would, therefore, have held California's unitary tax unconstitutional.²⁸⁵

Justice Powell, writing for the dissent, stated that actual double taxation inevitably resulted from California's use of an allocation method fundamentally inconsistent with the internationally recognized method.²⁸⁶ The dissent maintained that formula apportionment systematically inflated the amount of income taxable in California.²⁸⁷ Because California's formula takes into account payroll, property and sales, it allocates a higher proportion of income to jurisdictions where wage rates, property values and sales prices are higher.²⁸⁸ The amount of income allocated by formula has no necessary relationship to the amount calculated under the arm's length method.²⁸⁹ The dissenters stated that as long as the three factors of the formula remained higher in California, that state would inevitably tax income under its formula that had already been taxed by another country under accepted international practice and double taxation would result.²⁹⁰ In the dissent-

Convention Between the Government of the United States of America and the Government of the United Kingdom of Great Britain and Northern Ireland for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital Gains, 94th Cong., 2d Sess., art. 9(4) (1976); Protocol to the Convention, 94th Cong., 2d Sess. (1976); Second Protocol to the Convention, 95th Cong., 1st Sess. (1977), reprinted in 2 TAX TREATIES (P-H) ¶ 89,039, ¶ 89,061, ¶ 89,063. The Senate withheld its consent from the portion of the treaty limiting state tax power in part on the ground that if such limitations should be effected at all, they should be effected through the traditional legislative process, rather than by treaty. See *State Taxation of Foreign Source Income: Hearing on H.R. 5076 Before the House Comm. on Ways and Means*, 96th Cong., 2d Sess. 239-90 (1980). Proposed article 9(4) of the Treaty would have prohibited unitary business treatment by a state of a United Kingdom parent corporation and its United States subsidiaries for purposes of worldwide formula apportionment. 103 S. Ct. at 2956.

²⁸³ *Id.* at 2956.

²⁸⁴ *Id.* at 2957 (Powell, J., dissenting).

²⁸⁵ *Id.* (Powell, J., dissenting).

²⁸⁶ *Id.* at 2957-58, 2959 (Powell, J., dissenting).

²⁸⁷ *Id.* at 2958 (Powell, J., dissenting).

²⁸⁸ *Id.* (Powell, J., dissenting).

²⁸⁹ *Id.* (Powell, J., dissenting).

²⁹⁰ *Id.* (Powell, J., dissenting). Justice Powell supported this view on the record. *Id.* Since wage rates, property values and sales prices were lower in Latin America, where the overwhelming majority of Container's foreign income was earned, California, where all three factors were higher, would inevitably tax under its formula income that had *already* been taxed by another country under the arm's length standard. *Id.* (Powell, J., dissenting).

er's view, the foreign commerce clause mandates that California adopt some version of the arm's length standard.²⁹¹ The dissent conceded that even if California were to do so, double taxation could still exist through technical differences in the application of a similar approach. Justice Powell, however, maintained that this kind of duplicative taxation is presently tolerated under international practice because the occurrences of double taxation would most likely cancel out over time.²⁹² Moreover, disagreements in the implementation of a compatible standard are more likely to be resolved by international negotiation, according to the dissenters.²⁹³

Justice Powell was also critical of the Court's distinction between United States based and foreign based multinationals.²⁹⁴ First, the dissent argued that although the taxpayer in *Container* was technically a domestic corporation, California was taxing the income of the foreign subsidiaries, thereby giving foreign nations legitimate grounds to complain that California was in reality taxing income earned outside its borders.²⁹⁵ Moreover, the dissenters predicted that difficult questions would be presented if a state in the United States attempted to tax the American subsidiary of a foreign parent company on the basis of the parent's worldwide income.²⁹⁶ Justice Powell observed that most of the Court's analysis would be inapplicable to such a case.²⁹⁷ According to the dissent, the United States/foreign parent dichotomy is an issue which Congress must address.²⁹⁸

The dissenters also disagreed with the Court's reliance on the federal government's decision not to file an *amicus curiae* brief in opposition to the state tax.²⁹⁹ The dissent considered the Solicitor General's memorandum in *Chicago Bridge & Iron Co. v. Caterpillar Tractor Co.*,³⁰⁰ a case filed before *Container*, but pending before the Supreme Court at the same time, which involved issues almost identical to the *Container* case, applicable to this latter case as well.³⁰¹

The dissenters concluded that the *Container* case did not satisfy the requirements of the foreign commerce clause, as developed in *Japan Line* and therefore did not address the due process aspects of the case. The dissent was most critical of the Court's attempt to draw a distinction between the case of a United States based multinational with foreign subsidiaries and the case of a foreign parent company with United States subsidiaries and affiliates.

²⁹¹ *Id.* at 2957-58 (Powell, J., dissenting).

²⁹² *Id.* (Powell, J., dissenting). Justice Powell noted that there is no reason why conflicts in the specific rules of income allocation among different nations should "consistently favor one jurisdiction over another." *Id.*

²⁹³ *Id.* at 2959 (Powell, J., dissenting).

²⁹⁴ *Id.* (Powell, J., dissenting).

²⁹⁵ *Id.* (Powell, J., dissenting).

²⁹⁶ *Id.* at 2959-60 (Powell, J., dissenting).

²⁹⁷ *Id.* at 2960 (Powell, J., dissenting). The dissent noted that in such a case retaliation on the part of the parent's government might be expected, so that, under the Court's test, the state tax would have to be held unconstitutional. *Id.* This outcome, however, would be unjustifiable and unacceptable to the extent that "it would leave California free to discriminate against a Delaware corporation in favor of an overseas corporation." *Id.*

²⁹⁸ *Id.* (Powell, J., dissenting).

²⁹⁹ *Id.* (Powell, J., dissenting). See *supra* note 246 and accompanying text.

³⁰⁰ *Caterpillar Tractor Co. v. Lenches*, 84 Ill. 2d 102, 417 N.E.2d 1343 (1981), *appeal dismissed sub nom.*, *Chicago Bridge & Iron Co. v. Caterpillar Tractor Co.*, 51 U.S.L.W. 3937 (1983). For a detailed analysis of this case and the Solicitor General's brief, see *supra* note 246.

³⁰¹ 103 S. Ct. at 2960 (Powell, J., dissenting). While Justice Powell recognized that the government's position might have changed between the time when the *Chicago Bridge & Iron* brief was filed

III. THE *Container* DECISION: SOUND CONSTITUTIONAL PRECEDENT OR COURT'S SHOWING OF POLITICAL WISDOM?

In *Container Corporation of America v. Franchise Tax Board*, the Supreme Court approved a state's scheme of worldwide unitary taxation. The decision is best analyzed through its two theoretically distinct components: (1) the due process discussion of the unitary business concept and fair apportionment,³⁰² and (2) the foreign commerce portion, dealing with international double taxation federal uniformity.³⁰³ Although the first portion of the opinion is merely a development of recent Supreme Court precedent and a consistent application of fairly settled doctrine, the second part addresses more novel issues and is, thus, far more controversial. Commentators who have consistently criticized the Court's tolerance of state division-of-income rules³⁰⁴ are more likely to agree that the *Container* decision is the latest embodiment of an "overbroad grant of discretion" to the states, promoting "inhibitive uncertainty" for multistate and multinational enterprises.³⁰⁵ Criticism of this kind is likely to be even more widespread because *Container* signals a retreat from the attitude of judicial vigilance shown by the Court in the *ASARCO* and *Woolworth* decisions.³⁰⁶

This section will first discuss the Court's position on the unitary business concept in *Container* in light of the views and proposals of leading commentators. The particular aspects of the issue of fair apportionment in the case of multinational firms will then be explored. Finally, this section will analyze the Court's treatment of the issue of double taxation and the problems involved in the Court's distinction between United States based and foreign based multinationals.

A. Unitary Business Concept

The Supreme Court's discussion of the unitary business concept in *Container* is likely to be a prime target for criticism. In finding that the core of a unitary enterprise is a "flow of value not a flow of goods,"³⁰⁷ the Court refused to set up a "bright-line test" of unitariness. One leading scholar has long proposed a "basic operations interdependence" test that would find an enterprise unitary only if it carried on integrated operating functions.³⁰⁸ According to this proposal, the nonoperating functions of a business, such as

and the time when *Container* was argued, the former case was still pending when the latter was decided and he believed the Court should have taken the government's arguments into consideration. *Id.*

³⁰² See *supra*, notes 220-47 and accompanying text.

³⁰³ See *supra*, notes 248-83 and accompanying text.

³⁰⁴ See, e.g., W. Hellerstein, *State Income Taxation*, *supra* note 3, at 422-23; J. Hellerstein, *Recent Developments*, *supra* note 3, at 502-03.

³⁰⁵ See WhiteNack, *State Tax Litigation After the Container Decision*, 20 TAX NOTES 771, 775-77 (Sept. 5, 1983) [hereinafter cited as WhiteNack].

³⁰⁶ See *supra* notes 145-49 and accompanying text.

³⁰⁷ *Container*, 103 S. Ct. at 2947. See *supra* notes 232-34 and accompanying text.

³⁰⁸ J. Hellerstein, *Allocation and Apportionment*, *supra* note 184, at 165. In the author's own words: "a business is not unitary unless interdependent basic operations are carried on to a substantial extent in different states by the branches or subsidiaries that comprise the controlled enterprise." *Id.* Examples of basic operating functions are: manufacturing in one state and selling in another; buying in one state and selling in another; processing goods or assembling products in one state and transporting them elsewhere. *Id.* Since interdependent operating functions necessarily imply a flow of goods among different components of a unitary business, this proposed test is nothing but the "flow of goods" test by another name. McLure, *The Basic Operational Interdependence Test of a Unitary Business: A Rejoinder*, 20 TAX NOTES 91, 96 (Oct. 10, 1983) [hereinafter cited as McLure, *A Rejoinder*].

centralized management, accounting, personnel management, legal and similar services, centralized advertising, pension and benefit plans or the furnishing of capital, should *not* make a business unitary.³⁰⁹ Because the cost of centralized nonoperating functions can be *specifically allocated* to the various components of an enterprise through established accounting procedures, there is arguably no reason to use formula apportionment in such a case.³¹⁰ Critics of this proposed "bright-line test" point to the intra-group economic profits generated by centralized management and services, which make it inherently impossible to divide income between affiliated firms.³¹¹ Two typical situations support this latter view. The first is when demand for the similar products of two affiliated firms is highly interdependent.³¹² In such a case, centralized management is in a position to maximize group profits and allocate net income to one or the other of the affiliated firms, even without any flow of products or services between them.³¹³ The second situation is when there are transfers of technical expertise, know-how, managerial and organizational skills and good will, including brand loyalty.³¹⁴ In such circumstances, it is impossible to price the constant flow of proprietary and highly specialized information or to allocate the profits generated by separate activities drawing on a "common pool of technology."³¹⁵

Commentators and practitioners have long advocated a certain and simple test of a unitary business.³¹⁶ While some point to the flow of goods/basic operational interdependence test as the proper solution,³¹⁷ others argue that the identification and definition of "basic operations" is hardly more workable than the "flow of value" test.³¹⁸ Although the

³⁰⁹ McLure, *A Rejoinder*, *supra* note 308, at 96. See also J. Hellerstein, *Allocation and Apportionment*, *supra* note 184, at 165; J. Hellerstein, *The Basic Operations Interdependence Requirement of a Unitary Business: A Reply to Charles E. McLure, Jr.*, 18 TAX NOTES 723, 728 (Feb. 28, 1983) [hereinafter cited as J. Hellerstein, *A Reply*].

³¹⁰ J. Hellerstein, *Allocation and Apportionment*, *supra* note 184, at 165; J. Hellerstein, *A Reply*, *supra* note 309, at 728. It has been pointed out, however, that the quantification, aggregation, and specific allocation of intra-group relationships and centralized services is likely to be more difficult and burdensome than formula apportionment. McLure, *A Rejoinder*, *supra* note 308, at 96. Since the main purpose of any "bright line test" is simplification and the saving of resources, it has been suggested that there may be a very serious flaw in this proposal. *Id.*

³¹¹ McLure, *Operational Interdependence is not the Appropriate "Bright Line Test" of a Unitary Business — At Least, Not Now*, 18 TAX NOTES 107, 108 (Jan. 10, 1983) [hereinafter cited as McLure, *Operational Interdependence*]; McLure, *A Rejoinder*, *supra* note 308, at 93. According to this view, the need for formula apportionment does not stem from the difficulty of spreading the costs of centralized services, but rather from the impossibility of distributing the benefits of increased overall efficiency to the components of an integrated enterprise. *Id.*

³¹² McLure, *Operational Interdependence*, *supra* note 311, at 108-09; McLure, *A Rejoinder*, *supra* note 308, at 92-93.

³¹³ McLure, *Operational Interdependence*, *supra* note 311, at 108-09; McLure, *A Rejoinder*, *supra* note 308, at 92-93.

³¹⁴ McLure, *Operational Interdependence*, *supra* note 311, at 109-10; McLure, *A Rejoinder*, *supra* note 308, at 94.

³¹⁵ McLure, *Operational Interdependence*, *supra* note 311, at 109-10; McLure, *A Rejoinder*, *supra* note 308, at 94.

³¹⁶ See, e.g., J. Hellerstein, *A Reply*, *supra* note 309, at 730. There Hellerstein stated: "Broad, vague tests of unitariness . . . have led not only to burdensome, time-consuming and expensive compliance and administration, but also to severe distortion and misattribution of income. . . . What [is needed] is a workable and equitable method of determining whether a business is unitary . . . without such inordinate expenditures of time and money." *Id.*

³¹⁷ J. Hellerstein, *Allocation and Apportionment*, *supra* note 184, at 165.

³¹⁸ McLure, *A Rejoinder*, *supra* note 308, at 96. J. Hellerstein, in *A Reply*, *supra* note 309, at 729, concedes that "[l]ike most legal distinctions, the line between [basic and non-basic operations] . . . has

Supreme Court in *Container* explicitly endorsed the "flow of value" approach,³¹⁹ the controversy is far from moot, because individual states are free to adopt their own standards and because Congress will undoubtedly be asked to embody one approach or the other in uniform federal legislation.³²⁰

B. Fair Apportionment

The taxpayer's argument that disparate costs of production and rates of profitability in different nations make formula apportionment unfair did not persuade the *Container* Court.³²¹ The Court correctly recognized that the flaw in the taxpayer's argument was theoretical, rather than factual.³²² Even if the taxpayer's evidence goes unchallenged, the source of income principle³²³ is irrelevant in determining the fairness of formula apportionment.³²⁴ If the states resort to unitary apportionment because separate accounting is an inappropriate method to allocate the tax base, it is difficult to justify the use of separate accounting data to invalidate the apportionment result when applied to a unitary business.³²⁵ This use of logically inconsistent arguments bespeaks a misconception on the part of the taxpayer concerning the foundations for unitary apportionment.

In light of these considerations, the Supreme Court appropriately found that *Container* Corporation's argument that its foreign subsidiaries were more profitable than its California operations was faulty because this argument sought to undermine formula apportionment by showing that its results did not have a necessary relationship with the source of taxable income.³²⁶ Moreover, the Court was consistent with its position in *Mobil* in concluding that when profitability arises from the operation of the business as a whole,

its gray and fuzzy areas" and that what constitutes a basic operation in one industry may not be such in others. *Id.* at 730.

³¹⁹ *Container*, 103 S. Ct. at 2947.

³²⁰ McLure, *A Rejoinder*, *supra* note 308, at 91-92.

³²¹ 103 S. Ct. at 2948-49.

³²² 103 S. Ct. at 2948-49.

³²³ The source principle, on which the separate accounting approach is based, says that income should be taxed solely and entirely in the jurisdiction where it is actually generated. J. Hellerstein, *Allocation and Apportionment*, *supra* note 184, at 163. While the states still consider the source principle in their division-of-income rules, it is no longer their sole concern. *Id.* at 163-64. It is widely recognized today that the benefits and protection afforded a multistate or multinational business and the public costs incurred in furnishing public service, facilities and resources to the business also ought to be taken into account in apportioning the tax base. *Id.* at 164. The Supreme Court in *General Motors Corp. v. District of Columbia*, 380 U.S. 553, 561 (1965), said that "[t]he standard three-factor formula can be justified as a rough, practical approximation of the distribution of either a corporation's sources of income or the social costs which it generates." See also HOUSE SPECIAL SUBCOMMITTEE ON STATE TAXATION OF INTERSTATE COMMERCE, 1 Willis Committee Report, 158, 159, H.R. REP. NO. 1480, 88th Cong., 2d Sess. (1964). In this report the committee stated:

[A] company's net income should be viewed only as a measure of the company's ability to contribute to governmental costs and . . . once this ability is established, the contribution should be divided among the States without regard to how this ability was obtained. Instead of locating income by its geographical source, the division-of-income rule should measure the relative extent to which the company has caused the various States to incur governmental costs.

Id.

³²⁴ J. Hellerstein, *Allocation and Apportionment*, *supra* note 184, at 164.

³²⁵ Dexter, *The Unitary Concept*, *supra* note 3, at 192.

³²⁶ *Container*, 103 S. Ct. at 2948-49.

it is misleading to characterize the income of the business as having a single identifiable "source."³²⁷ The same conclusions are true for the differences in costs of production, property values, and sales prices. The unitary concept is not based on the assumption that there must be uniformity of operating revenues and expenses among the various components of the enterprise,³²⁸ so that every dollar of payroll or property spent in a foreign jurisdiction will produce approximately the same amount of income as a dollar of payroll or property spent in the taxing state.³²⁹ As the Court stated in *Container*, the justification for apportioning the income of a unitary multinational enterprise is that California payroll *as well as* foreign payroll goes into the production of any given product, whether manufactured in California or abroad.³³⁰

C. International Double Taxation

The Court's reasoning on the issue of international double taxation is very refined,³³¹ but at times it is so rarefied it becomes unconvincing. The dissenters' view³³² in this respect is much stronger because it is summary and of immediate, if superficial, understanding. The Court concluded that whether the combination of California's worldwide unitary tax and of a foreign nation's arm's length approach actually results in the same income of a foreign subsidiary of a United States parent being taxed twice or in some portion of income not being taxed at all depends solely on the facts of the individual cases.³³³ In purely abstract terms, the Court was correct in its conclusion. In fact, assuming that the foreign jurisdiction imposes corporate income tax, the actual occurrence of double taxation depends both on the particular interplay between the two jurisdictions' definitions of taxable income and on the foreign country's application, if any, of an "adjustment" provision similar to section 482 of the I.R.C.³³⁴ Double taxation would be as possible, in theory, if both California and the foreign nation adopted some version of the arm's length approach, as it would when California adopts unitary apportionment because the "crossing" of heterogeneous definitions of taxable income and/or inconsistent

³²⁷ See *Mobil Oil Corp. v. Commissioner of Taxes of Vermont*, 445 U.S. 425, 438 (1980). For an enlightening illustration of this principle see J. Hellerstein, *Allocation and Apportionment*, *supra* note 184, at 164.

³²⁸ *John Deere Plow Co. v. Franchise Tax Board*, 38 Cal. 2d 214, 228, 238 P.2d 569, 576 (1951). See also Dexter, *The Unitary Concept*, *supra* note 3, at 205-07.

³²⁹ J. Hellerstein, *Allocation and Apportionment*, *supra* note 184, at 164. Hellerstein contends that the problem with the taxpayer's argument is one of *proof*, namely that there are not sufficient factual elements to adjust wage rates and property costs "for comparative productivity, country by country, and the effects on unit costs of production of the greater use of modern sophisticated machinery in developed as compared to developing countries." *Id.* at 164. In this view he is, however, mistaken. The question is not whether, as a matter of fact, the existence of substantial disparities in the *nominal* wage rates and property cost, when adjusted for comparative productivity, country by country, is nevertheless such as to make the effective *real* cost of production so different as to cause apportionment to result in severe distortion and misattribution of income. No matter how well supported by the evidence the disparity in real costs per unit of production is, the source rule remains legally irrelevant in determining the appropriateness of formula apportionment.

³³⁰ *Container*, 103 S. Ct. at 2949. In light of this statement contained in the *text* of the opinion, the Court's notation in a *footnote* that formula apportionment is based on "the assumption that rates of return on property and payroll . . . are roughly the same in different jurisdictions," *id.* at 2949-50 n.20, remains an enigma.

³³¹ See *supra* notes 267-69 and accompanying text.

³³² See *supra* notes 287-93 and accompanying text.

³³³ *Container*, 103 S. Ct. at 2952.

³³⁴ See *supra* note 252 and accompanying text.

reallocations of income under section 482-type rules might still produce double taxation of the same income. As a practical matter, however, the dissenters were correct in pointing out that multiple taxation is much less likely to occur when the two jurisdictions involved have adopted homogeneous approaches.³³⁵ Furthermore, even if double taxation actually resulted in this latter case, it would be unlikely that the effects on tax revenues would favor consistently and uniformly one jurisdiction over another and thus its distortive effects would tend to balance out over time.³³⁶

The Court's opinion had the merit of pointing out that international double taxation is not linked to any particular set of technical division-of-income rules, but that double taxation arises whenever two taxing authorities assert overlapping jurisdiction over the same taxable income and neither one provides the taxpayer compensatory relief for the other's claim.³³⁷ The Court recognized that international double taxation is simply a specific instance of unfair apportionment. Multiple taxation occurs whenever one or more jurisdictions taxes, either intentionally or inadvertently, a share of the overall tax base out of proportion with the benefits and protection afforded to and the public costs incurred in furnishing government services to the multijurisdictional enterprise that generated the income. Double taxation, therefore, is neither more nor less "inevitable" if both jurisdictions adopt the arm's length standard than if one uses formula apportionment. The disagreement between the majority and the dissent can be translated into the difference between "inevitable" and "likely." The majority concentrated on the theoretical issues underlying the *Container* situation, while the dissent looked at the actual circumstances of the situation. If the correctness of logical deductions is the focus, the majority is correct, if practical realities are the focus, the dissenters are correct.

The bottom line, as the Court said in *Container*, is that "allocating income among various taxing jurisdictions bears some resemblance to slicing a shadow."³³⁸ To the extent that there is a "right" way of dividing the tax base, the "right" result may be accomplished equally well through formula apportionment as through the arm's length rule. Fair apportionment is the result of political good will, rather than technical rules. Ultimately,

³³⁵ See *supra* notes 292-93 and accompanying text. Even the California tax authorities implicitly conceded that this was a correct view by "not seriously disput[ing] the actual existence of double taxation," even though it was not conclusively demonstrated on the record. See *Container*, 103 S. Ct. at 2951-52 n.22. *Container*, in fact, did not produce the tax returns filed by its subsidiaries in their foreign domiciles. *Id.* It was entirely possible that deductions, exemptions, or adjustments available in the foreign income tax systems eliminated any overlap in taxable income caused by California's apportionment. *Id.*

³³⁶ *Container*, 103 S. Ct. at 2958-59 (Powell, J., dissenting). The possibility that conflicts between the substantive section 482-type allocation rules applied by each of the taxing jurisdictions involved may result in overlapping taxation has long been recognized. See Madere, *International Pricing: Allocation Guidelines and Relief from Double Taxation*, 10 TEX. INT'L L.J. 108, 109-10 (1975). Double Taxation occurs, for example, when the United States federal government assesses a deficiency against a United States parent based on income reallocated to it from its foreign subsidiary pursuant to I.R.C. section 482, and the subsidiary has already reported that same income to the foreign tax authorities and paid taxes on it. *Id.* at 109. The subsidiary may, of course, try to obtain a corresponding reduction of its tax liability in the foreign domicile. *Id.* at 109-10. Most countries, however, refuse to grant a downward adjustment solely on the basis of the reallocation practices of a foreign jurisdiction. *Id.* at 121. Moreover, it must be noted that this kind of double taxation, contrary to the kind present in the *Container* case, is nearly confiscatory, because the principle rate of corporate income taxation at the national level is between forty and fifty percent in most industrial countries. *Id.* at 110.

³³⁷ See generally Madere, *supra* note 336, at 122.

³³⁸ *Container*, 103 S. Ct. at 2954.

then, double taxation from whatever source has to be eliminated through international negotiation and cooperation.³³⁹

D. *The United States/Foreign Parent Dichotomy*

The Court's handling of the issue of foreign retaliation against California's worldwide unitary tax centers on the United States/foreign parent dichotomy.³⁴⁰ What motivated the Court to distinguish unitary taxation of a United States based multinational from that of a foreign based multinational was probably the fact that the protests against worldwide combined taxation submitted by several foreign countries to the federal government dealt mostly with the case of a foreign parent with United States subsidiaries.³⁴¹ One commentator has criticized the Court for choosing "not to dwell" on such protests, taking the position that the *Container* decision presented an issue of "local rather than international concern."³⁴² Nevertheless, the Court's conclusion that foreign retaliation against the California tax was unlikely is supported by the findings of a study of the Advisory Commission on Intergovernmental Relations.³⁴³ After a thorough investigation triggered by the formal protests of several foreign governments, the Commission found no evidence that state use of worldwide combination had caused harm to the nation.³⁴⁴ The study concluded that unitary taxation of multinational firms by the states did not result in any cut-back in investment in the United States, any retaliatory taxation by foreign governments of American corporations operating abroad, or any refusal by foreign governments to conclude tax treaties with the United States government.³⁴⁵ Furthermore, because the Court considered the issue in *Container* as one involving merely the local corporate income tax on a domestic taxpayer, in the Court's view, foreign countries were really complaining of excessive taxation indirectly affecting economic

³³⁹ The proof that no system of taxation of multi-jurisdictional taxpayers contains any magic self-correcting feature against double taxation is that modern tax conventions invariably provide for "mutual agreement procedures," authorizing bilateral negotiations directly between the competent tax authorities of the signatory countries in order to remedy double taxation on a *case-by-case* basis. Madere, *International Pricing*, *supra* note 336, at 124.

³⁴⁰ See *supra* notes 277-78 and accompanying text.

³⁴¹ WhiteNack, *supra* note 305, at 780. Several foreign nations, including Canada, France, the United Kingdom, the Netherlands, the European Economic Community, and Japan, protested against the worldwide unitary tax, through *amici curiae* briefs filed in the *Container* and *Chicago Bridge & Iron* cases. *Container*, 103 S. Ct. at 2960 n.4. In its memorandum for the United States as *amicus curiae* in *Chicago Bridge & Iron*, the Solicitor General noted that a "number of foreign governments have complained — both officially and unofficially — that the apportioned combined method . . . creates an irritant in their commercial relations with the United States." Memorandum for the United States as Amicus Curiae at 3, *Chicago Bridge & Iron Co. v. Caterpillar Tractor Co.*, *appeal dismissed* 51 U.S.L.W. 3937 (U.S. October 10, 1983), *reprinted in* 14 LAW REPRINTS (BNA) No. 9, 967, 973 (1981-82 term).

When a state seeks to levy a worldwide unitary tax on a foreign multinational the concern over the threat of retaliation is far more serious. Javaras & Browne, *Litigation Prospects After Container: The Foreign Parent Issue*, 20 TAX NOTES 1027, 1030 (Dec. 19, 1983). One commentator suggested that in this case the technical argument that the legal incidence of the tax falls on the United States subsidiary of a foreign parent would be far less persuasive. *Id.*

³⁴² WhiteNack, *supra* note 305, at 780 (citing *Container*, 103 S. Ct. at 2956).

³⁴³ Advisory Commission on Intergovernmental Relations, *State Taxation of Multinational Corporations*, 18 TAX NOTES 995 (March 21, 1983) [hereinafter cited as *ACIR Report*].

³⁴⁴ *Id.* at 1002.

³⁴⁵ *Id.*

activity abroad, rather than multiple taxation or tax discrimination.³⁴⁶ In the absence of double taxation of foreign income or discriminatory treatment of foreign enterprises operating in the United States, it was rather easy for the Court to dismiss foreign retaliation as an unlikely and unwarranted response to the California tax.³⁴⁷

The *Container* opinion leaves a significant gap in the delimitation of the unitary business concept as applied to foreign based multinational firms.³⁴⁸ The issue of the constitutionality of worldwide unitary taxation by a state of domestic corporations with foreign parents, or foreign corporations with either foreign parents or foreign subsidiaries will have to be brought before the Supreme Court again on a more appropriate record. This issue has already been presented by several lower court cases in various federal courts.³⁴⁹

Besides adhering to constitutional precedents and doctrine, the Court in the *Container* case took the appropriate political stance. The combination of deference to the states' division-of-income rules and deference to the federal government's authority to lay uniform rules creates a powerful momentum toward a forthcoming, and badly needed, compromise solution in the area of state income taxation of multijurisdictional corporations.

IV. THE IMPACT OF THE *Container* DECISION

The effectiveness and equity of the unitary business formula apportionment approach depends on its widespread and uniform application by the states and, ultimately, by the federal government and foreign nations. Although adoption by the latter is

³⁴⁶ *Container*, 103 S. Ct. at 2956. The majority noted that "foreign nations have a legitimate interest in reducing the tax burden of domestic corporations" and that "[they] may be . . . offended by what [they] consider unorthodox treatment of [Container Corp.]." *Id.* These complaints, however, do not rise to the level of legally cognizable rights of injuries, the Court held. *Id.* The dissenters apparently recognized this problem with the taxpayer's argument when they admitted that even if foreign governments have no grounds for complaining about the overall tax burden of an American corporation, they have legitimate grounds to complain against the worldwide unitary tax because, "if nothing else, such a tax has the effect of discouraging American investment in their countries." *Id.* at 2959 (Powell, J., dissenting). See also Javaras and Browne, *supra* note 341, at 1029-30.

³⁴⁷ See *Container*, 103 S. Ct. at 2956. It must be kept in mind that the Court refused to engage in fact finding and policy making on the issue of foreign retaliation. See *id.* at 2955. Instead the Court chose to consider the issue in the abstract, based on the "imperatives of international trade and international relations." *Id.*

³⁴⁸ Javaras and Browne, *supra* note 341, at 1027; WhiteNack, *supra* note 305, at 780.

³⁴⁹ See *Shell Petroleum, N.V. v. Graves*, 709 F.2d 593 (9th Cir. 1983), *cert. denied sub nom.* *Shell Petroleum v. Franchetti*, 51 U.S.L.W. 3440 (Dec. 6, 1983); *Capitol Industries EMI, Inc. v. Bennett*, 681 F.2d 1107 (9th Cir. 1982), *on remand sub nom.* *EMI, Ltd. v. Bennett*, 560 F. Supp. 134 (N.D. Cal. 1982), *cert. denied*, 103 S. Ct. 1189 (1983); *Alcan Aluminium, Ltd. v. Franchise Tax Board*, 558 F. Supp. 624 (S.D.N.Y. 1983), *aff'd*, — F.2d — (2d Cir. 1983), *cert. denied*, 51 U.S.L.W. 3309 (U.S. January 10, 1984). Recent litigation on the foreign parent issue has dealt primarily with procedural issues, in particular a foreign corporation's right to initiate an action challenging a unitary tax directly in the federal courts. Javaras and Browne, *supra* note 341, at 1032. Such right has been repeatedly denied. See cases cited *supra*. Foreign parents are typically barred from initiating an action against state tax authorities in federal courts on grounds of standing and ripeness. Javaras and Browne, *supra* note 341, 1032-33. The few cases pending in state courts are all in the early stages at the trial level. WhiteNack, *supra* note 305, at 782. Pending the *Container* case, both the states and the taxpayers were unwilling to go beyond the administrative level. *Id.*

speculative,³⁵⁰ uniformity among the states has always been the underlying concern in all of the Supreme Court's decisions in this area.³⁵¹ There is, however, no uniformity among the states today.³⁵² This state of affairs creates difficulties for both the states and businesses.³⁵³ Uniform division-of-income rules would produce benefits for both the states and businesses in the form of improved tax administration and reduced compliance burdens.³⁵⁴

Both the taxing states and the taxpayers stand to lose from a continuation of the present situation of nonuniformity. While some states may temporarily increase revenues through aggressive division-of-income practices, such a practice will inevitably lead to loss of foreign investment. The states may force each other into fiscal disaster through complacent income taxation to attract foreign capital. Multijurisdictional corporations may try to play off the differences in state tax laws to reduce their taxes or to play shell games with their income, but the benefits so generated would be outweighed in the long run by the inefficiency of allocating resources solely on the basis of tax minimization and tax avoidance considerations. The federal government may avoid a conflict with the state's claim of unfettered sovereignty and a possible sacrifice of some of its own revenues to offset lost state taxes. But it would become increasingly difficult for the federal government to deal with foreign countries in order to protect United States businesses abroad and foreign businesses in the United States. Conflicting interests will generate an

³⁵⁰ Presently no foreign nation adopts the unitary business/formula apportionment approach. Consideration of the great difficulties encountered by the Internal Revenue Service in enforcing section 482 of the Internal Revenue Code of 1954 has led to suggestions that the United States federal government adopt the unitary approach. See GENERAL ACCOUNTING OFFICE, DIGEST OF THE REPORT TO THE CHAIRMAN OF THE HOUSE COMMITTEE ON WAYS AND MEANS, *IRS Could Better Protect U.S. Tax Interests in Determining the Income of Multinational Corporations*, reprinted in 13 TAX NOTES 877 (October 19, 1981). No such action has yet been taken by the federal government.

³⁵¹ See *supra* note 223 and accompanying text.

³⁵² GENERAL ACCOUNTING OFFICE, DIGEST OF THE REPORT TO THE CHAIRMAN OF THE HOUSE COMMITTEE ON WAYS AND MEANS, *Key Issues Affecting State Taxation of Multijurisdictional Corporate Income Need Resolving*, reprinted in 16 TAX NOTES 159 (July 12, 1982) [hereinafter cited as GAO REPORT DIGEST, *Key Issues*]. According to a recent GAO report, forty-five states (including the District of Columbia) presently access taxes on the income of multi-jurisdictional — multistate and multinational — corporations, using "a bewildering variety of rules." *Id.* Of the forty-five states that tax such income, six do not have specific criteria for multi-jurisdictional corporations, while the thirty-nine others use one or more of sixteen different rules. *Id.* at 160. Thirty-four states use federal taxable income as the starting point for determining state taxable income; the other eleven generally require a corporation to start with gross income and deduct specific items. *Id.* Thirty-nine states use an equally weighed three-factor formula composed of property, payroll, and sales, but four of these states also can use alternative formulas which are differently composed and weighed. *Id.* The other six states use different formulas. *Id.* States do not define uniformly the factors of property, payroll, and sales. *Id.* Some states choose to allocate, instead of apportion, certain types of income in total to individual states. *Id.* Eleven states allocate little or no income; twenty-four allocate non-business income; and ten states allocate income which they classify in various ways. *Id.* Only thirteen states currently adopt worldwide combined reporting, but a great majority of the large corporations with foreign operations do business in states using this method. *Id.*

³⁵³ See generally GAO Report Digest, *Key Issues*, *supra* note 352, at 159. The present degree of non-uniformity increases the risk of over- or undertaxation. Ultimately, a non-uniform and complex tax system creates the risk of non-compliance and generates an unacceptable level of enforcement costs, compliance burdens, and uncertainty. *Id.*

³⁵⁴ See Corrigan, *Toward Uniformity in Interstate Taxation*, 10 TAX NOTES 507 (Sept. 15, 1980) [hereinafter cited as Corrigan, *Toward Uniformity*]; McLure, *Toward Uniformity in Interstate Taxation: A Further Analysis*, 13 TAX NOTES 51 (July 13, 1981) [hereinafter cited as McLure, *Toward Uniformity*].

increasing amount of litigation, thereby wasting the courts' limited resources and producing a crazy quilt of weaving precedents.

There are two self-correcting forces operating within the existing network of disparate division-of-income rules used by the states: businesses' freedom to locate in states that provide the most favorable tax climate and judicial scrutiny of unconstitutional state practices.³⁵⁵ These self-correcting forces may be effective in preventing the present system of nonuniform rules from generating excessive distortions in the taxation of multijurisdictional entities. These forces, however, will never achieve tax efficiency and equity, which require that neither more nor less than one hundred per cent of a multijurisdictional corporation's income be taxed overall, with each jurisdiction receiving a share of tax revenues proportionate with the benefits and protection provided by it. This optimal result can only be obtained through positive, nationally uniform rules, either through the states' voluntary cooperation or through congressional legislation.

Although the Supreme Court is aware of the need for uniformity and certainty in division-of-income rules, it is unwilling to interfere with the political process and act directly to achieve those goals. The Court has repeatedly stated that Congress and the Executive Branch have the constitutional power and authority to deal with the interstate and international commerce issues posed by state taxation of corporate income.³⁵⁶ The Court itself has steadfastly and appropriately refused to "assume the legislative mantle" and dictate uniform rules for the states through its decisions.³⁵⁷ Nevertheless, the Court's piecemeal provision of answers to issues raised in adversary proceedings between individual taxpayers and individual states on a case-by-case basis is not a satisfactory way of resolving the policy conflicts underlying unitary taxation.³⁵⁸ Consequently, it seems very unlikely that the Court would "try to pick apart" a negotiated solution at the federal level or a congressional statute achieving true uniformity in division-of-income practices among the states.³⁵⁹

The Court's attitude of judicial restraint in the *Container* case creates a propitious climate for a political solution to division-of-income problems. By granting wide discretion to the states in the taxation of multinational firms, the *Container* decision may inspire congressional activity aimed at curbing the states' freedom to adopt aggressive tax policies in this area.³⁶⁰ The threat of federal legislation, however, evokes immediate and vigorous

³⁵⁵ *ACIR Report*, *supra* note 343, at 1002. According to the ACIR Report, these self-correcting forces make congressional action unnecessary. *Id.* Others disagree. See GAO REPORT DIGEST, *Key Issues*, *supra* note 352, at 160; see also, Committee on Interstate Commerce of the New York State Bar Association Tax Section, *Congress and the Taxation of Multijurisdictional Corporations*, 20 TAX NOTES 451 (Nov. 7, 1983) [hereinafter cited as *N.Y. Bar Ass'n Report*].

³⁵⁶ See, e.g., *Moorman Mfg. Corp. v. Bair*, 437 U.S. 267, 280 (1978); *Mobil Oil Corp. v. Commissioner of Taxes of Vermont*, 445 U.S. 425, 449 (1980); see generally Corrigan, *Toward Uniformity*, *supra* note 354, at 510.

³⁵⁷ See McLure, *Toward Uniformity*, *supra* note 354, at 55.

³⁵⁸ See *id.*; GAO REPORT DIGEST, *Key Issues*, *supra* note 352, at 160; *N.Y. Bar Ass'n Report*, *supra* note 355, at 454. But see *ACIR Report*, *supra* note 343, at 1001-02. It is important to note the time and context in which the different comments were made. The perception of the Supreme Court's attitude varied dramatically and repeatedly in the four-year period between 1978 and 1982 through the sequence of cases analyzed *supra* at notes 101-187 and accompanying text.

³⁵⁹ Corrigan, *Toward Uniformity*, *supra* note 354, at 510. See also McLure, *Toward Uniformity*, *supra* note 354, at 55.

³⁶⁰ The Supreme Court's decisions in *ASARCO* and *Woolworth* undermined ongoing efforts to shape a congressional solution to state division-of-income problems, while its decisions in *Moorman*, *Mobil*, and *Exxon* provided a powerful stimulus for congressional involvement in these questions.

opposition from the states.³⁶¹ Therefore, the likelihood of independent congressional action is at best remote, as is shown by the history of recurrent bills to restrict the states' power to tax the income of multijurisdictional corporations.³⁶² Legislation in this area by Congress has long been paralyzed by a political stalemate with one group of congressmen supporting multinationals and another group backing the states. To date, neither group has sufficient votes to end this congressional standoff.³⁶³ The hope for uniform rules lies entirely in a negotiated compromise among the states, the business community and the federal government. The possibility of achieving such a compromise depends largely on the Administration's determination to effect a strong conciliation.³⁶⁴

W. Hellerstein, *State Income Taxation of Multijurisdictional Corporations, Part II: Reflections on ASARCO and Woolworth*, 81 MICH. L. R. 157, 190-91 (1982).

³⁶¹ See *ACIR Report*, *supra* note 343, at 1000 & nn.26 & 27. The states oppose federal legislation on a pragmatic level because of their concern about the revenue losses that would result if unitary combination were limited to the "water's edge." *Id.* See generally Rosapepe & Goldberg, *The Revenue Effects of the Unitary Method: Two Responses to Shell's View*, 21 TAX NOTES 147 (Jan. 9, 1984); Rosch & Kennedy, *State Revenues That Would Be Lost by Prohibiting Worldwide Unitary Taxation or the "Flaky Data" Capex*, 20 TAX NOTES 1035 (Dec. 19, 1983). It has been questioned, however, whether revenue considerations should play such a prominent role in the policy debate. McLure, *Toward Uniformity*, *supra* note 354, at 55 n.21. In the words of Charles McLure, "One can, after all, think of many bad taxes that would raise substantial revenue!" *Id.* On a more doctrinal level, the states claim that federal legislation would be an unconstitutional encroachment on their sovereignty. Dexter, *State Taxation of Multinationals: Are the Mathias and Conable Bills Constitutional?*, 14 TAX NOTES 715, 716-17 (1982) [hereinafter cited as Dexter, *Mathias and Conable Bills*]; *ACIR Report*, *supra* note 343, at 1000. They argue that the states should be free to select any particular method of tax they see fit, absent overriding national commerce constraints. *Id.*

³⁶² Since 1965, various bills have been introduced which would restrict the power of the states to impose various taxes on multistate-multinational corporations. S. 1225, introduced by Senator Charles C. Mathias, Jr., R-Md., and H.R. 2918 introduced by Ways and Means Committee member Barber B. Conable, Jr., R-NY, would restrict the application of the unitary method in the case of multinational corporations and would exempt foreign-source dividends from state taxation. In particular, H.R. 2918 and its identical Senate counterpart S. 1225 would add a new section (§ 7518) to the miscellaneous provisions of the Internal Revenue Code of 1954. Subsection (a) would prevent the states from applying "combined reporting", by forbidding them to take into account, in determining the income tax liability of any corporation, the gross income of "foreign corporations" unless that income is subject to federal income tax. The states would then have to resort to section 482 of the I.R.C. Subsection (e) would restrict the states' power to levy corporate income taxes on dividends received from foreign corporations or from domestic corporations whose income derives largely from foreign sources. For a detailed analysis of a predecessor of H.R. 2918, H.R. 5076, identical in substance to H.R. 2918 and S. 1225, see W. Hellerstein, *State Income Taxation of Multijurisdictional Corporations: Reflections on Mobil, Exxon, and H.R. 5076*, 79 MICH. L. REV. 13, 154-71 (1980). In sum, H.R. 2918 contains three different restrictions: (1) restrictions on the application of the unitary concept to *foreign parents* conducting operations in the United States through subsidiaries; (2) restrictions on the application of the unitary concept to *domestic parents* conducting business in foreign countries through subsidiaries; and (3) the exemption of foreign-source dividends. H.R. 2918 and S. 1225 have been severely criticized. W. Hellerstein, *supra*, at 170-71. It has even been questioned whether such legislation is constitutional under the National League of Cities v. Usery, 426 U.S. 833 (1976), doctrine. Dexter, *Mathias and Conable Bills*, *supra* note 324, at 718.

³⁶³ J. Hellerstein, *Allocation and Apportionment*, *supra* note 184, at 168; WhiteNack, *supra* note 305, at 783.

³⁶⁴ While the Administration refused to go on record against the worldwide unitary tax and combined reporting, it is actively promoting the adoption of a compromise plan on the unitary method. Treasury Secretary Donald T. Regan announced the formation of a working group to study the unitary issue and to develop a federal policy on the unitary method. 20 TAX NOTES 70 (1983). The working group includes representatives of the federal government, state governments, and the

V. CONCLUSION

After the series of Supreme Court decisions beginning with *Mobil* and ending with *Container* the constitutional parameters of unitary taxation are reasonably well drawn. The Court may be expected in the near future to confront the issue of worldwide unitary taxation by a state of foreign-based multinationals, which was left open in *Container*. The Court, however, has clearly manifested its unwillingness to go beyond broad constitutional doctrine in scrutinizing state practices and to immerse itself in the technical intricacies and policy judgments involved in the fine-tuning of state division-of-income rules. It is therefore up to the political process to forge normative solutions that will allow a balanced network of state apportionment practices to operate efficiently and equitably. The states must resist the temptation to be content with the power and discretion that the Court has granted them. They must be willing to compromise some of their freedom for a measure of uniformity and certainty. Orderly growth of interstate and international commerce and efficient allocation of resources demand such a compromise. The equilibrium of the United States federal system and the viability of a community of nations committed to free international trade also require it. The states, the business community and the federal government have an interest and a duty to achieve a stable agreement in the near future.

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U.S. business community. For a complete list of the members, see 20 TAX NOTES 525, 526-27 (1983). For a complete list of the group's staff see 20 TAX NOTES 627 (1983). The most pressing issue being examined is state taxation of multinationals, rather than domestic multistate corporations. 20 TAX NOTES 1011 (1983).