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State Unitary Business Taxation: Are Multinational Corporations Being SubJECTED to an Unconstitutional Tax

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STATE UNITARY BUSINESS TAXATION: ARE MULTINATIONAL CORPORATIONS BEING SUBJECTED TO AN UNCONSTITUTIONAL TAX?

Due to inflation and tax measures such as California's Proposition 13, many state governments found themselves lacking necessary funds. In an attempt to replenish their depleted budgets, several states adopted the unitary method for taxing corporations. Heavily criticized by the multijurisdictional corporations from its beginning, the unitary method has reached the forefront of international trade conflicts. This Comment examines the constitutionality of the unitary method as it is applied to corporations with foreign parents. In addition, the Comment discusses the constitutionality of preemptive federal legislation barring the unitary method and proposes a solution for striking the delicate balance between states' rights and the need for strong foreign trade.

INTRODUCTION

The States' power to tax corporate income is constitutionally limited to that portion of a corporation's income derived from within the State's jurisdiction.1 Difficulties are encountered when a state taxing authority seeks to equitably allocate the income of a corporation operating through branches or subsidiaries in several taxing jurisdictions.2 The States have employed two methods for dividing income among the multiple taxing jurisdictions: the arms-length (or separate accounting) method, and the unitary business apportionment method.3


The following terms will be used frequently:

To "allocate" means to attribute the income to a specific state. For example, a corporation operating in only a single state will have its income allocated to that state.

There are three methods employed to allocate the income of multijurisdictional corporations. Specific allocation, which is not widely used, attempts to allocate the income to a specific "source" state. Separate accounting relies on the corporation's accounting and allocates the income among the jurisdictions as it was treated by the corporation. Apportionment is the third method used and involves applying a formula to the entire income of the corporation to determine each state's individual tax base.


3. Hellerstein, State Taxation of Multijurisdictional Corporations and the Su-
The objective under the arms-length method is to allocate to each subsidiary that portion of profit which it would have earned had it been dealing at arms-length with other members of the corporate group. Critics of the method contend it forces the State to assume a fictitious arrangement because dealings between members of the same corporate group are seldom carried on at prices reflecting true market conditions. Additionally, the critics claim the method produces so many problems when applied at the federal level that it would be virtually impossible to operate at the state level. Finally, manipulation within the corporate group requires frequent readjustment by the taxing authority. Despite these problems, the arms-length method has become the internationally accepted apportionment method, employed by the United States Government and most trading nations.

Twenty-six states employ the unitary business apportionment method (in some form) to determine the tax base of the subsidiary operating within the unitary tax jurisdiction. The taxing authority must first determine whether the subsidiary is actually engaged in a “unitary business” with other members of the corporate group before the subsidiary in the taxing state is subject to unitary apportionment. This initial determination has fostered considerable contro-

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4. See Comment, supra note 2, at 501.
8. 1 Tax Treaties (CCH) ¶ 153.
10. The courts have accepted various definitions of “unitary business.” For years the most widely accepted and employed definition was the “three unities” test approved in Butler Bros. v. McColgan, 315 U.S. 501, 508 (1942). This test involved a showing of (1) unity of ownership; (2) unity of operation as evidenced by central purchasing, advertising, accounting and management divisions; and (3) unity of use in its centralized force and general system operation.

Another test that has been accepted is the “benefits of integration” criterion developed in Western Auto Supply v. Comm’r of Taxation, 245 Minn. 346, 71 N.W.2d 797, 804-05 (1955). Additionally, the test employed by Pennsylvania, “the integral coordination of various functions,” has gained widespread acceptance. See, e.g., Commonwealth v. Ford Motor, 350 Pa. 236, 38 A.2d 329 (1944).

Although the Supreme Court still acknowledges the “three unities test,” the Court recently has relied on the “functional integration” test. See, e.g., Mobil Oil Corp. v. Comm’r of Taxes, 445 U.S. 425 (1980).

For a discussion of the tests and definitions used, see Note, State Taxation of Non-domiciliary Corporations, 40 Wash. & Lee L. Rev. 191 (1983).
versary because the definition of “unitary business” varies with each taxing jurisdiction.11

Once the taxing authority establishes that the subsidiary is a member of a unitary business, the apportionment formula is applied. Most states apply the three-factor formula suggested by the Uniform Division of Income for Tax Purposes Act.12 Under the Act, the subsidiary’s tax liability is based on a ratio of its sales, payroll and property to the world-wide combined sales, payroll and property of the entire corporate group.13 Critics assert the disproportionate values of sales, property, and payroll present on the international level distort the apportionment ratio and the subsidiary’s tax liability.14 Additionally, they charge that unitary apportionment discourages foreign investment,15 presents substantial administrative burdens,16 interferes with federal foreign trade policy, and creates multiple taxation.17

The combination of increased tax liability inherent in the unitary business principle18 and increased presence of multinational corporations has fostered recent constitutional challenges to unitary apportionment before the United States Supreme Court.19 Corporations have based their challenges on Due Process20 and Commerce Clause21 restrictions on state taxation. To date, all the challenges before the Supreme Court have been registered by domestic-based multinational corporations. As exemplified by the most recent deci-

11. Comment, supra note 2, at 502-03.
13. Id. For example, assume that a California subsidiary had 10 X in payroll, 100 X in sales, and 50 X in property and that the total corporate group had 100 X in payroll, 1000 X in sales, and 500 X in property. The income allocated to California under the apportionment formula would be 1/10 of the total corporate income since the ratio is 160 X/1600 X.
tion, *Container Corporation v. Franchise Tax Board*, the Supreme Court has approved most applications of the unitary method to domestic-based corporate groups. The states, however, have lost two recent cases involving the determination of the unitary nature of the business.

Presently, no domestic subsidiary of a foreign corporation has successfully challenged unitary taxation before the Supreme Court. In *Container Corp.*, however, the Court expressly declined to extend its holding to include subsidiaries with foreign parents. The Court implied the analysis and result might have been altered were a foreign parent involved. Considering the criteria set forth in *Japan Line Ltd. v. County of Los Angeles*, some commentators have concluded the Supreme Court would declare that the application of unitary apportionment to foreign parents violates the negative implications of the Commerce Clause.

Part I of this Comment will analyze the recent challenges to unitary taxation litigated before the Supreme Court and will determine the tests the Court applies to challenges by corporations with domestic parents. The section will then focus on the distinction between these tests and those to be applied to corporations with foreign parents. Part II will analyze problems incurred in establishing a judicial forum, the likely result of the issue before the Supreme Court, and the merits and disadvantages of selecting litigation as the method for avoiding unitary taxation.

Congress has also considered the issue of limiting the states' taxation of foreign-based corporations. Additionally, President Reagan has formed a task force to consider the possibility of limiting state unitary taxation through national legislation or voluntary action by the states. Part III examines the constitutionality of federal legislation limiting state taxing power, discusses the policy arguments for both opponents and proponents of such legislation, and suggests a resolution of the issues in light of the reasoning and conclusions of Parts I and II.

25. Id. at 4997 n.32.
28. The negative implications of the Commerce Clause prevent the states from placing an undue burden on interstate commerce.
30. Although issues of allocation of dividend income are present in some of the principal cases, this Comment will not deal specifically with the taxation of dividends.
PART I: THE CONSTITUTIONALITY OF UNITARY APPORTIONMENT AS APPLIED TO DOMESTIC BASED PARENT CORPORATIONS

Since 1980, the Supreme Court has decided five cases regarding the constitutionality of state unitary taxation of multinational corporations. Each of these cases involved an action brought by a domestic-based parent corporation challenging a state tax assessment. This portion of the Comment will analyze the constitutional arguments presented by the corporations in the cases prior to Container, the Supreme Court’s resolution of those challenges, and the reasoning employed in Container. Finally, it will distinguish between the tests applied to corporations with domestic parents and those which should be applied to corporations with foreign parents.

Due Process Considerations

In each of the above mentioned challenges, the taxpayer relied upon Due Process Clause restrictions on state taxation. For example, Mobil Oil Corp. v. Commissioner of Taxes concerned Vermont’s application of the unitary business principle to foreign-source divided income of Mobil, one of the world’s largest integrated oil companies. Mobil, a New York corporation, had operated abroad largely through wholly owned subsidiaries. Vermont included in the apportionment dividends from these foreign subsidiaries to determine Mobil’s taxable income. Mobil protested that the inclusion of these dividends in its apportionable tax base was forbidden by Due Process and Commerce Clause considerations.

The Court declared two Due Process Clause limitations on state taxation of income generated in interstate commerce. First, to collect income tax a “'minimal connection' between the intrastate activities and the taxing state must exist.” Second, there must exist a “rational relationship between the income attributed to the State

33. Discussion of the Commerce Clause considerations follows in the text accompanying notes 66-105.
Mobil argued that because the entire amount of the dividends would be taxed in the state of incorporation, New York, it would violate due process for Vermont to be permitted to tax Mobil on the apportioned value of the dividends.
34. 445 U.S. at 436.
35. Id. at 437.
and the intrastate values of the enterprise.  

The "minimal connection" or "nexus" is established when a member of the corporate group carries on a business within the state. Mobil fulfilled this requirement by transacting a portion of its unitary business (sale of petroleum products) within Vermont. Furthermore, Mobil and its subsidiaries were a "functionally integrated" enterprise, subject to treatment as a unitary business. The finding of unitary business established a sufficient nexus between the state and all of Mobil's income, although Mobil argued that the foreign source of income did not arise from in-state activities. Thus, the nexus requirement was satisfied by showing Mobil's enterprise was functionally integrated. 

To fulfill the "rational relationship" standard, the state must limit its tax to that portion of interstate income reasonably related to the corporation's activity in the state. Vermont applied the unitary business apportionment principle to determine the portion of income related to the business conducted within the state. The Mobil Court approved, noting "the linchpin of apportionability in the field of state taxation is the unitary business principle." Therefore, once a state determines the taxpayer is engaged in a unitary business, the apportionment formula provides a "reasonably related" tax base calculation consistent with the second due process requirement. In Exxon Corp. v. Department of Revenue, Wisconsin had applied a three-

36. Id. The "nexus" requirement concerns the physical presence of a member of the corporate group doing business in the state. The rational relationship standard involves the amount of income attributed to the state instead of actual physical presence.

37. Id.

38. Id. at 439. See supra note 10.

39. Id. at 439.

40. Id. at 439-40.

Once the state determines the business was part of a unitary business, the "nexus" requirement is established for the entire corporate group and not only the in-state business.

41. See Hellerstein, supra note 3, at 404.

42. 445 U.S. at 439.

43. Once a unitary business is established, the Supreme Court has approved the three-factor formula as a means of calculating the reasonably related tax base. However, the "rational relationship" requirement may remain an obstacle to state income taxation. If the apportioned tax liability is "out of all appropriate proportion to the business transmitted by the appellant in that state," then the "rational relationship" requirement is violated. Hans Rees' Sons, Inc. v. North Carolina ex rel. Maxwell, 283 U.S. 123, 135 (1931).

Furthermore, if the taxpayer establishes the income was earned outside the scope of the unitary business, then apportionment of worldwide income is not appropriate. 445 U.S. at 439. See Hellerstein, supra note 3, at 406 ("[o]nly in the absence of unitary business does the Due Process Clause require the state to exclude from the payee's apportionable tax base dividends received from the payor."). Mobil, however, failed to prove that the foreign activities were part of a discrete enterprise, rather than a unitary business. Therefore, the Court concluded that both due process requirements were satisfied. 445 U.S. at 439-40.

44. 447 U.S. 207 (1980). Unlike Mobil, the challenge did not involve taxation of
factor apportionment formula to Exxon's entire income. Exxon objected to this three-factor formula because Exxon had performed only marketing activities in Wisconsin. Exxon utilized separate functional accounting, thereby separating its Wisconsin income from its other activities. Because Exxon conducted all nonmarketing activities outside Wisconsin, Exxon argued no established nexus existed between the income from those activities and Wisconsin.\(^4\) The Court rejected the argument, holding that a "nexus" would be lacking only where the out-of-state income was derived from an "unregulated business activity" which constitutes a "discrete business enterprise" such that the business in an out of the taxing state are not functionally integrated.\(^4\)

The Court also found that separate functional accounting failed to defeat the "rational relationship" requirement. This relationship existed even though Exxon's accounting demonstrated that the Wisconsin operation had failed to show a net profit for the years in question.\(^4\) Holding that Exxon's internal accounting system was not binding on the state for tax purposes,\(^4\) the Court relied upon Wisconsin's three-factor apportionment formula to demonstrate the "rational relationship" existed between the tax base attributed to the State and the intrastate value of the business.\(^4\) Again, as in Mobil, the corporation's failure to prove it was not engaged in unitary business precipitated failure of its due process arguments.

In 1982, the Supreme Court decided ASARCO, Inc. v. Idaho State Tax Commission\(^5\) and F.W. Woolworth Co. v. Taxation and Revenue Department.\(^5\) The two cases involved dividends and gains from foreign subsidiaries that were included in the domestic parent's tax base because the state taxing authorities concluded the compa-

\(^{45}\) Id. at 220.
\(^{46}\) Id. at 223-24. The Court concluded that Exxon's use of separate functional accounting did not sufficiently establish that its functional departments were discrete enterprises.
\(^{47}\) Id. at 227.
\(^{48}\) Id. at 226.
\(^{49}\) Id. at 226-27.
\(^{50}\) 458 U.S. 307 (1982).

Both ASARCO and Woolworth denied they were engaged in unitary business with their subsidiaries. The due process requirements, they asserted, were not fulfilled because the businesses were not unitary, and this taxation violated the "nexus" and "rational relationship" standards. As a result of the arguments, both opinions relied heavily on the facts, and have been criticized by some commentators.
nies were engaged in unitary business. 52

Although the decisions were greatly limited to the facts presented, ASARCO and Woolworth have some precedential value concerning the burden of proof for the due process arguments. The corporations in ASARCO and Woolworth succeeded in establishing that the foreign members of the corporate group were engaged in discrete business enterprises. 53 Proving the entire income apportioned was not earned as part of a unitary business activity, the corporations successfully proved the tax had been unconstitutionally applied. 54 The implication after ASARCO and Woolworth is that those challenging unitary taxation might receive a de novo adjudication by challenging the trial court’s classification of unitary business. 55

In Container Corp. v. Franchise Tax Board 56 the Court limited its role in applying the “unitary business” standards, and refined the due process requirements enunciated in Mobil.

In Container, the plaintiff, a Delaware corporation headquartered in Illinois, operated through subsidiaries in California and overseas. Container disputed the state court’s determination that it was engaged in a unitary business with its subsidiaries; Container asked the Supreme Court to reexamine the facts and make its own determination. 57 The Court refused, explaining its position on review of state court judgments. 58 The Court commented, in a footnote, that in both ASARCO and Woolworth it had also relied on findings made by the

52. See Hellerstein, supra note 3, at 415-20. See also Greene, ASARCO and Woolworth, Anomalous Anachronisms with Limited Precedential Value, 18 Tax Notes 795 (1983). Mr. Greene has called the pair “two deviant cases” and suggests their applicability is limited because of the heavy reliance on the facts. He asserts the two cases fit into an exception created in Mobil because of their unique facts and are of limited precedential value. Mr. Greene asserts their only value is affirmation of the principle that the taxpayer carries the burden of proof with regard to “unitary business.” Further, Mr. Greene declares the cases are analytically defective because they fail to enunciate a due process rationale that can be applied to those situations where income from stock investments should constitutionally be includable in the taxpayer’s apportionable tax base.

53. 458 U.S. 307. The Supreme Court reached its conclusion despite the state court’s factual documentation and contrary conclusion regarding the unitary nature of the businesses. The Court found fault in the standards applied by the lower court.

54. Id.

55. Further, the Court’s extensive documentation of findings may provide some standards in future litigation pertaining to the unitary nature of a business.


57. Id. at 4991-92.

58. The factual records in such cases, even when the parties enter into a stipulation, tend to be long and complex, and the line between “historical fact” and “constitutional fact” is often fuzzy at best. It will do the cause of legal certainty little good if this Court turns every colorable claim that a state court erred in a particular application of those principles into a de novo adjudication whose unintended nuances would then spawn further litigation and an avalanche of critical comment. Rather, our task must be to determine whether the state court applied the correct standards to the case; and if it did, whether its judgment was within the realm of permissible judgment. Id. at 4992 (citations omitted).
state courts. Therefore, it now seems unlikely that the Court will overturn state court findings of unitary business.

Container also argued the three-factor apportionment formula was inaccurate and unfair as applied to multinational corporations because of salient differences among national economies. It contended that such inaccuracy violated the Due Process Clause rational relationship requirement. The Court responded that after a state has determined that the corporate activities are a unitary business, due process requires the taxing authority to apply a "fair" apportionment formula. Fairness is determined by a two-part test:

The first, and again obvious, component of fairness in an apportionment formula is what might be called internal consistency — that is the formula must be such that, if applied by every jurisdiction, it would result in no more than all of the unitary business's income being taxed. The second and more difficult requirement is what might be called external consistency — the factor or factors used in the apportionment formula must actually reflect a reasonable sense of how income is generated.

The Court has accepted the three-factor test suggested by the Uniform Division of Income for Tax Purposes Act, as satisfying the

59. Id. at 4992 n.15. This seeming inconsistency (see supra note 53) may have resulted from the Court's interpretation of the standards applied in ASARCO rather than its desire to avoid ASARCO-type review. Only future cases will reveal the extent of scrutiny in which the Court is willing to engage.

60. Id. at 4988.

Varying rates of return in different countries are not reflected by the formulas. However, this distorts the values and attributes more income to the state than actually earned there.

For example, if salary of 10X is paid in the California subsidiary to staff 10 employees, in another country 10K spent on salary by a related corporation might employ 40. The foreign partner will be earning at a higher rate of return on each salary dollar spent since his capacity for production will be greater. However, applying the apportionment does not reflect this and because the California operation had one-half the salary expense, a larger portion of the income will be attributed to California even though the foreign operation may operate at a net profit (because of the higher return) while the California operation ends up with a net loss. Therefore, if a California subsidiary has $0 in before-tax income, and because of much higher expenses for property and salary has one-half the group's payroll and property and one-fifth of the sales, it will be taxed on 40% of worldwide income despite the much higher rate of return elsewhere. See infra notes 199 & 217. The formula apportions income to California that was not earned there and may even result in taxation where there is no net income.

61. The two due process requirements developed in Mobil and Exxon pertained to the general exercise of state taxation of interstate commerce. The test in Container applies to the formula only.

62. 51 U.S.L.W. 4987, 4940. This test applies to the formula(s) employed by the states to apportion the income of the unitary corporate group, whereas the Mobil due process requirements applied to the taxation of interstate commerce in general.

63. See supra note 9.
Container requirements. 64

In summary recent cases involving state taxation of domestic parent corporations have established two due process requirements that must be satisfied by any state tax on interstate commerce. First, a "minimal connection" must exist between the income and the taxing state. Second, there must be a "rational relationship" between the extent of tax liability and the intrastate business activities.

To prove a violation of either of these due process requirements, the domestic-based corporation must show the income was earned by a "discrete business enterprise" rather than by unitary business. Although the Court has engaged in extensive judicial review of the state courts' "unitary business" determination, the Container opinion indicates it may decline such analysis in the future.

Additionally, when a state apportions the income of a unitary business, its formula must be "fair" as judged by the tests provided in Container. 65

Commerce Clause Considerations

Challenges to unitary taxation raised by domestic-based multinational corporations have also been founded on the "negative implications" of the Commerce Clause. 66 This Clause prohibits state imposition of undue burden on interstate or foreign commerce.

In Mobil, 67 the domestic corporation argued that the unitary tax method subjected interstate commerce to duplicative taxation. Mobil asserted that a possibility of double taxation of dividend income existed because the state of incorporation could tax the dividends in full in addition to Vermont's tax based also on the apportioned dividend income. 68 Mobil further asserted that wholly intrastate corporate taxpayers would not be subject to these duplicative tax possibilities. 69

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64. 51 U.S.L.W. at 4990.
65. Id.
66. In ASARCO and Woolworth, however, the Court decided the cases without consideration of the Commerce Clause requirement because the due process standards were violated. This portion of the Comment, therefore, analyzes the tests developed and applied in Mobil, Exxon, and Container.

The Commerce Clause prohibits the states from placing an undue burden upon interstate or foreign commerce. The challenges were based on the unitary tax and its effects that unduly burdened those participating in interstate and foreign commerce.

See Hellerstein, State Tax Discrimination Against Out-of-State, 30 NAT'L TAX J. 113, 117 (1977) ("Although the Commerce Clause is framed as a grant to Congress of the power to regulate interstate and foreign commerce, it has long been interpreted as restricting state taxing powers despite the silence of Congress . . . the Commerce Clause, by its own force, prohibits states from imposing 'undue burdens' on interstate commerce.").

68. Id. at 443.
69. Id.
In reply, the Court applied the four-year test first suggested in *Complete Auto Transit, Inc. v. Brady.* Under the test, the Court must examine the practical effect of the challenged tax to determine whether it "is applied to an activity with a substantial nexus with the taxing State, is fairly apportioned, does not discriminate against interstate commerce, and is fairly related to the services provided by the State." In response to Mobil's allegations of potential discrimination, the Court concluded that Mobil had offered no proof of actual multiple taxation. Additionally, the Court refused to declare a constitutional preference for specific allocation tax methods over unitary apportionment. Mobil failed to demonstrate interstate commerce violations, and the Court refused to condemn unitary taxation on the theoretical possibility of multiple taxation.

Exxon also founded its interstate commerce objections upon potential multiple taxation. Again applying the *Complete Auto* test, the Court concluded that no instance of actual multiple tax had been shown; therefore, there was no discrimination. The Court further stated that the Commerce Clause did not prevent a state from apportioning worldwide income that the corporations had separated from its in-state operations through its own departmental accounting methods. Therefore, Exxon failed to show either actual double taxation or an unfair relationship to the services provided by the taxing state because the unitary apportionment formula provided the "reasonable" relationship.

In addition to interstate commerce challenges, Mobil attacked the tax under the foreign commerce element of the Commerce Clause. The domestic-based corporation relied on the rationale developed in *Japan Line Ltd. v. County of Los Angeles.* In *Japan Line,* six Japanese shipping companies had transported cargo exclusively in foreign commerce. Each ship used Japan as its home port and site of registration. Each ship carried cargo containers which Japan taxed in full value. While the containers were in Los Angeles County, the

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72. Id. at 444.
73. Id. at 444-46.
74. Exxon Corp. v. Dep't of Revenue, 447 U.S. 207, 228 (1980).
75. Id.
76. Id. at 229-30.
77. Id.
78. 441 U.S. 434 (1979).
79. Id. at 436.
county leveled an *ad valorem* property tax on them.\(^8\)

The Japanese shipping companies protested the assessments under the Commerce Clause standards incorporated in the *Complete Auto* test. The Court concluded these limited standards were too narrowly focused to evaluate the constitutionality of state taxes on foreign commerce.\(^8\) The Court determined that two additional factors, beyond those of *Complete Auto*, must be considered in such situations.\(^8\) First, the Court must consider the enhanced risk of multiple taxation.\(^8\) The second consideration is whether state taxation on instrumentalities of foreign commerce might impair essential federal uniformity.\(^8\)

*Japan Line* determined that even a slight overlap of tax, deemed *de minimis* in a domestic context, assumes greater importance in the foreign commerce context.\(^8\) Therefore, state or local taxation of foreign commerce dictates a stricter inquiry due to limits in Supreme Court jurisdiction, the likelihood of multiple taxation, and the drastic effects resulting from state interference with national trade policy.\(^8\)

The Court recognized three areas where state policy may interfere with uniform federal policy concerning tax on foreign commerce. First, there might be international disputes over reconciling apportionment formulae.\(^8\) Second, such taxation may result in retaliation against United States owners of foreign subsidiaries.\(^8\) Third, various instrumentalities of foreign commerce might be subject to varying degrees of multiple taxation among the states, thereby preventing the nation from "speaking with one voice."\(^8\)

The Court rejected Mobil's reliance upon *Japan Line* because it was a domestic-based corporation;\(^8\) the issue in *Mobil* was domestic

\(^8\) *Id.* at 437-38.

81. *Id.* at 445-46 ("the premise . . . that the Commerce Clause analysis is identical, regardless of whether interstate foreign commerce is involved . . . . must be rejected").

82. *Id.* at 445-46.

83. *Id.* at 446.

84. *Id.* at 446.

85. *Id.* at 448.

86. *See* Rudy, supra note 17, at 386-89.

87. 441 U.S. at 450.

88. *Id.*

89. *Id.* at 450-51.

90. 445 U.S. at 446-48.
multiple taxation, not taxation by foreign and domestic authorities. The key factor was that the Supreme Court had jurisdiction over both taxing authorities in Mobil, although the source of the income was foreign.

Therefore, prior to Container, the Court applied the Complete Auto test to domestic-based parents, and the stricter Japan Line standards only when the same income or instrumentalities were taxed by state and foreign taxing authorities.

Container Corporation also raised Commerce Clause objections to unitary taxation. The Court conceded that the possibility of international double taxation required a stricter inquiry into Commerce Clause objections. However, the policies supporting the application of the Japan Line standards did not apply to Container, a domestic-based corporation.

Initially, the Court analyzed the similarities between Container and Japan Line, including “actual double taxation” on the parent corporation’s income resulting from serious divergence in the taxing schemes adopted by the state and foreign tax jurisdictions. Second, the method employed by the foreign taxing authority was consistent with internationally accepted practice. Third, federal policy preferred arms-length apportionment to the unitary business method.

The Court, however, distinguished the cases. First, Japan Line involved a property tax whereas Container involved an income tax. Further distinguishing Japan Line, the Court found that the double taxation, although actually occurring in this case, was not the inev-

91. Id. at 447.
92. Id.
93. Unlike Mobil, in Exxon the Court did not engage in analysis of the applicability of Japan Line. The parent was again domestic-based and the Supreme Court had jurisdiction over the taxing authorities. As a result, the Court relied only on the Complete Auto test for the same reasons given in Mobil.
94. See generally, Rudy, supra note 17.
96. Id. at 4995-97.
97. Id. at 4994-95.
98. Id. at 4995.
99. Id.
100. Id. As commentators have suggested, this distinction is rather tenuous because the unitary tax concept was originally developed as a property tax device. See Rudy, supra note 17, at 391. Additionally, the Court had relied heavily on property tax concepts sustaining the constitutionality of the tax. 51 U.S.L.W. at 4995.
table result of the California taxing scheme.\textsuperscript{101}

The Supreme Court emphasized that the tax in \textit{Container} fell not on a foreign business or instrumentality of foreign commerce, but on a corporation domiciled and headquartered in the United States.\textsuperscript{102} The decision explicitly excluded unitary taxation of companies with foreign parents.\textsuperscript{103} The Court had once again illustrated the distinction in the tests to be applied to domestic-based parents and to foreign-based parents.\textsuperscript{104}

In summary, analysis of recent Commerce Clause challenges advanced by domestic-based corporations reveals two essential points. First, if the challenge to the unitary tax method is made by a domestic-based corporation, the Supreme Court will apply the four-part \textit{Complete Auto} test. Second, the Supreme Court has refused to approve specifically the constitutionality of application of the unitary tax principle to corporations with foreign-based parents. However, the treatment in \textit{Container} indicates that the policies outlined in \textit{Japan Line} apply to such corporations and the Court may apply the stricter \textit{Japan Line} standards.\textsuperscript{105} The focus now turns to judicial treatment of challenges by foreign-based corporations in light of the appropriate Commerce Clause criteria to be applied.

\textbf{PART II: LITIGATION OF CONSTITUTIONAL OBJECTIONS BY FOREIGN PARENTS OF MULTINATIONAL CORPORATIONS}

Foreign parent corporations of subsidiaries subject to unitary taxation have two alternative means to assert their constitutional objections: (1) litigation; or (2) indirect challenge by successful lobbying efforts encouraging Congress to enact uniform limitations on unitary taxation.\textsuperscript{106} The discussion considers the probability of success in a constitutional challenge before the Supreme Court. Additionally, the disadvantages of attacking unitary taxation by this alternative will be discussed.

\footnotesize{\textsuperscript{101} \textit{Id.} \textsuperscript{102} \textit{Id.} \textsuperscript{103} \textit{Id.} n.26. \textsuperscript{104} See Rudy, supra note 17, at 390-91. Mr. Rudy analyzes the distinctions between the two Commerce Clause tests and the proper fact situations for applications of each. \textsuperscript{105} The \textit{Container} Court, nevertheless, applied the policies supporting the \textit{Japan Line} principles to the facts in the \textit{Container} case, concluding that when the situation involved a domestic parent corporation, the application of the stricter \textit{Japan Line} standards is not justified. The value of \textit{Container}, for the purpose of this inquiry, is that it analyzes the policies supporting the application of the stricter \textit{Japan Line} standards. This enables one to anticipate the treatment of a Foreign Commerce Clause challenge by a foreign-based corporation. \textsuperscript{106} See P. Hartman, \textit{Federal Limitations on State and Local Taxation} 677-704 (1981). See Part III, \textit{infra} for a discussion of the second alternative.}
Likelihood of Success in Litigation of Foreign Corporations’ Commerce Clause Objections

As Part I illustrated, the Supreme Court employs a more searching Commerce Clause inquiry into the constitutionality of state taxation when the international multiple taxation is a possibility.107 The Court has applied the four-part Complete Auto test to the constitutional challenges advanced by domestic-based parents.108 However, the stricter Japan Line standards109 will be applied to taxation of instrumentalities of foreign commerce when the underlying policies support application in the specific case.110 This portion of the Comment analyzes those policies expressed in Japan Line and interpreted in Container to predict the Supreme Court’s treatment of a Commerce Clause challenge brought by a foreign-based corporation.111

In Japan Line, the Court required a trial court to investigate whether the challenged state tax creates a substantial risk of international multiple taxation,112 and whether the state tax prevents the federal government from “speaking with one voice” in the regulation of foreign trade.113 Violation of either of these precepts renders the state tax unconstitutional.114

Four principles are relevant to demonstrating violations of the Japan Line precepts. First is the existence of actual international multiple taxation.116 Second, the Court suggested that reconciling of different apportionment formulae may create serious international administrative burdens.116 Third, whether foreign nations whose companies were disadvantaged by the state tax might retaliate

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107. Container Corp. v. Franchise Tax Bd., 51 U.S.L.W. 4987, 4990 (U.S. June 27, 1983). This portion of the Comment will analyze only the Commerce Clause objections that can be claimed by all foreign parents with domestic subsidiaries subject to unitary apportionment. The due process objections depend largely on factual proof that the income was earned outside the scope of a unitary business. The Commerce Clause objection, conversely, is common to all foreign-based corporations.


110. 51 U.S.L.W. at 4995-97.

111. Recall, that the Container Court expressly refused to extend its holding to the situation of corporations with foreign parents. Id. at 4995 n.26.

112. 441 U.S. at 451.

113. Id.

114. Id.

115. Id. at 447-48.

The Court declared that “even a slight overlapping of tax — a problem that might be deemed de minimis in a domestic contest — assumes importance when sensitive matters of foreign relations and national sovereignty are concerned.” Id. at 456.

116. Id. at 450.
against American-owned instrumentalities present in foreign jurisdictions. Fourth, the state tax may become an international irritant in the realm of governmental foreign trade policy.

Unitary taxation of subsidiaries of foreign-based corporations breaches each of the Japan Line precepts. First, the unitary tax system inherently causes multiple taxation of the same income when applied on the international level. The foreign parent's worldwide income is taxed in its home country. That same worldwide income is then used as a basis for state apportionment to determine its taxable share of income. The arms-length method is the internationally preferred method primarily because it avoids the extensive multiple taxation present in the unitary method.

Compliance with both state unitary taxation and a foreign government's own separate accounting principles places a significant administrative burden upon foreign parents that is not equally borne by domestic-based parents. Furthermore, the parent may be precluded by foreign secrecy laws from releasing some information demanded by the states in computing the apportionment.

Additionally, state use of unitary taxation precipitates retaliation from trading partners by raising taxes on U.S. companies. In addition to tax increases against domestic-based companies, foreign parent corporations are locating subsidiaries in states that do not em-

117. Id.
118. Id. at 450-51.
119. See Rudy, supra note 17, at 387. Mr. Rudy asserts that the resultant multiple taxation alone is enough basis to justify a finding of unconstitutionality as applied to foreign-based parent corporations.

For tax purposes in the parent corporation's home country, the parent will conform to that country's accepted accounting principles and currency. However, the unitary tax method requires that the parent correct all values to United States currency and conform to the United States accepted accounting principles. Additionally, nonuniformity among the states magnifies the burden for those corporations operating in more than one unitary taxation state. House Hearings, supra note 15, at 182 (statement of James W. McCrath).

121. See House Hearings, supra note 15, at 360 (letter from Paola Pansa Cedronio). See also Note, supra note 16, at 356-58. If all jurisdictions use the arms-length method without readjustment then there will not be multiple tax on the same income. But, if the home country uses the arms-length method, that same income that was taxed in the home country might, as a result of the apportionment formula, be attributed to the state and also taxed by the state. Therefore, use of unitary taxation leads to multiple taxation. The arms-length method, however, may also produce multiple taxation in those situations where the taxing authority readjusts the returns attributing more income to the jurisdiction than corporate accounting revealed. However, this multiple taxation is not an inherent function of the system such as it is with unitary taxation.

122. See House Hearings, supra note 15, at 91 (California guidelines for the preparation of combined returns).
123. Id. at 226 (statement of D.E. Hammond).
124. Id. at 137-38 (statement of Senator Charles McC. Mathias, Jr).
ploy unitary apportionment. Some states have lost considerable tax revenues because of their employment of the unitary tax method.

Finally, the unitary apportionment method employed by the states has interfered with federal foreign trade policy. The ratification problems associated with the United States-United Kingdom Tax Treaty illustrate the grave effects state unitary taxation can have for foreign trade.

Therefore, state unitary taxation of subsidiaries of foreign corporations violates the concerns voiced in Japan Line. Assuming the Court would apply the Japan Line standards to challenges by these subsidiaries, the Court would probably declare this application of unitary taxation unconstitutional.

The Court’s reasoning in refusing to apply the Japan Line standards to the domestic corporation in Container indicates that those stricter standards would be applied in constitutional challenges pursued by foreign parent corporation subsidiaries subject to unitary taxation.

Concluding that Japan Line did not absolutely prohibit double taxation, the Container Court also considered fairness to the state of requiring the state to shift to alternatives to unitary taxation. The Container Court reasoned that because the possibility of multiple taxation existed with the arms-length method, the unitary method

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125. Id. at 141-44. See L.A. Times, Feb. 16, 1984, at 3, col. 6 & at 28, col. 1. Japanese companies have decided to halt all growth in California and other states that employ the unitary tax concept.

126. However, the unitary tax method results in revenues that are much larger than generated with a separate accounting. The theory of many states may be that revenue loss from discouragement of foreign investment (see infra note 224) is more than offset by employment of the unitary tax principle. Florida is considering repeal of its unitary tax statute because of the disincentive to foreign investment. Advocates of repeal argue that income generated by the tax does not outweigh the loss due to relocation of foreign investment. DAILY TAX REPORTER (BNA), No. 32, G-12 & No. 55, G-9 (1984).

127. See Note, supra note 16, at 359-60.

128. See House Hearings, supra note 15, at 138 (statement of Senator Charles McC. Mathias, Jr.). See also Comment, supra note 2, at 499.

129. The treaty was not ratified for a long period because of negotiations over a provision for the elimination of state unitary taxation. The United Kingdom adopted the treaty only because the Carter Administration promised to provide pre-emptive federal legislation limiting the states. DAILY TAX REPORTER (BNA), No. 242, G-7, G-8 (1983).

130. The Container court realized that the reason it gave for distinguishing Japan Line might not apply to an analysis involving foreign parent corporations. 51 U.S.L.W. at 4997 n.32.

131. See supra note 121.
should not be struck down merely to avoid multiple taxation.\textsuperscript{182} However, the Court asserted that it had justifiably invalidated the taxing practice in \textit{Japan Line} because the method violated international practice and express federal policy.\textsuperscript{183} State unitary taxation on the international level also violates international practice and is inconsistent with the federal policy in employing the arms-length method. Therefore, state unitary taxation of foreign-based corporations is similar in effect to the tax involved in \textit{Japan Line}, and could justifiably be invalidated for many of the same reasons given in \textit{Japan Line}.

Assuming, \textit{arguendo}, that international multiple taxation alone does not condemn the unitary method, the other policies suggested in \textit{Container} justify holding the tax unconstitutional. If a state “either implicates foreign policy issues which must be left to the federal government or violates a clear federal doctrine,” the Court concluded, the state tax would then violate the \textit{Japan Line} “one voice” requirement.\textsuperscript{184} First, the Court considered the possibility that irritated foreign trading partners might retaliate against domestic-based corporation.\textsuperscript{185} The Court then relied on its own objective standards created to “reflect very general observations about the imperatives of international trade and international relations.”\textsuperscript{186} The Court concluded that the tax against the \textit{domestic} parent did not automatically create an “asymmetry in international taxations.”\textsuperscript{187} However, when the unitary tax is applied to the income of \textit{foreign} parents, such an automatic “asymmetry” exists in the violation of internationally accepted practice.\textsuperscript{188}

Further, the Court believed that a foreign government might be no more concerned by the method of allocation than by an increase in a state’s tax rates.\textsuperscript{189} The pivotal role played by the unitary tax provision in the United States-United Kingdom Tax Treaty,\textsuperscript{190} and the protests leveled by the Common Market countries,\textsuperscript{191} however, indicate foreign governments are much more concerned with limiting the use of unitary taxation than with limiting prevailing state tax rates.

\textsuperscript{132} 51 U.S.L.W. at 4995-96.
\textsuperscript{133} \textit{Id}. at 4995.
\textsuperscript{134} Additionally, the Court distinguished \textit{Japan Line} because \textit{Container} involved a domestic corporation. Clearly, this distinction would not apply to challenges brought by subsidiaries of foreign corporations. \textit{Id}. at 4997 n.32.
\textsuperscript{135} \textit{Id}. at 4996.
\textsuperscript{136} \textit{Id}.
\textsuperscript{137} \textit{Id}.
\textsuperscript{138} The asymmetry exists because the unitary tax states employ a method that is not employed by the overwhelming majority of major trading nations.
\textsuperscript{139} 51 U.S.L.W. at 4997.
\textsuperscript{140} \textit{See supra} note 128.
\textsuperscript{141} \textit{See House Hearings, supra} note 15, at 36 (letter from Paola Pansa Cedronio).
The *Container* Court assumed no federal opposition to the California unitary tax because the federal government had failed to file an *amicus curiae* brief.\(^{142}\) The Executive Branch however, had not acquiesced in *Container*. Initially, President Reagan asked the Court to reconsider its decision. Recently, the President announced he had formed a task force to deal with the problems caused by state unitary taxation.\(^{143}\)

In summary, the distinguishing rationale employed in *Container* indicates the Supreme Court should apply the *Japan Line* standards in a constitutional challenge pursued by a subsidiary of a foreign corporation. Furthermore, state unitary taxation should be found unconstitutional under the *Japan Line* standards.

**Problems Encountered in Litigating a Constitutional Challenge**

The foreign parent seeking to litigate its constitutional claims immediately encounters problems in selecting the desired judicial forum. Although corporations normally prefer to litigate constitutional challenges in the federal courts,\(^{144}\) the Injunction Act\(^{145}\) may bar corporations from challenging the tax in a federal forum. Instead, the corporation must bring its challenge in the state courts, which may be reluctant to invalidate taxes which provide their states with large revenues.\(^{146}\) Thus, the taxpayer is usually denied a federal forum until all state judicial remedies have been exhausted, and then only if the Supreme Court agrees to hear the case.\(^{147}\)

If barred from federal courts, foreign parents may be denied any judicial forum in many states. The reason is that many states, including California, provide state court remedies only after the taxpayer actually pays the tax.\(^{148}\) Because the subsidiaries, not the parents, are responsible for tax payment, the parent has no state court remedy either.

Recently, the federal courts have faced the difficult issues surrounding the interplay between the Injunction Act and state refund

\(^{142}\) 51 U.S.L.W. at 4997.  
\(^{143}\) See *DAILY TAX REPORTER* (BNA), No. 186, G-3 (1983).  
\(^{145}\) 28 U.S.C. § 1341 (1976) provides: “The district courts shall not enjoin, suspend or restrain the assessment, levy or collection of any tax under State law, where a plain, speedy, and efficient remedy may be had in the courts of such State.”  
\(^{146}\) See Elliot & Lauber, *supra* note 144, at 94.  
\(^{147}\) Id.  
\(^{148}\) *E.g.*, *CAL. REV. & TAX. CODE* § 26102 (West 1979).
Capitol-EMP involved companion cases brought against the members of the Franchise Tax Board as individuals to prevent them from assessing further taxes upon the California subsidiary. EMI, Inc., the United Kingdom parent corporation, engaged in the same recording business as its subsidiary, Capitol, but primarily in markets other than the United States. The district judge dismissed the complaint concluding that the California refund scheme provided a "plain, speedy, and efficient" remedy within the ambit of the Injunction Act. Both corporations appealed.

The Ninth Circuit agreed that the California refund action provided Capitol a sufficient remedy, despite exhaustive administrative prerequisites. Therefore, the Injunction Act barred the subsidiary's federal action, limiting the subsidiary to challenging the unitary tax in the state court. However, in assessing EMI's contention that it had no adequate state court remedy, the court recognized that the California refund action was only available for the actual taxpayers. The Ninth Circuit concluded that EMI's interests, although similar to Capitol's, were not identical. Thus, EMI was denied a state court remedy and the Injunction Act did not bar its federal action. The court concluded that "[a] nontaxpayer that has stated a claim with respect to an assessment or collection is entitled to a judicial remedy in which they can participate as a party." However, the court qualified EMI's victory by remanding the case to the district court to determine whether EMI had standing to sue.

149. See Elliot & Lauber, supra note 144, at 94-96.
151. 681 F.2d at 1112.
152. Id. at 1115.
153. Id. at 1118.
154. Id.
155. Id. The district judge had concluded that EMI's interests were identical to Capitol's and, therefore, EMI had in effect "a plain, speedy, and efficient state remedy."
156. Id. at 1119.
157. Id. n.31. Defendants also raised eleventh amendment defenses. The court rejected this bar to EMI's action concluding that a suit for declarative or injunctive relief against a state official in federal court was not barred by the eleventh amendment where it was alleged that the officer was performing pursuant to an unconstitutional statute.
158. Id. at 1119 n.31. Considering the applicability of the Injunction Act to actions brought by foreign parents, the court in Alcan Aluminium Ltd. v. FTB followed the Ninth Circuit's lead. The court considered the policy behind the enactment of the Injunction Act, namely, that foreign parents should not be given an advantage over domestic corporations by granting them access to federal courts to challenge state taxes (advantage of forum shopping). Nonetheless, the court concluded that as a result of the different parent and subsidiary interests, the Injunction Act should not bar the parent's action. Additionally, the court expressed reservations over the standing of the parent, similar to those expressed in Capitol-EMI. Therefore, the court stayed the action pending resolution of the standing and other issues in the EMI action on remand. 539 F.
On remand, the district judge concluded EMI lacked the requisite standing because EMI had suffered no injury. Although the assessment was made against Capitol, EMI arguably suffered injury because, as the majority shareholder, the value of its investment would decrease if Capitol must pay the challenged tax. "Although an injury to a corporation may indirectly harm a shareholder by decreasing the value of his shares, that fact does not give the shareholder standing to sue on his own behalf." Therefore, EMI's shareholder status failed to provide standing absent proof the shareholder suffered from a breach of a separate duty owed to him.

The court also rejected EMI's argument that it enjoyed standing because the tax violated the United States-United Kingdom Income Tax Convention. The court reiterated that EMI did not pay the tax and held that the treaty did not create a right of action in the parent of a tax paying subsidiary.

Other theories have been proposed as possible solutions to the standing problem. Arguably, the subsidiary pays the tax as an "agent" for the "principal" parent. Therefore, any injury to the agent would be an injury to the principal, providing standing. Another possible argument relies on cases allowing standing for an or-

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160. Id. at 135.
162. 560 F. Supp. at 135.
163. Id.
164. Id. Similarly, the Alcan court concluded the parent had no independent right to sue. The court quoted the Supreme Court:

"The standing question in its Art. III aspect "is whether the plaintiff has 'alleged such a personal stake in the controversy' as to warrant his invocation of federal court jurisdiction and to justify exercise of the court's remedial power on his behalf"...[T]he relevant inquiry is whether...the plaintiff has shown an injury to himself that is likely to be redressed by a favorable decision." 558 F. Supp. 624, 626. In response to Alcan's argument that the tax was directly upon the parent, the court reasoned that since California employed unitary apportionment, the tax was proportionate only to the business done within the state and by definition could not be upon the parent. Therefore, Alcan's claim that it had suffered a "distinct and palpable injury" was invalid. Id. at 625-26.

Additionally, Alcan failed to establish standing because of its shareholder status. The court concluded that mere fluctuations in the value of stock or size of dividend was not enough to grant the shareholder an independent cause of action. The Supreme Court refused to grant certiorari on these issues, 104 S. Ct. 705 (1984). See also Shell Petroleum, N.V. v. Graves, 709 F.2d 593 (9th Cir. 1983), cert. denied, 104 S. Ct. 537 (1983).
165. See Elliot & Lauber, supra note 144, at 94-96.
ganization suing on behalf of a member. However no precedent exists for such arguments and the policies reflected in EMI suggest the argument would fail. Again, weighty countervailing policies, such as federalism, are involved, and the subsidiary still has a state court action. It is doubtful a court would accept that argument either.

As the preceding discussion illustrates, standing principles will likely preclude the foreign parent from the federal courts. Additionally, in many states which provide refund actions only for the actual taxpayer, the parent is also precluded from the state courts. Likewise, the subsidiary is barred from the federal courts by the Injunction Act. Therefore, foreign parent corporations can only pursue their constitutional objections to the state tax through a state court action brought by the subsidiaries.

Although these corporations would likely succeed in litigation before the Supreme Court, disadvantages exist. The first disadvantage to litigation is the time factor. As previously discussed, the state administrative procedures are extensive and must be exhausted before reaching the state trial courts. The action may be litigated for several years before reaching the Supreme Court. Another disadvantage is expense. The costs of such long-term litigation from inception of the action in the state administrative procedures until the judicial resolution of the issue by the Supreme Court would be staggering.

Primary among the disadvantages is the lack of uniformity in a case-by-case evaluation of the state statutes. Because each state has different taxing statutes, any adjudication of constitutionality will apply only to the statute before the court. Therefore, if the end to be achieved is uniform limitation of state unitary taxation, litigation of constitutional challenges is not a desirable alternative. In light of the Supreme Court deferment to Congress, the passage of uniform legislation limiting state uniform taxation must be

169. See General Accounting Office (GAO), Key Issues Affecting State Taxation of Multijurisdictional Corporate Income Need Resolving, 16 TAX NOTES 159 (1982).
170. See DAILY TAX REPORTER (BNA), No. 183, G-1 & No. 234, G-5 (1982). Also, there is no guarantee that the Supreme Court will review the case after the administrative remedies have been exhausted.
171. GAO, supra note 169, at 161. See also DAILY TAX REPORTER (BNA), No. 233, G-5 (1983).
172. Moorman Mfg. Co. v. Bair, 437 U.S. 267, 280 (1978) ("It is to that body [Congress], and not this Court, that the Constitution has committed such policy decisions."). In light of the Supreme Court's refusal to grant standing in the Shell case (see supra note 164), foreign parents are forced to choose the legislative alternative.
PART III: PASSAGE OF NATIONAL UNIFORM LEGISLATION

A favorable alternative to litigation might be a preemptive federal law which would prohibit state unitary taxation of corporations with foreign parents. However, the constitutionality of congressional action limiting state taxing power is questionable in light of National League of Cities v. Usery. Moreover, despite the presence of policies supporting such a proposal, the states and some commentators have suggested many countervailing policies. This portion of the Comment analyzes two issues: first, whether a federal preemptive statute limiting state unitary taxation of foreign-based corporations would be a constitutional exercise under the Commerce Clause and second, whether, in light of the competing policy arguments advanced, Congress should adopt such a proposal.

The Impact of National League of Cities v. Usery On the Constitutionality of Congressional Control Over State Taxation

The constitutionality of any federal regulation limiting state taxation has fostered considerable speculation. In National League of Cities, Justice Rehnquist determined that Congress’s power to regulate commerce was not unlimited when Congress chooses to regulate the States as States. Justice Rehnquist found that Congress had limited constitutional power to regulate the states’ freedom of choice in areas of “integral governmental functions.” As a result, congressional governmental extension of minimum wage and maxi-

173. See Rudy, supra note 17, at 393. In terms of cost, lobbying and support of congressional action are much more efficient than litigation. As mentioned previously, the cost of the administrative burdens and state court remedies is staggering. The Federal Income Tax deduction for lobbying expenses (26 U.S.C. § 162(e) (1978)) acts as an added incentive for such corporations to engage in lobbying.

Another possible alternative is to lobby the individual states for a voluntary repeal of their unitary tax statutes. This alternative is being exercised (see DAILY TAX REPORTER (BNA), No. 40, G-4 (1984)), but it is unlikely that many states will abandon the method without pressure from Congress or the Executive Branch.

176. There was no majority opinion in Usery. Justice Rehnquist wrote for four members of the Court. Justice Blackmun concurred with the express understanding that the Rehnquist opinion adopted his balancing approach. The dissenters filed two separate opinions.
177. 426 U.S. at 855.
178. Id. at 852.
mum hours laws to state government employees was unconstitutional.

No case has yet decided whether the state taxation structure is a "traditional governmental function." Commentators, however, have suggested the state taxing power should qualify as a "traditional governmental function." If so, the Rehnquist approach would prohibit a congressional limitation of state taxing power. This protection has not materialized, however, because the Court will apply Justice Blackmun's "balancing approach" when considering possible congressional acts favoring uniform state taxation measures. In *Moorman Mfg. Co. v. Bair*, the Supreme Court upheld the single factor apportionment formula employed by Iowa. The Court noted, however, that the states' freedom to formulate independent policy in the area of unitary taxation is not unlimited:

[State independence] may have to yield to an overriding national interest in uniformity, and the content of any uniform rules to which they must subscribe should be determined only after due consideration is given to the interests of all affected States. It is clear that the legislative power granted to Congress by the Commerce Clause of the Constitution would amply justify the enactment of legislation requiring all States to adhere to uniform rules for the division of income.

This dicta indicates the Court will employ a "balancing approach" in considering the constitutionality of federal regulation of state taxation. This also implies the Court would support congressional establishment of uniform rules for income division. Previously, the Court directed future corporate plaintiffs to the congressional forums stating "[I]t is to [that] body, and not this Court, that the Constitution has committed such policy decisions."

179. See Parnell, *supra* note 175, at 238.
180. *Id.* Hartman, in his work on federal limitations on state taxing powers, commented that "[T]here is sufficient elasticity and indefiniteness in the Rehnquist rhetoric to warrant the conclusion that the present tax structure of the state and local governments are 'traditional ways in which the local governments have arranged their affairs,' so as to be shielded from congressional regulation." P. HARTMAN, *supra* note 106, at 687.
181. See *supra* note 176.
182. See Parnell, *supra* note 175, at 239-41.
184. *Id.* at 280.
185. See Parnell, *supra* note 175, at 240.
186. This conclusion can be drawn by weighing the state's interests against the national interests as expressed in *Japan Line Ltd. v. County of Los Angeles*, 441 U.S. 434 (1979). The national interest in free foreign trade, speaking with one voice, and preventing retaliation, would support the constitutionality of the congressional action also.
187. 437 U.S. at 280. Thus, it has been suggested that "the optimal congressional solution must strike that delicate balance between the sovereignty of the states to structure their tax laws to provide themselves with adequate revenues and the desirability of the minimum amount of interference on the national economy." Parnell, *supra* note 175, at 252. The Court has suggested it would uphold enactment of uniform rules which followed such careful consideration by Congress. 437 U.S. at 280.
Policies Opposing Congressional Enactment of Limitations on Unitary Apportionment

Opponents of congressional action limiting state unitary taxation frequently argue that businesses engaged in interstate commerce must pay their fair share of state taxes and the unitary method is an accurate means to calculate the fair tax liability. Their arguments against uniform federal legislation eliminating unitary taxation of corporations with foreign parents include: (1) constitutionality of restricting state taxing power, (2) general considerations of federalism, (3) the resulting loss in state revenue for the states, (4) the problems involved in state administration of the arms-length method, and (5) the creation of unfair advantages for "big business."

The constitutionality argument has been settled above in favor of uniform legislation. Opponents of the legislation argue the proposal would limit state sovereignty, and may serve as precedent for further encroachment on state taxing power. These arguments however, do not justify congressional inaction. First, the Moorman Court noticed these concerns when it suggested a uniform law. The Court expressly required that "due considerations [be] given to the interests of all attached States," as a prerequisite to passage of uniform laws. Therefore, opponents of the measure need not be concerned that Congress will run roughshod over state sovereignty.

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188. See generally House Hearings, supra note 15. The importance of state power to employ unitary taxation has been evident not only by the recent Supreme Court litigation but also by recent congressional attempts to enact such legislation.


192. See Parnell, supra note 175, at 230.

193. Id.

194. 437 U.S. at 280. The court implies in Moorman that congressional failure to consider state interests would destroy the constitutionality of such a law.

195. Any congressional exercise of the commerce power necessarily concerns the policies of federalism and comity. However, the Court implies in Moorman that there is a strong national interest that may justify enactment of the uniform measure. Id.; cf. Parnell, supra note 175, at 248-49. Mr. Parnell suggests that any restrictions on the states prohibiting the use of unitary taxation would severely restrict the state taxing power and should be declared an unconstitutional exercise of the commerce power. This fails, however, to take cognizance of the likelihood that unitary taxation as applied to foreign-based corporations is unconstitutional. On the basis of this unconstitutionality of the state tax, the author suggests that congressional action would not be unconstitutional.
The third point of opposition is the inherent decrease in state revenues. Estimates of such losses range as high as $485 million for California alone. However, the decrease in state revenues might be offset by increases in in-state investment and state tax revenues incited by abandonment of the unitary method. Furthermore, proponents argue that the increased income from use of the unitary method results from a distortion of income and should not be received by the states.

Another argument advanced in opposition to the legislation is the onerous problem incurred in administering the arms-length method. Proponents, however, have suggested that the congressional act include a provision providing the states the access to the Internal Revenue Service audits employing the arms-length method. This provision would greatly reduce the administrative burden on the states.

Opponents of the proposal also argue that the measure would provide to foreign corporations an unfair advantage over state and local business. They point to the manipulation by taxpayers that often

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Members of the European Community do not view the question as one of "states' rights," but as a failure of the United States to live up to its double-taxation treaties. Daily Tax Reporter (BNA), No. 242, G-8 (1983).

197. Id. at 34-35 (statement of Kenneth Cory); cf. Daily Tax Reporter (BNA), No. 40, G-4 (1984) where there is some question raised as to the accuracy of the $500 million figure.
198. House Hearings, supra note 15, at 139, 141-44 (statement of Senator Charles McC. Mathias, Jr.).
199. Id. at 4-6 (statement of Donald C. Lubick, Asst. Sec. of Treasury). Mr. Lubick furnished an example of a California banking enterprise causing $707,000 before taxes. When the state applied unitary apportionment on the basis of a questionable construction of "unitary business," the income was increased to $4,832,000. Therefore, the tax was $560,000, or a 79% tax rate. See San Diego Daily Transcript, Feb. 13, 1984, at IA, W1 5-6 (Kyocera Corp was taxed at 101% on California income when the apportionment formula was applied).
201. See House Hearings, supra note 15, at 146 (statement of Charles W. Wheeler). The provision would also remedy the state's potential inability to negotiate with foreign governments because the federal government has the requisite power to engage in the necessary negotiations. Cf. Container Corp. v. Franchise Tax Bd., 51 U.S.L.W. 4987, 4996 n.31 (U.S. June 27, 1983).
202. House Hearings, supra note 15, at 34-35 (statement of Kenneth Cory). The advantage for big business is that by operating in many jurisdictions it can manipulate its tax liability through its divisions while small unjurisdictional businesses have no such
occurs with the arms-length method. However, the alternative method is unitary apportionment which creates actual multiple taxation on instrumentalities of foreign commerce. The legislator is faced with balancing the threat of manipulation against the certainty of unconstitutional multiple taxation. With the assistance of the Internal Revenue Service audits, the balance swings to favor the legislation.

Policies Supporting Enactment of Uniform Legislation

The policy arguments supporting uniform legislation include: (1) the excessive administrative burden placed upon foreign parents created by unitary taxation, (2) the distortion of income levels and taxes through use of unitary taxation, (3) the multiple problem, (4) problems with finding a suitable definition for “unitary business,” (5) the disastrous effects upon federal trade policies brought by state unitary taxation, and (6) Congress is uniquely situated to strike a delicate policy balance, and the Supreme Court has committed the issue to Congress.

Proponents argue the individual filing requirements for state tax returns employing the unitary apportionment method place an excessive administrative burden upon foreign parent corporations that is not equally shared by corporations with domestic parents. The administrative burdens may be grouped into five categories: (1) conversion into United States dollars and accounting principles, (2) re-evaluation of properties held by the corporations, (3) difficulties incurred in complying with disclosure requirements, (4) lack of uniformity among the states, and (5) substantial compliance costs.

For corporations with foreign parents, substantial administrative burdens arise from the requirements that all values be converted into United States dollars and accepted United States accounting principles.

opportunities.

203. Id.

204. Id. at 5 (statement of Donald C. Lubick). Mr. Lubick notes that if a foreign nation such as Japan were to employ unitary taxation it would be an impossible burden to cope with for the U.S. corporations operating there. Further, Mr. Lubick suggests that the result would make it very difficult for the U.S. to continue as an important nation in world commerce.

205. Id. at 92-94 (California Guidelines).

206. Id. Properties must be valued in United States dollars.

207. See infra text accompanying note 212.

208. For purpose of analysis, this Comment refers to the California reporting guidelines appearing in the House Hearings.
pies be used. This requirement has been described as the source of a "horrendous" administrative burden for those corporations with foreign parents. In some instances, the cost of compliance may even be greater than the tax itself.

One of the most sensitive areas of discord concerning employment of the unitary tax method is the requirement that the parent disclose all information to the taxing authority. The problem is that many foreign governments have extensive secrecy laws regarding defense contracts restricting the publication of certain information. Reconciling these requirements results in an "operational nightmare" for foreign parents.

Furthermore, the costs incurred in preparing one type of return for the federal tax employing the internationally accepted method and then a separate return for states employing unitary taxation have caused disruption in trade and resulted in protest leveled by the Common Market countries.

Another argument advanced for the uniform legislation is the distortion of income levels and taxes for the United States-based subsidiaries created by the apportionment. The unitary apportionment theory assumes that the rate of return is uniform among the taxing jurisdictions. Although this assumption is valid when applied among the various states, it does not apply on a multinational level. The result of unitary apportionment of worldwide income is that when a higher return on overseas operations exists, more income is apportioned to the taxing state than actually earned there.

209. See House Hearings, supra note 15, at 92. For example, a European-based worldwide corporation with subsidiaries operating in California would prepare its accounting reports based on those principles and currency values of the parent’s home country. However, in order to comply with state unitary taxation, all values must be converted into United States dollars and all accounting must be reconsidered to insure compliance with United States accounting principles. Such an extreme burden will have to be endured even if the foreign corporation operates over 100 subsidiaries with only one operation in a unitary taxation state. Id. at 165 (statement of Paul W. Cook).

210. Id.

211. Id. at 360 (letter from Paolo Pansa Cedronio). Furthermore, the costs incurred in preparing one type of return for the federal tax, employing the internationally accepted method, and then a separate return for states employing unitary taxation have caused disruption in trade and resulted in protest leveled by the Common Market countries. Id. at 226 (statement by D.B. Ham mond).

212. Id. at 226 (statement by D.B. Hammond).


215. See supra note 199.


217. Id. at 4 (statement of Donald C. Lubick). This is because much larger salary and property values present in the U.S. distort the ratios resulting in exaggerated values from the three-factor formula. Once the income is distorted, so is the tax liability. See also statement of Dallas A. Hurston at 194; and supra note 60.

The actual multiple taxation problem, acknowledged by the Supreme Court in *Container*, has been cited by proponents as another reason supporting congressional limitation. The Common Market countries have urged Congress to enact legislation limiting unitary apportionment and double taxation to relieve the multiple taxation.\(^{219}\)

Lack of a uniform definition of "unitary business" and uniformity among state reporting guidelines have also been mentioned to justify legislation. In light of the Supreme Court's acceptance of the "three unities"\(^{220}\) test and reliance on "functional integration" in *Mobil* and *Exxon*, the first question seems largely moot.\(^{221}\) However, serious administrative burdens result from nonuniform "unitary business" definitions.\(^{222}\) In addition to the problems incurred in conversion and re-evaluation, the problems are magnified when the subsidiaries operate in many states employing different definitions and reporting guidelines.\(^{223}\)

Proponents of federal legislation argue that in federal foreign trade policy concerns, the same concerns supporting the "one voice" requirement in *Japan Line* support congressional limitations. First, continual state use of unitary taxation may result in worldwide retaliation against United States corporations with operations abroad.\(^{224}\)

Opponents of federal legislation suggest that although the values are distorted, United States labor may have contributed to the high rate of return in the foreign countries. Proponents counter arguing that such results are at best arbitrary and inequitable and should not be employed to calculate a fair tax base. *Id.* at 309 (statement of Joseph H. Guttentag).

219. *Id.* at 360 (letter from Paolo Pansa Cedronio). Opponents may counter that as recognized in *Container*, the arms-length method itself is no absolute guarantee against multiple taxation. Proponents argue that it is not the effect of multiple taxation alone, but the combination of multiple taxation with other factors that justifies limiting legislation. *Id.* at 146 (statement of Charles W. Wheeler). See *DAILY TAX REPORTER* (BNA), No. 242, G-7, G-8 (1983) & No. 29, G-4, G-5 (1984) (protests of the United Kingdom and Japan).


221. This is because the Supreme Court has accepted at best the "three unities" and the "functional integration" tests. *See supra* note 10.

222. *See supra* note 214.


224. *Id.* at 137-38 (statement of Senator Charles McC. Mathias, Jr.). Continual use could lead other countries which have rejected the method to now accept it to increase their tax revenues. *See L.A. Times*, Feb. 16, 1984, at 3, col. 1, concerning such an effort being undertaken by Japanese companies.

Second, foreign investment is plainly discouraged. Third, the method is incompatible with the internationally accepted method employed by the federal government. Fourth, and most significant, is the direct impediment that state unitary taxation places in the way of federal treaty negotiations.

Congress plays a unique role in this controversy. First, the Supreme Court has committed the problem to Congress, and President Reagan has formed a task force to study the problem. Additionally, Congress appears to be the only branch of federal government that can provide the forum for extensive debating, fact finding, and weighing of competing state and national interests prior to enacting legislation. Congress should investigate the possible solutions available and consider enactment of uniform legislation prohibiting state unitary taxation of subsidiaries of foreign corporations unless the states voluntarily agree to employ a different mode of taxation.

CONCLUSION

The recent constitutional challenges to state unitary taxation leveled by domestic-based multinational corporations reveal the tests applied by the Supreme Court to Due Process and Commerce Clause objections. Although the foreign parent corporation is itself precluded from litigating any claim with respect to the tax, the domestic subsidiary may press its claims, but only in the state courts. Application of the appropriate tests reveal that the application of unitary taxation to domestic subsidiaries of foreign corporations is a violation of the negative implications of the Commerce Clause. Practical considerations, however, limit the effectiveness of selecting litigation as the alternative to pursue to avoid consequences of unitary taxation.

The Supreme Court has committed to Congress the delicate bal-

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226. Id. at 291 (statement of John S. Nolan).
227. See, supra note 128 and accompanying text. In addition to the treaty with the United Kingdom, other treaties with major trading parties have been jeopardized by state employment of unitary tax principles. Proponents argue strongly that states' use of unitary apportionment in contrast to the federal government and other nations has precipitated foreign trade conflicts and requires congressional action. House Hearings, supra note 15, at 292 (statement of John S. Nolan).
230. See GAO, supra note 169 at 160-61.
231. In addition to the policy expressed in Moorman, see Chief Justice Burger's consent in ASARCO. The Chief Justice consented to those judgments only in reliance upon the Court's expressed statement that the Court's holding would not preclude future congressional action in this area. ASARCO, Inc. v. Idaho State Tax Comm'r, 438 U.S. 307 (1982).
ancing process that must be engaged in prior to passing any limiting legislation. Both proponents and opponents of pre-emptive legislation have suggested formidable policy considerations. In light of the unconstitutionality of the tax as applied to foreign-based corporations the balance favors the limiting legislation.

Pre-emptive legislation as a remedy, however, deals a harsh blow to the states. Therefore, the best compromise would be to pass legislation providing for increased state access to Internal Revenue Service audits, increased state information exchange, and better IRS policing of transactions, without directly limiting unitary taxation. This method will allow the states to repeal voluntarily their unitary statutes without suffering from corporate manipulation. In addition, it will supply the states necessary time to implement other systems to provide for losses in revenue. At the close of a congressionally imposed period, the Congress must pass pre-emptive legislation prohibiting unitary taxation of foreign-based corporations.

This system will place the burden on the states because they are now employing an unconstitutional tax. In the interests of states’ rights, it will allow the states considerable freedom to plan alternative tax policy prior to the ban, and result in equal treatment of all multinationals. Additionally, it will put an end to an unconstitutional tax and restore good relations with our foreign trading partners.

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232. The United Kingdom and several other trading partners have suggested they will provide more tax information if the states will abandon the unitary tax concept. DAILY TAX REPORTER (BNA), No. 59, G-7 (1984).