

NOTES

Desperate for Revenue: The States' Unconstitutional Use of the Unitary Method to Apportion the Taxable Income of Foreign Parent Corporations

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Introduction

Understanding the process by which each state determines the state income tax liability of multinational corporations can be a taxing subject in itself. This Note will analyze this complicated subject in simplified terms so that the reader can focus on the controlling question of whether the unitary method of taxation is constitutional.

Part I of this Note reviews briefly the basic methods that individual states use to determine the state income tax liability of multinational corporations and focuses on the worldwide combined reporting (WWCR) method or unitary method of taxation. California, Montana, North Dakota, and Alaska currently use this method to apportion the state income tax liability of multinational corporations. This section also provides definitions and explains the mechanics of the unitary method. Part II analyzes whether the unitary method is constitutional under the Foreign Commerce Clause and the Due Process Clause of the United States Constitution.

The Supreme Court recently ruled that states may use the unitary method to apportion the taxable income of a *United States* parent corporation with foreign subsidiaries.¹ The Court explicitly refused, however, to decide whether the method may be used constitutionally to apportion the income of *foreign* parent corporations with domestic subsidiaries.²

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1. *Container Corp. of Am. v. Franchise Tax Bd.*, 463 U.S. 159 (1983).

2. *Id.* at 189 n.26, 195 n.32.

This Note considers this unresolved issue and concludes that it is unconstitutional to use the unitary method of taxation to apportion the state income tax liability of a foreign parent corporation with domestic subsidiaries. It argues that the Court should rely on the precedent established in *Japan Line, Ltd. v. County of Los Angeles*³ and that the issue is distinguishable from the issue decided in *Container Corp. v. Franchise Tax Board*.⁴ The Note concludes that under the *Japan Line* test, the unitary method as applied to foreign parent corporations is an unconstitutional infringement of the Due Process and Commerce Clauses of the Constitution.

I. Definitions

This section reviews the two primary methods of attributing income tax to a taxing jurisdiction. Forty-five states use a formula to apportion the corporate income tax attributable to the state.⁵ The apportionment formulae differ widely among the states and take into account different factors in determining what income is attributed to the state.⁶

A. Methods of Allocating Income

There are two basic methods used to apportion the income of a multijurisdictional business to a particular state for income tax purposes: (1) separate accounting, or the arm's-length method; and (2) formulary apportionment.⁷ Under the arm's-length method, the taxing jurisdiction treats the separate affiliates of a business as wholly separate entities for purposes of determining the tax liability of each affiliate.⁸ All transactions between the members of the affiliated business must be conducted at "arm's-length," as though the affiliates were dealing with unrelated par-

3. 441 U.S. 434 (1979) (holding an ad valorem tax imposed on a foreign parent corporation unconstitutional under the Foreign Commerce Clause).

4. 463 U.S. 159 (1983).

5. *Review of the Unitary Method of Taxation: Hearings on S. 1113 and S. 1974 Before the Subcomm. on Taxation and Debt Management of the Senate Comm. on Finance*, 99th Cong., 2d Sess. 8 (1986) [hereinafter *Review of Unitary Method*].

6. Riccarda Heising, Comment, *Container Corp. of America v. Franchise Tax Board: The Constitutionality of State Power to Tax Multinational Corporations*, 16 LAW & POL'Y INT'L BUS. 299, 301 (1984) [hereinafter Comment, *Container Corp.*].

7. See JEROME R. HELLERSTEIN & WALTER HELLERSTEIN, STATE AND LOCAL TAXATION 454-59 (4th ed. 1979). See also Michael P. McAllister, Note, *The Controversy Over Worldwide Unitary Taxation: Legal, Economic, and Political Implications*, 9 SUFFOLK TRANS-NAT'L L.J. 265, 270 (1985) [hereinafter Note, *The Controversy*].

8. Walter Hellerstein, *State Income Taxation of Multijurisdictional Corporations: Reflections on Mobil, Exxon, and H.R. 5076*, 79 MICH. L. REV. 113, 117 (1980) [hereinafter *Taxation of Multijurisdictional Corporations*]. See also Note, *The Controversy*, supra note 7, at 270-71.

ties.⁹ The taxing jurisdiction may tax only the income which is reflected in the separate accounts of the corporation as arising from the operations of the demographic affiliate within the jurisdiction.¹⁰ The federal government and members of the international community favor this attribution method and use it to calculate the income tax liability of multinational corporations.¹¹

States, on the other hand, believe this method is unreliable and does not accurately reflect the amount of income from a multijurisdictional business that is attributable to a particular state. The primary argument against the separate accounting method is that "it endeavors to treat separately what is, in fact, inseparable."¹² The economic reality is that multinational businesses perform functions in various jurisdictions that are interdependent. Income is produced when the operations are combined and integrated. The states argue that it is impossible, therefore, to separate and allocate the income-producing functions from the non income-producing functions, as the separate accounting method seeks to do.¹³

Moreover, the states argue that when the arm's-length method is employed, corporations can shelter income in states or countries with low tax rates using ingenious accounting techniques.¹⁴ As a result, the states have unanimously rejected the arm's-length method for apportioning multijurisdictional business income.¹⁵

Because the arm's-length method is inherently difficult to apply, all states which tax corporate income have adopted a formula apportionment method for determining the income of a multijurisdictional corpo-

9. Hellerstein, *Taxation of Multijurisdictional Corporations*, *supra* note 8, at 117. See also *Barclays Bank Int'l, Ltd. v. Franchise Tax Bd.*, 275 Cal. Rptr. 626 (Cal. Ct. App. 1990), *petition for review granted*, 806 P.2d 308 (Cal. Feb. 28, 1991) (No. S019064), *rev'd*, 829 P.2d 279 (Cal. 1992). For recent developments in the *Barclays* case, see *infra* notes 215-23 and accompanying text. See also Note, *The Controversy*, *supra* note 7, at 271.

10. Note, *The Controversy*, *supra* note 7, at 271.

11. See 26 U.S.C. § 482 (1988); see also U.N. Model Double Taxation Convention Between Developed Countries and Developing Countries, arts. 7(1), 7(2), 9(2) (1980), U.N. Doc. No. ST/ESA/102, *reprinted in* 1 Tax Treaties (CCH) ¶ 1023 (1982); OECD Model Convention for the Avoidance of Double Taxation with Respect to Taxes on Income and Capital, arts. 7(2), 9(1) (1977), *reprinted in* 1 Tax Treaties (CCH) ¶ 151 (1980); see also *Container Corp. of Am. v. Franchise Tax Bd.*, 463 U.S. 159, 184, 187 (1983); see also Note, *The Controversy*, *supra* note 7, at 270.

12. Frank M. Keesling, *A Current Look at the Combined Report and Uniformity in Allocation Practices*, 42 J. TAX'N 106, 107 (1975).

13. See George H. Weissman, *Unitary Taxation: Its History and Recent Supreme Court Treatment*, 48 ALB. L. REV. 48, 51-52 (1983).

14. See Timothy C. Blank, Note, *A Proposed Application of the Compact Clause*, 66 B.U. L. REV. 1067, 1070-71 (1986).

15. See Jerome R. Hellerstein, *The Unitary Business Principle and Multicorporate Enterprises: An Examination of the Major Controversies*, 27 TAX EXECUTIVE 313, 315 (1975). See also Note, *The Controversy*, *supra* note 7, at 271.

ration taxable to the state.¹⁶ Formulary apportionment, first approved by the Supreme Court in 1920,¹⁷ involves the application of a formula to a multistate or multinational business to determine the income attributable to the state. Though used by all states that tax corporate income, the states employ different versions of formulary apportionment.

The WWCR method, or unitary tax method, is a method of formulary apportionment that applies a formula to a multinational unitary business' *worldwide* "income" to determine which portion is attributable to a given state. California law describes the unitary tax method as follows:

When the income of a taxpayer subject to the tax imposed under this part is derived from or attributable to sources both within and without the state the tax shall be measured by the net income *derived from* or *attributable to* sources within this state in accordance with the provisions of [this article].¹⁸

One commentator rationalizes the unitary method as follows: "Under the unitary business principle, when a multijurisdictional unitary business is doing business within a state, that state has the required nexus to both the in-state and out-of-state activities of the business and is, therefore, entitled to tax an apportioned share of all its income."¹⁹

Under the unitary method, the state treats affiliated businesses as a single unitary group and apportions a part of the worldwide income of the group to the state by applying a three-part formula. The formula compares the property, payroll, and sales figures for the group in the state to the property, payroll, and sales figures of the group worldwide to determine what percentage of the unitary group's property, payroll, and sales are located in the state.²⁰ This percentage is then applied to the worldwide income of the unitary group to determine the income taxable to the state.²¹ "Simply put, if 25 percent of the property, payroll, and sales of the unitary group is located in [the state], then 25 percent of the group's worldwide income is apportioned to [the state]."²²

The unitary method of taxation is not used by any other country in the world, nor by forty-one of the forty-five states which tax corporate

16. *Review of Unitary Method*, *supra* note 5, at 8. See Comment, Container Corp., *supra* note 6, at 301.

17. *Underwood Typewriter Co. v. Chamberlain*, 254 U.S. 113 (1920) (upholding a Connecticut law that based a business' taxable income to the state on the ratio of the value of the property owned by the business in the state to the value of all other property owned by the business).

18. CAL. REV. & TAX. CODE § 25101 (West 1992) (emphasis added).

19. Walter Hellerstein, *State Taxation of Interstate Business: Perspectives on Two Centuries of Constitutional Adjudication*, 41 TAX LAW. 37, 75 (1987).

20. See *Colgate-Palmolive Co. v. Franchise Tax Bd.*, 284 Cal. Rptr. 780, 783-84 (Cal. Ct. App. 1991).

21. *Id.*

22. *Id.*

income.²³ At one time, thirteen states used the unitary method.²⁴ Today, only four states retain the unitary method and all four allow corporations to choose the "water's-edge" alternative.²⁵

The water's-edge alternative is a method of formulary apportionment that is similar to the unitary method because it also measures income by averaging the payroll, property and sales figures of the corporation.²⁶ It differs from the unitary method, however, because it compares the payroll, property and sales figures in the state to the payroll, property and sales figures within the United States.²⁷

B. The Unitary-Business Principle

To withstand constitutional scrutiny, a state may apply an apportionment formula, including the unitary method, only to a unitary business.²⁸ Though the existence of a unitary business is critical to the valid application of the unitary method, the Court has not adequately defined what constitutes a unitary business.²⁹ Instead, the Court ordinarily defers to state court definitions of what constitutes a unitary business.³⁰ As long as the state definition is "within the realm of permissible judgment,"

23. 135 CONG. REC. E780 (daily ed. Mar. 14, 1989) (statement of Rep. Frenzel).

24. States that no longer use the unitary method, and their post unitary method code provisions, are Colorado, COLO. REV. STAT. § 39-22-303 (1990); Florida, FLA. STAT. ANN. § 220.135 (West 1984); Idaho, IDAHO CODE § 63-3027 (West 1991); Indiana, IND. CODE ANN. § 6-3-2-2 (Burns 1990); Massachusetts, MASS. GEN. L. ch. 63, § 38 (1986); New Hampshire, N.H. REV. STAT. ANN. § 77A:3 (1986); Oregon, OR. REV. STAT. §§ 314.280, 314.650 (1986); Utah, UTAH CODE ANN. § 59-13-78 (1986).

25. Alaska, California, Montana, and North Dakota still use the unitary method, but allow the corporation to elect either the water's-edge or unitary method of apportionment. See ALASKA STAT. §§ 43.20.065, 43.20.073 (1990); CAL. REV. & TAX. CODE §§ 25120-25140 (West 1992); MONT. CODE ANN. §§ 15-31-301, 15-31-305; N.D. CENT. CODE § 57-38-12 (1983 & Supp. 1991). See Carol Douglas, *State Tax Officials Debate Interstate Competition and Water's Edge Unitary*, 40 TAX NOTES 347, 349 (1988); Note, *Foreign Multinationals and the Commerce Clause: Should the States Mind Their Own Business?*, 41 TAX LAW. 785, 799 (1988). No two states' water's edge provisions are alike. Proponents of federal, rather than state-by-state, resolution of the unitary issue argue that the states retreat to the water's edge is not an adequate solution to the problem because the situation is still confusing to multinational corporations. *Review of Unitary Method*, *supra* note 5.

26. See CAL. REV. & TAX. CODE §§ 25101, 25110 (West 1992).

27. See *id.* For a discussion of California's water's-edge election see Ruurd G. Leegstra et al., *The California Water's-Edge Election*, 6 J. ST. TAX'N 195 (1987); Barclays Bank Int'l, Ltd. v. Franchise Tax Bd., 275 Cal. Rptr. 626 (Cal. Ct. App. 1990), *petition for review granted*, 806 P.2d 308 (Cal. Feb. 28, 1991) (No. S019064), *rev'd*, 829 P.2d 279 (Cal. 1992).

28. ASARCO, Inc. v. Idaho State Tax Comm'n, 458 U.S. 307, 320 n.14 (1982).

29. One commentator noted that because there are no easily ascertainable minimum requirements for a unitary business finding, a "unitary business in the end may simply be something that the Court knows when it sees." Walter Hellerstein, *State Income Taxation of Multijurisdictional Corporations, Part II: Reflections on ASARCO and Woolworth*, 81 MICH. L. REV. 157, 183-84 (1982) [hereinafter *Reflections on ASARCO*].

30. Container Corp. of Am. v. Franchise Tax Bd., 463 U.S. 159, 175 (1983).

the Court will not interfere with it.³¹ In fact, in all but two cases, the Supreme Court has upheld the states' determinations of what comprises a unitary business.³² By allowing the states to formulate their own definitions, the Court essentially reaffirms its position that the states should be free to tax businesses by any method that reasonably relates income to the in-state activities of a business.³³

The Supreme Court considers a variety of factors in deciding whether a state designation of a unitary business is appropriate.³⁴ The Court essentially reviews the "underlying economic realities of a unitary business" to determine whether the functional departments of a business are really "discrete business enterprise[s]" or whether they are a unitary business.³⁵

A central inquiry is whether the profits from a group of affiliated businesses are the result of "functional integration, centralization of management, and economies of scale."³⁶ Although this analysis involves many considerations, the Court has established a three-prong test to assist it in determining if a unitary business exists.³⁷ Under the three-unities test, a group of affiliated businesses is generally unitary if there is (1) unity of ownership, (2) unity of operation, and (3) unity of use of its centralized executive force and general system of operation.³⁸ Unity of

31. *Container*, 463 U.S. at 176 (citing *Norton Co. v. Department of Revenue*, 340 U.S. 534 (1951)). See Note, *The Controversy*, *supra* note 7, at 272.

32. In *ASARCO, Inc. v. Idaho State Tax Comm'n*, 458 U.S. 307, 320-24 (1982), Idaho claimed that ASARCO and certain of its subsidiaries in which it held minority or bare majority interests constituted a unitary business. The Supreme Court rejected this contention on the ground that the partial subsidiaries were not even minimally controlled by ASARCO and were actually passive investments. *Id.*

In *F.W. Woolworth Co. v. Taxation and Revenue Dep't*, 458 U.S. 354, 363 (1982), the Court rejected New Mexico's attempt to broaden the definition of unitary business to include all income from operations that related to or contributed to the corporation's business in any way. *Id.* *Woolworth* involved one partially owned subsidiary and three wholly owned subsidiaries.

These cases generally are considered deviant cases whose applicability is restricted to their individual fact situations. See *Reflections on ASARCO*, *supra* note 29, at 191-92. The decision by the Court in *Container* that California's finding of a unitary business was reasonable is now the established precedent. See Joel M. Greene, *ASARCO and Woolworth: Anomalous Anachronisms with Limited Precedential Value*, 18 TAX NOTES 795 (1983).

33. See Heising, *supra* note 6, at 312-13.

34. See *Exxon Corp. v. Department of Revenue*, 447 U.S. 207, 223-25 (1980); see also E. George Rudolph, *State Taxation of Interstate Business: The Unitary Business Concept and Affiliated Corporate Groups*, 25 TAX L. REV. 171 (1970).

35. *Exxon Corp.*, 447 U.S. at 223-24 (quoting *Mobil Oil Corp. v. Commissioner of Taxes*, 445 U.S. 425, 439, 441 (1980)).

36. *Mobil Oil Corp. v. Commissioner of Taxes*, 445 U.S. 425, 438 (1980), quoted in *Container Corp. of Am. v. Franchise Tax Bd.*, 463 U.S. 159, 179.

37. *Butler Bros. v. McColgan*, 111 P.2d 334 (Cal. 1941), *aff'd*, 315 U.S. 501, 508 (1942).

38. *Id.* at 341. Butler Brothers' subsidiaries were considered a unitary business based on the finding that they were integrated because of unity of ownership, centralized management, and the operation of a centralized purchasing division. *Id.*

ownership usually exists when there is fifty percent or more common stock ownership, that is, when at least fifty percent of the *voting* stock of two or more corporations is owned by one taxpayer.³⁹ Unity of operation exists if the affiliated businesses use central purchasing, advertising, accounting, or management divisions.⁴⁰ Unity of use occurs when the affiliated businesses share staff, particularly executives, and general operational systems.⁴¹ California adds a fourth unity: strong central management coupled with the existence of centralized departments for such functions as financing, advertising, research or purchasing.⁴²

Admittedly, these are not very clear guidelines, but the Court specifically has refused to adopt a "bright line" test.⁴³ In *Container Corp. of America v. Franchise Tax Board*, the Court acknowledged that functional integration, centralization of management, and economies of scale are key factors in the unitary business analysis. The Court stated, however, that "[t]he prerequisite to a constitutionally acceptable finding of unitary business is a flow of value, not a flow of goods."⁴⁴

In sum, the unitary business analysis is very fact intensive and depends on the circumstances of each particular case. There are no hard and fast rules, only guidelines. This Note assumes *arguendo* that the states correctly apply the unitary method only to unitary businesses. The question addressed here is whether the unitary method, as an apportionment formula, can be applied constitutionally to foreign unitary businesses.

II. Constitutional Concerns

The Supreme Court first approved formulary apportionment as a method for attributing business income in 1920.⁴⁵ More recently, the Court considered the validity of using the unitary apportionment method to apportion the income of United States corporations that have foreign subsidiaries.⁴⁶

39. Leegstra, *supra* note 27, at 252.

40. *Butler Bros.*, 315 U.S. at 508.

41. Leegstra, *supra* note 27, at 253.

42. *Mole-Richardson Co. v. Franchise Tax Bd.*, 269 Cal. Rptr. 662, 667 (Cal. Ct. App. 1990).

43. *Container Corp. of Am. v. Franchise Tax Bd.*, 463 U.S. 159, 178 (1983). Container Corporation suggested that a "bright line" test should be adopted whereby a "substantial flow of goods between a parent corporation and its subsidiary would be required for a unitary business to exist." *Id.* at 179. Although the Supreme Court refused to impose this "bright line" test on all of the states, it did not preclude individual states from adopting such a test. *Id.* at 178 n.17. In fact, at least one state has adopted such a test. *See, e.g., Commonwealth v. ACF Indus., Inc.*, 271 A.2d 273 (Pa. 1970).

44. *Container*, 463 U.S. at 178-79.

45. *Underwood Typewriter Co. v. Chamberlain*, 254 U.S. 113 (1920).

46. *Container Corp. of Am. v. Franchise Tax Bd.*, 463 U.S. 159 (1983). Container Corporation is a vertically integrated company which manufactures custom-ordered paperboard

In *Container Corp. of America v. Franchise Tax Board*, the Court held that the unitary method of taxation as applied to domestic parent companies with foreign subsidiaries is constitutional.⁴⁷ The Court essentially approved the imposition of an income tax on United States corporations based on income earned outside of the United States. The Court decided three issues in reaching this conclusion: (1) Container Corporation was a unitary business,⁴⁸ (2) California's unitary tax method fairly apportioned income to the state,⁴⁹ and (3) California was not obligated by the Foreign Commerce Clause to employ the "arm's-length" method of attributing income.⁵⁰

The Court has not decided whether it is constitutional for the states to use the unitary method to apportion the income of a United States subsidiary of a foreign-based multinational company.⁵¹ The Court had the opportunity to address the issue in two cases, but instead dismissed them both on the ground that the foreign parent corporation lacked

packaging. *Id.* at 171. Incorporated in Delaware with headquarters in Chicago, Container controlled foreign subsidiaries in four Latin American countries and four European countries at the time of the imposition of the unitary tax method by the California Franchise Tax Board. *Id.* at 163, 171. The corporation's ownership interest in these foreign subsidiaries ranged from 66.7% to 100%. *Id.* at 171.

47. *Container*, 463 U.S. 159. This was a 5-3 decision, with Chief Justice Burger, Justice Powell, and Justice O'Connor dissenting. *Id.* at 197. Justice Stevens took no part in the consideration or decision of the case. *Id.*

48. *Container*, 463 U.S. at 180.

49. *Id.* at 180-84. In determining that the three-factor formula used by California was fairly apportioned, the Court relied on the assumption that any method of taxation would inevitably lead to some problems. *Id.* at 183. The Court reasoned that:

Of course, even the three-factor formula is necessarily imperfect. But we have seen no evidence demonstrating that the margin of error (systematic or not) inherent in the three-factor formula is greater than the margin of error (systematic or not) inherent in the sort of separate accounting urged upon us by appellant.

Id. at 183-84. Container offered statistics showing that using three-factor WWCR formula to apportion income resulted in gross distortions in income. *Id.* at 184. The Court reviewed tables that compared income determinations under the WWCR method and the separate accounting method. *Id.* at 184, 174 n.11, 175 n.12. The Court concluded that using the WWCR method only increased the amount of taxable income to California by 14% and found that this was "within the substantial margin of error inherent in any method of attributing income among the components of a unitary business." *Id.* at 184. As a result, the Court excused the distortion of income which WWCR could potentially cause as not outrageous enough to require reversal. *Id.* at 183-84.

50. *Id.* at 184-97.

51. The Court in *Container* explicitly left this question open, stating that "[w]e 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." *Container Corp. of Am. v. Franchise Tax Bd.*, 463 U.S. 159, 189 n.26 (1983).

standing to challenge California's unitary method.⁵²

Recently, in *Franchise Tax Board v. Alcan Aluminum Ltd.*,⁵³ the Supreme Court considered whether a foreign parent corporation had standing to challenge the unitary tax imposed on its domestic subsidiaries. The Court set forth two necessary components for standing: (1) Article III standing and (2) "non constitutional prudential considerations."⁵⁴ The Court granted Article III standing on the ground that foreign parent corporations are threatened with financial injury when the unitary method is used to calculate the tax liability of their domestic subsidiaries.⁵⁵ The Court did not determine whether the non constitutional prudential requirements for shareholder standing were met.⁵⁶ The Court simply stated that such a decision was unnecessary in light of the fact that the case was barred by the Tax Injunction Act, even if Alcan Aluminum Limited (Alcan) did have standing.⁵⁷

Removing this procedural obstacle, the Court imposed yet another procedural hurdle. In *Alcan*, the Court remanded the case to state court on the ground that the federal action was barred by the Tax Injunction Act.⁵⁸ In this case, Alcan was a Canadian company and indirect sole shareholder of Alcan Aluminum Corporation (Alcancorp), incorporated in Ohio with operations in California. Alcan sought declaratory and injunctive relief from California's use of the unitary method on the ground that it violated the Foreign Commerce Clause.⁵⁹ Instead of deciding the issue, the Supreme Court deferred to the California courts. The Court held that the action in federal court was barred by the Tax Injunction Act which provides that "[t]he district courts shall not enjoin, suspend or restrain the assessment, levy or collection of any tax under State law where a plain, speedy and efficient remedy may be had in the courts of

52. *Shell Petroleum, N.V. v. Graves*, 709 F.2d 593 (9th Cir. 1983), *cert. denied*, 464 U.S. 1012 (1983); *EMI Ltd. v. Bennett*, 738 F.2d 994 (9th Cir. 1984), *cert. denied*, 469 U.S. 1073 (1984).

Shell contended that the 1956 Treaty of Friendship, Commerce, and Navigation between the Netherlands and the United States prevented California from utilizing the unitary method to apportion its taxable income. The Ninth Circuit refused to consider the argument, affirming the district court's dismissal on the ground that, as the majority shareholder, Shell lacked standing to sue. *Shell Petroleum*, 709 F.2d at 595-96.

Likewise, *EMI* was dismissed on the ground that EMI, as a shareholder, did not have standing to bring the action. *EMI*, 738 F.2d at 996-98.

53. 493 U.S. 331 (1990).

54. *Id.* at 335.

55. The Court reasoned that if the unitary method illegally assesses taxes and results in a higher tax liability for the domestic subsidiaries, the foreign parent corporations would be injured because it would reduce the return on their investments in the subsidiaries and would lower the value of their stockholdings in the subsidiaries. *Id.* at 336.

56. *Id.* at 336-41.

57. *Id.* at 338.

58. *Id.*

59. *Id.* at 334.

such State.”⁶⁰ The Court found that California law allows taxpayers, who feel that a tax assessed against them is invalid, to bring a claim for a refund under section 26102 of the California Revenue and Taxation Code.⁶¹ The Court rejected Alcan’s argument that the California courts would not entertain foreign commerce claims made by its subsidiaries on the ground that there was no evidence that the courts had done so in the past.⁶² In conclusion, the Court held that mere speculation that the California courts would not entertain the claims of Alcan’s subsidiaries was not sufficient to allow the federal court to retain the action.⁶³

Recently, in *Barclays Bank Int’l, Ltd. v. Franchise Tax Board*, the California Court of Appeals considered the foreign parent issue for the first time.⁶⁴ The court decided that California’s use of the unitary method to apportion the tax of the United States subsidiaries of foreign parent corporations was unconstitutional.⁶⁵ The California Supreme Court has recently reviewed this case.⁶⁶

A. Foreign Commerce Clause

Opponents of the unitary method frequently argue that it violates the Foreign Commerce Clause.⁶⁷ The Foreign Commerce Clause authorizes Congress to regulate commerce with foreign nations.⁶⁸ The Commerce Clause provides Congress with power “[t]o regulate Commerce with foreign Nations, and among the several States, and with the Indian Tribes.”⁶⁹

In *Complete Auto Transit, Inc. v. Brady*, the Supreme Court established a four-prong test to determine whether a method of taxation is constitutional under the Commerce Clause.⁷⁰ Under this test, a state may constitutionally apply a method of taxation to a business if (1) the business’ activities have a “substantial nexus” with the state, (2) the tax is fairly apportioned, (3) the tax does not discriminate against interstate commerce, and (4) the tax is fairly related to the services provided by the state.⁷¹

60. *Id.* at 338 (citing 28 U.S.C. § 1341 (1982)).

61. *Id.* at 340.

62. *Id.*

63. *Id.* at 341.

64. 275 Cal. Rptr. 626 (Cal. Ct. App. 1990), *petition for review granted*, 806 P.2d 308 (Cal. Feb. 28, 1991) (No. S019064), *rev’d*, 829 P.2d 279 (Cal. 1992). For recent developments in the *Barclays* case see *infra* notes 215-23 and accompanying text.

65. *Id.*

66. 806 P.2d 308 (Cal. Feb. 28, 1991) (No. S019064).

67. See *Container Corp. of Am. v. Franchise Tax Bd.*, 463 U.S. 159 (1983); *Franchise Tax Bd. v. Alcan Aluminum Ltd.*, 493 U.S. 331 (1990); *Barclays Bank*, 275 Cal. Rptr. at 628-29.

68. See *Container Corp.*, 463 U.S. at 185; *Barclays Bank*, 275 Cal. Rptr. at 628-29.

69. U.S. CONST. art. I, § 8, cl. 3.

70. 430 U.S. 274 (1977).

71. *Id.* at 279.

The Court in *Japan Line, Ltd. v. County of Los Angeles* established two additional requirements to determine whether a tax is constitutional as applied to instrumentalities of foreign commerce.⁷² The tax must not create a “substantial risk of international multiple taxation,”⁷³ and must not interfere with federal uniformity in foreign relations by preventing the federal government “from ‘speaking with one voice when regulating commercial relations with foreign governments.’”⁷⁴

The unitary method affects foreign commerce when it is used to tax the domestic subsidiaries of foreign corporations. In such a case, the tax must satisfy both the *Complete Auto* and *Japan Line* tests in order to be constitutionally permissible. As discussed below, the unitary method does not satisfy these tests and is unconstitutional as applied to the domestic subsidiaries of foreign parent corporations.

1. *The Complete Auto Test*⁷⁵

Under the first prong of the *Complete Auto* test, the activities of a business must have a “substantial nexus” with the taxing state in order for the state to impose a tax on the business.⁷⁶ In order to satisfy this requirement, the state must prove that there is a minimal connection between the activities of the business and the taxing state. There must also be a rational relationship between the income attributed to the state and the intrastate values of the enterprise.⁷⁷

Second, the tax must be fairly apportioned.⁷⁸ A tax is fairly apportioned if the state’s apportionment formula approximates the amount of business income properly attributable to the corporation’s business activities within the state.⁷⁹ Under this prong, the Court will not find that a formula is unfair as applied unless it appears by “clear and cogent evidence” that it yields a “grossly distorted” result.⁸⁰ Specifically, the plaintiff must show that there is “no rational relationship between the income

72. 441 U.S. 434 (1979).

73. *Id.* at 451.

74. *Id.* at 451.

75. *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274 (1977).

76. *Id.* at 279. See Weissman, *supra* note 13, at 78. This is also a due process concern and is discussed *infra* in part II.B.

77. *Moorman Mfg. Co. v. Bair*, 437 U.S. 267 (1978). See also Weissman, *supra* note 13, at 78.

78. *Complete Auto*, 430 U.S. at 279.

79. *Hans Rees’ Sons, Inc. v. North Carolina ex rel. Maxwell*, 283 U.S. 123, 135 (1931). See also *Exxon Corp. v. Department of Revenue*, 447 U.S. 207, 223-25 (1980) (state may apply an apportionment formula to the total income of a unitary business to determine income attributable to activities conducted within the state).

80. *Container Corp. of Am. v. Franchise Tax Bd.*, 463 U.S. 159, 164 (1983) (quoting *Exxon Corp.*, 447 U.S. at 221, quoting *Butler Bros. v. McColgan*, 315 U.S. 501, 507 (1942), quoting *Norfolk & W. Ry. v. North Carolina ex rel. Maxwell*, 297 U.S. 682, 688 (1936)).

attributed to the state and the intrastate values of the enterprise.”⁸¹

Third, the application of the tax may not discriminate against interstate or foreign commerce.⁸² The Court briefly addressed this issue in *Container* and suggested that under certain circumstances a tax might be invalid if it was substantially different from methods used by other jurisdictions.⁸³ Specifically, a tax could be struck down if it resulted in multiple taxation of income in various jurisdictions.⁸⁴ The tax might also be invalid if it resulted in a higher tax burden than if the business was conducted in a single jurisdiction.⁸⁵

The Court concluded that a tax method that differs from other state attribution methods is not invalid solely because it differs from other methods.⁸⁶ The Court did not decide, however, whether the unitary method, which substantially differs from the federal government and internationally accepted arm’s-length method, is invalid.⁸⁷ The Court reserved judgement on the question, stating that: “a more searching inquiry is necessary when we are confronted with the possibility of international double taxation.”⁸⁸

Finally, in order to satisfy the requirements of *Complete Auto*, the tax must be fairly related to the services provided by the state.⁸⁹ The test is “whether the taxing power exerted by the state bears fiscal relation to the protection, opportunities and benefits given by the state. That simple but controlling question is whether the state has given anything for which it can ask return.”⁹⁰

2. *The Japan Line*⁹¹ Test for Instrumentalities of Foreign Commerce

The state must satisfy two additional requirements before a tax can be applied constitutionally to “instrumentalities of foreign commerce.”⁹² The tax must not create a “substantial risk of international multiple taxation,”⁹³ and must not interfere with federal uniformity in foreign relations by preventing the federal government “from ‘speaking with one voice when regulating commercial relations with foreign

81. *Container*, 463 U.S. at 180 (quoting *Exxon Corp.*, 447 U.S. at 220).

82. *Complete Auto*, 430 U.S. at 278-79; *Container*, 463 U.S. at 170.

83. *Container*, 463 U.S. at 170-71.

84. *Id.*

85. *Id.*

86. *Id.* at 171.

87. *Id.* at 189 n.26.

88. *Id.* at 171.

89. *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274, 279 (1977).

90. *ASARCO, Inc. v. Idaho State Tax Comm’n*, 458 U.S. 307, 315 (1982) (quoting *Wisconsin v. J.C. Penney Co.*, 311 U.S. 435, 444 (1940)).

91. *Japan Line, Ltd. v. County of Los Angeles*, 441 U.S. 434 (1979).

92. *Id.* at 446.

93. *Id.* at 451.

governments.’ ”⁹⁴

In *Japan Line*, the Court held that a California property tax was unconstitutional as applied to cargo containers owned by Japanese shipping companies.⁹⁵ The containers were used exclusively in foreign commerce and were based, registered, and subject to property tax in Japan. The Court held that the tax violated the Commerce Clause because it resulted in “multiple taxation of instrumentalities of foreign commerce . . . and prevents this Nation from ‘speaking with one voice’ in regulating foreign trade and thus is inconsistent with the Congress’ power to ‘regulate commerce with foreign Nations.’ ”⁹⁶

The argument that the unitary method, as applied to the domestic subsidiaries of foreign parent corporations, violates the Foreign Commerce Clause primarily focuses on these two *Japan Line* factors.⁹⁷ The emphasis on these factors in recent cases is understandable because the unitary method, as applied to the domestic subsidiaries of foreign parent corporations, does not satisfy the *Japan Line* requirements and is unconstitutional under the Foreign Commerce Clause.⁹⁸

a. Substantial Risk of Multiple Taxation

When considering the validity of taxes imposed on domestic corporations, the Court has construed broadly *Japan Line*’s prohibition of taxes that create a substantial risk of multiple taxation.⁹⁹ In *Container*, Container Corporation unsuccessfully argued that the unitary method violated the Foreign Commerce Clause because it resulted in double taxation.¹⁰⁰ The Court admitted that imposition of the unitary method “has resulted in actual double taxation,”¹⁰¹ but found that the unitary method did not “inevitably” lead to double taxation and, thus, withstood Container’s constitutional challenge.¹⁰² The Court in *Container* ac-

94. *Id.*

95. *Id.*

96. *Id.* at 435 (citations omitted).

97. See *Container Corp. of Am. v. Franchise Tax Bd.*, 463 U.S. 159 (1983); *Franchise Tax Bd. v. Alcan Aluminum Ltd.*, 493 U.S. 331 (1990); *Barclays Bank Int’l, Ltd. v. Franchise Tax Bd.*, 275 Cal. Rptr. 626 (Cal. Ct. App. 1990), *petition for review granted*, 806 P.2d 308 (Cal. Feb. 28, 1991) (No. S019064), *rev’d*, 829 P.2d 279 (Cal. 1992). For recent developments in the *Barclays* case, see *infra* notes 215-23 and accompanying text..

In fact, the Court in *Japan Line* did not decide the constitutionality of the California ad valorem tax under the four-prong test of *Complete Auto* and only briefly referred to the test. *Japan Line*, 441 U.S. at 445, 451. Likewise, in *Container*, the Court did not even mention the *Complete Auto* test. See *Container Corp. of Am. v. Franchise Tax Bd.*, 463 U.S. 159 (1983).

98. See *Container*, 463 U.S. at 185-96; *Franchise Tax Bd. v. Alcan Aluminum Ltd.*, 493 U.S. 331 (1990).

99. *Container*, 463 U.S. at 193.

100. *Id.* at 189-93.

101. *Id.* at 187.

102. *Id.* at 190-93.

knowledged the concern expressed in *Japan Line* regarding double taxation of foreign entities but reasoned that this did not proscribe absolutely state taxation resulting in multiple taxation.¹⁰³ The Court circumvented the dictate of *Japan Line* by deciding that it must consider the context in which the double taxation occurred and the alternatives available to the state when assessing the validity of the tax.¹⁰⁴ Thus, rather than review the unitary method on its own merits, the Court insisted that the alternative, the arm's-length method, was also likely to result in double taxation.¹⁰⁵ The Court concluded that a strict interpretation of *Japan Line's* admonition against double taxation was not plausible because any available method of taxation presented a substantial risk of multiple taxation.¹⁰⁶ The Court stated that "it would be perverse, simply for the sake of avoiding double taxation, 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."¹⁰⁷

In applying this different standard, the Court in *Container* distinguished the case from *Japan Line*.¹⁰⁸ First, it found that the tax in *Japan Line* was a property tax rather than an income tax.¹⁰⁹ It also found that the California income tax imposed on *Container* did not inevitably result in multiple taxation, unlike the tax in *Japan Line*.¹¹⁰ Finally, the tax in *Container* fell on a domestic-based corporation rather than a foreign-based corporation.¹¹¹

Although the *Container* court was able to overlook and excuse the double taxation of a domestic corporation, it should not tolerate the multiple taxation of foreign-based corporations.¹¹² The Court in *Japan Line*

103. *Id.* at 189.

104. *Id.*

105. *Id.* at 191.

106. *Id.* The validity of this deduction has been questioned. Some argue that even if the arm's-length method potentially results in multiple taxation, the application of the same method by the different taxing jurisdictions will more likely avoid overlapping of tax liability than if the jurisdictions use opposing methods of attributing income. Thus, the best way to avoid multiple taxation is to prohibit the use of widely varying attribution methods (*i.e.*, the unitary method). See Philip T. Kaplan, *The Unitary Tax Debate, The United States Supreme Court, and Some Plain English*, 10 J. CORP. TAX'N 283, 291 (1984).

107. *Container*, 463 U.S. at 193.

108. *Container*, 463 U.S. at 187-96.

109. *Id.* at 187-88.

110. *Id.* at 188-93. In *Japan Line*, both Japan and California claimed the right to tax the containers in part. *Japan Line, Ltd. v. County of Los Angeles*, 441 U.S. 434, 451-52 (1979). The Court refused to allow California to impose its tax on the containers, reasoning that taxes must be apportioned among taxing jurisdictions so that no instrument of commerce can be taxed more than once on its value. *Id.* at 444. The Court struck down California's use of the ad valorem tax on the ground that it resulted in multiple taxation because Japan had fully taxed the containers. *Id.* at 452.

111. *Container*, 463 U.S. at 188.

112. See *Container*, 463 U.S. at 189.

specifically mandated that a state tax which affects foreign commerce is subject to greater scrutiny than one that affects only domestic commerce.¹¹³ Furthermore, the Court stated that “[e]ven a slight overlapping of tax—a problem that might be deemed *de minimis* in a domestic context—assumes importance when sensitive matters of foreign relations and national sovereignty are concerned.”¹¹⁴ Accordingly, in *Japan Line* the Court found that the ad valorem tax was unconstitutional because it resulted in double taxation.¹¹⁵

The issue of whether the unitary method survives scrutiny under the Foreign Commerce Clause when it is applied to the domestic subsidiary of a foreign parent corporation remains unresolved because the Court has not decided whether to follow the precedent established in *Container* or the precedent established in *Japan Line*. The Court in *Japan Line* specifically restricted its decision to situations involving foreign companies involved exclusively in international commerce.¹¹⁶ It reserved judgement regarding the “taxability of foreign-owned instrumentalities engaged in interstate commerce.”¹¹⁷ Likewise, the Court in *Container* specifically refrained from deciding whether the unitary method could be used to tax the domestic subsidiaries of foreign parent corporations.¹¹⁸ The unitary method is unconstitutional, however, under both the *Japan Line* test and the *Container* test (which modifies *Japan Line* slightly by providing for a contextual analysis of the taxing method based on the alternative reasonable taxing methods available).

First, under *Container*, the unitary method is unconstitutional when it is applied to the domestic subsidiaries of foreign parent corporations because a reasonable alternative taxing method exists. The three available alternatives to the unitary method are the arm’s-length method, the separate-allocation method, and the water’s-edge method. The arm’s-length method and the separate-allocation method are not, for reasons discussed earlier, reasonable alternatives available to the states for attributing the income of multinational corporations.¹¹⁹ The “water’s-edge” method, however, is a reasonable alternative.¹²⁰ If the states used the water’s-edge method, problems of multiple taxation would diminish considerably because the states determine the tax liability based on the property, payroll and sales that occur within the continental United States. Because

113. *Japan Line*, 441 U.S. at 447-48.

114. *Id.* at 456.

115. *Id.* at 451-54.

116. *Id.* at 444.

117. *Id.* at 444 n.7.

118. *Container Corp. of Am. v. Franchise Tax Bd.*, 463 U.S. 159, 189 n.26, 195 n.32 (1983).

119. See Eric J. Coffill, *Differences in Productivity and Profitability: A Response to Allegations of the Misattribution of Income in the Application of California’s Worldwide Unitary Method*, 5 INT’L TAX & BUS. LAW. 246 (1987); *supra* notes 7-15 and accompanying text.

120. See *supra* notes 26-27 and accompanying text.

no other foreign nation utilizes the unitary method, the income produced in the United States is not part of the tax base used to calculate tax liability in the foreign country. If the taxing authority of the states was limited to the water's-edge method, then theoretically only the states would be taking United States property, payroll, and sales factors into account in the tax base. This would avoid international double taxation since the foreign country would include only income earned in the country in its tax base. Because the water's-edge method is a reasonable alternative taxing method for taxing the income of the domestic subsidiaries of a foreign parent corporation, the unitary method should be deemed unconstitutional under *Container* in this context.

Japan Line concerned a foreign parent company involved in foreign commerce. Therefore, the constitutionality of the unitary method, as applied to the domestic subsidiary of a foreign parent corporation, is more appropriately analyzed under the *Japan Line* test. In *Container*, the tax was imposed on a United States-based foreign parent corporation. Hence, the foreign policy implications were not as severe. The requirement of *Container* that a taxing method must *inevitably* result in double taxation before it is held unconstitutional may appropriately be applied to domestic corporations. When a tax is imposed on a foreign parent corporation, however, the more lenient test enunciated by the Court in *Japan Line* should be used: a tax that substantially increases the risk of international multiple taxation is unconstitutional.¹²¹ Under this test, the unitary method as applied to the domestic subsidiaries of foreign parent corporations creates a substantial risk of multiple taxation and, thus, violates the Foreign Commerce Clause.

States apply apportionment formulas, in part, to reduce the risk of multiple taxation. If all countries utilized the same method of formulary apportionment, multiple taxation would be avoided. In reality, however, all other countries use some form of arm's-length method to attribute and tax corporate income earned within their borders. The unitary method reaches within those same borders to apportion income, inevitably resulting in multiple taxation.¹²²

Complicating this problem is the fact that when a state imposes an income tax based on the unitary method it does not adjust liability to account for the tax burden borne by the corporation in other jurisdictions.¹²³ Moreover, foreign governments do not, in most instances, take into account corporate income taxes paid by foreign corporations to indi-

121. *Japan Line*, 441 U.S. at 434. See Winthrop S. Smith Jr., Comment, *Constitutional Law—Commerce Clause—State Apportionment Tax Laws—Container Corp. of America v. Franchise Tax Board*, 30 N.Y.L. SCH. L. REV. 193, 216 (1985).

122. See Kirsten Schlenger, Note, *State Worldwide Unitary Taxation: The Foreign Parent Case*, 23 COLUM. J. TRANSNAT'L L. 445, 462-65 (1985) (arguing that multiple taxation is the necessary result when foreign parent corporations are involved).

123. See Kaplan, *supra* note 106, at 292.

vidual states.¹²⁴ If the foreign country exercises full taxing powers over its domicile corporation and a state apportions tax liability based on the income earned abroad by the same foreign multinational corporation, the inequitable result is that both jurisdictions tax the same income without providing for any deductions for taxes paid in the other jurisdiction.¹²⁵ One commentator summarized the problem as follows: "The use of worldwide unitary taxation necessarily results in international double taxation; once by the host country and again by the State using the method."¹²⁶

b. The One-Voice Doctrine

The unitary method presents another constitutional problem. It not only results in double taxation, it also violates the second requirement of *Japan Line* because it prevents the federal government from speaking with one voice when regulating commercial relations with foreign governments.

The states generally are allowed to impose taxes on commerce absent federal preemptive legislation or special considerations that require uniformity in foreign affairs.¹²⁷ The federal government, however, has the power to act when a state tax interferes with its ability to regulate foreign commerce. In *Japan Line*, the Court found that a state tax may be invalidated in any one of three circumstances: (1) if implementation of a state apportionment formula causes international disputes,¹²⁸ (2) if a state tax on foreign-based commerce could lead foreign governments to retaliate if they believed their domestic corporations were operating at a competitive disadvantage,¹²⁹ and (3) if other states might adopt a similar formula, increasing the propensity for multiple taxation of foreign com-

124. *Id.* at 294 n.33.

125. For a discussion on the tax implications of imposition of WWCR, see Kaplan, *supra* note 106, at 286-97.

This double taxation occurred in *Japan Line*. *Japan Line, Ltd. v. County of Los Angeles*, 441 U.S. 434, 451-54 (1979). The Court in *Container* also conceded this point. *Container Corp. of Am. v. Franchise Tax Bd.*, 463 U.S. 159, 187 (1983). *But cf.* *Barclays Bank Int'l, Ltd. v. Franchise Tax Bd.*, 275 Cal. Rptr. 626 (Cal. Ct. App. 1990), *petition for review granted*, 806 P.2d 308 (Cal. Feb. 28, 1991) (No. S019064), *rev'd*, 829 P.2d 279 (Cal. 1992). The California Court of Appeals disagreed with this contention in *Barclays*. The court decided that foreign and domestic parent corporations are not distinguishable and should be treated the same in relation to the risk of multiple taxation. *Id.* In *Barclays*, the court found that the unitary method did not inevitably result in double taxation when applied to the domestic subsidiary of a foreign parent corporation, and held that under *Container* the tax was constitutionally applied in that situation. *Id.* at 638-39.

126. 135 CONG. REC. E780 (daily ed. Mar. 14, 1989) (statement Rep. Frenzel).

127. *Container Corp.*, 463 U.S. at 196-97.

128. *Japan Line*, 441 U.S. at 450.

129. *Id.* at 450-51.

merce.¹³⁰ In *Container*, the Court interpreted the one-voice doctrine to uphold a state tax as long as it does not implicate "foreign policy issues which must be left to the Federal Government" or violate a "clear federal directive."¹³¹

i. Implication of Foreign Policy Issues That Must Be Left to the Federal Government

One of the chief tests to determine whether a state tax implicates foreign policy issues that are mandatorily within the province of the federal government is whether the state tax would offend foreign trading partners and potentially cause them to retaliate against the United States.¹³² The Court considers three factors in its assessment of the potential for retaliation.¹³³ First, the Court looks at whether the tax creates an "automatic 'asymmetry' in international taxation" that is disadvantageous to the foreign-based multinational business.¹³⁴ Second, the Court considers whether the tax is applied to a domestic corporation or a foreign corporation.¹³⁵ Finally, the Court considers whether the tax burden is attributable more to the tax rate in the state or to application of the unitary method.¹³⁶

The Court in *Container* applied these factors and held that the unitary tax method, as applied to a domestic parent corporation with foreign subsidiaries, did not implicate foreign policy issues that are within the province of the federal government.¹³⁷ The Court commenced its discussion of the issue by expressing its opinion that:

[t]his Court has little competence in determining precisely when foreign nations will be offended by particular acts, and even less competence in deciding how to balance a particular risk of retaliation against the sovereign right of the United States as a whole to let the States tax as they please.¹³⁸

First, the Court held that the unitary method does not create an automatic asymmetry in international taxation because it does not inevitably result in multiple taxation.¹³⁹ Second, the court found that the legal inci-

130. *Id.* See Kevin M. Kohls, Note, *State Unitary Taxes Imposed on Foreign-Based Multinational Groups: A Post Container Analysis*, 31 WAYNE L. REV. 219, 233-34 (1984).

131. *Container*, 463 U.S. at 194.

132. *Container*, 463 U.S. at 194 (citing *Japan Line, Ltd. v. County of Los Angeles*, 441 U.S. 434, 450 (1979)).

133. *Container*, 463 U.S. at 194-95.

134. *Container*, 463 U.S. at 195.

135. *Id.* The Court in *Container* addressed the issue in relation to a U.S. parent corporation but refrained from an analysis with respect to a foreign parent corporation. *Id.* at 195 n.32.

136. *Container*, 463 U.S. at 195.

137. *Id.* at 194-95.

138. *Id.* at 194.

139. *Id.* at 188, 192-93.

dence of the tax fell on a domestic corporation, rather than on a foreign corporation as was the case in *Japan Line*.¹⁴⁰ Notably, the Court directly commented that this factor might be analyzed differently if the tax fell on a domestic subsidiary of a foreign parent corporation.¹⁴¹ Finally, the Court reasoned that the California tax burden of a domestic corporation with foreign subsidiaries is primarily attributable to California's tax rate, not its allocation method.¹⁴² The Court based this final conclusion on an unsupported assumption that:

Although a foreign nation might be more offended by what it considers unorthodox treatment of appellant than it would be if California simply raised its general tax rate to achieve the same economic result, we can only assume that the offense involved in either event would be attenuated at best.¹⁴³

Although the Court upheld the unitary method in *Container*,¹⁴⁴ it suggested that if the parent corporation in *Container* had been a foreign corporation, the Court might have conducted a stricter Foreign Commerce Clause analysis.¹⁴⁵ In dissent, Justice Powell, joined by Justice O'Connor and Chief Justice Burger, expressed the view that "[i]t seems inevitable that the tax would have to be found unconstitutional at least to the extent it is applied to foreign companies."¹⁴⁶

In *Barclays Bank Int'l, Ltd. v. Franchise Tax Board*, the California Court of Appeals evaluated the *Container* factors in a case involving a foreign parent corporation, and agreed with Justice Powell's conclusion that the tax in this situation is unconstitutional.¹⁴⁷ The court in *Barclays* determined that the unitary method creates an automatic asymmetry in international taxation because it puts the foreign parent corporation at a competitive disadvantage.¹⁴⁸ The court stated that domestic parent corporations with foreign subsidiaries are at an advantage because they are not subject to this taxation method in other countries since no other

140. *Id.* at 195.

141. *Id.* at 195 n.32.

142. *Id.* at 195.

143. *Id.* In light of the recent uproar in the international community over the unitary method, primarily based on the difficulty of complying with the filing and accounting requirements and concerns regarding multiple taxation, this argument is without basis. It is inconceivable that simply raising the tax rate would create the same level of furor and retaliation among the international community as the unitary method. Increasing the tax rate, while perhaps generating the same amount of revenue for California, would not result in double taxation and would not force the foreign corporations to comply with the burdensome reporting and accounting requirements imposed by the unitary method.

144. *Id.* at 194-95.

145. *Id.* at 195 n.32. See also Schlenger, *supra* note 121, at 449.

146. *Container*, 463 U.S. at 203 (Powell, J., dissenting).

147. 275 Cal. Rptr. 626 (Cal. Ct. App. 1990), *petition for review granted*, 806 P.2d 308 (Cal. Feb. 28, 1991) (No. S019064), *rev'd*, 829 P.2d 279 (Cal. 1992). For recent developments in the *Barclays* case, see *infra* notes 215-23 and accompanying text.

148. *Id.* at 638.

country in the world uses the unitary method.¹⁴⁹ Further, the administrative burdens and costs of compliance are much higher, at times even prohibitive, for a foreign corporation than for a domestic corporation.¹⁵⁰ The court listed several difficulties that foreign-based corporations face in complying with the unitary method that domestic corporations do not face. For instance, their records may be in many different languages, their bookkeeping methods may not be in accord with United States general accounting principles, and they may not record their books in United States currency.¹⁵¹ In *Barclays*, witnesses testified that it would cost Barclays between \$6.4 million and \$7.7 million to establish a system for complying with California's unitary method and another \$2 million to \$3.8 million each year to maintain the system even though all the records were in English.¹⁵² In light of this overwhelming burden, the court found that the unitary tax method created an "automatic asymmetry" disadvantageous to the foreign corporation.¹⁵³

The court easily dispensed with the second prong of the *Container* retaliation test by finding that the incidence of the tax in *Barclays* fell directly on a domestic corporation with a foreign parent and directly on a foreign corporation with a foreign parent and foreign subsidiaries.¹⁵⁴ The court rejected arguments that the tax burden fell only on the United States subsidiary of the corporation.¹⁵⁵ It held, instead, that it is impossible to isolate the income of a United States subsidiary from the income of a foreign parent corporation and, therefore, it is impossible to isolate the tax liability of unitary business by jurisdiction.¹⁵⁶ The Court concluded that the incidence of the unitary method of taxation "falls on the entire business, including the foreign parent."¹⁵⁷

Finally, the court in *Barclays* concluded that the tax burden is more a function of the unitary method than of California's tax rate.¹⁵⁸ The Court compared the difficulties the foreign parent corporation would face under the separate accounting, or arm's-length method, to those it faced under the unitary method.¹⁵⁹ Citing the administrative burdens of compliance associated with the unitary method, and the fact that even the

149. *Id.* at 638-39.

150. *Id.* at 639. Language barriers, in part, account for this added burden. *Id.* Alcan also complained to the Court about the immense burden of complying with California's information demands in assessing tax liability under the unitary method. *Franchise Tax Bd. v. Alcan Aluminum Ltd.*, 493 U.S. 331, 337 (1990).

151. *Barclays*, 275 Cal. Rptr. at 639.

152. *Id.* at 640.

153. *Id.* at 638.

154. *Id.* at 638-39.

155. *Id.*

156. *Id.*

157. *Id.*

158. *Id.* at 639.

159. *Id.* at 640.

Franchise Tax Board found that only 1.5% of the worldwide income generated by the Barclays group in 1977 was attributable to California, the court reasoned that the tax burden was more a function of the unitary method than California's tax rate.¹⁶⁰

Foreign retaliation is no longer a matter of speculation, it is a reality. Many countries vehemently oppose the use of the WWCR method and some have even retaliated against the United States and its domestic-based corporations. Moreover, foreign corporations that are subject to a taxing method they perceive to be unfair, may choose to do business in states or other countries that do not use the unitary method.¹⁶¹

Kazuo Inamori, Chairman of Kyocero (an international corporation), expressed the frustration of foreign corporations:

[T]he unitary tax was put in effect retroactively and we found ourselves paying close to 100% of our profits in taxes. This stiff taxation meant that no matter how hard we worked, we would never be able to use any of our profits. . . .

The amount of money we have had to pay or accrue amounts to more than thirty and some million dollars from California's unitary tax alone. What should have been used for revitalization and capital investment had to go to pay the double taxation.¹⁶²

Some Japanese companies have threatened not to do business in states utilizing the WWCR method.¹⁶³ Such threats caused Florida, Indiana, and Oregon to repeal their unitary taxes.¹⁶⁴

The most prevalent opposition and retaliation has come from Britain. The United Kingdom retaliated by unanimously passing a bill that denies favorable tax treatment to United States corporations headquartered in states that use the unitary method of taxation.¹⁶⁵ The United States response to this legislation was summed up by Senator Mathias:

160. *Id.*

161. The Seventh Circuit articulated the dilemma: "The unitary tax diminishes the attractiveness of owning American subsidiaries in comparison with entering into contracts with independent companies as a means of engaging in foreign commerce." *Franchise Tax Bd. v. Alcan Aluminum Ltd.*, 860 F.2d 688, 697 (7th Cir. 1988), *quoted in* *Franchise Tax Bd. v. Alcan Aluminum Ltd.*, 493 U.S. 331, 337 (1990). The Court concluded "[i]t is the incidence of the unitary tax, its potential to disfavor a particular mode of foreign participation in the American economy, rather than the magnitude of the costs, that provides the strongest argument for standing." *Id.*

162. 133 CONG. REC. E3973, E3974-75 (daily ed. Oct. 14, 1987) (statement of Rep. Shumway).

163. Executives of Sony of America, a subsidiary of the Japanese company, threatened California and Florida from 1984 to 1986 that they would cancel plans to build facilities in these states unless their unitary taxes were repealed. 134 CONG. REC. E1, E2 (daily ed. Jan. 25, 1988) (statement of Rep. Florio).

164. *See* WALL ST. J., Dec. 28, 1984, at A15.

165. Favorable treatment is provided to all other corporations under a bilateral tax treaty between the United States and the United Kingdom. 134 CONG. REC. E1, E2 (daily ed. Jan. 25, 1988) (statement of Rep. Florio).

"This legislation will be injurious to American corporations, and . . . I think it will cost America jobs."¹⁶⁶

ii. *Clear Federal Directive*

Container also held that a state tax is unconstitutional if it violates a clear federal directive.¹⁶⁷ The Court in *Container* sustained the unitary method in spite of this prohibition, noting that Congress had not enacted legislation that prohibited the states from using the unitary method.¹⁶⁸ The Court emphasized that although the United States is a party to a number of tax treaties that require the federal government to use the arm's-length method in taxing multinational corporations, these treaties generally do not require the states to use the arm's-length method when taxing domestic corporations.¹⁶⁹ The Court points out that Congress has not prohibited the states from using the unitary method, noting that United States tax treaties do not apply to state taxing activities and that "in none of the treaties does the restriction on 'non arm's-length' methods of taxation apply to the States."¹⁷⁰ In support of this, the Court cited the fact that the Senate specifically rejected a treaty provision that would have prohibited the states from using the unitary method in some circumstances.¹⁷¹ Based on these findings, the Court held that U.S. foreign policy concerns were not implicated directly and that California's unitary method, as applied to foreign subsidiaries of domestic corporations, did not violate a clear federal directive and was not "fatally inconsistent with federal policy."¹⁷² Rather, in this context, the corporate taxation is a matter of local, not international, concern.¹⁷³

The Court in *Japan Line*, however, interpreted the requirement and found that California's use of the ad valorem tax violated a federal policy.¹⁷⁴ The federal policy at issue in *Japan Line* was expressed in the Customs Convention on Containers to which the United States was a party.¹⁷⁵ The Convention provided for the uniform treatment of containers used exclusively in foreign commerce and allowed containers temporarily imported to be admitted free of any importation taxes.¹⁷⁶ The Court held that California's tax would make it difficult to achieve this

166. 131 CONG. REC. 19,000 (July 15, 1985) (statement of Sen. Mathias).

167. *Container Corp. of Am. v. Franchise Tax Bd.*, 463 U.S. 159, 196-97 (1983).

168. *Id.* at 196-97.

169. *Id.* at 196.

170. *Id.*

171. *Id.* (citing 124 CONG. REC. 18,400, 19,706 (1978)).

172. *Id.* at 197.

173. *Id.* at 196.

174. *Japan Line, Ltd. v. County of Los Angeles*, 441 U.S. 434, 452-54 (1979).

175. *Id.* at 436 n.1, 452-53 (citing Customs Conventions on Containers, *opened for signature* May 18, 1956, art. 1(b), 20 U.S.T. 301, 304 (entered into force with respect to the United States on Mar. 3, 1969)).

176. *Id.* at 453 (citing 20 U.S.T. at 304).

federal policy of uniform treatment. In addition, if other states followed California's example, the foreign-owned containers would be subject to varying degrees of multiple taxation depending on which port they entered. This would make it virtually impossible for the federal government to speak with one voice.¹⁷⁷

As in *Japan Line*, the imposition of the unitary method on foreign parent corporations with domestic subsidiaries interferes with a federal directive. First, Congressional inaction should not be interpreted as satisfaction with the unitary method.¹⁷⁸ Rather, the principle of federalism governs and Congress' inaction should be attributed primarily to its hesitancy to interfere with the states' power to tax.¹⁷⁹ Many pieces of legislation have been introduced on this issue.¹⁸⁰ The primary debate does not concern whether the unitary method is fair, but whether Congress should preempt the states in their ability to collect revenue.¹⁸¹

Second, contrary to assertions made by the Court in *Container*, the executive branch has expressed deep concern regarding the unitary method; three administrations have denounced its use.¹⁸² The Carter Administration agreed to resolve the issue in light of protests from major trade partners and complaints from the multinational enterprises. After the United States Senate refused to prohibit the states from using the unitary method, the Carter Administration included a provision in a United States-United Kingdom income tax treaty prohibiting the states from using the unitary method in certain circumstances.¹⁸³ President Reagan also responded to international pressure by establishing a Worldwide Unitary Taxation Working Group to examine the unitary method

177. *Id.* at 453.

178. See 131 CONG. REC. E5754 (daily ed. Dec. 19, 1985) (statement of Rep. Duncan); 135 CONG. REC. E780 (daily ed. Mar. 19, 1989) (statement of Rep. Frenzel).

179. See 135 CONG. REC. E780, E781 (daily ed. Mar. 14, 1989) (statement of Rep. Frenzel); 132 CONG. REC. S7837 (daily ed. June 18, 1986) (statement of Sen. Mathias).

180. See, e.g., 135 CONG. REC. E780 (daily ed. Mar. 14, 1989); 132 CONG. REC. S7488 (daily ed. June 13, 1986); 131 CONG. REC. E5759 (daily ed. Dec. 19, 1985).

181. See *supra* note 179.

182. The Ford Administration drafted a bilateral tax convention with the United Kingdom that would have prohibited the states' use of the unitary tax method. Convention Between the United States and the United Kingdom for Avoidance of Double Taxation, Dec. 31, 1975, U.S.-U.K., 31 U.S.T. 5670, 5677.

Likewise, President Carter included a similar provision in an income tax treaty between the United States and the United Kingdom. See *infra* note 183 and accompanying text.

President Reagan formed a working group to research the problem and eventually recommended that Congress pass legislation to prohibit the states from using the unitary tax method. See *infra* notes 184-85 and accompanying text.

183. See Peter Winship, *State Taxation of Multinational Business: The Unitary Tax Debate*, 1985 J. BUS. L. 179, 179-80. The Senate debates surrounding this issue provide insight regarding the U.S. concerns. See 124 CONG. REC. 18,400-30, 18,651-70, 19,076-78 (1978).

and make recommendations regarding its use.¹⁸⁴ This group recommended that the unitary method be abolished and that the water's-edge alternative be used instead for all foreign and domestic based companies.¹⁸⁵ Further, the Solicitor General filed an amicus curiae brief stating that the unitary method "impairs federal uniformity in an area where such uniformity is essential."¹⁸⁶

The unitary method also frustrates the federal government's ability to negotiate and deal with foreign nations. The United States is a party to at least thirty-six tax treaties.¹⁸⁷ One of the major goals of these tax treaties is to eliminate multiple taxation.¹⁸⁸ In order to further this goal, the treaties require the federal government to tax foreign corporations with the arm's-length method.¹⁸⁹ Most of these tax treaties also prohibit discrimination against citizens of foreign countries through the imposition of taxes more burdensome than those imposed upon its own citizens.¹⁹⁰ One treaty, the United States-France Convention of Establishment, specifically prohibits attribution methods which account for income earned outside the taxing jurisdiction.¹⁹¹

Though the treaties do not bind the states, the federal government may assert treaty provisions to preempt state tax laws.¹⁹² The general purpose of the treaties is to avoid multiple taxation.¹⁹³ Because the unitary method leads to multiple taxation, it interferes with this goal. The states should not be allowed to interfere with the federal directive by using the unitary method.

In conclusion, both Congress and the executive branch have clearly expressed their dissatisfaction with the unitary method. In the interest of

184. *Chairman's Report on the Worldwide Unitary Taxation Working Group: Activities, Issues, and Recommendations*, 24 TAX NOTES 581 (1984); see Martin Miller & William M. Dunlap, Jr., *Unitary Tax Working Group—An Impossible Dream*, 3 J. ST. TAX'N 85 (1984).

185. See *Chairman's Report*, *supra* note 184, at 581-99; see also 24 TAX NOTES 1044-67 (1984).

186. Memorandum for the United States as Amicus Curiae at 2, *Chicago Bridge & Iron Co. v. Caterpillar Tractor Co.*, 463 U.S. 1220 (1983) (No. 81-349).

187. I.R.S. PUB. NO. 54, TAX GUIDE FOR U.S. CITIZENS AND RESIDENT ALIENS ABROAD 30 (1990-91).

188. Carl Estes, *Tax Treaties*, 14 INT'L LAW. 508, 508-09 (1980).

189. Notes, *A Post Container Analysis*, *supra* note 130, at 244.

190. I.R.S. PUB. NO. 54, TAX GUIDE FOR U.S. CITIZENS AND RESIDENT ALIENS ABROAD 23-24 (1990-91). It is questionable whether the WWCR method would be struck down directly under such provisions since the method is imposed on domestically based corporations as well as foreign based corporations, though the argument could be made that the WWCR method discriminates against foreign corporations because of the enhanced compliance costs for foreign corporations. For a discussion of these arguments see *A Post Container Analysis*, *supra* note 130, at 243 n.192.

191. Convention of Establishment, Nov. 25, 1959, U.S.-Fr., art. IX, 11 U.S.T. 2398, 2409 (entered into force Dec. 21, 1960). See *A Post Container Analysis*, *supra* note 130, at 243.

192. U.S. CONST. art. VI, cl. 2.

193. Estes, *supra* note 188, at 508-09.

federalism, however, neither has specifically prohibited the states from using it. The Court should nonetheless follow the precedent set forth in *Japan Line* and find the unitary method unconstitutional because there is a clear federal directive disfavoring it. Judicial action is the only way to assure that the federal government is able to speak with one voice in this sensitive area regarding foreign affairs.

B. Due Process Concerns

Although the California Court of Appeals recently deemed a review of the constitutionality of the WWCR method under the Due Process Clause unnecessary, instead holding that the method was unconstitutional under the Foreign Commerce Clause,¹⁹⁴ the issue will be considered here.

The Due Process Clause of the Constitution prohibits a state from taxing income earned outside of the state.¹⁹⁵ Due process requires a "minimal connection" or "nexus" between the taxing state and the interstate activities of a multinational corporation and "a rational relationship between the income attributed to the state and the intrastate values of the enterprise."¹⁹⁶ In terms of a domestic-based corporation, these tests are satisfied as long as the business affiliates are a unitary business and some part of its business is conducted in the state.¹⁹⁷

1. *The Fairness Requirement*

The Due Process Clause also requires that the applicable apportionment formula be fair.¹⁹⁸ A formula is fair if it is both internally and externally consistent.¹⁹⁹ An internally consistent apportionment formula is one that, if used by every jurisdiction, would result in the total income of the aggregate unitary business being taxed only once.²⁰⁰ An apportionment formula is externally consistent if the factors in the apportionment formula "actually reflect a reasonable sense of how income is

194. *Barclays Bank Int'l, Ltd. v. Franchise Tax Bd.*, 275 Cal. Rptr. 626 (Cal. Ct. App. 1990), *petition for review granted*, 806 P.2d 308 (Cal. Feb. 28, 1991) (No. S019064), *rev'd*, 829 P.2d 279 (Cal. 1992). For recent developments in the *Barclays* case, see *infra* notes 215-23 and accompanying text.

195. U.S. CONST. amend. XIV, § 1. See also *Exxon Corp. v. Department of Revenue*, 447 U.S. 207 (1980) (holding that state's taxation of Exxon as a unitary business violated both the Due Process Clause and the Foreign Commerce Clause).

196. *Container Corp.*, 463 U.S. at 165-66 (1983) (quoting *Exxon Corp.*, 447 U.S. at 219-20, quoting *Mobil Oil Corp. v. Commissioner of Taxes*, 445 U.S. 425, 436-37 (1980)).

The Supreme Court has repudiated a state tax on the basis of lack of rational relationship only in one instance. *Exxon Corp. v. Department of Revenue*, 447 U.S. 207 (1980).

197. *Container*, 463 U.S. at 165-66.

198. *Id.* at 169. See also *Exxon Corp. v. Department of Revenue*, 447 U.S. 207 (1980); *Moorman Mfg. Co. v. Bair*, 437 U.S. 267, 272-73 (1978).

199. *Container*, 463 U.S. at 169.

200. *Id.*

generated.”²⁰¹ To prove external inconsistency the taxpayer must prove by “ ‘clear and cogent evidence’ that the income attributed to the State is in fact ‘out of all appropriate proportions to the business transacted . . . in that State.’ ”²⁰²

The Court in *Container* upheld the WWCR method as constitutional under the Due Process Clause when applied to domestic parent corporations.²⁰³ In support of this determination, the Court found that *Container* had not shown that the income apportioned to California was completely disproportionate to the amount of business transacted by the corporation in the state.²⁰⁴

Container argued that its foreign subsidiaries were more profitable than its domestic operations and that because the unitary method ignores this differentiation, the income allocation was distorted.²⁰⁵ The Court rejected this argument on the ground that the data submitted by *Container* to prove this distortion was gathered in accordance with separate accounting principles which the Court deemed theoretically unsound.²⁰⁶

Container further argued that lower production costs in foreign countries resulted in the inflation of income attributable to the United States.²⁰⁷ The Court dismissed this argument as well. The Court concluded that *Container* could not rely on one factor to prove distortion of income and that factors other than the cost of production would need to be taken into consideration.²⁰⁸

The Court decided that the three-factor unitary method fairly reflected the generation of income within the state.²⁰⁹ The Court’s approval of this formula, however, should not be accepted as a blanket rule applicable in all situations. Rather, the Court should re-evaluate the fairness of the formula on a case-by-case basis in the context in which it is applied.

Although *Container* excused the distortions of income in cases involving domestic parent corporations, the Court should scrutinize the distortions more closely when foreign parent corporations are involved. Application of the unitary method to foreign parent multinational corpo-

201. *Id.*

202. *Id.* at 170 (quoting *Hans Rees’ Sons, Inc. v. North Carolina ex rel. Maxwell*, 283 U.S. 123, 135 (1931)).

203. *Container*, 463 U.S. at 180-84.

204. *Id.* at 180-85.

205. *Id.* at 181.

206. *Id.*

207. *Id.* at 181-82. *Container* supported this with data illustrating the lower wage rates in foreign countries, without commensurate lower productivity. *Id.* at 182. In one instance, it demonstrated that the labor costs in a foreign plant were 40% of similar costs in the California plants. *Id.*

208. *Id.* at 182.

209. *Id.* at 183.

rations creates enormous potential for income earned outside a state to be taxed. Under the unitary method, profits of a multinational are aggregated from the worldwide operations of the company.²¹⁰ The proportionate value of the property, payroll, and sales is then applied to determine the amount of income subject to state tax.²¹¹ This method, however, does not even attempt rationally to determine what portion of the income of a foreign-based company was actually generated in a state. Rather, the unitary method disproportionately assigns income to a state, especially "if inputs such as property and payroll are cheaper abroad, or if management systematically requires higher profit ratios from offshore operations to compensate for greater risks."²¹² For example, the California-based domestic subsidiary of a foreign-based multinational company could be unprofitable and still pay income tax in California under the unitary method if the worldwide operations of the corporation were profitable.²¹³ The result is that California taxes income earned outside its borders in violation of the Due Process Clause.

Foreign-based companies, in the interest of economy and efficiency, often perform many functions outside the United States and relatively few within the United States. Companies seek to manufacture products and locate factories in countries where the costs of labor, production, property, and materials are the lowest.²¹⁴ While a United States-based corporation may perform some income producing activities through foreign subsidiaries, the probability that income actually will be earned outside the borders of the state or the United States is greater with a foreign-based corporation. Thus, distortion in income due to distortion of the property, sales, and payroll factors is more likely. This is best illustrated by a hypothetical. Company X is a Mexican multinational corporation that produces and distributes widgets. Company X owns a subsidiary Company Y that is located in California. The two affiliated businesses are considered a unitary business. Company Y produces 100 widgets in California. Each widget takes one hour to produce. In California, labor costs \$4.00 per hour. In Mexico, the cost of labor is \$1.00 per hour. In California, the cost of materials to produce a widget is \$2.00

210. See *supra* notes 20-22 and accompanying text; see also *Review of Unitary Method of Taxation: Hearing on S. 1113 and S. 1974 Before the Subcomm. on Taxation and Debt Management of the Senate Comm. on Finance, 99th Cong., 2d Sess. 12 (1986)*. This conflicts with the federal approach of determining taxable income individually by item. *Id.*

211. *Id.* at 8-9.

212. *Id.*

213. See Blank, *supra* note 14, at 1072 n.25.

214. Likewise, it would be logical to assert that companies will seek to conduct production and income producing activities in jurisdictions in which the tax liability will be lower. Because the arm's length method is the internationally accepted method of taxation, the primary concern of the corporation would be locating income-producing activities in jurisdictions with lower tax rates. This strategy is, however, defeated by conducting any activity remotely contributing to income in a state utilizing the unitary method.

and in Mexico it is \$1.00. Company X owns a plant in Mexico valued at \$500,000. Company Y owns an identical plant in California valued at \$2 million. Eighty percent of the widgets are sold in the United States, 10% in California for \$20 per widget. The remaining 20% are sold in Mexico for \$5 per widget. Applying the WWCR method, 10% of sales occur in California, 80% of the property is in California (\$2M/\$2.5M), and 80% of payroll (\$400/\$500) is in California. The average is 56.6%. Total worldwide profit for the company is \$2360, \$120 from the 40 widgets sold in Mexico and \$2240 from the widgets sold in the United States. California, applying the unitary method, will tax 56.6% of the total profits (\$2360), even though only half of the widgets were actually produced in California and only 10% were actually sold there. Moreover, Mexico will apply some form of arm's-length method to tax income attributable to that country. Thus, the 100 widgets produced in Mexico will be taxed there also.

The same amount of widgets were produced in Mexico, but at a higher profit margin. Although the same amount of widgets were produced in Mexico as in California, the widgets produced in Mexico account for a greater portion of the company's total income. Under the unitary method, though, California will benefit from the aggregation of the profits.

Conclusion

Because of the substantial sum of revenue at stake and the international uproar, the Court should determine whether the unitary method is constitutional as applied to a foreign parent corporation. The Court inevitably will be assigned this arduous task because both Congress and the executive branch continue to avoid the issue. Following the tests set forth in *Complete Auto Transit v. Brady*; *Japan Line, Ltd. v. County of Los Angeles*; *Container Corp. of America v. Franchise Tax Board*; and *Barclays Bank International, Ltd. v. Franchise Tax Board*, the Court should hold that the unitary method violates the Foreign Commerce and Due Process Clauses of the Constitution when it is applied to a foreign parent corporation.

Recent Developments

Shortly before this Note was published, the California Supreme Court reversed the decision of the appellate court in *Barclays Bank International, Ltd. v. Franchise Tax Board*.²¹⁵ The California Supreme Court upheld the state's use of the unitary tax method on the ground that the

215. *Barclays Bank Int'l, Ltd. v. Franchise Tax Bd.*, 275 Cal. Rptr. 626 (Cal. Ct. App. 1990), *petition for review granted*, 806 P.2d 308 (Cal. Feb. 28, 1991) (No. S019064), *rev'd*, 829 P.2d 279 (Cal. 1992).

court of appeals improperly applied the dormant Commerce Clause to invalidate the unitary tax method.²¹⁶

Specifically, the court held that the court of appeals erred by not following the precedent set forth in *Wardair Canada, Inc. v. Florida Department of Revenue*.²¹⁷ The Court in *Wardair* refused to apply the dormant Commerce Clause to invalidate California's unitary method because it found that the federal government was "silent" regarding the viability of the state unitary taxation method, and that this silence precluded a dormant Commerce Clause analysis.²¹⁸

Applying *Wardair*, the court held that the dormant Commerce Clause was not applicable in this case since the federal government was silent regarding the application of the unitary method to foreign parent corporations with domestic subsidiaries.²¹⁹ The court based its finding of governmental "silence" on the fact that Congress clearly was aware of problems with the unitary tax method, yet repeatedly had failed to pass legislation to remedy the problem.²²⁰ The court also found that the Senate's express rejection of an income tax convention with the United Kingdom, which would have prevented states from using the unitary method, indicated that there was no "clear federal directive" which prohibited the states from using the method.²²¹ The court stated that the Senate's action "demonstrates that while federal executive branch officials *aspired* to eliminate a state tax practice . . . the *law* as it presently stands acquiesces."²²² The court concluded its discussion by stating that where Congress "evidences both an awareness of an issue and a refusal to adopt the remedy urged upon it," their inaction "is a governmental silence that is eloquent."²²³

216. *Id.* at 292-99.

217. 477 U.S. 1; *Barclays*, 829 P.2d at 292-95.

218. *Barclays*, 829 P.2d at 291.

219. *Id.* at 300.

220. *Id.* at 294-95.

221. *Id.* at 295-96.

222. *Id.* at 295 (quoting *Wardair*, 477 U.S. at 11).

223. *Id.* at 300.