Santa Clara Law Review

Volume 25 | Number 3 Article 6

1-1-1985

The Container Aftermath: The Unconstitutionality of California's Unitary Corporate Tax Concept as Applied to a Foreign Parent Corporation

Randel Mathias

THE *CONTAINER* AFTERMATH: THE UNCONSTITUTIONALITY OF CALIFORNIA'S UNITARY CORPORATE TAX CONCEPT AS APPLIED TO A FOREIGN PARENT CORPORATION

I. INTRODUCTION

California taxes corporate income under the "unitary business" method. The United States Supreme Court, in *Container Corporation of America v. Franchise Tax Board,*[1] recently upheld California's "unitary business" three-factor apportionment formula as constitutional.[2] The case involved an allegation that the state's unitary taxation method violated the due process and commerce clauses.[3] Although the Court upheld the constitutionality of the system, its holding was limited to domestic corporations doing business worldwide. The Court did not address the question of whether California's system of taxing corporate worldwide income would be valid under the foreign commerce clause if the taxpayer is a foreign parent corporation with a United States subsidiary that operates within California.[4]

This comment examines the constitutionality of the three-factor apportionment formula that California uses to tax the unitary income of a foreign parent corporation that operates a subsidiary in California. The foreign commerce clause[5] provides the constitutional analysis which is applied to these parent corporations. Under the foreign commerce clause, a state may not tax an instrumentality of foreign commerce if there is a risk of multiple taxation.[6] Further, a state may not impose a tax if: 1) it would impair an area in which federal uniformity is essential,[7] or 2) it would prevent the federal government from speaking with one voice in international trade.[8]

This comment will first discuss California's unitary tax concept. This taxation method initially determines whether a business organi-

1. 463 U.S. 159 (1983).
2. *Id.* For a description of California's unitary method, three-factor apportionment formula, see *infra* text accompanying notes 19-30.
3. 463 U.S. at 162.
4. *Id.* at 189 n.26, 195 n.32.
5. U.S. CONST. art. I, §8, cl. 3.
6. Japan Line, Ltd. v. County of Los Angeles, 441 U.S. 434, 446 (1979).
7. *Id.* at 448.
8. *Id.* at 453.

zation is "unitary" and then applies a three-factor apportionment formula to the "unitary income" in order to determine the amount of income taxable in California. Next, the effect of the *Container* case upon how business organizations are determined to be "unitary" is analyzed. The comment then examines the foreign commerce clause analysis and its application in two recent cases, *Japan Line, Ltd. v. County of Los Angeles*[9] and *Container Corporation of America v. Franchise Tax Board.*[10] The next section uses this analysis to determine whether California's "formula apportionment" method is constitutional when applied to a foreign parent corporation with a subsidiary operating in California. This comment concludes that California's formula apportionment method is unconstitutional when applied to a foreign parent corporation.

II. California's Unitary Business Concept: Formula Apportionment

The United States Supreme Court has recently considered the limits of state taxing power over nondomiciliary multistate and multinational corporations.[11] The Court considered whether the due process clause[12] or the commerce clause[13] of the United States Constitution prevents state apportionment of the consolidated income of a corporate taxpayer when the taxpayer performs only limited operations within the state.[14] The Court concluded that when a corporate taxpayer operates a "unitary business"[15] the state may levy a tax upon the total net corporate income that is reasonably related to the activities conducted within the taxing state.[16]

Because several methods of taxation are constitutional, taxation

---

9. *Id.* at 434.

10. 463 U.S. 159.

11. *See, e.g.*, F.W. Woolworth Co. v. Taxation & Revenue Dep't, 458 U.S. 354 (1982); ASARCO, Inc. v. Idaho State Tax Comm'n, 458 U.S. 307 (1982).

12. U.S. CONST. amend. XIV. The fourteenth amendment to the U.S. Constitution provides in part that no state shall deprive any person of life, liberty, or property without due process of law.

13. U.S. CONST. art. I, §8. This article provides in part that Congress shall have the power to regulate interstate commerce.

14. *See, e.g.*, Exxon Corp. v. Department of Revenue, 447 U.S. 207, 210 (1980); Mobil Oil Corp. v. Commissioner of Taxes, 445 U.S. 425, 427 (1980).

15. The Supreme Court first recognized the unitary business concept over 60 years ago. *ASARCO*, 458 U.S. at 320 n.14. See text accompanying *infra* notes 19-20 for a definition of unitary business.

16. *Woolworth*, 458 U.S. at 362; *ASARCO*, 458 U.S. at 316; *Exxon*, 447 U.S. at 222-23; *Mobil*, 445 U.S. at 439-40.

statutes vary from state to state.[17] Regardless of which method a state chooses, the threshold question remains whether the corporation subject to the tax does in fact operate as a "unitary business."[18] A corporation is part of a unitary business group if its operations are dependent upon or contribute to the business conducted by the group.[19] The unitary concept is premised upon the theory that the business activities within the state are an inseparable part of a business conducted outside the state.[20] If a group is deemed unitary, the state may apply its method of allocating unitary income.[21]

Once the unitary determination is made, the focus shifts to the amount of corporate income that the state should include in the corporation's tax base.[22] The tax base consists of all income produced by the unitary business.[23] California uses the "formula apportionment" method to determine corporate net income attributable to the sources and activities that occur within state borders. A corporate group which constitutes a unitary business must file a combined report[24] in order to calculate both the unitary income of the group and the formula factors necessary to apportion the income.[25]

Because a state cannot exercise its income tax extraterritorially, the total business income of an integrated group of corporations must

---

17. In Moorman Mfg. Co. v. Bair, 437 U.S. 267, 278-79 (1978), the Supreme Court stated that the U.S. Constitution does not favor one form of state taxation over another. In addition, the Court has declined to single out the most appropriate method of state taxation of corporations. General Motors Corp. v. District of Columbia, 380 U.S. 553, 561 (1965). *See* Wisconsin v. J.C. Penney Co., 311 U.S. 435, 445 (1940); Comment, *State Taxation of Foreign Source Corporate Dividends: Another Conquest of the Expanded Unitary Business Doctrine*, 22 WASH U. URB. L. ANN. 229, 229-30 (1981).

18. Edison Cal. Stores, Inc. v. McColgan, 30 Cal. 2d 472, 479-80, 183 P.2d 16, 20-21, (1947).

19. *See infra* note 26.

20. Comment, *California's Corporate Franchise Tax: Taxation of Foreign Source Income?*, 20 SANTA CLARA L. REV. 123 (1980).

21. *See* Ford Motor Co. v. Beauchamp, 308 U.S. 331, 336 (1939); Wallace v. Hines, 253 U.S. 66, 69 (1920).

22. *Moorman Mfg. Co.*, 437 U.S. at 272-74; Northwestern States Portland Cement Co. v. Minnesota, 358 U.S. 450, 452, 464-65 (1959).

23. *See* Western Auto Supply Co. v. Commissioner of Tax'n, 245 Minn. 346, 361, 71 N.W.2d 797, 804-05 (1955) (tax base includes income from both retail and wholesale operations); Coca Cola Co. v. Department of Revenue, 71 Or. 517, 519, 533 P.2d 788, 792 (1975) (tax base includes income from both bottling and syrup-producing operations).

24. The "combined report" is, in effect, a consolidated return of the corporate group's worldwide income. Carlson, *State Taxation of Corporate Income From Foreign Sources*, TAX POLICY RESEARCH STUDY NUMBER THREE: ESSAYS IN INTERNATIONAL TAXATION 231, 250 (1976). *See also* Rudolph, *State Taxation of Interstate Business: The Unitary Concept and Affiliated Corporate Groups*, 25 TAX. L. REV. 171, 197-98 (1970).

25. *See* CAL. REV. & TAX. CODE §§ 25101-25105 (West 1979).

be apportioned to California.[26] The apportioned income represents that portion of income generated by the integrated group which is properly attributable to activities conducted within California.[27] California uses a fractional formula for apportioning worldwide income. The numerator of the fraction is the sum of three factors: property, payroll, and sales;[28] the denominator is the number three.[29] These factors are determined by dividing the value of the corporate group's California property by the value of its worldwide property, the amount of its California payroll by its worldwide payroll, and the amount of its California sales by its worldwide sales.[30] After the fraction is calculated, net taxable income is determined and the unitary group may be taxed.

A. *What is Unitary after* Container?

Courts apply several of their own tests to determine which parts of a business operation are within the unitary business.[31] Generally courts have held that a business is unitary if operating the business within the taxing state depends upon or contributes to the operations of the business outside the state.[32]

In *Container Corporation of America v. Franchise Tax Board,*[33] the Supreme Court held that the "unitary business" concept requires that some of the business be conducted in the taxing state and that a bond of ownership or control unite the purported unitary business.[34] Container Corporation argued that under

26. 437 U.S. 267, 272-73 (a state may tax only income arising from sources within the state); Rudolph, *supra* note 24, at 181. The controlling question is whether the state has provided anything to the corporation for which the state then can assess a tax in return. Wisconsin v. J.C. Penney Co., 311 U.S. 435, 444 (1940).

27. 437 U.S. 267, 273.

28. CAL. REV. & TAX CODE § 25128 (West 1979).

29. *Id.*

30. *See* CAL. REV. & TAX CODE §§ 2519, 25132 and 25134 (West 1979).

31. *See, e.g.*, Butler Bros. v. McColgan, 315 U.S. 501, 508 (1942) (unitary business determined by unity of ownership operations and use); *Western Auto Supply*, 245 Minn. at 357, 71 N.W.2d at 804-05 (unitary business indicated by mutual contribution and mutual benefits regarding interdivisional relations); Commonwealth v. Ford Motor Co., 350 Pa. 236, 243, 38 A.2d 329, 334-35 (1944) (unitary business determined by necessity and connection of corporate divisions to each other).

32. *See* G. ALTMAN & F. KEESLING, ALLOCATION OF INCOME IN STATE TAXATION 101 (1946). The test of a unitary business is whether or not the operation of the portion of the business within the state is dependent upon or contributory to the operation of the business outside the state. *Id.*

33. 463 U.S. 159.

34. *Id.* at 166.

ASARCO, Inc. v. Idaho State Tax Commissioner[35] and *F.W. Woolworth v. Taxation & Revenue Department*,[36] Container and its foreign subsidiaries were not members of a unitary business.[37]

The Court in *Container*, however, noted that the "legal principles defining the constitutional limits on the unitary business principle are now well established."[38] It found that although Container's foreign subsidiaries evidenced some autonomy, "mere decentralization of day-to-day management responsibility and accountability cannot defeat a unitary business finding."[39] The Court upheld the approach used in *Woolworth*[40] and stated that the prerequisite to a constitutionally acceptable finding of a unitary business is a "flow of value" between parent and subsidiary.[41]

Justice Brennan stated in *Container* that a relevant question in the unitary business inquiry is whether the income contributions of the subsidiaries results from functional integration, centralization of management, and economies of scale.[42] If this inquiry is answered affirmatively, the parent and its subsidiaries present a "functionally integrated enterprise" which the state may tax as a single entity.[43]

35. 458 U.S. 307 (1982).

36. 458 U.S. 354 (1982).

37. Whitenack, *State Tax Litigation After the Container Decision*, 20 TAX NOTES 771, 773 n.4 (1983) (quoting Brief for Appellant at 49, Container Corp. v. Franchise Tax Board, 463 U.S. 159). *ASARCO* involved a claim that a parent and its parties owned subsidiaries. The court held either minority interests or majority interests were part of the same unitary business. The state supreme court upheld the claim. The U.S. Supreme Court concluded that a unitary business ruling was impermissible because the partial subsidiaries were not realistically subject to even minimal control by *ASARCO*, and were therefore only a "passive investment." 458 U.S. 307, 328. *Woolworth* involved a parent corporation and its one partially-owned subsidiary and three wholly-owned subsidiaries. The U.S. Supreme Court overturned the state court's unitary business determination and concluded that the legal standard applied to the state court was improper. 458 U.S. at 354, 363.

38. 463 U.S. at 176.

39. *Id.* at 180 n.19 (citing *Exxon*, 447 U.S. 207, 224). The Court in *Container* found that the foreign subsidiaries were not passive investments and therefore were not outside of the unitary business. Specifically, it found that Container's loans and loan guarantees made on behalf of the foreign subsidiaries constituted a "flow of value." This represented an effort to ensure that the foreign operations of Container would continue to grow and thus to further the corporation's profitability. Additionally, the management role of the parent corporation was more than "organizational oversight" and pointed toward active investment. *Id.*

40. 458 U.S. 354.

41. 463 U.S. at 178. The most common form of a flow of value is a contribution to income by the parent or subsidiary corporation to the other. This contribution to income can result from functional integration, centralization of management flow of capital resources, or economies of scale. *See infra* text accompanying note 42.

42. 463 U.S. at 178-79 (quoting Mobil Oil Corp. v. Commissioner of Taxes, 445 U.S. 425, 438 (1980)).

43. Mobil Oil Corp. v. Commissioner, 445 U.S. 425, 440 (1980).

The Court upheld the appellate court's finding that a functionally integrated enterprise existed.[44]

The *Container* Court concluded that the scope of its review over state court decisions regarding how to determine a unitary business is limited to whether the state court applied the proper standard.[45] If the proper standard is applied, the Supreme Court will then determine whether the state court's "judgment was within the realm of permissible judgment."[46] The Court stated that not all claims that a state court erred in making a unitary business finding will pose substantial federal questions.[47]

As a result of the *Container* decision, it appears that California can easily justify its finding that a corporation is unitary. First, the Court in *Container* ruled that the Constitution does not require objective tests to determine whether a business is unitary.[48] The Court relied upon the *Mobil Oil Corp. v. Commissioner of Taxes*[49] decision that profits from functional integration, centralization of management, and economies of scale were indicators of a unitary business, but that no single indicator is determinative.[50] Rather, it now appears sufficient if a number of indicia, similar to those found in *Container*, cumulatively support the state court's decision.[51] Second, potential control, which *Woolworth* held was "not dispositive of the unitary business issue,"[52] is now considered relevant.[53] The *Container* decision suggested that potential control may be considered to determine if a sufficient degree of implicit control exists to support a unitary finding.[54] The continuous flow and interchange of products described by Justice Powell as "essential factors" in *ASARCO*, are no longer essential.[55] Finally, corporations in the same type of business may now reasonably be presumed unitary.[56] Thus, the extreme view "that all income from commonly-owned business activities should be combined and apportioned by a single formula

---

44. 463 U.S. at 176.
45. *Id.*
46. *Id.*
47. *Id.* at n.14.
48. *Id.* at 178 n.17.
49. 445 U.S. 425, 440 (1980).
50. *Id.* at 179-80.
51. *Id.*
52. 458 U.S. at 362.
53. 463 U.S. at 177 n.16.
54. *Id.*
55. *Id.* at 178. "Continuous flow and interchange of products" refer to intercompany transactions between parent and subsidiary.
56. *Id.* at 179.

without inquiring as to whether such activities are unitary or separate in nature"[57] could be embraced.

Because a unitary finding is likely to be upheld, a successful challenge to California's apportionment formula has little chance of success. The Court has concluded that the Constitution permits states to enact different statutory variations of the unitary business concept.[58] California's three-factor formula is now a standard for judging the fairness of other formulas. Consequently, only domestic taxpayers with complaints less extreme than those in *Container* could successfully petition the Supreme Court. Taxation of a foreign parent corporation, however, presents a problem which differs from the unitary issue.

III. The Foreign Commerce Clause

Both the due process and commerce clauses of the United States Constitution limit a state's ability to tax income arising out of interstate activities. Well-established Supreme Court guidelines provide that no undue state tax burden exists when: 1) a substantial nexus exists between the taxed activity and 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.[59] In *Japan Line v. County of Los Angeles*,[60] however, the Court held that a state must satisfy a more extensive constitutional inquiry when dealing with foreign instrumentalities.[61]

A. *Japan Line v. County of Los Angeles*

In *Japan Line*, the Supreme Court required additional scrutiny under the Foreign Commerce Clause as it is applied to foreign corporations.[62] Six Japanese shipping companies were the taxpayers in *Japan Line*. The County of Los Angeles imposed an ad valorem property tax upon the companies' shipping containers which were located in Los Angeles harbor. The Japanese companies had been organized and incorporated under the law of Japan and they were domiciled there. The shipping containers, the property subjected to

57. Keesling, *A Current Look at the Combined Report*, 1975 J. of Tax'n 106, 109.
58. 463 U.S. at 166-67.
59. Complete Auto Transit, Inc. v. Brady, 430 U.S. 274, 279 (1977); Washington Revenue Dept. v. Stevedore Assn., 435 U.S. 734, 750 (1978).
60. 441 U.S. 434.
61. *Id.* at 447.
62. *Id.*

the tax, were used exclusively in foreign commerce. As well as being taxed by the County of Los Angeles, all of the taxpayers' containers were subject to a Japanese property tax which was based upon 100 percent of their value.

The taxpayers contended that the Los Angeles property tax contravened the federal government's power under the foreign commerce clause. The Court, using standards set forth in *Complete Auto Transit, Inc. v. Brady*,[63] first found that the tax in question satisfied the constitutional requirements demanded by the due process and interstate commerce clauses.[64] Nevertheless, the Court rejected the County's argument that the same analysis applied regardless of whether interstate or foreign commerce was involved.[65]

The Court held that when a state imposes a tax upon instrumentalities of foreign commerce, a twofold inquiry beyond that mandated by *Complete Auto* is required.[66] The court must first inquire whether the tax creates a substantial risk of multiple taxation. Second, the court must determine whether the tax impairs federal uniformity in an area in which federal uniformity is essential, and thus prevents the federal government from "speaking with one voice when regulating commercial relations with foreign governments."[67] A state tax that contravenes either of these requirements is unconstitutional.

Applying those additional considerations to the facts in *Japan Line*, the Court held that the Los Angeles tax resulted in multiple taxation in fact.[68] The Court also found that California's tax frustrated federal uniformity and prevented the federal government from

---

63. 430 U.S. 274, 279 (1977).

64. 441 U.S. at 441, 445-46.

65. *Id.* at 447.

66. *Id.* at 452.

67. *Id.* Addressing the second prong the Court stated:

> A state tax on instrumentalities of foreign commerce may frustrate the achievement of federal uniformity in several ways. If the State imposes an apportioned tax, international disputes over reconciling apportionment formulae may arise. If a novel state tax creates an asymmetry in the international tax structure, foreign nations disadvantaged by the levy may retaliate against American-owned instrumentalities present in their jurisdictions. Such retaliation of necessity would be directed at American [corporations] in general, not just that of the taxing state, so that the Nation as a whole would suffer. If other States followed the taxing State's example, various instrumentalities of commerce could be subjected to varying degrees of multiple taxation, a result that would plainly prevent this Nation from "speaking with one voice" in regulating foreign commerce.

Id. at 451-52.

68. *Id.* at 453.

"speaking with one voice" in international trade.[69] In fact, United States-Japan treaties reflect that California's tax was inconsistent with national policy.[70] Accordingly, the tax was struck down for violating the foreign commerce clause. But the Court in *Japan Line* specifically reserved the question of the "taxability of domestically owned instrumentalities[71] engaged in foreign commerce," and cited two California Supreme Court decisions which upheld the imposition of property taxes in such situations.[72] This reservation in *Japan Line* paved the way for the Supreme Court's recent decision in *Container Corporation of America v. Franchise Tax Board.*[73]

B. *Container Corporation of America v. Franchise Tax Board*

In *Container*, California sought to impose an income tax on the basis of a domestic corporation's apportioned worldwide unitary income. The defendant, Container Corporation, contended that the tax violated the foreign commerce clause under the *Japan Line* analysis because it resulted in actual multiple taxation and violated the uniform international arm's length standard of taxation.[74] The Court disagreed and upheld California's method of formula apportionment.[75]

The Court began its analysis by acknowledging the similarities between *Container* and *Japan Line.* First, both of the disputed taxes resulted in double taxation.[76] Second, the double taxation resulted from the application of different taxation methods by California and foreign authorities.[77] Third, the internationally accepted arm's

---

69. *Id.* at 452-53.

70. Treaties between the United States and Japan evidence the desirability of uniform taxation of containers which are used exclusively in foreign commerce. This uniform treatment resulted in exempting from tax any foreign-owned containers temporarily located in the United States. *Id.*

71. The term "instrumentality" includes a corporation for purposes of this comment. In *Container*, Justice Brennan also used the term when referring to Container Corporation. He analogized a corporation to a cargo container because in *Japan Line*, the containers were the instrumentalities engaged in foreign commerce. 463 U.S. at 188-89.

72. *Id.* at 444 n.7. The cases cited by the Court were Sea-Land Service, Inc. v. County of Alameda, 12 Cal. 3d 772, 528 P.2d 56, 117 Cal. Rptr. 448 (1974) (domestically-owned containers used in intercoastal and foreign commerce held subject to apportioned property tax), and Flying Tiger Line, Inc. v. County of Los Angeles, 51 Cal. 2d 314, 333 P.2d 323 (1958) (domestically owned aircraft used in foreign commerce held subject to apportioned property tax).

73. 463 U.S. 159.

74. *Id.* at 162-63.

75. *Id.* at 197.

76. *Id.* at 187.

77. *Id.*

length taxation method was consistent with the method used by the foreign taxing authorities.[78] Finally, the Court found that the internationally accepted method was preferred by the federal government.[79] The Court, however, also distinguished *Japan Line* on several grounds. The Court noted that *Japan Line* involved a property tax rather than a tax on income.[80] The Court also found that the existing double taxation was "not the 'inevitabl[e]' result of the California taxing scheme,"[81] and therefore did not meet the substantial risk of multiple taxation test. More importantly, the Court concluded that California had imposed the tax upon a corporation domiciled and headquartered in the United States, unlike *Japan Line* in which an instrumentality of foreign commerce was subjected to taxation.[82] That final point emphasizes the question left unanswered in *Container*: whether California's formula apportionment method is constitutional if it taxes a corporation domiciled and headquartered *outside* of the United States.[83]

IV. Application of the Foreign Commerce Clause Analysis To a Foreign Parent Corporation

Japan Line established that a state tax violates the foreign commerce clause if the tax "creates a substantial risk of multiple taxation" or impairs federal uniformity and prevents the federal government from "speaking with one voice" on foreign commerce.[84] When those foreign commerce clause principles are applied to the case of a foreign parent corporation with a California subsidiary, California's formula apportionment method is unconstitutional.

A. *Multiple Taxation*

The Supreme Court in *Japan Line* clearly stated that "[e]ven a slight overlapping of tax . . . assumes importance when sensitive matters of foreign relations and national sovereignty are con-

78. *Id.*

79. *Id.*

80. *Id.*

81. *Id.* (quoting *Japan Line*, 441 U.S. at 447).

82. 463 U.S. at 189. The majority of the Court noted that the double taxation was the result of allocating the income of a multinational enterprise by using two distinct methods.

83. The Court in *Container* specifically stated: "We have no need to address in this opinion the constitutionality of combined apportionment with respect to state taxation of domestic corporations with foreign parents . . . ." *Id.* at 189 n.26.

84. *See supra* text accompanying notes 66-67.

cerned."[85] Both the majority and the dissenting opinions in *Container* pointed out that the California method of taxing corporate income not only creates a substantial risk of international multiple taxation but has also resulted in double taxation.[86] The majority of the *Container* Court, however, was able to distinguish the actual double taxation in that case from the double taxation which was found unconstitutional in *Japan Line.*[87]

The Court found that when two two different methods are used to allocate the income of a multinational enterprise, determining whether any resulting double taxation is constitutional depends upon the facts of each case.[88] Multiple tax burdens alone are not sufficient to impugn a fairly apportioned tax; the context in which the double tax arises and the alternatives available to the taxing state must be considered.[89] The Court was not convinced that the use of the international arm's-length standard,[90] as opposed to formula apportionment, would necessarily remove the risks of international multiple taxation.[91]

The Court's *Container* approach differed from that used in *Japan Line. Japan Line* held that one jurisdiction's "right to tax a given value in full" and another's right to tax the same entity in part" necessarily resulted in double taxation.[92] In *Japan Line*, the containers subjected to California tax were also subjected to property tax in Japan at their full value.[93] Because both California and Japan had levied a tax, it was inevitable that *Japan Line* would pay a double tax. The Court held that the California taxing scheme was unconstitutional because it caused this result.[94] Unlike the double tax

85. 441 U.S. at 456.

86. 463 U.S. at 187. The Majority in *Container* explained that the double taxation resulted because California's formula apportionment method seriously diverged from the methods adopted by international authorities and by our own federal government. *Id.*

87. *Id.* at 189-193.

88. *Id.* at 188.

89. *Id.* at 189.

90. The arm's-length standard is a form of separate accounting. Under separate accounting, business within the state is treated separately and distinctly from business outside the state; the income is computed as if the taxpayer's activities were confined solely to the taxing state. F. Keesling & J. Warren, *The Unitary Concept in the Allocation of Income*, 12 HASTINGS L.J. 42, 43 (1960). This method necessitates the computation of all intercorporate transactions on an "arms-length" basis. *Id.* This requires that a hypothetical selling price be determined, which treats the parties in the intercorporate transaction as if they were bargaining in a freely competitive market situation.

91. 463 U.S. at 190-93.

92. *Japan Line*, 441 U.S. 434, 447-55.

93. "Full value" taxation is an unapportioned form of taxing.

94. 441 U.S. at 451-52.

result found in *Japan Line*, the Court in *Container* held that the double taxation was not a direct result of the California taxing scheme.[95]

The factors the *Container* Court relied upon to distinguish *Japan Line* have less significance when applied to a foreign parent corporation. In order to prevent multiplicity, yet allow states the power to raise revenues, the Supreme Court has required that taxes be apportioned among taxing jurisdictions so that no instrumentality of commerce is subjected to more than one tax on its full value.[96] Therefore, no state is permitted to tax an instrumentality in full.[97] As stated in *Japan Line*, the Court's basis for approval of apportioned taxation rests in "its ability to enforce full apportionment by all potential taxing bodies."[98]

The Court in *Container* distinguished *Japan Line* because that case involved a foreign corporation.[99] While full tax apportionment of a domestic corporation may be successfully enforced, the Court in *Container* noted that the legal consequence of a tax upon a foreign parent corporation has more significance.[100] If a foreign parent corporation is involved, a court is unlikely to have the ability to enforce full apportionment because of jurisdictional problems. As the *Japan Line* Court clearly stated, "neither [the] Court nor [our] Nation can ensure full apportionment when one of the taxing entities is a *foreign* sovereign."[101]

Multiple taxation can occur if a foreign sovereign chooses to tax corporations domiciled in its country and its subsidiaries abroad at full value. The resulting multiple taxation is inevitable because a state also taxes the foreign parent company's subsidiary, albeit on an apportioned basis, which is operating within the state's borders. California should be precluded from taxing a foreign parent and its subsidiary through its unitary business method. No assurance of full apportionment exists and therefore a high likelihood of multiple taxation results from the unitary method.

95. *See supra* text accompanying note 81.

96. 441 U.S. at 446-47.

97. *Id.* at 447-48.

98. *Id.* Although *Japan Line* involved an unconstitutional property tax, and not an income tax, the Court stated that it was "a commonplace of constitutional jurisprudence that multiple taxation may well be offensive to the commerce clause." 441 U.S. at 446. In addition, the Court spoke of taxation in a general context without limiting its discussion to the taxation of property. *Id.* at 446.

99. 463 U.S. at 188-89.

100. *Id.* at 195 n.32.

101. 441 U.S. at 448 (emphasis added).

It is difficult to distinguish *Container* in a foreign parent context because all existing multiple taxation cannot be the inevitable result of California's taxing scheme. The internationally accepted method, arm's-length separate accounting, was recognized by the Majority to be a system "subject to manipulation" which often ignores "unquantifiable transfers of value."[102] But, as the dissent argued, separate accounting and formula apportionment are so incompatible that double taxation must be "inevitable."[103] The Majority, however, failed to yield because as it noted, "arm's-length" separate accounting would "not eliminate the risk of double taxation"[104] either. The Court concluded that California should not be required to "give up one allocation method . . . in favor of another . . . that also sometimes results in double taxation."[105]

This argument fails to comport with the foreign commerce clause because it allows California to tax a foreign instrumentality in a manner which may result in multiple taxation. California's formula apportionment produces the inevitable risk of double taxation because its basic assumptions are fundamentally different from methods used in international jurisdictions.[106] California's method allocates a higher proportion of income to itself because its allocation factors are based on higher wage rates, property values, and sales prices than those in most international taxation jurisdictions.[107] To this extent, the method "inherently leads to double taxation"[108] which cannot be avoided without changing the system itself.

In contrast, separate accounting produces only a *possible* risk of multiple taxation. This risk results from different applications of the same tax system among taxing jurisdictions.[109] Any double taxation which results in this context is "more likely to be resolved by international negotiation."[110] Certainly if California is to adopt a method

---

102. 463 U.S. at 164-65.

103. *Id.* at 201 (Powell, J., dissenting).

104. *Id.* at 191 (emphasis added).

105. *Id.* 193. The majority in *Container* noted that the application of a worldwide combined apportionment method had resulted in a refund to the taxpayer in Chicago Bridge of Iron Co. v. Caterpillar Tractor Co., 463 U.S. 1220 (1983). However, the mere receipt of a refund does not rule out the possibility of double taxation resulting due to the use of a state's taxing method. In addition, *Chicago Bridge* dealt with a tax return that did not involve foreign income or foreign apportionment factors. *Id.* at 188 n.25.

106. 463 U.S. at 198.

107. *See* J. HELLERSTEIN & W. HELLERSTEIN, STATE AND LOCAL TAXATION 538-39 (4th ed. 1978).

108. 463 U.S. at 199.

109. *Id.*

110. *Id.*

which results in multiple taxation of a foreign corporation, it should at least be required to choose the method least likely to produce such a result. Nevertheless, if either method produces *actual* multiple taxation, the foreign commerce clause dictates that the method be held unconstitutional.

The imposition of multiple taxation on a foreign parent corporation presents a particularly serious violation of the foreign commerce clause which should allow a court to distinguish *Container*. First, the state tax will fall upon a foreign rather than a domestic corporation, thus exceeding the jurisdiction of the state tax authority. Second, the court will be unable to enforce full apportionment which will result in an inevitable multiple tax.

Both *Container* and *Japan Line* concluded that any state taxing method which produces an inevitable multiple tax must be struck down.[111] Because California's formula apportionment violates this principle in a foreign parent context, it must be held unconstitutional.

B. *One Voice Standard*

Assuming that a unitary tax applied to a foreign parent case can survive the multiple taxation inquiry of the foreign commerce clause, it must then pass muster under the one voice standard enunciated in *Japan Line*.[112]

Several Supreme Court decisions have reflected the Court's awareness that taxation of foreign commerce requires federal uniformity.[113] The Court elaborated on this requirement in *Michelin Tire Corp. v. Wages*[114] by stating that "the federal government must speak with one voice when regulating commercial relations with foreign governments."[115] More recently, in *Container* the Court held that if the tax in question "either implicates foreign policy issues which must be left to the Federal Government or violates a clear

111. *Container*, 463 U.S. at 159; *Japan Line*, 441 U.S. at 434.

112. 441 U.S. at 450.

113. *See, e.g.*, Buttfield v. Stranahan, 192 U.S. 470 (1904); Bowman v. Chicago & N.R. Co., 125 U.S. 465 (1888); Henderson v. Mayor of New York, 92 U.S. 259 (1876).

114. 423 U.S. 276 (1976).

115. *Id.* at 285. Several policy reasons exist which justify the need for uniformity and the ability to speak with one voice in foreign affairs. First, there is the need to deal in a unified manner with foreign nations. In addition, federal revenue, which otherwise may be disrupted by state action, should be presented. Also, there is a need to preserve harmony among the states. *See* Abel, *The Commerce Clause in the Constitutional Convention and in Contemporary Comment*, 25 MINN L. REV. 432, 446-49 (1941).

federal directive"[116] the one voice standard is violated. The most obvious foreign policy implication of a state tax is the threat of retaliation by the foreign nation in which the corporation is domiciled.[117]

1. *Foreign Policy Implications*

A state tax method such as California's formula apportionment may frustrate the goal of federal uniformity because it subjects a foreign parent corporation to income tax. In *Container*, the Court noted that a "legal incidence" of taxing a foreign parent corporation may implicate foreign policy more than taxing a domestic corporation.[118] Foreign governments have legitimate grounds to complain when a heavier tax is calculated on the basis of income of corporations domiciled in *their* countries.[119] California's tax has the effect of discouraging American investment in foreign countries[120] because those countries may now subject American companies to some form of economic retaliation. Additionally, foreign companies may refuse to do business in California if they are subjected to a double tax.

If such an imbalance in the international tax structure results, a foreign sovereign might retaliate militarily against the United States. In that event, the nation as a whole and not just the taxing state, would suffer.[121] Moreover, the federal government would plainly be prevented from speaking with one voice if other states applied California's unitary taxation method.

Foreign nations have already expressed their displeasure with California's taxing scheme and with the outcome of the *Container* decision. The Kingdom of the Netherlands has indicated that it will take action in opposition to worldwide formula apportionment, particularly when a foreign parent corporation is involved.[122] In addition, Japan intends to refuse to expand its business in California

---

116. 463 U.S. at 194.

117. *Id.* (Retaliation by foreign nations may occur in several forms. Foreign trading partners may refuse to sign or honor current income tax treaties. Foreign nations may impose severe tax measures upon the U. S. companies conducting business in offended countries. Foreign trading may be suspended indefinitely. Or such retaliation may ultimately lead to war against our country).

118. *Id.* at 195 n.32.

119. *Id.* at 202 (Powell, J., dissenting).

120. *Id.*

121. 441 U.S. at 450-51.

122. Javaras and Browne, *Litigation Prospects After Container*, 21 TAX NOTES 1027, 1030 (1983). The Kingdom of the Netherlands has announced that it will not sign a newly agreed upon income tax treaty with the United States unless the foreign parent issue can be resolved.

because of that state's method of unitary taxation.[123] Canada also joined the ranks of possible retaliating countries when it recently stated that it would file an *amicus curiae* brief to support a challenge against California's unitary tax system.[124] This foreign displeasure implicates foreign policy issues that should be left to the federal government and not to the states. Thus, unitary taxation of a foreign parent also fails to satisfy the one voice standard.[125]

2. *Inconsistency With a Clear Federal Directive*

A state may also violate the one voice standard if its tax is inconsistent with a clear federal directive.[126] This inconsistency can occur in several instances.

Our tax treaty system is one such directive in this area. The United States federal government has a strong national interest in harmonizing international taxation systems. This interest includes promoting the efficient flow of trade and investment. One way to harmonize tax systems is to develop treaties with foreign nations. These treaties do not apply to taxes imposed upon domestic parent corporations,[127] but they do apply to foreign parent corporations.[128] Many of these treaties require the adoption of some form of arm's-length separate accounting.[129] California's income taxation of foreign entities would clearly violate the federal policy expressed in many of these treaties if the state required the adoption of a different tax method, such as formula apportionment.

Another federal directive occurs when the executive branch voices its position in an area of national policy. In *Container* the Court noted that the executive branch had decided not to file an *amicus curiae* brief opposing the state tax.[130] The executive branch, however, had stated its position in an *amicus curiae* brief for an-

---

123. A delegation from the Japan Federation of Economic Organizations regards California's unitary tax system as "very unreasonable and unfair." According to the delegation, most Japanese companies will cease new investment or expansion in California because of the formula apportionment method. San Francisco Chronicle, Feb. 11, 1984, at 47, col. 5.

124. 22 TAX NOTES 15 (1984). France, the United Kingdom, and Japan have challenged California's unitary tax system by submitting *amicus curiae* briefs.

125. One commentator noted that the unitary method of taxation in a "domestic context" is sound. But in his view a worldwide application results in "inequitable . . . international double taxation" and suffers from an "even more compelling constitutional defect" because it violates the one voice standard. The Wall Street Journal, Dec. 23, 1983, at 12, col. 4.

126. 463 U.S. at 193-94.

127. 463 U.S. at 196.

128. *Id.*

129. *Id.*

130. *Id.* at 195.

other case before the Court during the same term in which *Container* was heard. The Solicitor General on behalf of the executive branch stated in *Chicago Bridge & Iron Co. v. Caterpillar Tractor Co.*[131] that imposing a state tax on the "apportioned combined worldwide business income of a unitary group of related corporations including foreign corporations, impairs federal uniformity in an area where such uniformity is essential."[132] Presuming that the Government's views have not changed, California's tax directly conflicts with this expression of federal policy.

Therefore, California's tax method plainly impairs federal uniformity. First, it is inconsistent with the method chosen and preferred by the federal government in its treaties. Second, it is inconsistent with the position taken by the executive branch in an area of national policy.

V. Conclusion

After the *Container* decision, it may now be easier for a state to find a "unitary" group.[133] A foreign parent corporation, however, presents a significantly different set of facts from that in *Container*. Unlike the domestic corporation facts in *Container*, unitary taxation of the foreign parent corporation inevitably results in double taxation. In addition, the Supreme Court does not have the same ability to assure full apportionment with foreign parent corporations as it does with a domestic corporation. Because of this multiple taxation, the first requirement of the foreign commerce clause cannot be satisfied.

California's tax on foreign-owned or organized corporations has provoked reactions from foreign nations. This foreign displeasure prevents federal uniformity. Furthermore, California's taxation method directly conflicts with the federal directive of the international arm's-length, separate accounting method of taxation which is embodied in numerous government treaties. Formula apportionment also conflicts with the executive branch's view that foreign corporations should be taxed by the internationally accepted methods. Thus, California's unitary tax also violates the one voice standard. Califor-

131. 463 U.S. 1220.

132. Chicago Bridge & Iron Co. v. Caterpillar Tractor Co., 463 U.S. 1220 (1983) (memorandum for the United States as *amicus curaie*).

133. *See supra* text accompanying notes 48-57.

nia's tax system as applied to a foreign parent corporation should be held unconstitutional because it violates both of these inquiries.

Randel Mathias