1-1-1980

California's Corporate Franchise Tax: Taxation of Foreign Source Income

Gordon T. Yamate

Follow this and additional works at: http://digitalcommons.law.scu.edu/lawreview

Part of the Law Commons

Recommended Citation
Available at: http://digitalcommons.law.scu.edu/lawreview/vol20/iss1/6

This Comment is brought to you for free and open access by the Journals at Santa Clara Law Digital Commons. It has been accepted for inclusion in Santa Clara Law Review by an authorized administrator of Santa Clara Law Digital Commons. For more information, please contact sculawlibrarian@gmail.com.
COMMENTS

CALIFORNIA'S CORPORATE FRANCHISE TAX:
TAXATION OF FOREIGN SOURCE INCOME?

INTRODUCTION

California levies a franchise tax on domestic and foreign corporations for the privilege of doing business in California and measures the tax by the amount of the net income derived from business transacted in California during the preceding calendar or fiscal year.1 When the income of a taxpayer subject to the franchise tax is derived from or attributable to sources both within and without the state, California Revenue and Taxation Code section 25101 provides that "the tax shall be measured by the net income derived from or attributable to sources within this state in accordance with the provisions of Article 2," which adopts the Uniform Division of Income for Tax Purposes Act.2 Formula apportionment is used to determine California source income only when the business conducted both within and without California is "unitary" in nature.3 Where a group of corporations constitutes a unitary business, section 25101 authorizes the California Franchise Tax Board to require that a combined report be filed by the business to determine the unitary income of the group and the formula factors for apportionment.4

In general, a corporation is part of a unitary business if its operations are dependent upon or contribute to the business conducted by the group. The concept is based on the theory that the business activities within the state are considered an inseparable part of a business carried on outside the state. Business income attributable to a particular taxing state is determined by applying an apportionment formula which consists of various factors thought to be relevant to the production

© 1979 by Gordon Yamate.
4. CAL. FRANCHISE TAX BD., supra note 3.

123
of income (i.e., property, payroll, and sales), compared with total worldwide income.\(^5\)

The apportionment method for a unitary business is often contrasted with "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.\(^6\) Such method necessitates the computation of all intercorporate transactions on an "arms-length" basis.\(^7\)

Formula apportionment has been adopted on the grounds that it conforms more equitably to economic reality in distributing tax burdens, and that it remedies the alleged shortcomings of the separate accounting method: use of separate accounting to engage in wide-scale tax avoidance and the theoretical problem of establishing an arms-length market price when such a standard does not exist.\(^8\)

---


Section 25128 provides that "all business income shall be apportioned to this state by multiplying the income by a fraction, the numerator of which is the property factor plus the payroll factor plus the sales factor, and the denominator of which is three." *Cal. Rev. & Tax. Code* § 25128 (West 1970).

The unitary theory reflects the belief that multinational corporation (MNC) parents will tend to exercise strong centralized control over all parts of the enterprise and treat each subsidiary as an interdependent part of a larger system. Since all MNC subsidiaries are considered to be parts of the same unitary business, intercompany transactions cannot produce a real economic profit or loss and must therefore be eliminated from tax consideration. Rather, income is not recognized for tax purposes until some part of the MNC earns a profit from sales to an unrelated party.


7. The "arms-length" standard 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.

Separate accounting is also the method generally adopted by the federal government to allocate income between domestic and foreign corporations. Internal Revenue Code § 482, the principle authorizing provision, attempts "to place a controlled taxpayer on a tax parity with an uncontrolled taxpayer, by determining, according to the standard of an uncontrolled taxpayer, the true taxable income from the property and business of a controlled taxpayer." Treas. Reg. 1.482-1(b)(1) (1968); [1978] 4 Stand. Fed. Tax Rep. (CCH) ¶ 2991. Under § 482, the Internal Revenue Service is authorized to allocate or rearrange the incidents (i.e., gross income, deductions, credits, or allowances) whenever necessary "to prevent evasion of taxes or clearly to reflect the income" of the subject taxpayers. Lewis, *Allocations (sec. 482)—General Coverage*, [1975] Tax Mgmt (BNA) 327.

8. See generally, J. Zeifman, *The Taxation by California of the Income of Multi-
Despite the merits of the unitary concept of taxation, perhaps no single area of state taxation has caused more conflict between the international business community and state taxing authorities than California's inclusion of foreign income in the apportionment formula. Enforced on a worldwide basis, the unitary business doctrine has been a source of both political and legal debate. The tax method was criticized as a deterrent to foreign investment in California because of its discriminatory burden on foreign businesses and was a focal point of controversy in the amendment of Article 9(4) of the newly negotiated United States-United Kingdom Tax Treaty. 9

While opposition to the unitary tax method comes from multistate and multinational businesses alike, unique problems exist when foreign operations, including both parents and subsidiaries of California operations, are included in the unitary business. Although corporations are not uniformly opposed to the application of formula apportionment, since the formula may on occasion operate to reduce a corporation's California franchise tax liability by offsetting California income with losses in its foreign subsidiaries or affiliates, 11 the inequities imposed on the multinational corporation warrant a closer evaluation of the applicability of the unitary doctrine. The problems are both practical and conceptual and are cast in a legal setting where statutory guidelines are minimal and judicial guidance is sparse.

This comment examines those problems affecting the foreign corporation by first reviewing the historical basis of the unitary concept and the development of its extensive application by the California courts and administrative bodies. It then explores the theoretical economic difficulties of employing the apportionment formula on a worldwide basis as well as reviews the administrative problems created by the combined report requirement. The comment then examines the suggested legal grounds for challenging the inclusion of foreign corporations in the unitary method of apportionment, and concludes that any

---

10. Id.
of the inequities suffered by foreign businesses will have to be remedied by legislation.

DEVELOPMENT OF THE UNITARY BUSINESS DOCTRINE

The Traditional Standard—Requirements of Due Process

The unitary business concept of taxation was first applied to a foreign corporation in the leading United States Supreme Court decision of *Bass, Ratcliff & Gretton, Ltd. v. State Tax Commission.* At issue was the constitutional validity of a New York statute that imposed an annual franchise tax on a foreign manufacturing and mercantile corporation for the privilege of doing business in the state. The tax was computed by the State Tax Commission at the rate of three percent upon the net income of the corporation for the preceding year. If the entire business of the corporation was not transacted within the state, the tax was to be based upon the portion of such net income determined by the proportion which the “aggregate value of specified classes of the assets of the corporation within the state bears to the aggregate value of all such classes of assets wherever located.” The taxpayer in *Bass* was a British brewing corporation. Although all of its brewing was done in England, the corporation sought a market in the United States, conducting sales through its branch offices in New York City and Chicago.

For the year in which the franchise tax was assessed, *Bass* reported no net income for federal income tax purposes from its Chicago and New York operations. However, the Commission computed a worldwide net income of over $2 million for the corporation and, by allocating to New York income proportional to the segregated assets located in New York, attributed nearly $30,000 to the New York operation upon which the franchise tax was computed.

*Bass* argued that the franchise tax was not based upon any net income derived from its operations in New York but that the New York statute arbitrarily allocated a portion of its net income derived from business carried on outside the United States.

---

12. 266 U.S. 271 (1924).
13. *Id.* at 277.
14. *Id.* at 278.
15. *Id.* at 278-79.
16. *Id.* at 279.
17. *Id.* at 280.
States. The taxpayer argued that such imposition of the tax deprived the corporation of its property in violation of the due process clause of the fourteenth amendment and imposed a direct burden upon its foreign commerce in violation of the commerce clause of the Constitution.

The Supreme Court sought guidance in the Bass case from its earlier landmark decision, Underwood Typewriter Co. v. Chamberlain, where a Connecticut statute imposed a similar net income tax on corporations doing business partly within and without the state. The amount of the Connecticut levy was fixed by taking the proportion of the net income on which the corporation was required to pay federal tax determined by a comparison of the value of its real and tangible-personal property within the state to the value of all its real and tangible-personal property. The taxpayer in Underwood demonstrated that, while forty-seven percent of its real estate and tangible-personal property was located in Connecticut (thus attributing forty-seven percent of the corporation’s total net income to Connecticut operations), in fact, $1.3 million of its net profit was earned in other states and only about $43,000 was earned in Connecticut. The Court concluded that such showing failed to sustain an objection to the validity of the tax and noted:

The profits of the corporation were largely earned by a series of transactions beginning with manufacture in Connecticut and ending with sale in other States . . . The legislature in attempting to put upon this business its fair share of the burden of taxation was faced with the impossibility of allocating specifically the profits earned by the processes conducted within its borders. It, therefore, adopted a method of apportionment which . . . reached, and was meant to reach, only the profits earned within the State.

Simply stated, the taxpayer had failed to carry the burden of proving that forty-seven percent of its net income was not reasonably attributable to the manufacture of products, the sale of which accounted for eighty percent of its gross earnings after manufacturing costs. Since Underwood had not even attempted proof, there was nothing in the record to show that the

20. 254 U.S. 113 (1920).
22. Id. at 281.
method of apportionment was inherently arbitrary or that its application to the taxpayer produced an unreasonable result.\textsuperscript{23} The Court "determined that it was impossible to compute the Connecticut manufacturing profits separately from the total profits of the business, and concluded that the formula was reasonably designed to achieve a fair apportionment, at least in the absence of any express showing to the contrary."\textsuperscript{24}

In Bass the Court recognized that the company carried on a unitary business (manufacturing and selling ale) in which its profits were earned by a series of transactions beginning with the manufacture in England and ending with sales in New York and elsewhere. Since the manufacturing process resulted in no profits until it ended in sales, the Court concluded that the state was justified in attributing to New York a just proportion of the profits earned by the company.\textsuperscript{25}

The Bass Court relied heavily on Underwood, making no distinction between the fact that formula apportionment was applied among the states in Underwood while the unitary business in Bass transcended national boundaries. In fact, the Court's decision does not reveal any consideration of the problem of extending formula apportionment beyond the United States borders. The Court would permit the use of formula apportionment of income from a unitary business to the extent that "the formula must not be intrinsically arbitrary, and it must not produce an unreasonable result."\textsuperscript{26}

\textsuperscript{23} Id. at 281-82.\textsuperscript{24} E.G. Rudolph, \textit{State Taxation of Interstate Business: The Unitary Business Concept and Affiliated Corporate Groups}, 25 Tax. L. Rev. 171, 181 (1970).\textsuperscript{25} Referring to its earlier decision in Wallace v. Hines, the Court stated: A State, in imposing an excise tax upon foreign corporations in respect of doing business within the State, may look to the property of such corporations beyond its borders to "get the true value of the things within it, when they are part of an organic system of wide extent," giving the local property a value above that which it would otherwise possess, and may therefore take into account property situated elsewhere when it "can be seen in some plain and fairly intelligible way that it adds to the value of the [property] and the rights exercised in the State." This is directly applicable to the carrying on of a unitary business of manufacture and sale partly within and without the state.\textsuperscript{26} 254 U.S. 113, 121 (1920). This standard was reaffirmed in Butler Bros. v. McColgan, 17 Cal. 2d 664, 672, 111 P.2d 334, 339 (1941).

To be violative of due process, "the misapportionment must be palpable and the burden is on the taxpayer to satisfy the exacting test." F.W. Woolworth Co. v. Director of Div. of Taxation, 45 N.J. 466, 213 A.2d 1, 17 (1965). Moreover, the U.S. Supreme Court has long recognized the practical impossibility of a state's achieving a perfect
The California Approach

The Butler Brothers test. The California Supreme Court has provided two general tests for determining whether or not a business is unitary and thus subject to formula apportionment. In its leading statement on this issue, the court, in Butler Brothers v. McColgan, held that the existence of a unitary business is conclusively established by the presence of: "(1) unity of ownership; (2) unity of operation as evidenced by central purchasing, advertising, accounting and management divisions; and, (3) unity of use in its centralized executive force and general system of operation." Rejecting the taxpayer's showing of a substantial loss from its California branch on the basis of separate accounting, the court explained that when a state adopts a formula for allocation of income to the various states in which the business is conducted, a presumption arises that the formula produces a fair result. The taxpayer then has the burden to demonstrate, by clear and convincing evidence, the uniqueness of its California operation so that the formula produces an erroneous result. In other words, the taxpayer must show "a variance from normal in either the California sales, property or payroll, or in either expenses or revenues" in order to demonstrate the taxation of extraterritorial values; separate accounting alone is not sufficient.

The Edison California Stores, Inc. test. Six years later, the California Supreme Court in Edison California Stores, Inc. v. McColgan offered an alternative test that establishes a unitary business where the operation of the business within California contributes to or is dependent upon the operation of the business outside the state. In Edison, a California subsidiary contended that the application of a three-factor formula to the combined income of its entire affiliated group amounted to requiring a consolidated return. This, the taxpayer argued, California could not require because it had no jurisdiction over

27. 17 Cal. 2d 664, 111 P.2d 334 (1941), aff'd, 315 U.S. 501 (1941).
28. Id. at 678, 111 P.2d at 341.
29. Id. at 677, 111 P.2d at 341.
31. Id. at 481, 183 P.2d at 21.
32. Under the federal income tax law, a consolidated tax return may be filed by an affiliated group of corporations pursuant to Internal Revenue Code sections 1501 and 1504(a) with certain exceptions. Such consolidation treats the group as if it were one corporation for tax purposes.
the parent company. The court held that the action by the Franchise Tax Commissioner neither involved a consolidated return nor disregarded the separate entity status of the various members of the group. Rather, the combined-report concept, coupled with the apportionment formula as applied to the California subsidiary, was consistent with the Butler Brothers decision.

Although the court felt that the taxpayer had met all the elements of a unitary business under the Butler Brothers test, the plaintiff in Edison contended that the finding of a unitary business between a Delaware parent corporation and its out-of-state branches, organized as corporations in other states (e.g., the California subsidiary), should be distinguished from the Butler Brothers situation which involved a single California corporation with operating branches in several states. The court failed to see any distinguishable difference between the two cases and offered the contribution-dependency test of a unitary system. Thus, the unitary concept was not disturbed and its application was extended to subsidiary and affiliated corporations.

Although the Edison decision declares a new test for determining the existence of a unitary business, it is unclear whether such test, without the three unities of ownership, use, and operation, can sustain a unitary determination. In Chase Brass and Copper Co. v. Franchise Tax Board (hereinafter Chase Brass I), the California Court of Appeal spoke of the contribution-dependency test of Edison as the general test for a unitary business and the Butler Brothers test as a more particular statement of the test. However, in applying the tests in Chase Brass I, the court only mentioned the three Butler Brothers unities, implying that the contribution-dependency test may be presumed to be satisfied if the elements of the more particular test are proven. Moreover, the State Board of Equalization, in the Appeal of F.W. Woolworth Co. refused to interpret Butler Brothers as holding that a unitary business exists only if the three unities of ownership, operation and use are present. The Board held that a unitary business may also exist if the alternative test of Edison is satisfied.

34. 10 Cal. App. 3d at 501-02, 86 Cal. Rptr. at 353.
35. 4 CAL. TAX REP. (CCH) ¶ 204-806 (July 31, 1972).
36. In subsequent cases both the Butler Bros. and Edison tests have been consis-
Chase Brass I left the unitary concept undisturbed but broadened its scope of application by lowering the standards for satisfying the elements of the three-factor test of Butler Brothers. The court was faced with the task of determining whether sufficient intercorporate unity was present to warrant the unitary treatment of a group of vertically integrated corporations within the copper industry. Although the unity of ownership requirement was easily satisfied, the court drew criticism when it determined the existence of the unities of operation and use upon facts that have been characterized as those "which would almost inevitably be present in any parent-subsidiary relationship." The facts indicating unity of operation were markedly different than the more common Edison situation where all essential staff functions were performed for the subsidiary by the parent. The Chase Brass I court noted individually insignificant facts such as the "minor" purchasing by the parent for a subsidiary, the use of the same accounting firm, a common retirement plan and an isolated financing arrangement at the prime rate between the parent and a subsidiary to establish the unitary operation. The court found unity of use in the reservation of major policy decisions by the parent and the degree of cooperation existing among members of the affiliated group.

State Board of Equalization


The court in Chase Brass I recognized the problem that the staff functions of a vertically integrated enterprise were not so markedly unitary as in a horizontally integrated business and explained that in the case of horizontal integration, functions such as central control of advertising of the same product, central purchasing, and the like are designed to give advantages to the business despite geographic differences. In the case of vertical integration involving various steps in the production and distribution, integration of staff functions probably will be considerably less.

Id. at 502-03, 86 Cal. Rptr. at 353.
ization has sustained the Franchise Tax Board’s efforts to extend the application of the unitary method to foreign subsidiaries and affiliates of California parent corporations and, most recently, to a parent corporation that was organized and controlled under the laws of another country. While such applications may not be amenable to a generalized rule that a unitary business will necessarily include foreign operations, whether they be subsidiaries or parent corporations, the decisions do indicate an aggressive and thorough application of the Butler Brothers and Edison tests.

Foreign subsidiaries. In Appeals of the Anaconda Co., et al. 41 the taxpayer did not contest the Franchise Tax Board’s finding that Anaconda (California parent) and all of its domestic subsidiaries were engaged in a single unitary business, but did argue that several of its subsidiaries engaged in mining in Chile and Mexico were not a part of the unitary business. None of the foreign mining companies in question owned property or did business in California, but each corporation’s stock was owned by either a Delaware corporation or a Minnesota corporation who were each, in turn, ninety-nine percent owned by Anaconda. The Board concluded that the key to the relationship was copper, as Anaconda owned and operated copper mines in the continental United States, and copper was the principle metal mined by the Latin American companies. In determining that the foreign affiliates were part of the unitary business, the Board noted that the three unities of Butler Brothers were present 42 and that the integrated operation among the Latin American affiliates involving the mining, refining, and fabricating of copper represented the type of operational interdependence which lay at the heart of the unitary business concept. 43

Anaconda also appealed the Franchise Tax Board’s determination on the ground that it was inconsistent with the California courts’ only decision relating to the inclusion of foreign

41. 4 CAL. TAX REP. (CCH) ¶ 204-759 (May 11, 1972).
42. The Board noted that the unity of ownership exists by virtue of Anaconda’s controlling stock ownership in the companies here involved; unity of operation is evidenced by the centralization of service and overhead functions; and unity of use is established by the vertical integration of the copper operations and by Anaconda’s control, through interlocking top executives, of the major management decisions of the Latin American affiliates.

43. Id.
operations in the unitary business. Although the court held in *Chase Brass I* that Braden Copper Co., a Kennecott subsidiary operating copper mines in Chile, was not part of a unitary business conducted within and without California, the Board in *Anaconda* refused to interpret the *Chase Brass I* decision as providing a general rule that foreign subsidiaries or affiliates should be excluded from the unitary business. The Board explained that whatever the court's theory for finding the Kennecott subsidiary in *Chase Brass I* to be non-unitary, the court did not articulate it clearly, and the Board cannot speculate as to what that theory might have been. The Board in *Anaconda* then noted that the general body of precedent in the unitary business area compelled the conclusion that Anaconda and its Latin American affiliates were engaged in a unitary business.44

In *Appeal of Grolier Society, Inc.*,45 the State Board of Equalization extended the scope of the unitary business concept to include foreign subsidiaries whose only link to California was through an out-of-state parent corporation, which also operated a subsidiary in California. In that case, Grolier-parent, who was headquartered in New York, directly owned all of the domestic and some of the foreign subsidiaries and indirectly controlled other foreign subsidiaries through a wholly-owned subsidiary. The Board rejected the taxpayer's argument that there was an absence of any intercorporate relationships between Canadian and Latin American subsidiaries and the California operations of the domestic affiliates on the ground that a unitary business does not require an interdependence between every segment of the foreign and domestic operations. The Board relied on its earlier decision in *Appeal of Monsanto Co.*,46 where it declared "the argument misconceives the unitary business concept. All that need be shown is that during the critical period [the operating division] formed an inseparable part of appellant's unitary business wherever conducted."47 The Board went on to conclude the existence of

---

44. See also *Appeal of F.W. Woolworth*, 4 CAL. TAX REP. (CCH) ¶ 204-806 (July 31, 1972) (Canadian subsidiary of taxpayer was part of unitary operation); *Appeals of Simonds Saw and Steel Co.*, et. al., [1966-1971 Transfer Binder] CAL. TAX REP. (CCH) ¶ 203-785 (Dec. 12, 1967) (two Canadian affiliates were part of unitary operation); *Appeal of Wm. Wrigley, Jr. Co.*, [1966-1971 Transfer Binder] CAL. TAX REP. (CCH) ¶ 203-535 (Dec. 15, 1966); *Appeal of American Can Co.*, 2 CAL. TAX CAS. (CCH) ¶ 201-180 (Nov. 19, 1958).

45. 4 CAL. TAX REP. (CCH) ¶ 205-301 (August 19, 1975).


47. Id.
a unitary business based on the Butler Brothers and Edison tests.48

Foreign-owned and -controlled parents. In perhaps its greatest extension of the unitary doctrine to foreign businesses, the Board of Equalization in Appeal of Beecham Inc.48 upheld a determination that the income of a foreign parent, organized and operating under the laws of the United Kingdom, and the parent’s subsidiaries, be included in the combined report. In commenting on the propriety of such inclusion, the Board explained that it was unable to discern any difference when the foreign corporation is the parent rather than the subsidiary. The following quotation from one commentator summarized the Board’s conclusion:

It seems clear, strictly as a logical proposition, that foreign source income is no different from any other income when it comes to determining by formulary apportionment, the appropriate share of the income of a unitary business taxable by a particular state. This does not involve state taxation of foreign source income any more than does apportionment—in the case of a multistate business—involves the taxation of income arising in other states. In both situations the total income of the unitary business simply provides the starting point for computing the in-state income taxable by the particular state. This proposition, so far as foreign source income is concerned, was recognized in the early Supreme Court case of Bass, Ratcliff & Gretton v. State Tax Commission [citation omitted]. While the Bass case involved a single corporation, the rationale is just as applicable where a unitary business is being conducted by an affiliated group of corporations, and even though some of the corporations are beyond the jurisdiction of the taxing state. This was in substance the holding of Edison Stores.50

In summary, the California courts have yet to clearly delimit the unitary business concept, except to state “[i]t is only if [a corporation’s] business within this state is truly separate and distinct from its business without this state, so that the segregation of income may be made clearly and accurately,

49. 4 CAL. TAX REP. (CCH) ¶ 205-635 (Mar. 2, 1977).
that the separate accounting method may properly be used." The cases and administrative rulings show a strong reliance on the three-factor test of Butler Brothers and the contribution-dependency test of Edison to establish a unitary business, but the Chase Brass I decision may produce some potentially disturbing results with parent-subsidiary related business.

By not distinguishing foreign businesses from interstate operations, the courts have neither directly authorized the inclusion of foreign corporations in the unitary business, nor have they ever expressly denied such inclusion. The Franchise Tax Board has interpreted such silence as implicit authority to include foreign operations in the apportionment formula, and

51. 17 Cal. 2d at 667-68, 111 P.2d at 336.
52. While the three unities and the contribution or dependency tests may be applied aggressively by the Franchise Tax Board to establish a unitary business, such tests are by no means applied blindly. In Appeal of Scholl, Inc., the Board of Equalization concluded that the operations of a domestic parent and its domestic subsidiaries were not unitary with its foreign subsidiaries despite the Franchise Tax Board's argument of the presence of (1) integrated executive forces, (2) substantial intercompany product flow, (3) free availability of trademarks and patents, and (4) over 50 percent ownership of the stock of all foreign corporations by the domestic parent. While the Board of Equalization explained that a number of factors crucial to the Butler Bros. and Edison tests were ostensibly indicated, a closer examination revealed that factual operations belied that indication. First, while there was some evidence of interlocking directors during the appeal years, the almost total lack of financial or operational reporting to the Chicago headquarters of the parent by the foreign subsidiaries indicated that eastern hemisphere subsidiaries operated as an autonomous unit. Moreover, while the parent owned a majority of the foreign subsidiaries' stock, its voting rights were exercised pursuant to proxies given to one executive in charge of foreign operations, and while such executive was in charge of the eastern hemisphere operations, no meaningful visits by executives of the domestic group were allowed. Second, while both domestic and foreign operations generally dealt with foot and leg care products, there was no substantial inter-company product flow between the groups, as sales by the domestic group to the foreign group never exceeded one-half of one percent of the domestic group's total net sales. The evidence indicated that so far as was material, the foreign group designed, manufactured and packaged their own products for ultimate distribution and sale solely by other foreign corporations. Third, while the free availability of trademarks and patents is a privilege not usually afforded to separate and distinct companies and is a clear indication of unity, the facts of this particular appeal indicated that there was no combined international advertising of the Scholl name; foreign and domestic market development were independent and parallel. Finally, in regard to the three unities test, only the unity of ownership requirement appeared satisfied. Appeal of Scholl, Inc., CAL. TAX REP. (CCH) ¶ 206-000 (Sept. 27, 1978).
53. It should be recognized that "the Executive Officer of the Franchise Tax Board has publicly announced that the Board will pursue the combined reporting concept just as far as the courts will allow." Cal. Certified Public Accountants Foundation for Education and Research, Overview of California's Taxation of Multicorporate Businesses with Activities Both Within and Without California I-5 (1975).
when contested, the State Board of Equalization has concurred with the Franchise Tax Board.

**CONTROLLING OWNERSHIP REQUIREMENT**

Although the Butler Brothers and Edison tests differ as to the particularities of the unitary elements, no court has found the existence of a unitary business in the absence of pervasive controlling ownership. Moreover, in *Appeal of Jack Harris, Inc.* the State Board of Equalization stated that the unity of ownership requirement is implicit in the contribution-dependency test.

The ownership element is crucial to the unitary theory: section 25101 contemplates controlling ownership. The lack of controlling ownership alone demands separate treatment for the businesses regardless of how closely the activities are otherwise integrated. Control requires that the various parts of the system operate as a single enterprise with each part dependent upon and contributing to the whole.

On two occasions, the State Board of Equalization has held that where the taxpayer and another enterprise each own fifty percent of the stock of a foreign corporation and each exercises one half of the control of that corporation, the taxpayer is not engaged in a unitary operation with the foreign corporation. However, the Board has indicated that equal stock ownership is not conclusive; certain operating agreements entered into by two fifty-percent corporate shareholders of a foreign corporation may substantially change the relationship between the two shareholders so that one corporation's fifty-percent stock ownership is the controlling interest.

For example, in *Appeal of Signal Oil and Gas Co.*, the Board found that where a subsidiary corporation lacks a major-

---

CORPORATE FRANCHISE TAX

ity stock interest in its affiliate but has a controlling ownership over operational matters, a unitary business operation exists, and the parent is entitled to include the income or losses from its subsidiary and the affiliate in its computation of income for the California franchise tax. Although this determination provided a favorable result for the California parent corporation taxpayer, since the business losses of a German affiliate of the California corporation's wholly-owned Swiss subsidiary could be included in the unitary business, such ruling explicitly authorizes extending the extraterritorial reach of the unitary business to allow the Franchise Tax Board to require the inclusion of a subsidiary's or affiliate's income where such income would increase the tax liability of the California operation.

The implications of *Signal Oil* are not completely clear. On one hand, the Board, in comparing section 25101 to its federal counterpart (section 482 of the Internal Revenue Code) adopted the substance-over-form approach that recognized certain unitary aspects of the affiliate (i.e., the other one-half owner of the German affiliate had relinquished his interest in the operational control of that company, indicating that the parent taxpayer would also control price negotiations) even though the technical more-than-fifty percent stock ownership requirement was not met. In part, *Signal Oil* relied on a federal decision where two shareholders controlled one of two relevant corporations but only owned two percent of the stock of another. In that case, the federal Court of Appeals held that, notwithstanding such minority ownership, the stockholders were in effective control of the latter company and section 482 was applicable.

Focus on the unity-of-ownership requirement as it relates to foreign corporations is significant for two reasons. First, once the unity-of-ownership test has been met, the other factors pointing to a unitary operation are likely to be found. The taxpayer then has the burden of showing that the three-factor test, or alternatively the contribution-dependency test, is not met, a task that most taxpayers find overwhelmingly difficult.

62. I.R.C. § 482.
Second, because the ownership test for combining a parent and subsidiary only requires that a parent own more than fifty percent of the subsidiary's stock, the unitary concept raises a serious issue of fairness. For example, a California parent corporation may be subject to a tax on a portion of the foreign subsidiary's income to which that parent is not entitled. Even though the minority interest may be as high as forty-nine percent, California requires that the total income of the foreign corporation be included in the combined return and subject to formula apportionment by the Tax Board. Furthermore, control arrangements as discussed in *Signal Oil* are not uncommon to multinational businesses; such arrangements may allow the state to set aside the more-than-fifty-percent ownership test for inclusion of affiliate income.

**ECONOMIC PROBLEMS OF FORMULA APPORTIONMENT**

*Income Distortion*

The Task Force on Foreign Source Income of the House Ways and Means Committee (Task Force) recognized the issue that states which apply the unitary method of taxing corporate business income under an apportionment formula may be indirectly taxing the income of related foreign corporations by apportioning too much income to the United States. A unitary business may be operating in a foreign country where wages and property values are lower in proportion to income than in the United States. If such a disparity exists, the unitary


66. *HOUSE COMM. ON WAYS AND MEANS, RECOMMENDATIONS OF THE TASK FORCE ON FOREIGN SOURCE INCOME*, 95th Cong., 1st Sess. 28 (1977) [hereinafter cited as TASK FORCE].

67. Indeed, legal counsel for one multinational business suggests that the worst offenders are the payroll and property factors. The former was adopted in order to provide some measure of the contribution of labor to the production of income. Presumably, this decision to use actual salaries and wages paid rather than the number of employees would reflect the relative value to the company of the contributions by each employee (i.e., the presence of the company president would be given greater weight than the presence of a janitor). However, when such standard is applied on a worldwide basis where wage rates may vary substantially, the payroll factor may produce distorted results. For example, the salary of a U.S. executive may be double that of his foreign counterpart, but he may be no more productive; yet, the U.S. executive's salary is double-weighted in the apportionment formula. Statistics indicate that California wage rates are among the highest in the world, which would suggest...
method may operate to apportion more income to the domestic operation than would otherwise be acceptable if such foreign affiliate was treated as an independent entity operating at arms-length.\(^8\)

From an economic viewpoint, formula apportionment presumes a "worldwide common market" where the economic costs of doing business are equal.\(^6\) This presumption is rejected by economists as it simply ignores economic reality.\(^7\) More-

---

\(^8\) That a disproportionate amount of income is allocated to California when the payroll factor is used. J. Condrau, Statement by Union Bank of Switzerland to the California Franchise Tax Board Regarding the Effect of Application of Worldwide Unitary Accounting 14-15 (on file at Santa Clara Law Review). Statistics compiled by Mobil Oil Corporation from government sources support the finding that this country maintains higher wage levels than the rest of the world. T. Bagg, Taxation of Multistate Corporations, Response of Mobil Oil Corp. before the California Franchise Tax Bd. app. A-D (July 12, 1977)(on file at Santa Clara Law Review).

Another commentator notes that

Wage levels are considerably lower in Japan, Italy or almost any other country than in the United States for similar work. In 1969, the cost of engineering work in Japan was only 70 percent of that in the U.S. (England was 75 percent, Holland 80 percent, France 90 percent). In 1972, the cost of skilled construction labor in Japan was approximately $14 per day including social charges. In Argentina, the cost was $7 per day. In England, it was $10 per day. In the United States, the cost is about $25 per day.

See R. Peterson, supra note 64, at 187.

The property factor encounters two problems. As in the case of wage levels, a similar disparity exists as to the cost of plants or property. One writer notes that it would have cost $244 million in California in 1969, to build an oil refinery to produce 125,000 barrels per day; the cost of the same refinery in Germany, however, would have been only about $190 million. Similarly, in 1964-70, the average investment needed to provide employment to one person in the rubber industry in the U.S. was $137,000, while an average of only $58,000 was required outside the U.S.

\(^6\) See J. Condrau, supra, at 16. See also F. Latchum, supra note 65, at 10.

\(^7\) See also F. Latchum, supra note 65, at 3-4.

\(^8\) TASK FORCE, supra note 66, at 28.

\(^9\) Id. See also F. Latchum, supra note 65, at 3-4.

\(^10\) Since capital markets are [not] perfect (especially at the international level) ... This assumption of equal productivity cannot be accepted. Factors of production are not wholly mobile, so that interna-
over, the lure of foreign location by domestic businesses lies, in great part, on the opportunity for higher profit margins due to the comparative advantages that cheaper foreign labor and capital markets may provide.

*Exchange Rates*

Variations in foreign exchange rates are significant to any determination of a multinational corporation's income for apportionment purposes. When a devaluation occurs, one currency becomes more valuable relative to another, thus producing losses for the holder of the devalued currency and gains for the holder of the non-devalued currency. By taking foreign book earnings as the basis for California taxable earnings, foreign currency losses arising out of fluctuations in the value of the dollar are converted to gains, and gains are converted to losses. The conclusion is that computing a dollar gain or loss reported from the books of a foreign corporation is not compatible with computing the worldwide income in dollars for purposes of California's apportionment formula.72

---

71. In many cases where the Franchise Tax Board issues a deficiency for the franchise tax to a U.S. subsidiary of a foreign parent, the Board makes no effort to determine the multinational’s worldwide income on a comparable basis. Instead, the Franchise Tax Board takes income determined under financial accounting standards prescribed by the foreign jurisdiction (which may vary substantially from generally accepted accounting principles (GAAP) and tax accounting standards of the United States) as the basis for determining worldwide income subject to apportionment. Indeed, such translation and recalculation may be impossible. J. Condrau, *supra* note 67, at 7-8.

72. An illustration may make this point more clear. Assume that a California corporation does business both within California and the United Kingdom. In its operations overseas, the California corporation presumably must deal in British pounds (or else find someone else willing to incur the exchange risk). Assume that the California corporation transfers $2.40 in British currency to its British operation when the exchange rate is £1 = $2.40. If the value of the pound drops to $1.70 by year-end, the California corporation will report a loss of 70¢. Compare this to the situation of a British corporation, which has its parent located in London and a subsidiary located in California. Operations of the foreign corporation in California presumably must be conducted in dollars. If the British parent corporation sends £1 in U.S. currency to California and the same rate changes occur, the redemption of U.S. currency into British pounds at the end of the year would result in a 70¢ gain to the British
The income distortion is magnified when the results from operations are translated into very strong or very weak currencies since the gains or losses are magnified by the exchange rate fluctuations. In addition, if California operations compose only a small part of the total operations of a multinational corporation, the effect of changes in foreign currency rates will be dominant.\(^7\) The exchange-rate fluctuations can also have an adverse effect in determining the apportionment of income because the property, payroll and sales associated with the foreign operations may be reduced in value by a devaluation of foreign currency, thereby apportioning a greater amount of income to California.\(^7\)

The Judicial Response

The distortions caused by the apportionment formula have been challenged on a number of occasions, but the courts generally have not been receptive to such arguments.\(^5\) The California State Board of Equalization has frequently disposed of corporate appeals on the basis that the taxpayer has not carried the burden of showing that the formula apportionment is distortive.\(^6\) In *John Deere Plow Co. v. Franchise Tax Board*,\(^7\) the taxpayer argued that adjustments should have been allowed for differences in operating markets when the apportionment formula. If the California Franchise Tax Board takes the financial income determined to a British parent as the measure of income subject to formula apportionment, it would thereby convert what would have been a loss to a California corporation into an equal gain by a British corporation. Since most foreign corporations do not keep their accounting records in the currencies of their foreign subsidiaries, they must either incur the administrative cost of such translation or risk the potential distortion of worldwide income. See J. Condrau, *supra* note 67, at 7-8.

73. *Id.* at 13.


75. An exception, however, involved an apportionment formula, which was based solely on the ratio of the value of the corporation's tangible property within the state to the value of all its tangible property. In *Hans Rees' Sons, Inc. v. North Carolina*, 283 U.S. 123 (1931), the Court invalidated the one-factor formula after the taxpayer produced evidence that its income was derived from three sources (i.e., buying profit, manufacturing profit, and selling profit) which could partially be attributed to out-of-state operations. The analysis submitted by the taxpayer indicated that 21.7 percent of its income was attributed to North Carolina as opposed to the determination of approximately eighty percent of appellant's income under the North Carolina statute. The Court accepted the evidence as sufficient to conclude that the statutory method "operated unreasonably and arbitrarily in attributing to North Carolina a percentage of income out of all appropriate proportion to the business transacted by the appellant in that state" and that taxes were laid beyond the State's authority. *Id.* at 135-36.

76. R. Peterson, *supra* note 64, at 186.

77. 38 Cal. 2d 214, 238 P.2d 569 (1951).
formula was applied to its operations across the United States because the formula operated to distort the productivity of its California business and failed to reasonably reflect the proportionate part of the unitary income attributable to California. The taxpayer submitted evidence that its California operation was not conducted so profitably as other jobbing houses in the national system because of the higher wage and salary levels, the higher ratio of dollars invested in net tangible assets and the higher ratio of selling and general expenses of its San Francisco operation compared to the average ratio of all included U.S. houses.\footnote{78} Although the California Supreme Court conceded that such figures were accurately calculated to show proof of variations from the norm, they rejected the taxpayer's contention because the corporation had failed to take into account the underlying concept of formula apportionment in the allocation of income from a unitary business—the fact that the business done within California is not truly separate and distinct from the business done without the state as to reasonably permit segregation of income by separate accounting.\footnote{79} The court explained that the propriety of the allocation formula does not require that the factors employed be equally productive in the taxing state as they are for the business as a whole. The court emphasized that varying conditions in different states where the unitary business functions must be expected to cause individual deviation from the national average of the allocation factors, but that more importantly, the mutual dependency of the interrelated activities of the entire business sustains the apportionment process.\footnote{80}

In essence, the Deere decision exalts theory over form by requiring strict adherence to the unitary business concept in order to sustain formula apportionment despite inherent inaccuracies. The Deere approach was reasserted by the California Court of Appeal in Chase Brass and Copper Co. v. Franchise Tax Board (hereinafter Chase Brass II),\footnote{81} where the appellant taxpayer argued in part that 1) the three-factor formula was intrinsically unfair, 2) the formula allocated to California more income than the California portion of the unitary business could possibly earn, 3) the payroll factor was arbitrary and

\footnote{78} Id. at 222-23, 238 P.2d at 573.  
\footnote{79} Id. at 223, 238 P.2d at 573-74.  
\footnote{80} Id. at 224-25, 238 P.2d at 574-75.  
CORPORATE FRANCHISE TAX

unfair because it failed to account for differences in productivity of its employees in the separate mining, fabrication and sales operations, and 4) the sales factor, which was computed by gross sales, was not appropriate to determine net income because no net income was produced by internal sales. The court concluded that the taxpayer had not met its burden of establishing by clear and convincing evidence that the three-factor formula used was arbitrary or productive of an unreasonable result. The court declared that it would be willing to afford protection to the three-factor formula so long as it remains within the limits of the "rough approximation standard," which recognizes that no method of allocation can precisely determine the amount of income attributable to any particular geographic area or part of a series of business transactions culminating in the realization of profit, and any effort in this regard must be more or less arbitrary or fictitious as a matter of practical tax administration.

The Deere and Chase Brass II decisions indicate a reluctance by the courts to deal with the hard issues of formula allocation and offer little guidance as to the limits to which the distortion of income will be tolerated; the rough-approximation standard appears to be more of a rationalization for the formula's inaccuracies. Arguably, however, the disparities in economies on a worldwide basis would produce greater distortion of income by using the allocation formula and could provide a more compelling argument to limit its application with respect to foreign business entities.

ADMINISTRATIVE PROBLEMS

The Task Force recognized the additional problem of the administrative burden that the unitary method places on cor-

---

82. Id. at 468-73, 138 Cal. Rptr. at 909-12.
83. Id. at 471, 138 Cal. Rptr. at 911.

Due process challenges were raised in Plaintiff's Brief in Container Corp. of America v. Franchise Tax Bd., Civ. No. 673-472 (Super. Ct. Cal., Oct. 23, 1979), appeal filed, (Ct. App. Cal., 1st. App. Dist. Nov. 20, 1979) [hereinafter referred to as Plaintiff's Brief] (on file at Santa Clara Law Review). The due process arguments are threefold: (1) that California's present system of formula apportionment fails to calculate fairly that portion of income reasonably attributable to the business done within the state, (2) that due process requires that the amount of income apportioned to a particular state bear some rational relationship to the protection and services provided to the business within the taxing state, and (3) that plaintiff's submission of such "strong evidence" of a grossly distorted result by the apportionment formula raises a rebuttable presumption that the tax method exceeds constitutional limits, which shifts the evidentiary burden to the taxing authority. Plaintiff's Brief at 91-105.
porate taxpayers, particularly those which are foreign-owned. The Task Force noted, for example, that a corporation with one manufacturing plant in a unitary state has to obtain, for that state's tax purposes, the income, sales, property and payroll figures of all of its affiliates operating worldwide if the activities of those affiliates are dependent upon or contribute to the activities of the local corporation. 84

The problem becomes more acute for the foreign parent with California subsidiaries. The Task Force noted:

[T]his compliance burden could be particularly costly because a foreign-owned foreign corporation ordinarily would not otherwise keep the books of its operations outside the United States in terms of U.S. dollars or in a manner which would conform to U.S. accounting concepts. 85

In many cases, new information must be developed solely for this limited purpose. 86 Foreign-owned and-based corporations also find that the combined report disclosure may violate their corporate policy, and, in some cases, they argue that such information may not be disclosed because of foreign laws. 87

**Federal Preemption**

The supremacy clause of the Federal Constitution provides that treaties and laws of the United States are expressly declared to be the supreme law of the land and will supersede inconsistent state law. 88 Although the federal government has adopted the separate accounting method and has retained the flexibility to reallocate income between a domestic corporation and a related foreign operation to prevent federal tax evasion, 89 it has not expressly required that such a system be adopted by the states for state income tax purposes in lieu of formula apportionment. Moreover, the United States Supreme Court's decision in Bass 90 indicates the Court's implicit recognition of the state's right to administer a formula that produces a determination of taxable income inconsistent with the federal result.
It should be recalled that the Court in Bass permitted a determination of income for state tax purposes even though no federal taxable income was reported.

Nor does there appear to be any preemption by treaty of California's unitary method of apportionment on a worldwide basis. An examination of the numerous bilateral tax treaties designed to prevent the double taxation of income by the United States and foreign governments reveals no prohibition of the use of an apportionment formula to allocate income for state tax purposes. As a matter of treaty construction, California authorities suggest that federal tax treaties and agreements with foreign governments providing for certain tax exemptions be given a narrow reading to permit state taxation of foreign corporations in the absence of an express prohibition. Moreover, a provision in the recently negotiated U.S.-U.K. Tax Treaty that was designed to restrict the states' use of an apportionment formula to within the nation's borders with respect to British corporations failed ratification by the Senate. Thus, there appears to be no federal prohibition on California's inclusion of foreign operations in the apportionment formula under the federal preemption doctrine.

**Commerce Clause**

In an effort to define the scope of the Federal Constitution's commerce clause the Supreme Court in Cooley v. Board of Wardens, provided that

Whatever subjects of this power are in their nature national, or admit only of one uniform system, or plan of regulation, may justly be seen to be of such a nature as to require exclusive legislation by Congress.

As a practical matter, however, the Cooley doctrine provides little guidance in the area of state taxation of multinational businesses since the implications of such taxation cannot be neatly classified as either wholly national or wholly local.

After abandoning efforts to establish a meaningful test based upon distinctions between direct and indirect burdens on

---

92. See text accompanying note 10 infra.
94. Id. at 319.
commerce, the United States Supreme Court developed a general methodology that involves 1) a finding of whether a state burden on interstate commerce is "unreasonable" or "undue" and 2) a balancing of the competing demands of the state and national interests involved. This methodology has been substantially retained by the Court in dealing with state taxation that interferes with interstate commerce.

In Dept. of Revenue of Washington v. Washington Stevedoring Co., the Supreme Court reaffirmed its earlier position in Complete Auto Transit v. Brady, that a state tax imposed upon the privilege of engaging in interstate commerce that is within the state is not a per se violation of the commerce clause. Under appropriate conditions, a state may tax directly the privilege of conducting interstate commerce. The Court recognized that the purpose of the commerce clause is not to relieve businesses engaged in interstate commerce from their just share of the cost of state government even though it may increase the cost of doing business.

Regarding the balancing test, the Court explained in Washington Stevedoring that "the commerce clause balance tips against the tax only when it unfairly burdens commerce by exacting more than a just share from the interstate activity." Based upon the income distortion theories discussed above, it is arguable that the inclusion of foreign operations in the uni-

100. 430 U.S. 274 (1977).
102. 430 U.S. at 288; 435 U.S. at 748, 750.
103. 435 U.S. at 748.

Question as to whether the balancing test was in fact employed in Washington Stevedoring exists. Although the Court referred to the balancing needs of the commerce clause, the majority in Washington Stevedoring appears to have disposed of the issue based upon the conclusion that respondents had failed to develop a factual basis to show the unfair burden aspects of the State of Washington's business and occupation tax on stevedoring activities. Id. at 750-51. Defendant's Brief in Container Corp. of America v. Franchise Tax Bd., Civ. No. 673-472 (Super. Ct. Cal., Oct 23, 1979), appeal filed. (Ct. App. Cal., 1st Dist. Nov. 20, 1979) [hereinafter referred to as Defendant's Brief] (on file at Santa Clara Law Review), insisted, however, that the Court's dicta in Washington Stevedoring does not represent the adoption of the balancing test to the area of state taxation, but "rather is merely part of a discourse of the defects of [the] Carter and Weekes" decisions, which the Court expressly overruled. Defendant's Brief at 137.
CORPORATE FRANCHISE TAX

The undue burden tests developed by the Court appear to be essentially the same as those developed in determining whether or not there has been extraterritorial taxation in violation of the Due Process Clause. In Washington Stevedoring, the Court reasserted its established guidelines that no undue state tax burden exists when 1) there is a substantial nexus 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. In light of the difficulties with the traditional apportionment standard, the Washington Stevedoring guidelines may not be satisfied.

Although one commentator has suggested that the “unreasonable” or “undue” burden doctrine and the “balancing of interests” doctrine in those cases of state regulation of interstate commerce are likely to apply equally to cases involving state interference with foreign commerce, the recent decision by the United States Supreme Court in Japan Line, Ltd. v. County of Los Angeles indicates that a more extensive constitutional inquiry than the four-part Washington Stevedoring analysis is necessary. In Japan Line, Ltd., the County of Los Angeles levied property taxes on the assessed value of foreign-owned cargo containers abroad foreign-owned and -registered vessels that were used exclusively in foreign commerce. The Court held that because California’s ad valorem tax, as applied to cargo containers, resulted in multiple taxation of instrumentalities of foreign commerce and prevented the federal government from “speaking with one voice”

105. 435 U.S. at 750.
106. L. Henkin, supra note 95, at 236.

In Japan Line, Ltd., the Court expressly rejected the municipality’s premise “that the Commerce Clause analysis is identical, regardless of whether interstate or foreign commerce is involved. 99 S. Ct. at 1820. In distinguishing between interstate commerce and foreign commerce, the Court fashioned two additional tests to the Washington Stevedoring and Complete Auto inquiries: (1) does the tax notwithstanding apportionment create a substantial risk of international multiple taxation and (2) does the tax prevent the federal government from “speaking with one voice when regulating commercial relations with foreign governments.” Id. at 1822-23.
in international trade, the tax was inconsistent with Congress' power to "regulate Commerce with foreign Nations" and was therefore unconstitutional under the commerce clause.\(^{109}\)

The *Japan Line, Ltd.* decision is significant in two respects: first, the Court recognized that a state tax which is apportioned in order to avoid multiple taxation may not achieve the same result when one of the taxing entities is a foreign sovereign\(^{110}\) and second, the Court emphasized the overriding concern of the Framers of the Constitution that the federal government be able to exercise plenary power when regulating commercial relations with foreign governments.\(^{111}\) Such broad observations by the Court suggest that the considerations addressed in *Japan Line, Ltd.* may be appropriate in assessing the propriety of the unitary method of apportionment of state income taxes as applied to foreign operations. On the other hand, the Court expressly narrowed its inquiry to "whether instrumentalities of commerce that are owned, based, and registered abroad and that are used exclusively in international commerce, may be subjected to apportioned ad valorem property taxation by a state."\(^{112}\)

Any discussion of the commerce clause necessarily involves the issue of whether, by excluding foreign income from

---

109. *Id.* at 1824.

110. This determination results from the logic that apportionment will prevent multiple tax burdens from arising when there is a tribunal capable of ensuring that the aggregation of taxes is computed on no more than one full value. Since a foreign sovereign may impose a tax on the full value of those instrumentalities of commerce domiciled within that country and no superior tribunal exists, it follows that "a state tax, even though 'fairly apportioned' to reflect an instrumentality's presence within the State, may subject foreign commerce 'to the risk of a double tax burden to which [domestic] commerce is not exposed, and which the commerce clause forbids.' [citations omitted]" *Id.* at 1821.

111. The Court in *Japan Line, Ltd.* listed several ways in which federal uniformity may be frustrated: (1) international disputes may arise over reconciling particular apportionment formulae; (2) a state tax creating an imbalance in the international tax structure may invite retaliation by foreign nations disadvantaged by the levy against American-owned instrumentalities located in their jurisdictions; and (3) a state tax may invite other states to impose taxes of their own, which could subject instrumentalities of foreign commerce to multiple tax burdens and prevent the federal government from "speaking with one voice" in regulating foreign commerce. *Id.* at 1822-23.

112. *Id.* at 1819. Moreover, *Japan Line, Ltd.* dealt with the special case of ocean-going vessels, which historically has been distinguished from those cases in which the Court discarded the "home port" doctrine in favor of upholding the validity of taxes on instrumentalities of foreign commerce on a properly apportioned basis. *Id.* at 1818. This raises the question as to whether the cargo containers aboard the foreign vessels are of a sufficiently unique character as to restrict the Court's analysis in *Japan Line, Ltd.* specifically to the facts of this case.
the unitary method of apportionment in the combined report, the resulting preferential treatment afforded unitary multinational corporations whose foreign operations would be ignored, as opposed to unitary domestic multistate businesses, which would still be entirely subject to the apportionment formula, will be tolerated. It is arguable that the equal tax treatment of interstate and foreign commerce is not only a legitimate state interest, which should be carefully recognized in the balancing test, but that such equal treatment is also required by the commerce clause itself.\footnote{113}

This nondiscrimination rule, first advanced by Justice Traynor in his dissenting opinion in Scandanavian Airlines,\footnote{114} has been recognized by both the United States Supreme Court and the California Court of Appeal. In addressing the propriety of a local property tax upon foreign aircraft, Justice Traynor commented: "Obviously there is no discrimination if a state taxes migratory property used in [interstate] commerce . . . . Moreover, [the commerce clause] precludes discrimination against interstate commerce."\footnote{115} And in Michelin Tire Corp. v. Wages,\footnote{116} the U.S. Supreme Court, in determining whether a state's nondiscriminatory ad valorem property tax against petitioner's inventory of imported tires stored within the state was within the import-export clause's prohibition against state levies of any imports or duties on imports, rejected the notion that a nondiscriminatory property tax can have an impact on the federal government's exclusive regulation of foreign commerce.\footnote{117} The Court emphasized that a tax "cannot be used to create special protective tariffs or particular preferences for certain domestic goods, and it cannot be applied selectively to encourage or discourage any importation in a manner inconsistent with federal regulation."\footnote{118} The Court reasoned that as long as the property tax does not fall within a particular category of imposts and duties on imports and exports, the tax will not deprive the federal government of anything to which it is entitled.\footnote{119}

In Zee Toys, Inc. v. Co. of Los Angeles,\footnote{120} the California

\begin{footnotesize}
\begin{enumerate}
\item 113. Defendant's Brief, supra note 103, at 138.
\item 114. 56 Cal. 2d 11, 43, 363 P.2d 25, 44, 14 Cal. Rptr. 25, 44 (1961).
\item 115. Id. at 44, 363 P.2d at 45, 14 Cal. Rptr. at 45.
\item 116. 423 U.S. 276 (1976).
\item 117. Id. at 286.
\item 118. Id.
\item 119. Id.
\item 120. 85 Cal. App. 3d 763, 149 Cal. Rptr. 750 (1978).
\end{enumerate}
\end{footnotesize}
Court of Appeal held that a state statute, which permitted a partial exemption from personal property taxation of imported goods that plaintiffs stored and planned to resell, violated the commerce clause of the United States Constitution. Relying on the Michelin decision, the court refused to permit different tax treatment for goods solely on the basis of place of origin, recognizing that to do so would give foreign goods a competitive advantage over interstate goods. If the nondiscrimination rule becomes a factor in assessing the validity of California's formula apportionment, the California corporate taxpayer may be practically foreclosed from any remedy (i.e., exclusion of a foreign operation's income from the apportionment formula) despite the merits of its challenge of the tax assessment on other grounds.

STATE INTRUSION IN FOREIGN AFFAIRS

The Zschernig Decision

In Zschernig v. Miller, the U.S. Supreme Court carved out an area of exclusive federal competence that arguably should be extended to state taxation of foreign income. In Zschernig, the Court dealt with the constitutionality of a state probate statute that controlled the disposition of an Oregon resident's estate to heirs residing in a foreign country. The Oregon Supreme Court had earlier denied certain personalty to the foreign nationals because reciprocity, required by the Oregon statute, was missing. The Supreme Court concluded that Oregon's probate law affected "international relations in a persistent and subtle way" and although the states have traditionally regulated disposition of property upon death, "those regulations must give way if they impair the effective exercise of the Nation's foreign policy."
The *Zschernig* decision represents a relatively new constitutional doctrine of limitations on the states; what these limitations are, and how far they purport to reach, remains to be determined. A narrow interpretation of *Zschernig*, which "excludes only state actions that reflect a state policy critical of foreign governments and involve ‘sitting in judgment’ on them," would offer only limited judicial grounds to attack the apportionment formula inequities. The Court may also be suggesting that the line distinguishing an area of federal competence be drawn "between state acts that impinge on foreign relations only ‘indirectly or incidentally’ and those that do so directly or purposefully" or "[b]etween those that ‘intrude’ on the conduct of foreign relations and those that merely ‘affect’ them." In any event, *Zschernig* at least suggests that application of formula apportionment to foreign business entities may be unwise.

**California’s Recognition of Exclusive Federal Competence**

While the precise demarcation between the exclusive federal domain and legitimate state activity was still unclear after *Zschernig*, the California courts have dealt with similar issues. In *Bethlehem Steel Corp. v. Board of Commissioners*, the California Court of Appeal struck down a state statute requiring that public contracts be awarded only to persons who agreed to use or supply materials manufactured in the United States from substantially domestic raw materials. The court held that this California "Buy American Act" was "an unconstitutional encroachment upon the federal government’s exclusive power over foreign affairs, and constituted an undue interference with the United States’ conduct of foreign relations." Like the statute in *Zschernig*, the court noted that the California "Buy American Act" had more than "some incidental or

In dicta, however, the Court implies that such preemption may occur even in the absence of a treaty so long as a state policy disturbs foreign relations. *Id.* at 441. Moreover, there is dicta that suggests the state action does not necessarily have to be contrary to a federal policy; such conflict was not present in the Court’s invalidation of the Oregon statute.

125. L. HENKIN, *supra* note 95, at 239.
126. *Id.* at 240.
127. *Id.* at 241.
130. CAL. GOV’T CODE §§ 4300-4305 (West 1966).
131. 276 Cal. App. 2d 221, 224, 80 Cal. Rptr. 800, 802 (1969).
indirect effect in foreign countries.”

The court recognized that such a state statute “may bear a particular onus to foreign nations since it may appear to be the product of selfish provincialism, rather than an instrument of justifiable policy.”

Faced with the question of the validity of a county personal property tax assessment on foreign-owned and-based aircraft, the California Supreme Court, in *Scandanavian Airlines Systems, Inc. v. County of Los Angeles*,

that the power to tax airplanes engaged solely in commerce with foreign nations is vested exclusively in the place of true domicile, which jurisdiction may impose a tax on the full value, to the exclusion of property taxation elsewhere, whether upon an apportioned basis or otherwise.

Although the court’s application of the “home-port” doctrine, which is peculiar to instrumentalities of foreign commerce such as air transportation and ocean-going vessels, was sufficient to dispose of the case, the court went further and noted that taxation of foreign owned and based instruments of commerce represents a field that is peculiarly federal in

---

132. *Id.* at 228, 80 Cal. Rptr. at 805.
133. *Id.*, 80 Cal. Rptr. at 805.
135. *Id.* at 36-37, 363 P.2d at 40, 14 Cal. Rptr. at 40.
136. In *Scandanavian Airlines*, the California Supreme Court offered the following explanation of the “home-port” doctrine:

By a series of opinions, covering a period of over a hundred years [the United States Supreme Court] has developed a body of law dealing with the power of local authorities to levy property taxes on instrumentalities of commerce which are transitory in character, and, in the course of engaging in trade, come within the territorial limits of one or more of the States of the Union. In each of the decisions embraced in the body of law, the United States Supreme Court has emphasized the importance of the true domicile, the port of registration, or home port, of the particular instrumentality sought to be taxed.

*Id.* at 20, 363 P.2d at 29-30, 14 Cal. Rptr. 29-30.

Focussing upon the true domicile, the Court then developed the rule that an ocean going vessel might be taxed at its full value in its home port, and that other states where it engaged in commerce were not entitled to levy a property tax of any nature. The rationale for such limitation lies in part upon the lack of a taxable situs in any but the home port. *Id.* at 21, 363 P.2d at 30-31, 14 Cal. Rptr. at 30-31, and upon the necessity of protecting against double taxation. *Id.* at 32, 363 P.2d at 37, 14 Cal. Rptr. at 37.

The court in *Scandanavian Airlines* proceeded to apply the home-port doctrine to foreign-owned and-based aircraft flown exclusively in foreign commerce with but a single United States port, after finding “no logical basis for holding that these airplanes differ from other instrumentalities of communication with foreign nations, so as to avoid that doctrine.” *Id.* at 33, 363 P.2d at 38, 14 Cal. Rptr. at 38.
nature, without regard to such specific constitutional considera-
tions as the commerce clause or the due process clause, and which must be left to the administration of the federal government, even in the absence of any present federal legislation thereon.137

Without addressing the question of whether the California Constitution or any statutory provision provided a basis for the tax, the court deemed it sufficient that no instance where any state ever attempted to levy a property tax upon an instrumentality of foreign commerce which was both owned and based in a foreign country could be cited. The court recognized that regardless of whether such assumption of nontaxability stemmed from constitutional prohibitions or from considerations of policy, to overrule such an assumption would open the door to state taxation of ocean vessels, previously believed to be nontaxable, and would invite retaliation.138

A number of factors suggest that the system of international taxation should be exclusively reserved to the federal government.

Retaliation. One of the fears that compelled the California courts to recognize federal preemption in Bethlehem Steel and Scandanavian Airlines is potentially present in the California corporate tax situation. One corporation warns:

In essence, the Franchise Tax Board has told California entrepreneurs, "Feel free to invest abroad as you please but you can expect your California taxes to be higher than if you do not invest abroad." As a result other nations rightly may believe they are being discriminated against. This discrimination invites retaliation. In effect, the California tax is a penalty for all firms which operate in California and which decide to go to those corners of the earth where land and labor are cheaper. To even the score those foreign governments may choose to penalize firms operating in their countries which desire to expand to selected countries. Such retaliations or even the suggestion of them clearly implicate our foreign trade policy.139

Harmonizing international taxation. Federal interest in preserving control over the taxation of foreign business operations is clearly indicated by the existing network of over thirty

137. Id. at 42, 363 P.2d at 43, 14 Cal. Rptr. at 43.
138. Id. at 42-43, 363 P.2d at 44, 14 Cal. Rptr. at 44.
139. Plaintiff's Brief, supra note 83, at 131.
bilateral tax treaties. The Treasury Department seeks negotiated treaties in the interest of harmonizing the tax system of the United States with its treaty partners to minimize the likelihood of double taxation and to ensure the efficient administration of the revenue laws of all parties. The treaties also attempt to define the appropriate amounts of foreign source income that may be taxable for federal income tax purposes.

**Arms-length standard.** The unitary doctrine is contrary to the traditional method of separate accounting that is used to determine the income of affiliated entities within treaty nations for federal income tax purposes. To the extent that the tax treaties reflect the "international rules of taxation" they suggest a strong preference for recognizing transactions for income tax purposes only if those transactions can be calculated on an arms-length basis. If California's unitary method of taxation results in the taxation of income that would not be taxed under the international standard, California may be taxing foreign source income in such a way that treaty-based tax harmonization goals are undermined.

Finally, the problems of income distortion and the combined-report compliance burdens on the foreign corporation suggest an area so laced with foreign affairs that state intrusion would not be appropriate.

**CONCLUSION**

California's development of the unitary business doctrine is multi-faceted. From the state taxing authorities' perspective, the courts firmly established the validity of the unitary method of apportionment by well insulating this tax device from challenge; the taxpayer faces a very difficult burden of proof if forced to demonstrate that the formula result is arbitrary or unreasonable. Where the distortions of income are minor, the apportionment formula will be upheld under the "rough approximation" rationale. The judiciary has produced two general tests for determining if a unitary business exists.

---

142. See I.R.C. § 482.
143. 1977 Hearings, supra note 141, at 226.
144. Id. at 227.
And the most recent treatment of the issue by the court of appeal suggests an expansion of the unitary business to a more loosely affiliated group of corporations. The State Board of Equalization has responded in kind by broadening the definition of unity of ownership.

From the perspective of the international business community, the courts have evaded the problems that arise when foreign corporations are included in the unitary business. As noted above, the courts' silence amounts to tacit consent. The position of the taxing authorities is unquestionably clear. The aggressive approach of California's Franchise Tax Board in applying the unitary doctrine and formula apportionment on a worldwide basis represents the furthest extreme to which the unitary concept has been developed.

An examination of whether California's tax policy has invaded an area that is explicitly preempted by federal legislation or treaty, restricted by the commerce clause or deemed to be a matter of exclusive federal competence reveals that the judiciary may offer only limited grounds for challenging the unitary treatment of the foreign corporation.¹⁴⁵

Perhaps the greatest problem in challenging the unitary concept of apportionment is the fact that the alternative separate-accounting method provides little, if any, standard of fairness in fixing income among affiliates and subsidiaries for tax purposes. Additionally, California's Franchise Tax Board would argue that under no circumstances is separate accounting an acceptable defense to an income determination based upon formula apportionment.¹⁴⁶ And in theory, the Board is

¹⁴⁵. A number of these constitutional issues will hopefully be resolved by the appeals court in Container Corp. of America v. Franchise Tax Bd., Civ. No. 673-462 (Super. Ct. Cal., Oct. 23, 1979), appeal filed, (Ct. App. Cal., 1st. App. Dist., Nov. 20, 1979). But, it is this author's view that the balance of judicial authority may not produce a satisfactory resolution of the income distortion issue.

¹⁴⁶. Interview with Mr. Benjamin F. Miller, Tax Counsel for the California
probably correct. A true measure of the unitary elements of a multinational operation may well be impossible under the present accounting framework employed by most multinational businesses. 147

Nonetheless, if California's franchise tax is to be administered fairly and equitably, the income distortion problems arising from the application of the unitary concept of apportionment to foreign enterprises cannot be ignored. In the 1977-1978 session, the California Legislature considered over half a dozen pieces of legislation that would have restricted this apportionment device. Although no legislative solution was reached, lawmakers should earnestly seek to develop standards which recognize and mitigate the distortion that presently occurs.

Gordon T. Yamate

Franchise Tax Board, in Sacramento, Cal. (Feb. 2, 1979).

147. The unitary business doctrine recognized that "[d]ue to the integrated nature of the multinational corporation and the interdependency of its parts, clearly defined and separable units of economic activity do not begin and end at political boundaries." Musgrave, The U.K. Treaty Debate: Some Lessons for the Future, 7 Tax Notes 27, 28 (1978). For example, if a California corporation decides to expand its operation to a Latin American country, the logical extension of the unitary business argument would recognize that the foreign operation acquires a considerable amount of business experience, expertise and technical resources that a comparable venture by local businessmen of that foreign country would not possess. Such benefits derived by the foreign operation from the California parent arguably produce a unitary tie between the two operations; yet, present accounting methods do not focus on this intangible "flow" in the calculation of business income.