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U.S. Perspectives of Worldwide Unitary Taxation

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I. Introduction

This article will discuss the subject of worldwide unitary taxation in its domestic and international aspects. The domestic aspects will be examined through a description of the different methods by

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which American states impose franchise or privilege taxes on corporations and through the constitutional issues raised therefrom. The international aspects will be discussed through risks of double taxation,[1] threats to the international economic relations, and the reaction which followed the United States Supreme Court's decision in *Container Corporations of America v. Franchise Tax Board*.[2] The final part of the article will focus on new legislation adopted by California in response to the international reactions to the *Container* decision.

II. State Apportionment of Corporate Income

Most American states impose annual franchise or privilege taxes on corporations.[3] The most widely used corporate tax measure is the taxation of net income generated in the taxing state.[4] The determination of the portion of net income of multi-jurisdictional corporations[5] to be included in the measure of each state's tax has always been troublesome and resolved by different approaches. Specific allocation, separate accounting, and apportionment by formula are three methods utilized to resolve this determination.

A. *Specific Allocation*

The specific allocation method traces all property, receipts, and income of a corporation to the state of their source and attributes each item to the specific state's tax base.[6] This method is almost inapplicable, however, and has been largely rejected by the states.[7] The impracticality of this method stems from the difficulty in identifying the source of income derived from multi-jurisdictional corporations.

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1. For the purpose of this article, the taxation of the same corporate income both at the federal and state level is not considered double taxation.

2. Container Corps. of Am. v. Franchise Tax Bd., 463 U.S. 159 (1983).

3. For a chart of tax treatments by individual states, *see* Gordon, *State Corporate Income Taxes — Problems and Solutions*, 6 J. OF ST. TAX'N 337, 344-47 (1988) [hereinafter Gordon]. "The traditional corporate tax was an excise on the privilege of doing business in the state." J. HELLERSTEIN, STATE TAXATION: CORPORATE INCOME AND FRANCHISE TAX 208-09 (1983) [hereinafter J. HELLERSTEIN].

4. J. HELLERSTEIN AND W. HELLERSTEIN, STATE AND LOCAL TAXATION 392 (1978) [hereinafter STATE AND LOCAL]. Other corporate tax measures are referred to as "capital-account" bases and "capital-value" bases. *Id.*

5. Multi-jurisdictional corporations are either domestic corporations engaged in multi-state or multi-national business through branches and subsidiaries, or foreign corporations having domestic branches or subsidiaries.

6. J. HELLERSTEIN, *supra* note 3, at 328 n.95.

7. Weissman, *Unitary Taxation: Its History and Recent Supreme Court Treatment*, 48 ALB. L. REV. 48, 50 n.12 (1983) [hereinafter Weissman].

B. *Separate Accounting*

The separate accounting method assumes that all transactions between affiliated corporations are carried out as if the companies are unrelated and dealing at arm's-length. It is very difficult, however, to determine a fair arm's-length price of the entire volume of intra-company transactions. Furthermore, the separate accounting method seems to "completely reject the economic interdependence and the positive effects that horizontal and vertical integration have on corporate purchasing, marketing, and selling."[8]

C. *Apportionment by Formula*

The apportionment by formula method has been developed to overcome the problem of allocating the operating income of multi-jurisdictional enterprises. The apportionment by formula method is based on mathematical approximation of the income related to the activities conducted within the taxing state and apportions the profit to the state. This method rests on the theory that activities in each state where an enterprise operates contribute to its overall profits, and on the economic reality that "the whole exceeds the sum of its parts."[9] Unlike earlier formulas which were based on a single factor, such as property, apportionment by formula has been challenged in the judicial arena leaving different results.

In *Underwood Typewriter v. Chamberlain*,[10] the Supreme Court upheld the Connecticut method which was based exclusively on the property factor. "There is nothing in this record to show that the method of apportionment adopted . . . was inherently arbitrary, or that its application to this corporation produced an unreasonable result."[11] Contrarily, in *Hans Rees' Sons, Inc. v. North Carolina*,[12] the Supreme Court found that "the statutory method, as applied to the appellant's business . . . 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."[13] Thus, the single property formula has been generally discarded.

Presently, of the 44 states and the District of Columbia which

8. *Id.* at 50.

9. Weissman, *supra* note 7, at 52.

10. Underwood Typewriter v. Chamberlain, 254 U.S. 113 (1920).

11. *Id.* at 121.

12. Hans Rees' Sons, Inc. v. North Carolina, 283 U.S. 123 (1931).

13. *Id.* at 135. The Connecticut and North Carolina tax methods were perfectly analogous. The question seems to have been whether the taxpayer had the burden of proving by "clear and cogent evidence" that the income apportioned to the state was out of all proportion to the business transaction in the taxing state. *Id.*

tax corporate income,[14] the majority utilizes the Massachusetts formula.[15] This formula employs property,[16] sales, and payroll as its measuring devices. The three factors are averaged and then multiplied to determine the total taxable income. "Property, payroll, and sales are generally used as apportioning factors because they are thought to be closely linked with income-producing activity and their geographic location is relatively easy to identify."[17]

Generally, the apportionment by formula provides a "reasonable approximation of a multi-jurisdictional corporation's activities in a particular state."[18] The underlying concept is the existence of a unitary business.[19] Each state extends this concept to different degrees of development. As a result, apportionment formulas contain different variables depending upon the extension of activities involved. The formula employed will reflect separate entity base domestic reporting or worldwide reporting.

1. Separate Entity Base.—If the unitary business theory is applied on a separate entity base, the state will impose a tax solely on its apportioned share of all net income derived by the taxpayer corporation from its unitary business. In short, this formula taxes only those activities which are carried on within the state.[20]

2. Water's-Edge Accounting and Domestic Combined Reporting.—States may also impose a tax on its apportioned share of all net income derived by the taxpayer corporation and its affiliates engaged in a unitary business. When the state "limits the permissible scope of the unitary business to the domestic operations of affiliates incorporated in the United States" it is commonly referred to as using a water's-edge accounting method.[21] In situations where the uni-

14. Gordon, *supra* note 3, at 339, 344-45.

15. The Massachusetts formula works as follows:

$$\frac{\frac{\text{In-state property}}{\text{Total property}} + \frac{\text{In-state payroll}}{\text{Total payroll}} = \frac{\text{In-state sales}}{\text{Total sales}}}{3} \times \begin{array}{c}\text{Total}\\ \text{Corporate}\\ \text{Income}\end{array} = \begin{array}{c}\text{Income}\\ \text{taxable}\\ \text{by the}\\ \text{state}\end{array}$$

In this formula, all intercorporate transactions are eliminated. Tannenwald, *The Pros and Cons of Worldwide Unitary Taxation*, 25 TAX NOTES 649, 650 (Nov. 12, 1984) [hereinafter Tannenwald].

16. Generally, only real and tangible personal property are considered because intangible personal property is allocated to the corporation's state of domicile. Gordon, *supra* note 3, at 340.

17. Tannenwald, *supra* note 15, at 650.

18. Note, *The Controversy Over Worldwide Unitary Taxation: Legal, Economical and Political Implications*, 9 SUFFOLK TRANSNAT'L L.J. 265, 274 (1985) [hereinafter Note].

19. The formula apportionment is also referred to as the unitary method.

20. Brooks, *Speaking With One Voice: A Uniform Glossary For State Taxation of Interstate Business*, 2 J. OF ST. TAX'N 5, 10 (1983) [hereinafter Brooks].

21. Tannenwald, *supra* note 15, at 652.

tary business is intended to include the net income derived from all the activities of the taxpayer corporation and its domestic affiliates, wherever conducted, the state is deemed to use domestic combined reporting.[22]

3. *Worldwide Combined Reporting.*—A state may impose a tax on its apportioned share of all net income derived by the taxpayer corporation and its worldwide affiliates, even though only part of the unitary business is carried on within that state's boundaries. In this situation, the state is referred to as utilizing either domestic or a total worldwide combined reporting depending upon the treatment of subsidiaries of foreign parent corporations.[23] In a unitary business, total worldwide reporting embraces the foreign parent and foreign affiliates conducting no trade or business in the United States.[24]

III. Definition of Unitary Taxation by the United States Supreme Court

The different models of formula apportionment, as well as the different concepts of unitary business, have been repeatedly discussed and challenged in the judicial arena. Ultimately, the Supreme Court has both developed the unitary business concept and defined the constitutional requirements which an apportionment formula must meet.

A. *The Unitary Business Concept*

The United States Supreme Court has dubbed the unitary business concept as "the linchpin of apportionability."[25] Accordingly, a state may only employ formula apportionment when "all of the income included in the apportionable base is derived from business activity unitary with the business carried on in the taxing state."[26] Both vertically[27] and horizontally[28] integrated businesses have been

22. Brooks, *supra* note 20, at 15.

23. Tannenwald, *supra* note 15, at 653.

24. Granwell, Hirsh, and Milton, *Worldwide Unitary Tax: Is It Invalid under Treaties of Friendship, Commerce, and Navigation?*, 18 LAW & POL'Y IN INT'L BUS. 695, 706 (1986). *See, e.g.*, Mobil Oil Corp. v. Comm'r of Taxes, 445 U.S. 425, 439 (1980).

25. Mobil Oil Corp. v. Comm'r of Taxes, 445 U.S. 425, 439 (1980).

26. Brooks, *supra* note 20, at 12. "If a business is not unitary, a separate accounting method is typically utilized." J. HELLERSTEIN, *supra* note 3, at 389.

27. *E.g.*, Underwood Typewriter Co. v. Chamberlain, 254 U.S. 113, 118-19 (1920). Vertical integration is a "combination of two or more businesses on different levels of operation such as manufacturing, wholesaling, and retailing the same products." BLACK'S LAW DICTIONARY 725-26 (5th ed. 1979).

28. *E.g.*, Butler Bros. v. McColgan, 17 Cal. 2d 644, 111 P.2d 334 (1941), *aff'd*, 315 U.S. 501 (1942). Horizontal integration "is a combination of two or more businesses of the same type such as manufacturers of the same type of product." BLACK'S LAW DICTIONARY 725 (5th ed. 1979).

held to be unitary by the California Supreme Court and the United States Supreme Court.

In *Butler Brothers v. McColgan*,[29] the Court upheld the California Supreme Court's test for the existence of a unitary business. The test requires the presence of unity of ownership, unity of operation, and unity of use.[30] Unity of ownership exists when all the business activities are conducted either by a single corporation or through controlled subsidiaries.[31] Unity of operation is generally represented by such functions as common legal representation, intercompany financing, and joint efforts in expanding the business. Unity of use pertains "to executive forces and operational systems."[32]

In *Edison California Stores Inc. v. McColgan*,[33] the California Supreme Court offered yet another test. "If the operation of the portion of the business done within the state is dependent upon or contributes to the operation of the business without the state, the operations are unitary."[34] More recently, in *Mobil Oil Corp. v. Commissioner of Taxes of Vermont*,[35] the United States Supreme Court defined the unitary business in terms of functional integration, centralization of management, and economies of scale.[36]

Additionally, in *Container Corp. of America v. Franchise Tax Board*,[37] the United States Supreme Court broadened the definition of a unitary business. The Court held that the prerequisite for the constitutionally acceptable existence of a unitary business should be the presence of a "flow of value" between its members.[38] The Court stated that the presence of a substantial flow of goods is not necessary. The qualifying element has become "contributions to income [of the subsidiaries] result[ing] from functional integration, centralization of management, and economies of scale."[39]

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29. *See* 315 U.S. 501.
30. *Id.*; J. HELLERSTEIN, *supra* note 3, at 400; Weissman, *supra* note 7, at 65 n.99.
31. B. MILLER, THE STATE CORPORATION INCOME TAX 140 (C. McLure ed. 1984) [hereinafter MILLER].
32. *Id.* at 141. Generally, intercompany transfer of products, uniform theory of management, and interchange of knowledge and expertise fall within the unity of use category.
33. Edison California Stores, Inc. v. McColgan, 30 Cal. 2d 472, 183 P.2d 16 (1947).
34. *Id.* at 481, 183 P.2d at 21. This was the pioneer case holding that the "unitary method was likewise appropriate in the case of apportioning the income of an enterprise conducted through controlled subsidiaries." J. HELLERSTEIN AND W. HELLERSTEIN, *supra* note 4, at 521.
35. Mobil Oil Corp. v. Comm'r of Taxes of Vermont, 445 U.S. 425 (1980). For a description of the case, *see* Hellerstein, *State Income Taxation of Multijurisdictional Corporations: Reflections on Mobil, Exxon, and H.R. 5076*, 79 MICH. L. REV. 113, 118-40 (1980) [hereinafter *Reflections*].
36. *Reflections*, *supra* note 35, at 118-40.
37. 463 U.S. at 159.
38. *Id.* at 178. *See also* Note, *supra* note 18, at 281.
39. 445 U.S. at 438. *See also*, 463 U.S. at 179. The presence of a supervisory role played by Container Corps.' officers in providing general guidance to subsidiaries, substantial

B. *Constitutional Issues*

Unitary taxation has been challenged in the courts principally on two constitutional grounds: the Due Process Clause[40] and the Commerce Clause.[41] Resulting decisions often provide "alternative but substantively indistinguishable bases" for disputing the constitutionality of formula apportionments.[42]

1. *The Due Process Clause.*—As applied to taxation, due process mandates that a state tax must not deprive the taxpayer of its property without due process of law. This requires that the state apply the tax only to income earned by the taxpayer within the state's jurisdiction. In *Moorman Manufacturing Co. v. Bair*,[43] the United States Supreme Court determined that a state tax survives Due Process Clause scrutiny when there is a definite link such as a minimum connection, or "nexus" between the state and the person, and the property or transaction to be taxed.[44] Moreover, there must be a rational relationship between the income attributable to the state and the "intrastate value of the business enterprise."[45]

The parameters of due process constraints regarding the unitary business principle are partially delineated in *Mobil Oil Corp. v. Commissioner of Taxes of Vermont*.[46] In that case, the Supreme Court stated that inclusion of foreign source dividend income is possible under the Due Process Clause when a unitary business is found to exist and the unitary entity being taxed has a sufficient "nexus" with the taxing state.[47]

2. *The Commerce Clause.*—In addition to due process requirements, state taxes on multi-jurisdictional corporations must also comply with constitutional restrictions imposed by the Commerce Clause.[48] In *Complete Auto Transit, Inc. v. Brady*,[49] the United States Supreme Court held that a state tax withstands Commerce Clause scrutiny when the tax imposed applies solely to activities

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technical assistance, and loans made to subsidiaries convinced the Supreme Court that the state court finding of a unitary business was within the realm of permissible judgment.

40. U.S. CONST. amend. XIV, § 1.

41. U.S. CONST. art. I, § 8, cl. 3.

42. *Reflections, supra* note 35, at 130 n.105.

43. Moorman Mfg. Co. v. Bair, 437 U.S. 267 (1978).

44. *Id.* at 272-73 (referring to minimum connection). *See also* Note, *supra* note 18, at 268 (referring to nexus).

45. Note, *supra* note 18, at 268 n.20.

46. 445 U.S. at 425. In Mobil Oil Corp.'s view, "the Due Process Clause restricted Vermont's inclusion of foreign dividends in the state's apportionable tax base because a nexus was lacking." Weissman, *supra* note 7, at 79.

47. 445 U.S. at 436-42. *See also* Exxon Corp. v. Wisconsin Dep't of Revenue, 447 U.S. 207, 223 (1980).

48. *See* J. HELLERSTEIN, *supra* note 3, at 99 for a historical overview of the topic.

49. 430 U.S. 274 (1977).

which bear a substantial "nexus" with the taxing state.[50] In addition, the tax must be fairly apportioned and fairly related to the services provided by the state to the taxpayer,[51] and state taxes must not discriminate against interstate commerce.[52]

Subsequently, in *Japan Line v. County of Los Angeles*,[53] the United States Supreme Court enunciated two additional requirements for state taxes which apply to foreign commerce income. The tax imposed by the state must neither create a substantial risk of double taxation[54] nor prevent the Federal Government from "speaking with one voice" in matters where national uniformity is considered essential.[55]

IV. The *Container* Decision

The leading case addressing worldwide unitary taxation is *Container Corps. v. Franchise Tax Board*.[56] In *Container*, the California Franchise Tax Board imposed an additional assessment on Container Corps. after determining that it had failed to include its Latin American affiliates in its initial formula apportionment of income.[57]

Container Corps. contended that it and its foreign subsidiaries did not constitute a unitary business.[58] Container Corps. argued that formula apportionment, although reasonably precise when applied to interstate activities, is grossly distorted when applied to a corporation with foreign subsidiaries, and that formula apportionment implies an equal rate of return from each of the corporations' holdings, regardless of where they are located. Here, however, Container Corps.' foreign subsidiaries were significantly more profitable than its domestic operations.[59]

The Supreme Court rejected these arguments because they de-

50. *Id.* at 287. The "substantial nexus" requirement seems to be "a stronger relationship than the minimum connection which is required by the due process analysis." Note, *supra* note 18, at 269, n.28.

51. Note, *supra* note 18, at 269 n.31. *See also* Commonwealth Edison Co. v. Montana, 453 U.S. 609, 628 (1981).

52. 430 U.S. at 279. *See also* Weissman, *supra* note 7, at 78.

53. Japan Line v. County of Los Angeles, 441 U.S. 434 (1979) (as described in J. HELLERSTEIN, *supra* note 3, at 165).

54. *Id.* Such double taxation would result in the state placing a discriminatory burden on multi-national corporations not borne by domestic enterprises. Note, *supra* note 18, at 269 n.30.

55. 441 U.S. at 453.

56. 463 U.S. at 159.

57. For an extensive description of the case, *see* J. HELLERSTEIN AND W. HELLERSTEIN, CORPORATE INCOME AND FRANCHISE TAX S127-S145 (1987 Supplement) [hereinafter Supplement].

58. 463 U.S. at 163.

59. *Id.* at 181. Thus, Container Corps. argued that formula apportionment resulted in a constitutionally impermissible tax on income which bore no rational relationship to its activities in California. *Id.*

pended on data generated through the use of a separate accounting method to illustrate the unreasonable effect of formula apportionment.[60] The Supreme Court refused to require California to switch from a method that imprecisely measured the income attributable to any given state to another method that suffered from the same deficiencies.[61] The Court also noted that states resorted to formula apportionment because of the inadequacy of separate accounting.

Since the California tax was assessed on income earned and taxed overseas, Container Corps. further argued the additional assessment involved the foreign commerce clause restrictions which were set forth in *Japan Line*.[62] The Court conceded that California's taxing system resulted in actual double taxation, in the sense that some of the income taxed without apportionment by foreign nations were also taxes by California based on its share of the unitary business.[63] The validity of the tax, however, was upheld on the ground that California would not necessarily reduce double taxation by adopting the arm's-length approach.[64]

Addressing the principle of federal uniformity in the international arena, the Court did not interpret the principle to hold that "treatment of foreign income at the federal level mandates identical treatment by the states."[65] Instead, a state violates the uniformity or "one voice" standard only if it implicates foreign policy issues that must be left to the Federal Government or violates a clear federal directive.[66] The Court did not find clear federal directives involved in the present case.

Emphasizing the possibility of retaliation by foreign trade partners, the Court presented three factors that defeated such a conclusion:[67] (1) Double taxation does not occur automatically in every case; (2) The tax was imposed upon a domestic, not foreign, corporation; and (3) The amount of tax is more a function of the state's rate of taxation rather than its apportionment method.[68] The Supreme Court also held that formula apportionment of a worldwide unitary business is constitutionally acceptable for calculating the state tax liability of a domestic parent corporation.[69] Having upheld the constitutionality of California's method of apportionment, the Supreme

60. *Id.* at 184. The formula apportionment increased by fourteen percent Container Corps.' income attributable to California. *Id.*

61. *Id.* at 181.

62. *See supra* notes 53-55 and accompanying text.

63. 463 U.S. at 187. This double taxation, however, is derived from the differences in the adopted taxing systems.

64. *Id.* at 192.

65. *Id.* at 194 (citing 445 U.S. at 448).

66. 463 U.S. at 194.

67. *Id.* at 194-95.

68. *Id.* at 195.

69. Supplement, *supra* note 57, at S127-28.

Court's decision represents the apex of worldwide unitary taxation. Shortly after the *Container* decision, other states introduced similar provisions in their statute books.[70]

V. Toward a Solution

The outcome of *Container* evoked several unfavorable reactions from the business world[71] and from major trading partners of the United States. International response to *Container* was aimed at lessening the penalties imposed on foreign corporations by individual state's statutes. For example, the British Prime Minister Margaret Thatcher alluded to possible retaliation against United States corporations in a letter to President Ronald Reagan.[72] Additionally, the Japanese Government expressed concern that worldwide unitary taxation would serve as a potential barrier to new Japanese investment in the United States.[73] Furthermore, the Government of the Netherlands in a telegram to Secretary of the Treasury Donald Regan expressed the opinion that even a worldwide unitary apportionment limited to United States multi-national corporations would be an obstacle to the growth of international economic relations.[74] Thus, the ultimate side effect of *Container* was to urge the federal government and Congress to act.

A. The Federal Government's Position

To appease multi-national and foreign interests, President Reagan appointed a "[h]igh-level [p]anel," known as the Working Group,[75] "to study the unitary tax issue and formulate a compromise solution . . . acceptable to all parties."[76] The panel's discussion centered around the twelve states currently using worldwide combined reporting.[77] Its final report which was submitted to the President on

70. *E.g.*, Florida adopted worldwide unitary taxation in July, 1983. Weissman, *supra* note 7, at 48 n.3.

71. Multi-national corporations engaged in a vigorous campaign against worldwide unitary taxation. Jurinski, *California's Water's-Edge Legislation: The Closing Chapter in the Unitary Tax Debate?*, 6 J. OF ST. TAX'N. 23, 25-27 (1987) [hereinafter Jurinski]. *See also* Note, *supra* note 18, at 294 n.179.

72. Weissman, *supra* note 7, at 48 n.3. Prime Minister Thatcher's "strongly worded" letter was dated September 6, 1983.

73. *Id.*

74. *Id.*

75. Ferguson, *Worldwide Unitary Taxation: The End Appears Near*, 4 J. OF ST. TAX'N 241, 242 (1986) [hereinafter Ferguson]. "The Worldwide Unitary Taxation Working Group (Working Group) [was] chaired by the then Treasury Secretary Donald Regan." It consisted of representatives from the business world, the states, and the federal administration. *Id. See also* Peters, *Reports on Legislation Prohibiting State Taxation on a Worldwide Basis*, 27 TAX NOTES 817, 818-19 (1986) [hereinafter Peters].

76. Note, *supra* note 18, at 298.

77. Ferguson, *supra* note 75, at 242. The twelve states were: Alaska, California, Colorado, Florida, Idaho, Indiana, Massachusetts, Montana, New Hampshire, North Dakota, Oregon, and Utah. *Id.* at 243.

July 31, 1984, "contained three [p]rinciples of [a]greement[78] and two principal areas of disagreement."[79] The three principles of agreement were: (1) Water's-edge unitary combination for both U.S. and foreign-based companies, (2) Increased federal administration assistance and cooperation with the states to promote full taxpayers' disclosure and accountability, and (3) Competitive balance for United States multi-national, foreign multi-national, and domestic businesses.[80] The two areas of disagreement were the treatment of foreign dividends and the treatment of corporations with 80% of their activities outside the United States.

The areas of disagreement were left to be resolved at the state level. According to the final report, if there was not sufficient state progress by July 31, 1985, federal legislation would be recommended.[81] To implement the Working Group's conclusions, the Treasury Department released a draft of proposed legislation.[82]

B. *California's 1985 Legislative Session*

In the international arena, the United Kingdom passed a bill that would have empowered Great Britain to retaliate against United States corporations with subsidiaries in the United Kingdom and substantial operations in a state which uses worldwide unitary taxation.[83] The major catalyst of the British legislation was the failure of California to repeal unitary taxation in its 1985 legislative session.

The failure emanated from two principal obstacles: the taxation of a domestic corporation's foreign dividends[84] and two foreign policy issues involving Japan and South Africa. The Japanese issue dominated the initial stage of the legislative session. California proposed unitary tax relief as a "*do ut des*[85] for relinquishment of Japanese trade barriers against certain California agricultural products."[86] Additionally, California Governor Deukmejian vetoed a bill

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78. *Id.*

79. *Id.*

80. *Id.*

81. *Id.* at 245. Six states—Oregon, Florida, Massachusetts, Idaho, Indiana, and Colorado—soon repealed worldwide unitary taxation. *Id.*

82. Peters, *supra* note 75, at 819. The draft was released on July 8, 1985. *Id.*

83. J. BISCHEL AND R. FEINSCHREIBER, FUNDAMENTALS OF INTERNATIONAL TAXATION 321 n.12 (1985). The retaliatory legislation would have had the effect of denying credit on corporate distributions for United Kingdom corporate tax purposes to corporations incorporated or having their principal place of business in a unitary state. *Id.*

84. The foreign dividends issue divided foreign and domestic multi-national corporations into "warring factions". Seward, *Worldwide Unitary Taxation — Revolt Begets Reform*, 8 HOUS. J. OF INT'L L. 247, 273 (1986) [hereinafter Seward].

85. "*Do ut des*" is Latin for "something in exchange for something else." The widely used "quid pro quo" more precisely refers to a "misunderstanding." BLACK'S LAW DICTIONARY 442 (5th ed. 1979).

86. Seward, *supra* note 84, at 273.

which would have disallowed a multi-national corporation to choose a water's-edge taxing base, on the condition that the corporation divest in South Africa.[87]

C. *President Reagan's Statement*

On November 8, 1985, the Federal Government decided to take a more active position. Since the states had not universally accepted the Working Group's principles, President Reagan announced that he would initiate the process of incorporating those principles into an act of Congress.[88] The trading partners of the United States welcomed Reagan's position. In fact, "the United Kingdom released a concurrent statement" delaying action under its retaliatory law until December 31, 1986.[89]

Accordingly, the Unitary Tax Repealer Act was introduced in the United States Senate.[90] The bill prohibits the use of worldwide unitary taxation in favor of a water's-edge limitation, restricts state taxation of foreign source dividends, and requires corporations to file a full disclosure spreadsheet report with the Internal Revenue Service.[91]

VI. The California Solution

Following the congressional act, California amended its franchise tax on corporations on September 5, 1986[92] to allow qualified taxpayers[93] to limit the reach of California's taxing jurisdiction to those activities occurring within the water's-edge.[94] The statute, however, does not define the water's-edge concept, but simply provides an exclusive list of the entities allowed to be combined in a water's-edge group.[95] The statute imposes liability on foreign corporations doing business within the United States but taxes only those activities occurring within the United States.[96] The statute also requires that "[a] taxpayer which makes a water's-edge election shall

87. Ferguson, *supra* note 75, at 252.
88. *Id.* at 254 n.1.
89. *Id.* at 254-55. *See also* Peters, *supra* note 75, at 820.
90. S. 1974, 99th Cong., 1st Sess., 131 CONG. REC. 17, 975-78 (1985) [hereinafter UTRA].
91. Peters, *supra* note 75, at 820-23; Stevenson, *California Unitary Reform: A Step Forward*, 6 J. OF ST. TAX'N. 3, 12-13 (1987) [hereinafter Stevenson].
92. 1986 CAL. STAT. 660 § 6.
93. "Qualified taxpayer" is defined in CAL. REV. & TAX. CODE § 25110(b)(2) (Deering 1988) [hereinafter CRTC].
94. This was CRTC § 25110(a). Worldwide unitary taxation is still provided for in CRTC § 25101.
95. Rosati and Knopke, *California Unitary Reform Law*, 6 J. OF ST. TAX'N 45, 47-51 (1987) [hereinafter Rosati]; Stevenson, *supra* note 91, at 5.
96. As defined in CRTC § 25110(a)(5). Leegstra, Eager and Stolte, *The California Water's Edge Election*, 14 INT'L TAX 101, 103 (1988) [hereinafter Leegstra].

take into account the income and apportionment factors"[97] of "[a]ny corporation, regardless of the place where it is incorporated, if the average of its property, payroll, and sales factors within the United States is 20 percent or more."[98] The California extension of the water's-edge accounting method[99] is within the parameters of the "water's-edge unitary combined report method" established by the Working Group.[100]

To be included as a member in a water's-edge group, the entities must be "affiliated" with the taxpayer[101] and meet the requirements of California Revenue and Taxation Code § 25110(a)(8)(A).[102] These stringent requirements often have the effect of excluding certain non-affiliated entities from a water's-edge group, thus subjecting them to worldwide unitary taxation.[103]

A. The Election Contract

The water's-edge election consists of a five-year contract between the taxpayer and the Franchise Tax Board (FTB).[104] Pursuant to California Revenue and Taxation Code § 25110(d), however, the FTB has the power to disregard the election at any time if certain conditions exist. The most peculiar aspect of the water's-edge contract is the payment of an annual election fee.[105] The fee equals thirty-thousandths of one percent of the sum of the taxpayer's property, payroll, and sales in California.[106] However, "[i]nvestment in new plants or facilities"[107] and expenditures incurred for new employees in California[108] will reduce the sum of the property, payroll, and sales used in calculating the election fee. Nonetheless, the sum to be paid cannot be smaller than ten-thousandths of one percent of the sum of the taxpayer's current-year California property, payroll, and sales.[109] Paradoxically, this "minimum", which can exceed the normal amount calculated on historical factors,[110] may also frustrate

97. CRTC § 25110(a).
98. CRTC § 25110(a)(3).
99. CRTC § 25110(a).
100. Tannenwald, *supra* note 15, at 819.
101. CRTC § 25110(a) and (b)(1).
102. Income and other factors of the water's-edge members can be taken into account only if the same income and factor would have been taken into account under worldwide unitary taxation pursuant to § 25101.
103. Leegstra, *supra* note 96, at 105.
104. CRTC § 25110(a).
105. CRTC § 25115.
106. CRTC § 25115(b). Property and payroll are determined with respect to the income year ending in calendar year 1986. *Id.*
107. CRTC § 25515(c).
108. CRTC § 25115(c). This includes expenditures incurred after January 1, 1988.
109. Leegstra, *supra* note 96, at 119.
110. CRTC § 25115(i). The election fee can be waived only if a taxpayer has no taxable income either under the water's-edge method or the worldwide method, but even one dollar of income is enough to trigger the payment of the ten-thousandths of one percent minimum.

the benefits of increasing investments in California.[111]

B. *Treatment of Foreign Dividends*

Under the new California legislation, domestic multi-national corporations making a water's-edge election will be granted a deduction for "qualifying dividends"[112] received from a corporation not included in the unitary group. The qualifying dividends are divided into two parts. First, taxpayers are entitled to a seventy-five percent deduction on the first part of dividends.[113] Second, taxpayers that have decreased their foreign investment are allowed up to a one hundred percent deduction of the amount of the second part of dividends attributable to such a decrease. In contrast, taxpayers that have increased their foreign investments have no deductions on the amount of the second part of dividends attributable to such an increase.[114] For these purposes, the measure of the increase or decrease on foreign investments is the foreign payroll factor of the taxpayer and its affiliates.[115]

VII. Conclusion

California legislation has quieted disputes about worldwide unitary taxation. Foreign governments, however, are concerned that in three states—Alaska, North Dakota, and California—worldwide unitary taxation is still "in the statutes."[116] Moreover, although the Federal Government and multi-national corporations have strongly supported water's-edge legislation,[117] they are dissatisfied with several provisions of the "California Plan."[118]

Minor criticisms are stressed in two Technical Correction Bills which are pending before the California legislature.[119] Other criticisms go further, focusing on the possible unconstitutionality of some

111. Stevenson, *supra* note 91, at 12. *See supra* note 98.
112. Leegstra, *supra* note 96, at 121.
113. CRTC § 24411.
114. CRTC § 24411(a). The first part of dividends is equal to the lesser of the amount of qualifying dividends received in the current year and the highest amount of qualifying dividends received in any of the income years 1984-85-86. The second part of dividends is the current year qualifying dividends in excess of the first part of dividends. Leegstra, *supra* note 96, at 127.
115. *Id.* Both taxpayers that have increased and that have decreased foreign investment have a seventy-five percent deduction on the eventual remainder of the second part of dividends. Stevenson, *supra* note 91, at 8-11.
116. CRTC § 24411(c), (d).
117. Weakley, *State Unitary Apportionment of Foreign Corporation Worldwide Income*, 5 B. U. INT'L L. REV. 91, 115 (1987) [hereinafter Weakley].
118. Gray and Forma, *The "California Plan": A Retreat to the Water's Edge*, 6 J. OF ST. TAX'N 33, 34 (1987) [hereinafter Gray]. Immediately after the enactment of the California legislation, the Federal Government withdrew its support to some of the UTRA provisions pending in the United States Congress. *Id. See also supra* note 90 and accompanying text.
119. Gray, *supra* note 119, at 34.

of the adopted solutions, such as the payment of a substantial election fee simply in order to be taxed in one "formation" of the unitary group instead of in another.[120] Additionally, the provision of a minimal election fee may lead to discrimination between two taxpayers having the same income, simply because one of them increases its current property, payroll, and sales in California.[121] Similarly, the foreign dividend deduction provision may also lead to discrimination between taxpayers; taxpayers are allowed an all-or-nothing deduction on a portion of qualifying dividends based on the ultimate increase or decrease of their foreign payroll factor.[122]

Inevitably these provisions will be challenged in the judicial arena. The California water's-edge election is effective for income years beginning on or after January 1, 1988.[123] In the coming years, the courts will have the opportunity to interpret the California solution. Hopefully, the courts will offer resolutions to the problems raised by the taxation of foreign and domestic multi-national corporations.

120. Leegstra, *supra* note 96, at 161. An example of this legislation is a provision for an alternative five-year election contract. *Id.*

121. The Federal Government is also concerned with the magnitude of the election fee, which could heavily influence the choice of the water's-edge method. Gray, *supra* note 118, at 35.

122. *See supra* notes 114-16 and accompanying text.

123. CRTC § 25110. Calendar year taxpayers will first be able to make the election on their returns for the year ending December 31, 1988. Fiscal year taxpayers must wait until the end of their fiscal year beginning after January 1, 1988.