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States’ Use of the Unitary Method: A Taxing Burden on International Commerce

I. Introduction

That the power of taxation is one of vital importance; that it is retained by the states; that it is not abridged by the grant of a similar power to the government of the Union; that it is to be concurrently exercised by the two governments; are truths which have never been denied. But such is the paramount character of the Constitution that its capacity to withdraw any subject from the action of even this power is admitted.¹

Although the Constitution grants the federal government power to lay and collect taxes,² nothing in the Constitution makes this power exclusive. The states undeniably exercise a concurrent power of taxation with the federal government.³ A state’s ability to tax, while not prohibited by the Constitution, is, however, subject to Constitutional limitations. One such limitation is the commerce clause.⁴ Under the commerce clause, Congress has plenary power to regulate taxation by the states.⁵ But even in the absence of any affirmative action by Congress, courts have been willing to infer a limitation on a state’s taxing powers from the free trade policy that lies at the heart of the commerce clause.⁶ Determination of whether a state tax is subject to limitations imposed by the dormant commerce clause⁷ depends upon the balance struck between state and federal interests.

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3. THE FEDERALIST No. 32 (A. Hamilton).
4. "The Congress shall have Power . . . To regulate Commerce with foreign Nations, and among the several states, and with the Indian Tribes." U.S. CONST. art. 1, §8.
7. The term dormant commerce clause, as used here, refers to the judicial tendency to implement the values implicit in the commerce clause by restricting state actions that inhibit the flow of commerce between states and nations even when Congress has not legislated. See generally, G. GUNThER, CONSTITUTIONAL LAW 256-71 (10th ed. 1980).
A state is primarily interested in maximizing its tax revenues and in maintaining the greatest possible degree of sovereignty. The federal government, on the other hand, is interested in maintaining and encouraging a free flow of commerce.

One area in which these interests have come into conflict is state taxation of multinational corporations. The problem arises from the difficulty involved in ascertaining the exact percentage of a multinational corporation's income attributable to a particular taxing jurisdiction in a given year. The states have devised a method known as the unitary method for allocating the total income of a multinational corporation between the jurisdictions in which the corporation operates. A formula incorporated in the unitary method determines the percentage of income generating activities existing within a particular jurisdiction and allocates to that jurisdiction an equivalent percentage of the corporation's income. The Supreme Court first recognized the constitutionality of the unitary method as applied to a multistate corporation in *United States Glue v. Oak Creek*. The Court has since sided with the states in upholding the application of the unitary method to multistate corporations in the large majority of cases.


9. See, e.g., id. at 177 (statement of Charles S. Levy, Vice President, Emergency Committee for American Trade).


11. *See infra* notes 94-111 and accompanying text.

12. 247 U.S. 321 (1918). Wisconsin determined the amount of income attributable to sources within the state by measuring the dollar value of sales and property within the state as a percentage of the total value of sales and property of the entire corporation. This percentage was then multiplied by the total income of the corporation to ascertain the percentage of income attributable to the state. Defendant glue company vainly argued that the method unduly burdened interstate commerce because it taxed income earned outside the state.

13. *See Exxon Corp. v. Wisconsin Dept. of Revenue*, 447 U.S. 207 (1980) (Wisconsin determined the income of Exxon's in-state marketing activities by apportioning a percentage of Exxon's entire operating income); Mobil Oil Corp. v. Comm'r of Taxes, 445 U.S. 425 (1980) (Vermont used the unitary method to allocate a percentage of dividends paid to Mobil by its subsidiaries throughout the world; although Mobil is a multinational corporation, it waived the objection that the tax would burden international commerce by conceding that all of its foreign dividends were subject to tax in the United States); Moorman Mfg. Co. v. Bair, 437 U.S. 267 (1978) (Illinois apportioned Moorman's income on the basis of sales occurring within the state); General Motors Corp. v. Washington, 377 U.S. 436 (1964) (Washington apportioned General Motors' wholesale sales receipts to determine sales occurring within the state and taxed the corporation accordingly); Northwestern States Portland Cement Co. v. Minnesota, 358 U.S. 450 (1959) (Minnesota taxed the percentage of Northwestern's entire income that was proportionate to the amount of payroll, property, and sales existing within the state); Butler Bros. v. McColgan, 315 U.S. 501 (1942) (California apportioned a percentage of Butler Bros.' net income to sources within the state despite the fact that the state branch operated at a loss for the year in question); Underwood Typewriter v. Chamberlin, 254 U.S. 113 (1920) (Connecticut apportioned a percentage of Underwood's net income to sources within the state on the basis of property owned by Underwood within the state). But see *F.W. Woolworth Co. v. Taxation and Revenue Dept.*, 102 S. Ct. 3128 (1982) (New Mexico's application of the
After the constitutionality of the unitary method as applied to multistate corporations was thus established, states began to use this method to tax the income of multinational corporations. In this new context, the focus of the Court’s scrutiny shifted from interstate commerce to international commerce. At first, it appeared that the increased scrutiny of state taxing procedures required by the foreign commerce clause would tilt the balance in favor of the federal government. In *Japan Line Ltd. v. Los Angeles*, the Supreme Court prohibited application of an apportioned property tax to instrumentalities of foreign commerce by states on the grounds that it was an undue burden on international commerce. In so holding, the Court enunciated two tests that a state tax must pass, in addition to the normal commerce clause requirements, to survive a constitutional challenge under the foreign commerce clause. First, the tax must not create a substantial risk of international multiple taxation. Second, the tax must not prevent the federal government from speaking with one voice when regulating commerce with foreign nations. The state tax involved failed both tests because it inevitably led to double taxation and created a risk of retaliation by United States’ trading partners.

Despite the holding in *Japan Line*, the Court’s deference to the federal interest in maintaining a free flow of international commerce did not last long. In the recent case of *Container Corp. v. Franchise Tax Board*, the Supreme Court upheld California’s use of the unitary method to tax the earnings of a domestically based multinational corporation. Container Corp. argued, among other things, that, like the tax involved in *Japan Line*, California’s apportioned income tax was invalid because it inevitably led to double taxation.
The Court disagreed, distinguishing Japan Line on its facts. Reverting to its earlier position, the Court sided with the states, holding that the Constitution does not prohibit application of the unitary method to domestically based multinational corporations.

This comment will discuss the constitutionality of state use of the unitary method to tax multinational corporations. After considering the problems involved in allocating income between the jurisdictions in which a multinational corporation operates, the comment will examine the two predominant methods of allocation designed to solve these problems. The discussion will then analyze and criticize the Court's decision in Container Corp. v. Franchise Tax Board.

II. The Problem

A. Transfer of Income

The relationship between component parts of a multinational corporation creates substantial difficulties for countries which must determine the amount of income generated within their borders for tax purposes. Such difficulties arise because income generated by a component in one country is often realized by a related component in another country. This transfer of income from one jurisdiction to another can occur in two ways. Related components of a multinational corporation can deal inter se at less than arm's length, or a component of a multinational corporation can passively receive a flow of value from a related component.

Related components of a multinational corporation that share a common economic or business interest by virtue of their common ownership will frequently buy and sell services or products to one another at prices that differ from those charged on the open market. This practice of setting prices at artificial levels is commonly referred to as transfer pricing, and results in transferring income generated in one country to a component in another country. Al-

23. See infra notes 26-46 and accompanying text.
24. See infra notes 47-128 and accompanying text.
25. See infra notes 129-187 and accompanying text.
26. Arm's length transactions are those transactions which occur on the open market between unrelated corporations. See Madere, International Pricing: Allocation Guidelines and Relief From Double Taxation, 10 Tex. Int'l L.J. 108 (1975) [hereinafter cited as Madere].
27. Flow of value denotes benefits that a component of a large corporation receives by virtue of its affiliation with the entire corporation. See McLure, Operational Interdependence Is Not The Appropriate Bright Line Test Of A Unitary Business — At Least Not Now, 18 Tax Notes 107 (1983) [hereinafter cited as McLure].
29. For example, suppose that parent X manufactures its products in country A and sells these products to subsidiary Y in country B at cost instead of normal wholesale market price. Subsidiary Y can then sell the products at normal retail market price in country B and realize a profit that consists of both its own markup on the product and the markup that could
though transfer pricing may be motivated by the corporation's desire to avoid taxes, a multinational corporation may also have legitimate business reasons to utilize this procedure. Regardless of the motivation, however, the net effect is that one country loses the opportunity to tax income that was generated within its borders and therefore may remain uncompensated for the benefits and protection it afforded the corporation through its laws.

Income can also shift from one country to another through the flow of value between related components of a multinational corporation. Subsidiaries of a multinational corporation often receive substantial economic benefits by virtue of their affiliation with the multinational corporation as a whole. These benefits include centralized management, economies of scale, enhanced reputation and goodwill, and increased bargaining power. Such benefits contribute to the profitability of the subsidiary of a multinational corporation. Thus, part of the profit realized by a subsidiary is attributable to activities of other components, most likely including a parent. In many cases, the subsidiary does not compensate the parent for these profit generating activities. The result is an uncompensated

have been charged and earned by parent X. In this way, profit margin that is attributable to parent X is transferred to subsidiary Y. Thus, income that constitutes this profit margin, which was generated through the manufacturing process in country A, is transferred to country B where it is realized.

Income can be shifted back the other way from country B to country A in the same type of transaction. If parent manufacturer X charges an inflated wholesale price to subsidiary Y and subsidiary Y then sells the product at normal retail market price in country B, the profit that subsidiary Y should have realized in country B will be transferred to country A as part of the inflated wholesale price charged by parent X.

If the rate of taxation in country A is significantly higher than the rate of taxation in country B, the multinational corporation will certainly profit by transferring income from country A to country B. Of course, transfer pricing will only reduce a multinational corporation's tax liability if it is engaging in business in countries with different rates of taxation. The rates of corporate income taxation in industrialized western countries are approximately the same. Madere, supra note 26, at 108.

A multinational corporation may engage in transfer pricing to bolster the financial stability of a foreign subsidiary or to expand a distributor's client base by subsidizing the distributor with lower prices. See generally Note, Multinational Corporations and Income Allocation Under Section 482 of the Internal Revenue Code, 89 Harv. L. Rev. 1202 (1976) [hereinafter cited as Note, Multinational Corporations].

See infra notes 47-128 and accompanying text.


Centralized management may be more effective than regional management because it can orchestrate all the components of a multinational corporation. If all the components are operating in harmony, resources will be used in the most efficient way possible and group profits will be maximized. McLure, supra note 27, at 108-9.

When the corporation as a whole buys in bulk, it can receive a better price than could an individual component purchasing a small quantity of material just for its own needs.

A small unknown business may benefit significantly in terms of increased visibility and recognition from its affiliation with an internationally recognized corporation.

A business that becomes affiliated with a large multinational corporation will be less vulnerable to the capricious effects of a fluctuating market. It will therefore be in a better position to bargain with its competitors.

Appellee's Brief on the Merits at 33-35, Container Corp. v. Franchise Tax Bd., 51
transfer of value from the country in which the parent company operates to the country in which the subsidiary operates.\textsuperscript{39}

B. Reallocation of Income

Transfer of income between jurisdictions can seriously erode a country's tax base and thereby reduce its tax revenues. Most nations accept the proposition that the country in which the income was generated—the source country—has the right to tax that income.\textsuperscript{40} Accordingly, the problem arises of how to reallocate to the source country income that has been transferred to another country.

Reallocation, however, is difficult to accomplish. When a corporation generates income by activities occurring in a number of different countries, allocation of a portion of that income to the country in which it was generated is mere conjecture.\textsuperscript{41} The uncertainty has spawned differing opinions concerning the means of achieving proper allocation. Two diametrically opposed methods of allocating income have been advanced as the proper manner of arriving at an equitable allocation—the arm's length method and the unitary method.

The basic difference between the two is the way in which each characterizes the relationship between the components of a multinational corporation.\textsuperscript{42} The arm's length method views each component of a multinational corporation as a separate, individual entity, dealing at arm's length. Accordingly, this approach requires the tax ad-

\textsuperscript{39} The transfer of income resulting from the functional integration of a multinational corporation can occur in any number of ways. The cited examples are some of the more obvious benefits. For a general discussion of some of the less obvious benefits arising from functional integration, see generally McLure, supra note 27.

\textsuperscript{40} In the field of income allocation there is an important distinction between source country and residence country. The source country is the country in which income is generated. The residence country is the country in which the corporation that realizes the income resides. Most bilateral agreements between countries require the residence country to recognize the jurisdiction of the source country to tax income. See Surrey, Reflections on the Allocation of Income and Expenses Among National Tax Jurisdictions, 10 Law and Policy in International Business 409, 409-412 (1978) [hereinafter cited as Surrey].

The United Nations Group of Experts on Tax Treaties Between Developed and Developing Countries has established a set of guidelines providing that source countries have primary jurisdiction to tax income. Because these guidelines were designed to be a model for tax treaties concluded between countries, it is likely that the trend toward recognizing the source country's jurisdiction to tax will continue. See generally, Surrey, United Nations Group of Experts and the Guidelines for Tax Treaties Between Developed and Developing Countries, 19 Harv. Int'l L.J. 1 (1978).

\textsuperscript{41} It has long been recognized that the effort to attribute precisely the profits of a large multicroporate business to any particular jurisdiction is futile. It is akin to asking what proportion of Ron Guidrey's pitching power is due to his legs, chest, shoulder, elbow, and wrist respectively." Hearings, supra note 8, at 21 (Statement of Byron Dorgan, the past Chairman of the Multistate Tax Commission).

The Supreme Court noted that "[a]llocating income among various taxing jurisdictions bears some resemblance . . . to slicing a shadow." Container Corp. v. Franchise Tax Bd., 51 U.S.L.W. 4987, 4996 (U.S. June 27, 1983) (81-523).

\textsuperscript{42} Note, Multinational Corporations, supra note 31, at 1206.
ministrator to scrutinize every intracorporate transaction to determine whether arm's length prices were charged for the goods or services exchanged. If they were not, the tax administrator reallocates income to reflect the distribution of income that would have occurred had arm's length prices prevailed.48

The unitary method considers the components of a multinational corporation as members of a single unitary business; intracompany transactions are ignored. Because the unitary method views all components of the multinational corporation as one large business, no income is realized for tax purposes until a transaction is conducted with an unrelated person. The income of the entire unitary business is then allocated between the components of the business on the basis of an abstract formula.44

The arm's length method and the unitary method each have their own adherents. Most nations employ a version of the arm's length method,46 while a number of states have adopted the unitary method.48

43. Whenever a corporation engages in transfer pricing it is not dealing at arm's length. See supra notes 25-27 and accompanying text. When the tax administrator discovers transfer pricing, he is empowered to reallocate the income involved. See I.R.C. §482 (P-H 1983). See also infra notes 53-60 and accompanying text. The proper distribution of income for any given transaction is determined by reference to comparable transactions that did in fact occur on the open market at arm's length. See infra notes 47-52 and accompanying text. See generally Bishel, Tax Allocations Concerning Inter-Company Pricing Transactions in Foreign Operations: A Reappraisal, 13 VA. J. INT'L L. 490 (1973) [hereinafter cited as Tax Allocations].

44. The formula works on the assumption that certain identifiable factors of production such as payroll, property, and sales, exist within a jurisdiction. The formula allocates the income of a multinational corporation to jurisdictions according to the value of the factors of production existing within that jurisdiction. See generally Keessling & Warren, supra note 33. See also Wahrhafting, Allocation Factors in Use in California, 12 HASTINGS L.J. 65 (1961).


III. National and International Approach

A. The Arm’s Length Method

In order to tax all income that is generated within its borders, a country must be able to reclaim income that has been transferred out of the country. Most countries reclaim such income by using the arm’s length method. This method is premised on the belief that an equitable distribution of income would have occurred between two unrelated parties dealing at arm’s length on the open market. Such open market transactions provide a standard—fair market value—by which income may be reallocated.

The tax administrator does not have authority to question the distribution of income that occurs under the rules of the uncontrolled market place. Accordingly, in most countries, before reallocating income, the tax administrator must make a preliminary finding that the corporations in question are commonly owned or controlled. This common ownership or control serves to remove the parties from the free market, and thereby justifies imposition of an objectively determined reallocation of income.

In the United States, the Secretary of the Treasury has the authority to reallocate income. Although the Internal Revenue Code

Washington (WASH. REV. CODE ANN. § 32.56.010, art. IV (West 1965)).

47. See supra, notes 29-39 and accompanying text.

48. It is almost universally accepted that the country in which the income was generated has the right to tax that income. See supra note 40.

49. This is the method utilized by the United States. For example: X’s International Division engages in a wide range of sales promotion activities. Although most of these activities are undertaken exclusively for the benefit of X’s international operations, some are intended to jointly benefit both X and Y and others are undertaken exclusively for the benefit of Y. The district director may make an allocation to reflect an arm’s length charge with respect to the activities undertaken for the joint benefit of X and Y consistent with the relative benefits intended as well as with respect to the services performed exclusively for the benefit of Y.

Treas. Reg. §1.482-2(b) 3 example 1 (P-H 1983).

In many countries the arm’s length method is statutorily authorized. See supra note 45. Other countries, such as Switzerland and the Netherlands, rely on the general provisions of their revenue laws to reallocate income according to the arm’s length standard. Madere, supra note 26, at 111.

50. In free market societies the uncontrolled market place is permitted to set the prices that will be charged for goods and services. Any resulting injustice is attributable to the fluctuations of the uncontrolled market place. See Surrey, supra note 40, at 414.

51. The actual form of ownership or control is not determinative. What is important is the substance or reality of a common economic interest. See Treas. Reg. §1.482-1(a) 3 (P-H 1983).

52. See Wisconsin Big Boy Corp. v. Comm’r, 452 F.2d 137 (7th Cir. 1971) (subsidiaries under control of parent precluded possibility of arm’s length dealing). But see Brittingham v. Comm’r, 598 F.2d 1375 (5th Cir. 1979) (absence of a common design to shift income was sufficient to prove absence of control even though business was owned by members of the same family).

53. In any case of two or more organizations, trades, or business (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Secretary may distribute, appor-
gives the Secretary wide latitude to reallocate income by any means he chooses, the regulations explicitly require use of the arm's length method of allocation. The types of transactions for which the regulations provide a reallocation procedure include loans or advances, performance of services, use of tangible property, transfer or use of intangible property, and sale of tangible property. In each case, the regulations require the Secretary to determine the arm's length price for a particular transaction by reference to the price which would have prevailed in the same or a similar transaction between unrelated parties on the open market.

The reallocation of a multinational corporation's income between components operating in different countries may well result in economic double taxation. Because there is often a substantial time lag between the transaction that gives rise to the original distribution of income and reallocation of that income by the taxing authority of one of the countries in which the corporation operates, the corporation will likely already have paid taxes on that income in one country before a second country makes its reallocation and assesses a deficiency.


Regular double taxation refers to the imposition of two taxes on the same income of a single taxpayer. In contrast, economic double taxation occurs when two taxes are imposed on the same income, but the taxes are paid by two different taxpayers. Economic double taxation only occurs when income has been reallocated from one taxpayer to another and both taxpayers are required to pay a full tax on that income. See Oetjen, The Competent Authority's Role in Resolving International Tax Issues, 26 Tax Executive 57, 60-61 (1973) [hereinafter cited as Oetjen].

62. Suppose that income has been shifted from a parent in country A to a subsidiary in country B through transfer pricing. The subsidiary would pay tax on the income to country B
The obvious avenue of relief in this situation is for the corporation to seek a correlative adjustment\textsuperscript{63} from the first country and a corresponding refund of taxes paid on the reallocated income.\textsuperscript{64} Countries, however, are often unwilling to make such adjustments in response to another jurisdiction's reallocation of income, especially when the original taxing jurisdiction considers the original allocation of income to be correct.\textsuperscript{65} Similar disagreements over the correct distribution of income may arise when the countries use different allocation methods producing different results.\textsuperscript{66} National government reluctance to provide some sort of unilateral relief\textsuperscript{67} for multinational corporations subjected to double taxation has encouraged the creation of bilateral agreements designed to prevent double taxation, and to remedy such double taxation when it does occur.\textsuperscript{68}

B. Income Tax Treaties

Bilateral agreements attempt to mitigate the detrimental impact in the year it is realized. A few years later, country $A$ discovers the transfer pricing. Accordingly, country $A$ reallocates the income and assesses a tax on that income. If the parent pays the tax, economic double taxation will have occurred.

\textsuperscript{63} A correlative adjustment is an adjustment of tax liability in one country made in response to the reallocation of income by another country. See Tax Allocations, supra note 43, at 500-09.

\textsuperscript{64} See Treas. Reg. \S 1.482-1(d)2 (P-H 1983), authorizing the Secretary of the Treasury to make correlative adjustments when both components of the corporation involved are in the United States. This, of course, provides no relief in the international sphere. For a discussion of international correlative adjustments see Miller, Proposals for Amelioration of Section 482 Allocations Affecting U.S. Taxpayers with Foreign Affiliates, 44 Taxes 209 (1966) [hereinafter cited as Miller].

\textsuperscript{65} It is almost an axiom of international taxation that no taxing jurisdiction will agree to reduce the amount of income subject to its tax merely because another taxing jurisdiction has allocated additional income to a related entity. . . . More often than not, our Service will not recognize the foreign country's reallocation of income, even though the Service would have insisted on the same type of reallocation had the roles of the United States entity and the foreign corporation been reversed. Phillips, The Current Status of the Application of Section 482 to Foreign Related Corporations, 48 Taxes 472, 474 (1970), quoting Aidinoff, Special Problems Involved in Dealings Between United States Corporations and Foreign Related Corporations, N.Y.U. 25th Annual Institute on Federal Taxation 415 (1967).

\textsuperscript{66} Disagreements over the correct distribution of income may also arise between countries that use the same allocation method when, because of defects inherent in the method, it produces inconsistent results. See Miller, supra note 64, at 214-15. See also infra notes 89 and 90 and accompanying text.

\textsuperscript{67} Unilateral relief refers to any type of tax exemption or tax credit provided by a single country in order to mitigate the harmful effects of double taxation. See, e.g., Rev. Proc. 64-54, 1954-2C.B. 1008-10 (providing a limited exemption from increased taxes assessed by the federal government resulting from reallocations under section 482). Cf. Rev. Proc. 65-17, 1965-1 C.B. 835 (providing a limited credit that may be applied to reduce increased tax liability resulting from reallocations under \S 482). The problem with unilateral relief, however, is that it requires one country to bear the full burden of relieving economic double taxation when the cause of the double taxation is overlapping assertions of jurisdiction by two or more countries. One country is rarely willing to play the good guy while other countries pocket the tax revenues. See generally Kragen, Avoidance of International Double Taxation Arising From Section 482 Reallocations, 60 Calif. L. Rev. 1493 (1972) [hereinafter cited as Kragen].

\textsuperscript{68} See J. Bischel, Income Tax Treaties 1-7 (1978) [hereinafter cited as Bischel].
of conflicting income allocations on the free flow of international commerce while preserving the ability of national governments to reallocate income to prevent tax evasion. Bilateral agreements work in two ways to achieve this goal. The first seeks harmonization of income allocation methods to prevent conflicting allocations of income. For example, a number of income tax treaties require use of the arm's length method of income allocation. These treaties, however, fail to provide specific guidelines directing its application. Therefore, each country will probably look to its own procedures regarding specific application of the arm's length method. As a result, conflicting allocations of income arising from inconsistent applications of the arm's length method still exist.

The second attempt to avoid double taxation while allowing countries to maximize tax revenues is manifest in Mutual Agreement Procedures (MAPs) within the tax treaties. The countries may resort to MAPs to resolve disagreements over the application of a specific treaty provision, such as the requirement of the arm's

69. Conflicting income allocations often result in economic double taxation of multinational corporations and thereby impede the flow of international commerce.

70. Income tax treaties are designed to prevent not only double taxation, but double tax evasion as well. See Norr, Jurisdiction to Tax and International Income, 17 TAX L. REV. 431, 445 (1961) [hereinafter cited as Norr].


72. In fact, the United States is the only country to promulgate specific guidelines regulating application of the arm's length standard in individual cases. See Madere, supra note 26, at 113. Treas. Reg. §1.482-2 (P-H 1983) (sets forth specific allocation methods the Secretary of the Treasury must use to reallocate income arising from the sale of goods). See also supra notes 55-59 and accompanying text.

73. Although the treaty partners are bound by the general arm's length standard provided for in the treaty, they are free to choose the way in which they will determine what the appropriate arm's length price is for a particular transaction. For example, in the United States, Treas. Reg. §1.482-2(e)(3) provides that the proper arm's length price for the sale of tangible goods shall be determined by the resale price method. This method starts with the price at which the buyer of the product would resell the product and reduces it by an appropriate markup percentage. The appropriate markup percentage is determined to be the rate of profit which the buyer would expect to realize on the sale of a similar product to a third party.

In contrast, Germans determine the arm's length price of a product by taking the manufacturer's cost and adding to it a profit which is equal to the normal rate of return earned on investment capital. The French and Japanese use a similar method insofar as they begin with the manufacturer's cost, but instead of adding on a profit equal to the rate of return on invested capital, they add on a profit comparable to that earned by domestic firms in the same industry. See Madere, supra note 26, at 113-19.


75. See BISCHEL, supra note 68, at 445-503.
length method. MAPs authorize competent authorities\textsuperscript{76} of contracting nations to resolve any differences relating to application or interpretation of treaty provisions.\textsuperscript{77} The authorities generally have wide latitude to negotiate agreements and settle disputes, but must still abide by the general provisions of the treaties. Accordingly, when settling disputes concerning proper allocation of income, the authorities must employ some version of the arm's length method.\textsuperscript{78} This limitation on types of allocations available to contracting countries is a major factor in enabling competent authorities to arrive at a mutual agreement concerning the allocation of income.\textsuperscript{79}

MAPs succeeded in relieving the effects of economic double taxation in the majority of cases which have reached competent authorities.\textsuperscript{80} This success may be due in part to general agreement between countries that any reallocation of income must follow the arm's length method.\textsuperscript{81}

Of course, MAPs are a remedy to be applied only after double taxation has occurred. Prevention of double taxation depends on harmonization and clarification of international rules of income allocation.\textsuperscript{82} Unfortunately, although the international community has adopted the arm's length method as the uniform rule of allocation, double taxation still occurs as a result of inconsistent application of this method. This inconsistency is attributable to the failure of the international community to promulgate sufficiently specific regulations regarding application of the arm's length method, as well as to

\textsuperscript{76} In the United States the Assistant Commissioner (Compliance) of the Internal Revenue Service is the competent authority.

\textsuperscript{77} The Competent Authorities of the Contracting States shall endeavor to resolve by mutual agreement any difficulties or doubts arising as to the interpretation or application of this Convention. In particular the Competent Authorities of the Contracting States may agree:

\begin{itemize}
  \item a) to the same attributions of income, deductions, credits, or allowances of an enterprise of a Contracting State to its permanent establishment situated in the other contracting states...
\end{itemize}

\textit{U.S. Model Income Tax Treaty of May 17, 1977, art. 25(3), 1 TAX TREATIES (CCH) ¶ 1019 (1977)}.

\textsuperscript{78} Oetjen, \textit{supra} note 61, at 60.

\textsuperscript{79} Countries can allocate income up to the point at which their tax revenues are maximized under the arm's length standard, but they cannot go beyond this point. The limitation on allocations facilitates the competent authorities arrival at a mutual agreement concerning proper allocation of income. \textit{Bischel, supra} note 68, at 461.

\textsuperscript{80} Statistics compiled in 1977 show that:

\begin{itemize}
  \item 104 cases, or about 87 percent, have been closed with full relief from double taxation;
  \item 5 cases or about 4 percent, have been closed with substantial relief provided. Only about 11 cases, or about 9 percent, have been closed without any relief. Generally, this has been the result of closed statutes of limitations on refunds, or other procedural bars, rather than any breakdown of negotiations.
\end{itemize}

\textit{Id. at 485-86, quoting Joseph McGowan, Director of International Operations Internal Revenue Service, THE INTERNATIONAL INSTITUTE ON TAX AND BUSINESS PLANNING, New York University, New York, N.Y. (September 27, 1977)}.

\textsuperscript{81} See \textit{supra} note 79.

\textsuperscript{82} \textit{See, e.g.}, Madere, \textit{supra} note 26, at 132-135; Kragen, \textit{supra} note 67, at 1516-17; Norr, \textit{supra} note 70, at 451-453.
the defects inherent in the method itself.\textsuperscript{83}

C. Critique

The most pronounced shortcoming of the arm’s length method of income allocation is that it does not accurately reflect economic reality. It is designed to reallocate income between related entities of a multinational corporation to simulate the distribution of income which would have arisen from the interaction of unrelated entities dealing on the open market.\textsuperscript{84} Before the arm’s length method can be applied, however, there must be a preliminary finding of common ownership or control of the entities involved in the transaction.\textsuperscript{85} The transaction between these commonly controlled entities is then compared to a similar transaction between uncontrolled entities dealing on the open market. But such a comparison of unique entities is not logically feasible. It is akin to comparing apples and oranges.

The arm’s length method does not recognize the basic difference in economic reality between controlled and uncontrolled corporations. Corporations under common control or ownership may be so interrelated that the types of intracompany transactions in which they engage are completely unlike those transactions between independent entities dealing at arm’s length.\textsuperscript{86} Similarly, the value that flows between the related components of a multinational corporation by reason of the functional integration of all the components simply does not exist between unrelated entities.\textsuperscript{87} Thus, when intracompany transactions are converted to arm’s length transactions, the benefits arising from interrelationship of component corporations are not considered.\textsuperscript{88} Accordingly, the resulting transfer of income is reallocated arbitrarily or not at all.

In addition to the theoretical weakness of the arm’s length method, problems arise in its practical application. Imposition of

\textsuperscript{83} Two countries using the arm’s length method may still arrive at differing allocations of income because of difference in the way in which they calculate the appropriate arm’s length price. \textit{See supra} notes 69-73 and accompanying text. Similarly, two countries may arrive at different allocations simply because of the arbitrary nature involved in applying the arm’s length method to unique transactions. \textit{See infra} notes 84-90 and accompanying text. Any time two countries arrive at different allocations of income, the possibility of double taxation exists.

\textsuperscript{84} \textit{See supra} notes 47-50 and accompanying text.


\textsuperscript{86} \textit{See, e.g.,} Wisconsin Big Boy Corp. v. Comm’r, 452 F.2d 137 (7th Cir. 1971) (court found it impossible to reconstruct arrangements on arm’s length basis because same exchange of value would never have occurred on open market).

\textsuperscript{87} The flow of value between the related components of a multinational corporation stems from such things as centralized management, economies of scale, and increased buying power. \textit{See supra} notes 32-39 and accompanying text.

\textsuperscript{88} The benefits of synergy do not exist on the open market. Note, \textit{Multinational Corporations}, \textit{supra} note 31, at 1215.
arm's length prices on transactions between controlled entities necessitates determining the actual arm's length price for a particular transaction. But, fluctuating variables such as time, place, and level of the market often make comparison between a particular controlled transaction and a similar uncontrolled transaction impossible. Moreover, although different methods for determining the arm's length price of a controlled transaction have been devised, these methods all ultimately rely on evidence of comparable transactions occurring on the open market. Therefore, because the arm's length method requires comparable uncontrolled transactions which often do not exist, determination of an arm's length price is frequently arbitrary.

Another shortcoming of the arm's length method is the administrative burden associated with its application. As discussed above, reallocation of income resulting from an intracompany transaction requires gathering evidence of comparable uncontrolled transactions. Because companies are not required to retain records of comparable transactions, the effort and cost involved in compiling such evidence can be formidable. In the words of the past chairman of the Multi-state Tax Commission, "This is the accounting equivalent of trying to build the Great Wall of China with an ice cream scoop."

This administrative burden, when coupled with the inaccuracy of the arm's length method, has led some taxing jurisdictions to discontinue use of the arm's length method. The states in particular have turned to the unitary method.

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89. See, e.g., Eli Lilly and Co. v. United States, 372 F.2d 990, 997-98 (Ct. Cl. 1967) (intracompany sales not sufficiently comparable to sales made to bulk purchasers to establish an arm's length value for the intracompany sales). For example, it is difficult to set an appropriate arm's length price for increased security, economies of scale, centralized management, and other intangible benefits a subsidiary may receive by virtue of its affiliation with a large, well established parent. See supra notes 33-38 and accompanying text.

90. The United States has promulgated the most specific regulations dealing with the determination of arm's length prices for particular transactions. For example, the treasury has devised four methods to determine arm's length price for sale of goods. See Treas. Reg. §1.482-2(e) 1-4 (P-H 1983). The first three, however, require some sort of comparison with similar transactions occurring on the open market. Treas. Reg. §1.482-2(e)2(ii) (P-H 1983); Treas. Reg. §1.482-2(e)3(vii) (P-H 1983); Treas. Reg. §1.482-2(e)4(iii) (P-H 1983). The fourth method allows the Secretary to allocate income by any method that is clearly more appropriate than the first three methods. Courts have interpreted this to require that an allocation under this method be reasonable. See P.P.G. Indus. Inc. v. Comm'r, 55 T.C. 928 (1970). Such a standard in turn ultimately relies upon a comparison with the open market to determine what is reasonable. See also supra note 73.

91. See supra notes 42-43 and accompanying text.

92. See Note, Multinational Corporations, supra note 31, at 1219-20.

93. Hearings, supra note 8, at 22 (statement of Byron Dorgan, Past Chairman, Multi-state Tax Commission).
IV. State Approach

A. The Unitary Method

An alternative approach to income allocation is the unitary method employed by a number of state taxing authorities. This method does not aim to recreate an allocation of income that would have occurred through transactions on the open market. Instead, it attempts to distribute the profits of an entire multinational corporation between the component's of the corporation in proportion to each component's contribution to the overall profits. Because the unitary method does not compare particular intercorporate transactions to similar arm's length transactions, it is able to account for contributions to income that arise solely in the context of a closely related unitary business, thereby correcting the basic defect of the arm's length method. Furthermore, administration of the unitary method does not require compilation of evidence regarding arm's length transactions. Therefore, it is significantly less burdensome than the arm's length method. Use of the unitary method involves little more than application of an abstract formula to a corporation's total profits.

Before a multinational corporation's income can be apportioned, however, there must be a preliminary finding that the corporation, with all of its components, constitutes a unitary business. A multinational corporation constitutes a unitary business when there is a substantial mutual interdependence between the component parts of the corporation. Upon determination that the corporation is unitary, each component of the corporation must file a combined report setting forth the total income and expenses of the entire corporation.

94. See supra note 44.
95. See supra note 46.
96. Income is allocated to those countries in which the factors of production are located.
97. The arm's length method treats a multinational corporation as a conglomeration of separate entities and focuses on each particular transaction engaged in by related components. In contrast, the unitary method treats the multinational corporation as one large unitary business and focuses on only the overall profits of the multinational corporation as a whole. Thus, intracompany transactions between related components are ignored for tax purposes because the multinational corporation as a whole does not realize any income until it engages in transactions with unrelated third parties.
98. See supra notes 84-88 and accompanying text.
99. See supra notes 92-93 and accompanying text.
100. See infra notes 108-11 and accompanying text.
102. See, e.g., Container Corp. v. Franchise Tax Bd., 51 U.S.L.W. 4987, 4992 (U.S. 27, 1983) (No. 81-523) (contributions to income arising from centralized management and economies of scale are sufficient to make a multinational corporation unitary). Compare F.W. Woolworth Co. v. Taxation and Revenue Dept., 102 S. Ct. 3128, 3139 (1982) (mere payment of dividends to a parent company by a subsidiary is insufficient to give rise to a unitary business). See generally McLure, supra note 27.
as well as its own income and expenses.\textsuperscript{103} The net income of the multinational corporation, as derived from the combined report, is then apportioned between the individual components of the corporation according to a formula designed to achieve an overall division and distribution of profits that fairly and properly reflects the contributions made by each component of the corporation.\textsuperscript{104} In order to do this, the formula incorporates certain factors of production\textsuperscript{105} which are used to measure contributions made by individual components. The percentage of overall corporate income to be allocated to an individual component equals the percentage of the overall factors of production attributable to that component.\textsuperscript{106} Clearly, then, the distribution of income produced by the unitary method depends upon the factors of production comprising the formula, and the relative weight given each factor.\textsuperscript{107}

The three factor formula first developed in the Uniform Division of Income for Tax Purposes Act is typical.\textsuperscript{108} The three factors deemed to produce income include payroll, property (real and personal), and sales.\textsuperscript{109} The three factors are given equal weight\textsuperscript{110} and are measured by their value in dollars. The combined value of the payroll, property, and sales existing within a particular jurisdiction is a percentage of the combined value of the payroll, property, and

\textsuperscript{103} A combined report is distinguished from a separate report in that a combined report contains information on the income of the entire multinational corporation. A separate report, on the other hand, contains information on the income of only the component that is filing the report. A combined report is distinguished from a consolidated report in that the consolidated report treats the entire multinational corporation as one corporation with no subsidiaries or affiliates. The combined report, on the other hand, preserves the individual identity of each component to report on the income and expenses of the entire corporation, as well as its own. Rudolph, \textit{State Taxation of Interstate Business: The Unitary Business Concept and Affiliated Corporate Groups}, 25 \textit{TAX L. REV.} 171, 197 (1970).

\textsuperscript{104} \textit{See} Surrey, \textit{supra} note 40, at 415.

\textsuperscript{105} The different factors of production that may enter an apportionment formula include property, payroll, sales, cost of manufacturing, gross receipts, average inventory, and purchases. The formula implicitly assumes that there is a direct relationship between the factors of production attributable to a corporation and the amount of income produced by that corporation. See generally Hartman, \textit{State Taxation of Corporate Income from a Multistate Business}, 13 \textit{VAND. L. REV.} 21, 64-75 (1960) [hereinafter cited as Hartman].

\textsuperscript{106} If 25 percent of a corporation's factors of production is attributable to a particular component then 25 percent of the entire corporation's income is allocated to that component. It is evident that the distribution of income that arises under the formula apportionment method has nothing to do with the distribution of income that would arise from the operation of the free market. Any correlation between the two is pure chance, unless it is believed that market prices are determined by the factors of production. \textit{See} Surrey, \textit{supra} note 40, at 415-18.

\textsuperscript{107} \textit{See} Hartman, \textit{supra} note 105.

\textsuperscript{108} \textit{See} UDITPA, \textit{supra} note 10.

\textsuperscript{109} Property is included because it is assumed that capital invested in a business produces income in return. Payroll is included because it reflects the value of the work done by the business and its employees. Sales are included because they represent the successful completion of business activity. \textit{See} Keesling & Warren, \textit{supra} note 33, at 73-91.

\textsuperscript{110} \textit{Id.} at 77 (suggesting that each factor is given equal weight because of the difficulty involved in doing otherwise).
sales attributable to the entire multinational corporation. Applying this percentage to the corporation's total profits determines the percentage of profits allocable to the jurisdiction.\footnote{111} 

**B. Critique**

The primary weakness of the unitary method is that it may produce artificial results. Its basic assumption that one unit of a factor of production—payroll, property, or sales,—will produce one unit of profit, regardless of the circumstances,\footnote{112} is not always true. For example, if a particular subsidiary of a multinational corporation operates at a loss for a given year, but the multinational corporation as a whole operates at a profit, the subsidiary will be allocated a percentage of that profit equal to its percentage of factors of production. The subsidiary will accordingly be required to pay tax even though it has no income.\footnote{113} This seemingly inequitable result may be explained in part by the possibility that the subsidiary, through its affiliation with the entire multinational corporation, contributed to the profit of other components of the corporation.\footnote{114} But, it is equally possible that the subsidiary did not contribute in any way to the profits of the corporation, or that the cost of running the subsidiary at a loss actually detracted from the profits of the corporation.\footnote{115} In either case, however, the tax consequences would be the same.

Moreover, state application of the unitary method to multinational corporations aggravates the problem of double taxation. Because it is fundamentally inconsistent\footnote{116} with established national and international practices of reallocating income according to arm’s length standards,\footnote{117} the unitary method will produce different allocations of income. Double taxation Will therefore occur when a state, using the unitary method, allocates to itself income which a foreign country claims under the arm’s length method.

In addition, the unitary method’s allocation of more income to
jurisdictions having more valuable factors of production ensures economic double taxation of multinational corporations. Because the United States tends to have higher payrolls and property values than many other foreign countries, the unitary method will allocate more income to United States based components of a multinational corporation than would a foreign country using the arm’s length method. Similarly, the unitary method does not account for differing rates of return on investment. Investment in one country might produce more profit than the same investment in another. The unitary method, however, would allocate the same amount of profit to each country because the factors of production which the investment purchased would be the same. This will result in double taxation because foreign countries using the arm’s length method will claim the “extra” income produced by higher rates of return within their borders, while the unitary method allocates this same income to the states.

State use of the unitary method in contravention of established national and international norms may be a significant international irritant. Although tax treaties to which the United States is a party do not bind subgovernmental units such as states, foreign countries still view the unitary method as contrary to the policy and

118. The factors of production are measured by their dollar value. See supra notes 108-111 and accompanying text.
119. See Hearings, supra note 8 at 3-11 (statement of Donald C. Lubick, Assistant Secretary of the Treasury for Tax Policy).
120. Corporations doing business abroad may earn greater profits on their foreign investments than will corporations operating in the United States. Four identifiable factors lead to higher rates of return on investment in less developed foreign countries: 1) lower payroll costs; 2) economies growing at a faster rate; 3) larger corporate share of the market; 4) lower property costs. See Unopposed Testimony of John C. McDonald, Joint Appendix at 118, Container Corp. v. Franchise Tax Bd., 51 U.S.L.W. 4987 (U.S. June 27, 1983) (No. 31-523).
121. Assume, for example, a California parent P and an Italian subsidiary S are equal in dollar value of their payroll, property, and sales. The investment in each enterprise is $10,000,000.00. Further assume that the corporations comprise a unitary business, but conduct all their transactions at arm’s length so no reallocation of income is required. California parent P realizes a profit of $2,000,000.00 in a given year. Italian subsidiary S, however, realizes a $4,000,000.00 profit because the $10,000,000.00 invested in Italy is able to purchase twice the property and labor as could be purchased in California. Italy will tax corporation S on the $4,000,000.00 income generated in Italy. California, in turn, will apply the formula apportionment method to the entire unitary business and allocate income equally between the two corporations because the dollar value of property, payroll, and sales attributable to each corporation is equal. Thus, California will tax corporation P on $3,000,000.00, or half the income generated by the entire unitary business. The result is that $7,000,000.00 is taxed when only $6,000,000.00 was earned. Double taxation has occurred to the extent of $1,000,000.00.
122. Several national governments, including the entire European Economic Community, have written letters to the United States Department of State expressing their disapproval of the unitary method and urging the United States Government to participate in the litigation concerning the constitutionality of the unitary method as amicus curiae. These countries consider states’ use of the unitary tax to tax multinational corporations to be inequitable and unsatisfactory. See, e.g., Appendix D to Appellants Brief on the Merits at A.6-A.8, Container Corp. v. Franchise Tax Bd., 51 U.S.L.W. 4987 (U.S. June 27, 1983) (No. 81-523).
123. BISCHEL, supra note 68, at 6-7.
The unitary method will often result in allocating income away from foreign countries and to the United States, foreign countries may be less willing to take unilateral steps to help relieve double taxation, and negotiations through the Mutual Agreement Procedure of tax treaties may be impeded. Furthermore, foreign governments may retaliate against the United States as a whole for what they regard as inequitable tax treatment at the hands of the states.

V. Constitutionality of the Unitary Method

A. Container Corp. v. Franchise Tax Board

In Container Corp. v. Franchise Tax Board, the Supreme Court held that state use of the unitary method to allocate income of a domestically based multinational corporation is not unconstitutional. Container Corp. involved application of California's three-factor formula apportionment method to allocate a multinational paperboard manufacturer's income to its California-based subsidiary. The corporation filed a tax return for the years 1963, 1964, and 1965 in which it reported its own net income, but not the income of its foreign subsidiaries. The California Franchise Tax Board issued notices to the corporation, directing it to include in its combined report the income of its foreign subsidiaries. The inclusion of this income had the effect of increasing the corporation's tax liability in California. The corporation paid the increased tax and sued for a refund, claiming that California's method of taxation violated both the Due Process Clause and Commerce Clause of the United States Constitution.

124. See, e.g., Hearings, supra note 8, at 308 (statement of Joseph H. Gutlentag, Counsel on Behalf of the Dutch Employers Federation).
125. See supra notes 118-120 and accompanying text.
126. See supra notes 61-68 and accompanying text.
127. Agreements to reduce double taxation will be reached much more easily when both countries are using the same basic methods to allocate income. Disagreements arising from differences in the fundamental approach to income allocation will be much more difficult to reconcile. See supra notes 74-79 and accompanying text.
128. See Appendix to Brief for the Committee on Unitary Tax as Amicus Curiae at 7-16, Container Corp. v. Franchise Tax Bd., 51 U.S.L.W. 4987 (U.S. June 17, 1983) (No. 81-523).
130. See CAL. REV. & TAX. CODE ANN. §25101 (West 1979).
131. Container Corporation of America is a Delaware corporation with its principal place of business in Illinois. It does business in a number of states including California. For the tax years in question, Container controlled twenty foreign subsidiaries located in four Latin American countries and four European countries.
132. For a discussion of a combined report see supra note 96.
133. See Exhibit A-7, Stipulation to Record at 76-79, Container Corp. v. Franchise Tax Bd., 51 U.S.L.W. 4987.
134. See generally Appellant's Brief on the Merits, Container Corp v. Franchise Tax Bd., 51 U.S.L.W. 4987.
1. **Due Process Clause.**—Under the due process clause, a state may not tax value earned outside its borders.\(^{136}\) The Court has enunciated two separate requirements that a state tax formula must meet to insure that it does not tax income earned in other jurisdictions. First, a minimal nexus, or connection, must exist between the international activities of the taxed corporation and the taxing state.\(^{136}\) Second, a rational relationship must exist between income allocated to the state and the in-state value of the enterprise.\(^{137}\)

Container first attempted to show that California's application of the unitary method to income from Container's entire multinational enterprise unconstitutionally taxed value earned outside the state. It reasoned that there was no connection between Container's California subsidiary and its foreign subsidiaries\(^{138}\) and that interaction between its domestic and foreign subsidiaries was insufficient to justify California's determination that the entire multinational corporation constituted a unitary business.\(^{139}\) The Court, however, disagreed, holding that a unitary business exists whenever there are contributions to income of subsidiaries resulting from "functional integration, centralized management, and economies of scale."\(^{140}\) Under this standard, Container's domestic and foreign subsidiaries were part of the same unitary business. The Court justified this finding on the grounds that Container provided advice and consultation services, sold equipment, and loaned money to its subsidiaries.\(^{141}\)

Container next claimed that there was no rational relationship between the income allocated to California and the value of Container's California based operations.\(^{142}\) Container argued that,

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136. The determination whether the international activities of a corporation have a minimal nexus with corporate activities in the taxing state focuses on the state's decision to include the income of foreign corporations in the domestic corporation's combined tax return. The state requires the income of all corporations that it considers a part of the unitary business to be included in the combined report because it is thought that any given component of a unitary business will have some minimal connection with all other components of the unitary business by reason of functional integration of all component parts. Controversies in this area, therefore, center on the state's definition of the scope of the unitary business. *See, e.g.*, Mobil Oil Corp. v. Comm'r of Taxes, 445 U.S. 425, 436-37 (1980).

137. The determination whether there is a rational relationship between income allocated to the state and instate value of the enterprise focuses on the factors employed by an apportionment formula to allocate income to a particular jurisdiction and whether these factors clearly reflect income produced in that jurisdiction. *See, e.g.*, Container Corp. v. Franchise Tax Bd., 51 U.S.L.W. at 4993.


139. *Id.*

140. 51 U.S.L.W. at 4992.

141. *Id.* at 4991.

according to its books,\textsuperscript{143} its foreign subsidiaries were substantially more profitable than its domestic subsidiaries, and that the inability of the unitary method to account for differing rates of return on investment resulted in an allocation of income to its California branch that was disproportionate to the actual value of its operations in California.\textsuperscript{144}

The Court rejected this argument, too, noting the possibility that certain aspects of the California operations contributed to the foreign subsidiaries' increased profitability.\textsuperscript{145} In so holding, the Court stated that evidence of profitability produced by the arm's length method, such as higher rates of return, cannot be used to impeach allocations of income produced by the unitary method.\textsuperscript{146} The Court justified its position on the grounds that the unitary method accounts for transfers of income which the arm's length method does not reflect.\textsuperscript{147} Therefore, the two methods will inevitably yield conflicting allocations of income, and until one method is proven more accurate than the other,\textsuperscript{148} the results produced by one cannot be used to impeach those created by the other.

2. Commerce clause.—Container's commerce clause objection was its strongest argument against California's use of the unitary method. Container relied upon the principles set forth in \textit{Japan Line Limited v. Los Angeles}.\textsuperscript{149} \textit{Japan Line} involved California's attempt to levy an apportioned property tax on shipping containers temporarily located in the state. The containers were owned and registered in Japan, and under accepted international practice, Japan, as the home port, was allowed to tax the containers in full. In its decision, the Court enunciated two considerations which come into play when a state seeks to tax foreign commerce. First, the Court must be sensitive to the enhanced risk of multiple taxation;\textsuperscript{146} and second, the

\textsuperscript{143} Profit figures produced by Container were based on separate accounting principles which distributes income between component corporations in accordance with the arm's length method of income allocation.

\textsuperscript{144} Appellant's Brief on the Merits at 16, Container Corp. v. Franchise Tax Bd., 51 U.S.L.W. 4987.

\textsuperscript{145} 51 U.S.L.W. at 4993. The court noted that because the California branch and the foreign branches were all part of the same unitary business there was a strong possibility that there existed a flow of value from the California branch to the foreign branches. This flow of value would account for the increased profit realized by the foreign subsidiaries.

\textsuperscript{146} \textit{id.}

\textsuperscript{147} \textit{See supra} notes 97-99 and accompanying text.

\textsuperscript{148} The court stated that it has seen "no evidence demonstrating that the margin of error (systematic or not) inherent in the three factors formula is greater than the margin of error (systematic or not) inherent in the sort of separate accounting urged on us by appellant." Container Corp. v. Franchise Tax Bd., 51 U.S.L.W. at 4993-94. Separate accounting and the arm's length method are the same.

\textsuperscript{149} 441 U.S. 434 (1979).

\textsuperscript{150} \textit{id.} at 447-8. The Court noted that the possibility of multiple taxation was greater in the international sphere because there is no authoritative tribunal to insure that no more
Court must consider the possibility that a state tax will impair federal uniformity in relation to foreign countries. The tax involved in *Japan Line* failed both tests. Because Japan was entitled to tax the containers in full, any tax imposed by California, even if fairly apportioned, would inevitably result in double taxation. Similarly, because the tax conflicted with established international policy, it impaired federal uniformity and created a risk of retaliation by the United States' foreign trade partners.

Armed with the reasoning of *Japan Line*, Container asserted that California's apportioned income tax was unconstitutional because it resulted in double taxation, impaired federal uniformity, and would lead to foreign retaliation. The Court was unpersuaded. It began its rejection of Container's argument by distinguishing *Japan Line* on its facts. The Court first noted that *Japan Line* involved a tax on property, not on income, and the reasons for allocation of the entire value of property to a single situs for property tax are absent in an income tax case. The Court then observed that because Japan did have the right to fully tax the property, the assessment of even a fairly apportioned tax on the property in *Japan Line* would necessarily have resulted in double taxation. In the case of an income tax, however, no one country has the right to tax all income of a multinational corporation, and a fairly apportioned income tax would therefore not necessarily cause double taxation. Finally, the Court reasoned that because the taxpayer in *Japan Line* was a foreign corporation, any double taxation would create a significant chance of retaliation. In contrast, Container was a domestically based corporation so there would be no chance of retaliation.

After distinguishing *Japan Line* factually, the Court went on to hold that the California apportioned income tax met both requirements set forth in *Japan Line*. First, unlike the tax in *Japan Line*, the tax in *Container Corp.* did not create a constitutionally unacceptable risk of double taxation. Recognizing the difficulty involved in allocating income among taxing jurisdictions, the Court pointed out that the internationally accepted arm's length method may itself

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151. *Id.* at 450-1. The Court recognized that a novel state tax may create an asymmetry in the international tax structure and could lead to foreign retaliation if a foreign country was disadvantaged by the tax.
152. *Id.* at 451-2.
153. *Id.* at 452-3.
155. 51 U.S.L.W. at 4995.
156. *Id.*
157. *Id.*
158. *Id.*
result in double taxation. Therefore, because a risk of double taxation exists under the arm's length method, it would be unreasonable to invalidate the unitary method because it also may result in double taxation.

The Court finally disposed of Container’s commerce clause objection by holding that the California income tax neither impaired federal uniformity nor created a significant risk of foreign retaliation. The Court began by disclaiming any competence to discern the foreign policy implications of a particular action. It then listed three factors which led it to believe the California tax would create no significant foreign retaliation. First, the Court reiterated its finding that formula apportionment as applied to income does not automatically result in double taxation. Second, the Court observed that the tax involved was imposed on a domestically based corporation, greatly reducing the possibility of offending a foreign nation. Finally, the Court noted that the corporation was amenable to taxation in California in one way or another and the amount of its tax liability is more a function of California’s tax rate than of California’s tax method. These three factors taken together persuaded the Court that risk of foreign retaliation was minimal. In sum, because California’s tax did not lead to automatic double taxation, it did not create a significant risk of foreign retaliation, and because it was not preempted by any federal statute or treaty, it was a constitutional exercise of state power.

B. Critique

In Container Corp., the Court adhered to its established policy of granting the states wide latitude in exercising their power of taxation. Implicit in the Court’s decision is the principle that “a formula-produced assessment will only be disturbed when the taxpayer has proved by ‘clear and convincing evidence’ that the income attributed to the state is in fact ‘out of all proportion to the business transacted . . . in that state.’” State taxing procedures thus enjoy an implicit assumption of validity absent conclusive evidence of unfairness or irrationality. The taxpayer’s burden of proof is nearly impossible to sustain in view of the Court’s statement that evidence of

159. See supra notes 61-68 and 71-73 and accompanying text.
160. 51 U.S.L.W. at 4996.
161. Id. at 4996-7.
162. Id.
163. Id.
164. See supra note 123 and accompanying text.
165. See supra note 13 and accompanying text.
income allocations derived from the arm's length method may not be used to impeach allocations of income produced by the unitary method.\textsuperscript{167} Extension of this stringent standard of proof to a case involving foreign commerce appears anomalous when the Court itself has recognized the need for increased scrutiny of state taxing schemes in accordance with the two-fold test set forth in Japan Line.\textsuperscript{168} Japan Line, therefore, should have controlled the Container Corp. decision.

Moreover, in Japan Line, the state's apportioned property tax inevitably led to double taxation since, according to international custom, the country in which the property was owned and operated has the right to tax the property in full.\textsuperscript{169} Similarly, the apportioned income tax levied by the state in Container Corp. inevitably led to double taxation because, according to international custom, foreign countries have the right to reallocate income of multinational corporations on an arm's length basis.\textsuperscript{170} As previously discussed, the unitary method and the arm's length method will lead to different allocations of income which, when applied at the same time to the same income, will inevitably lead to double taxation.\textsuperscript{171} Thus, the California tax should have been invalidated because it leads to substantial risk of multiple taxation.\textsuperscript{172}

The Court in Container Corp., refused to invalidate the unitary method on grounds of double taxation, reasoning that the arm's length method could lead to the same result.\textsuperscript{173} But this analysis fails to recognize the basic difference between the two types of double taxation involved. Double taxation under the arm's length method arises from inconsistent applications of the same method.\textsuperscript{174} In contrast, double taxation under the unitary method arises from the fundamental difference between the unitary method and arm's length accounting.

\textsuperscript{167} See supra notes 144-148 and accompanying text. The only time a taxpayer was able to prove that a unitary method allocated too much income to a particular jurisdiction was in Hans Rees' Sons Inc. v. North Carolina, 283 U.S. 123 (1931).

\textsuperscript{168} See Container Corp. v. Franchise Tax Bd., 51 U.S.L.W. at 4994.

\textsuperscript{169} The Home Port Doctrine states that instrumentalities of international commerce may be taxed only by the country in which the instrumentality is owned and registered. This country may tax the instrumentality in full. 441 U.S. at 441-44.

\textsuperscript{170} See supra note 71 and accompanying text.

\textsuperscript{171} Whenever two countries allocate the same income to sources within their own borders, double taxation will occur. See Norr, supra note 70.

\textsuperscript{172} The creation of a substantial risk of double taxation is enough to invalidate a tax under the foreign commerce clause. See Japan Line Ltd. v. Los Angeles, 441 U.S. at 447-8 (1979).

\textsuperscript{173} "It would be perverse, simply for the sake of avoiding double taxation, to require California to give up one allocation method that sometimes results in double taxation in favor of another allocation method that also sometimes results in double taxation." Container Corp. v. Franchise Tax Bd., 51 U.S.L.W. at 4996.

\textsuperscript{174} See supra notes 72 and 73 and accompanying text.
Double taxation produced by inconsistent applications of the same method can be eliminated through promulgation of more specific regulations to insure harmonization of application, and through international negotiation.\textsuperscript{175} Double taxation arising from use of two completely different methods, however, cannot be prevented through harmonization of application.\textsuperscript{176} Likewise, the possibility of reaching an agreement on the proper allocation of income through MAPs diminishes when the nations involved have fundamentally divergent views as to how the problem should be approached.\textsuperscript{177} Thus, while the arm's length method may not actually be the more accurate approach,\textsuperscript{178} the unitary method must be evaluated within the framework of established international practice favoring the arm's length method.

Use of the unitary method in contravention of otherwise uniform international practices creates a substantial risk of double taxation, and therefore fails the first \textit{Japan Line} test.\textsuperscript{179} Moreover, a number of income tax treaties require the arm's length method of income allocation.\textsuperscript{180} California's method conflicts with the uniform principles set forth in these treaties. It therefore prevents the United States from speaking with one voice with respect to this aspect of foreign trade. Consequently, the California unitary income tax fails the second \textit{Japan Line} test as well.\textsuperscript{181} The asymmetry in international income taxation created by California's use of the unitary method also leads to a substantial risk of foreign retaliation by our foreign trade partners who are disadvantaged by the asymmetry.\textsuperscript{182} Accordingly, California's apportioned income tax should have been invalidated in \textit{Container Corp.} for the same reasons its apportioned property tax was invalidated in \textit{Japan Line}.

VI. Conclusion

Undisputedly, double taxation severely burdens international commerce and should therefore be avoided.\textsuperscript{183} Although no rules of

\textsuperscript{175} Complete harmonization of the standards regulating the application of the arm's length method would prevent the assertion by taxing jurisdictions of overlapping claims to the same income. However, until complete harmonization occurs, Mutual Agreement Procedures are available to help mitigate the damaging effects of double taxation. \textit{See supra} 46-83 and accompanying text.

\textsuperscript{176} \textit{Cf. supra}, notes 70-73 and accompanying text.

\textsuperscript{177} The existence of the arm's length method as a limit on the allocation of income that countries make is a material factor in promoting agreement through the Mutual Agreement Procedure. \textit{See supra} notes 78 and 79 and accompanying text.

\textsuperscript{178} \textit{See supra} note 148.

\textsuperscript{179} \textit{See supra} note 152 and accompanying text.

\textsuperscript{180} \textit{See supra} note 71.

\textsuperscript{181} \textit{See supra} note 153.

\textsuperscript{182} \textit{See supra} note 122.

\textsuperscript{183} \textit{See generally} Hearings, \textit{supra} note 8.
international law require countries to grant relief from double taxation, a number of countries have recognized the negative effect of excessive tax burdens on international commerce, and have acted to reduce double taxation.\textsuperscript{184} The establishment of MAPs through international tax treaties is a step in the right direction.\textsuperscript{186} Nevertheless, MAPs are only a cure applied after double taxation has occurred. The real solution to the problem of international double taxation lies in harmonization of substantive tax methods used by individual governments.

The Supreme Court’s decision in \textit{Container Corp. v. Franchise Tax Board} is a step in the wrong direction. The Court claimed that because the arm’s length method of income allocation is no more accurate than the unitary method, there was no reason to prohibit state use of the unitary method.\textsuperscript{186} This analysis, however, fails to recognize the importance of uniformity of allocation procedures between taxing jurisdictions. Rather than refusing to require states to use one method of income allocation because it is no more accurate than another method, the Court instead could have chosen to preserve existing uniformity of allocation procedures between taxing jurisdictions. By permitting states to continue applying the unitary method to multinational corporations, the Court perpetuated irreconcilable allocations of income and inevitable double taxation.

Fortunately, the Court’s holding in \textit{Container} is limited to situations involving domestically based multinational corporations.\textsuperscript{187} A case involving a foreign owned and controlled multinational corporation would present the Court with additional reasons to invalidate state use of the unitary tax in the international context. The most persuasive reason would be the increased threat of foreign retaliation arising from states’ attempts to tax income realized by foreign parent corporations.\textsuperscript{188} Hopefully, in such a case, the Supreme Court would be more sensitive to the disruptive effect that application of the unitary method to multinational corporations has on international commerce. If not, international commerce will continue to suffer from states’ attempts to maximize their tax revenues through the unitary method.

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\textsuperscript{184} See supra notes 69-73 and accompanying text.
\textsuperscript{185} See supra notes 74-77 and accompanying text.
\textsuperscript{186} See supra notes 159-160 and accompanying text.
\textsuperscript{187} The Court twice specifically distinguished the situation involving a multinational corporation with a domestic parent from a situation involving a multinational corporation with a foreign parent. 51 U.S.L.W. at 4995 and 4996-7.
\textsuperscript{188} Foreign countries will be more prone to take offense and implement retaliatory measures when the corporation being taxed by the states is a foreign corporation as opposed to an American corporation. See notes 156-57 and 161-63 and accompanying text.