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Differences in Productivity and Profitability: A Response to Allegations of the Misattribution of Income in the Application of California's Worldwide Unitary Method

by
Eric J. Coffill†

INTRODUCTION

One of the most controversial areas currently in the field of state taxation is the use by some states of the so-called "worldwide" unitary method of taxation. Under this method, the taxing state includes the foreign operations of a unitary business in the calculations which determine the amount of income of the unitary business derived from or attributable to sources within the taxing state for state income tax purposes. California is a leading proponent of the use of this worldwide unitary method. However, in response to growing criticism of its application of the worldwide unitary method, the California state legislature has recently enacted legislation which will allow some unitary businesses to avoid the worldwide unitary method in certain circumstances.¹

This article will examine certain criticisms of California's unitary method, specifically, whether differences in wage rates, property costs, productivity, or profitability between the United States and the foreign operations of a worldwide unitary business require abandonment of the worldwide unitary method in favor of a separate accounting method, or in favor of a modification of the standard apportionment formula in order to compensate for these alleged differences. Generally, California's standard apportionment formula utilizes the three factors of payroll, property, and sales to determine the amount of income of a unitary business which is sourced to California for tax purposes. Critics of the worldwide unitary method argue that implicit in

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1. CAL. REV. & TAX CODE §§ 25110-25115 (West Supp. 1987).

the proper operation of the standard apportionment formula is the assumption that equal amounts of payroll, property, or sales generate equal profit or production in all geographical areas in which the worldwide unitary business operates. In the absence of such equality or near equality, the critics contend, the application of the standard apportionment formula to the entire operation of a worldwide unitary business leads to a constitutionally impermissible "distortion" of income by attributing to the taxing state income of the unitary business which it cannot constitutionally tax.

Part I of this article presents an overview of the California worldwide unitary method of taxation, which focuses on such elements as the concept of the unitary business, the combined report, and apportionable business income. The "distortion" argument against the use of the standard apportionment formula for a worldwide unitary business is then explained in Part II, followed by an analysis of two proposed modifications. In Part III, the article traces the history of the theory of misattribution of income in the United States Supreme Court with emphasis on the Court's 1983 decision in *Container Corp. of America v. Franchise Tax Board*,² which upheld California's application of the worldwide unitary business principle to a domestic multinational corporation and its foreign subsidiaries. Finally, Part IV presents an analysis of the two methods advocated by taxpayers to correct for the misattribution of income allegedly caused by the application of the standard apportionment formula to a worldwide unitary business. The article concludes that such proposed methods of correction do not withstand close scrutiny. Numerous judicial decisions, including decisions of the United States Supreme Court, have rejected attempts by taxpayers to use various kinds of separate accounting to impeach the results of formula apportionment. The reasoning supporting those and other judicial decisions applies with equal force to comparisons of productivity and profitability among segments of a worldwide unitary business for purposes of modifying the standard apportionment formula.

I

THE CALIFORNIA APPORTIONMENT PROCEDURE

A. Introduction

The growth of the multinational enterprise (MNE)³ over the past two decades has sparked increased interest in the manner in which states impose an income or franchise tax upon a business enterprise which is doing business

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

3. No single definition exists for the "multinational enterprise." Caves defines the term to mean simply "an enterprise that controls and manages production establishments—plants—located in at least two countries." R. CAVES, *MULTINATIONAL ENTERPRISE AND ECONOMIC ANALYSIS* 1 (1982). Dunning defines the term as "firms that engage in foreign direct investment." J. DUNNING, *INTERNATIONAL PRODUCTION AND THE MULTINATIONAL ENTERPRISE* 2 (1981). For a more exhaustive review of the literature concerning these definitional problems,

in a state and in at least one foreign country. During this period, the MNEs have experienced significant foreign sales. For example, one study showed that in 1974, for the 179 largest multinational enterprises headquartered in the United States, approximately \$200 billion of their aggregate sales of \$540 billion were garnered through foreign subsidiaries.⁴ Another study showed that between 1966 and 1973, more than eighty percent of the foreign sales of American MNEs were derived from the production of their majority-owned foreign affiliates and less than twenty percent from exports from the United States.⁵

The operations of an MNE "largely transcend" the geographical boundaries of incorporation of its various components and tend to be viewed as parts of a business which operates as a "single global system."⁶ Thus, the income taxation of an MNE poses difficulties in determining how to measure the amount of income which should be attributed for tax purposes to a state in which a portion of that MNE operates.⁷

In order to understand the allegation that differences in productivity and profitability among the various components of a worldwide unitary business result in a misattribution of income to California under standard formula apportionment, it is necessary first to understand certain basic elements of California's unitary method of taxation. The following discussion provides a brief overview of the unitary business principle and formula apportionment as they bear upon these allegations.

see Yelapaala, *The Efficacy of Tax Incentives Within the Framework of the Neoclassical Theory of Foreign Direct Investment: A Legislative Policy Analysis*, 19 *TEX. INT'L L.J.* 365, 367 n. 4 (1984).

4. R. VERNON, *STORM OVER THE MULTINATIONALS* 20 (1977).

5. C. BERGSTEN, *AMERICAN MULTINATIONALS AND AMERICAN INTERESTS* 8 (1978).

6. Note, *Multinational Corporations and Income Allocation Under Section 482 of the Internal Revenue Code*, 89 *HARV. L. REV.* 1202, 1202 (1976).

7. See Dexter, *Attribution of a Multinational Corporation's Net Income: The Position of Unitary States Regarding Combined Reporting*, 18 *VAND. J. TRANSNAT'L L.* 311, 313-14 (1985).

THE FINAL REPORT OF THE WORLDWIDE UNITARY TAXATION WORKING GROUP, CHAIRMAN'S REPORT AND SUPPLEMENTAL VIEWS (Office of the Secretary, Department of the Treasury, August, 1984) 1, reported that all forty-five states which levy corporate income taxes use formula apportionment to divide the taxable income of a single corporation operating a unitary business across state or national borders. Roughly one-half of the corporate income tax states, according to the report, also use the apportionment method to determine their share of the income of multicompany firms operating across state lines through subsidiaries. These states apply their apportionment formula to the combined income and business activities of related U.S. corporations forming a unitary business. The report indicated that approximately one-half of these states that combine domestic corporations engaged in a unitary business also include foreign corporations that are part of a unitary business in the company's combined report of income.

Numerous attempts have been made, in various forms, to limit or prohibit the states' use of worldwide combined reporting. One such legislative attempt is discussed in more detail in Section IV (C) of this article, *infra*, to the extent it will affect the misattribution of income issue. For a recent comprehensive discussion of the major issues and arguments surrounding worldwide unitary taxation, see Simmons, *Worldwide Unitary Taxation: Retain or Rationalize, or Block at the Water's Edge?* 21 *STAN. J. OF INT'L L.* 157 (1985).

B. *The Unitary Business Principle and Worldwide Combined Reporting*

When a taxpayer derives income from sources both within and outside California, that taxpayer is required to measure its franchise tax liability⁸ by its income "derived from or attributable to sources" within California.⁹ California's reliance upon a source basis for taxation, as opposed to a residence basis (which taxes residents upon all income earned regardless of the source) is consistent with both the Due Process Clause of the Fourteenth Amendment¹⁰ and the Commerce Clause of the United States Constitution¹¹ in that a state may not, when imposing an income tax, "tax value earned outside its borders."¹² Difficulties may arise, however, in properly allocating the income of an integrated business enterprise operating in more than one state or in foreign countries.¹³ The approach utilized by California is the unitary business principle, a familiar concept in income tax cases for more than fifty years.¹⁴

The theory underlying the unitary business approach has its roots in real property tax law, where the issue of apportionment arose in the context of railroad taxation. In *Union Pacific Railway Co. v. Ryan*¹⁵ the United States Supreme Court in 1884 recognized that the value of a railroad line could not be measured merely by looking to the value of the property located within a specific geographic area. The Court found that a "separate mile or two of its length is almost valueless by itself," and approved the method enacted by the city of Cheyenne which taxed the value of the track within its city limits as a percentage of the value of the entire railroad line. The value attributed to Cheyenne was calculated by determining the value of the entire line and dividing this value by the total number of miles of line to generate a valuation

8. Generally speaking, the California franchise tax is imposed upon corporations which are "doing business" in California and are not expressly exempted under the Bank and Corporation Tax Law or the Constitution of California. CAL. REV. & TAX CODE § 23151(a) (West 1979). "Doing business" means "actively engaging in any transaction for the purpose of financial or pecuniary gain or profit." CAL. REV. & TAX CODE § 23101 (West 1979). A minimum franchise tax is imposed on such corporations regardless of the corporation's activity or its profitability. CAL. REV. & TAX CODE § 23151(g) (West Supp. 1986). The California franchise tax law is set forth in full in CAL. REV. & TAX CODE §§ 23101-23364 (West 1979).

A corporation, while not "doing business" in California, may be subject to the California corporation income tax which, generally speaking, is imposed on all general corporations not "doing business" in California, but which have income derived from sources within the state. CAL. REV. & TAX CODE § 23501 (West 1979). For purposes of this article, "franchise tax" and "income tax" will be used interchangeably.

9. CAL. REV. & TAX CODE § 25101 (West 1979).

10. U.S. CONST. amend. XIV, § 1.

11. U.S. CONST. art. I, § 8, cl. 3.

12. ASARCO, Inc. v. Idaho State Tax Comm'n, 458 U.S. 307, 315 (1982).

13. Container Corp., 463 U.S. at 164.

14. See, e.g., United States Steel Corp. v. Multistate Tax Comm'n, 434 U.S. 452, 473 n.25, 474 n.26 (1978); ASARCO v. Idaho State Tax Comm'n, 458 U.S. at 320 n.14.

15. 113 U.S. 516 (1884).

per mile of track.¹⁶ In 1897, the Court expanded this concept of "unit" valuation in *Adams Export Co. v. Ohio State Auditor*,¹⁷ by recognizing that unity of use and management of a business which is scattered through several states may be considered when a state attempts to impose a tax on an apportionment basis.¹⁸

The next landmark in the development of the unitary theory was the 1920 Supreme Court decision in *Underwood Typewriter v. Chamberlain*.¹⁹ The Court in *Underwood* approved a formula used by Connecticut to determine the amount of income from a multistate business that was attributable to Connecticut for state tax purposes. In approving for the first time the use of an apportionment formula for income tax purposes, the Court commented, "The profits of the corporation were largely earned by a series of transactions beginning with manufacture in Connecticut, and ending with the sale in other states."²⁰

The term "unitary business" itself can best be traced to the Court's 1924 decision in *Bass Ratcliff & Gretton v. State Tax Commission*.²¹ There, the Court held that the State of New York was justified in using formula apportionment to attribute a "just proportion of the profits earned by the company from such unitary business" which included the brewing of ale in England and its sale in New York.²²

More recent decisions have set forth multiple tests for determining the existence of a unitary business.²³ Under the "three unities" test first promulgated in *Butler Brothers v. McColgan*,²⁴ affirmed by the Supreme Court in

16. *Id.* at 518-22.

17. 165 U.S. 194 (1897).

18. *Id.* at 222-24. See also *Butler Bros. v. McColgan*, 315 U.S. 501, 508 (1942).

19. 254 U.S. 113 (1920).

20. *Id.* at 120.

21. 266 U.S. 271 (1924).

22. "So in the present case we are of opinion that, as the Company carried on the unitary business of manufacturing and selling ale, in which its profits were earned by a series of transactions, beginning with the manufacture in England and ending in sales in New York and other places—the process of manufacturing resulting in no profits until it ends in sales—the state was justified in attributing to New York a just proportion of the profits earned by the company from such unitary business. In *Wallace v. Hines* . . . it was recognized that a state, in imposing an excise tax upon foreign corporations in respect to doing business within the state, may look to the property of such corporations beyond its borders to 'get the true value of things within it, when they are part of an organic system of wide extent,' giving the local property a value above that which it would otherwise possess, and may therefore take into account property situated elsewhere when it 'can be seen in some plain and fairly intelligible way that it adds to the value of the [property] and the rights exercised in the State.' This is directly applicable to the carrying on of a unitary business of manufacture and sale partly within and partly without the State." *Id.* at 282.

23. Numerous authors have addressed the general topic of when a unitary business exists. See, e.g., Keesling and Warren, *The Unitary Concept in the Allocation of Income*, 12 HAST. L. J. 42, 45-48 (1960); Miller, *Containerization Does Not Provide A Packaged Audit Approach*, 2 N.Y.U. INST. OF STATE AND LOCAL TAX'N, § 8.03 (1984); McLure, *Defining a Unitary Business: An Economist's View* in *THE STATE CORPORATION INCOME TAX* 89 (C.E. McLure, Jr., ed. 1984).

24. 17 Cal. 2d 664, 678, 111 P.2d 334, 341 (1941), *aff'd*, 315 U.S. 501 (1942). "In accordance with the foregoing analysis it is our opinion that the unitary nature of appellant's business is

1942, a unitary business is established by the presence of the unities of ownership, operation, and use. Under the "contribution or dependency" test of *Edison California Stores v. McColgan*,²⁵ decided by the Supreme Court in 1947, a business is unitary if operations within California are dependent on or contribute to the operation of the business outside the state. These tests were approved by the United States Supreme Court in *Container Corp.*²⁶ In addition, the Court in *Container* suggested another indicium of a unitary business, noting that, "[t]he prerequisite to a constitutionally acceptable finding of a unitary business is a flow of *value*, not a flow of goods."²⁷ One more test, alluded to by the United States Supreme Court, is one which looks to "contributions to income resulting from functional integration, centralization of management and economies of scale."²⁸

Once it has been determined that a taxpayer is engaged in a unitary business, California applies an apportionment formula to the "business income" of the combined unitary operations to determine the amount of income allocable to California. The method by which the combined unitary business income is calculated and apportioned to California by application of the apportionment formula is the "combined report." The combined report is not a return, but instead consists of a series of schedules which include the profit and loss of each corporation that is part of the unitary business and the combined apportionment formula for all included corporations. The report is used to determine the proper amount of income to be reported by each corporation engaged in the unitary business which is includable in that corporation's individual tax return.²⁹

definitely established by the presence of the following circumstances: (1) Unity of ownership; (2) Unity of operation as evidenced by central purchasing, advertising, accounting and management divisions; and (3) Unity of use in its centralized executive force and general system of operation."

25. 30 Cal. 2d 472, 481, 183 P.2d 16, 21 (1947). "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; otherwise, if there is no such dependency, the business within the state may be considered to be separate."

26. See 463 U.S. at 166-67, 177. See also Miller, 2 N.Y.U. INST. ON STATE & LOCAL TAX'N, § 8.03 at 8-25 (1984).

27. "Finally appellant urges us to adopt a bright-line rule requiring as a prerequisite to a finding that a mercantile or manufacturing enterprise is unitary that it be characterized by 'a substantial flow of goods.' . . . We decline this invitation. The prerequisite to a constitutionally acceptable finding of unitary business is a flow of *value*, not a flow of goods." *Id.* at 178 (emphasis in original).

28. *Mobil Oil Corp. v. Comm'r of Taxes of Vt.*, 445 U.S. 425, 438 (1980); *F. W. Woolworth Co. v. Taxation and Revenue Dep't of the State of N.M.*, 458 U.S. 354, 366 (1982).

29. The combined report is discussed in detail in Keesling, *A Current Look at the Combined Report and Uniformity in Allocation Practices*, 42 J. TAX'N 106 (1975), and Miller, *Worldwide Unitary Combination: The California Practice*, in *THE STATE CORPORATION INCOME TAX* (C.E. McLure, Jr., ed. 1984) 132, 136-40. See also, Instructions for Corporations Filing a Combined Report, Franchise Tax Board, State of California, FTB 1061 (Rev. 1-83), reprinted in *Cal. Tax Rep.* (CCH) Paragraph 12-690.

C. *UDITPA and the Apportionment Formula*

As discussed above, once it is established that a business is unitary, the combined report procedure is used to apportion the business income of the unitary business by use of a formula. "Business income" is defined as "income arising from transactions and activity in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations."³⁰ The "nonbusiness income" of a taxpayer, which is defined as "all income other than business income,"³¹ is not apportioned by use of a formula, but instead is allocated under a series of statutory rules to a particular situs (for example, to the state of the taxpayer's commercial domicile).³²

California has employed various apportionment formulas to divide the income tax base. Under the California Bank and Corporation Tax Code, as enacted in 1929, the portion of a taxpayer's net income derived from business conducted in California was apportioned on the basis of sales, purchases, manufacturing expenses, payroll, and value and situs of tangible property, "or by reference to these or other factors. . . ."³³ In practice, however, California tended to emphasize the use for most businesses of the factors of owned tangible property, payroll, and sales in a three factor formula.³⁴

In 1966, California adopted, with minor modifications, the Uniform Division of Income for Tax Purposes Act (UDITPA),³⁵ which is now found in sections 25120 through 25139 of the California Revenue and Taxation Code. UDITPA was drafted and sponsored by the National Conference of Commissioners on Uniform State Laws, which approved UDITPA in 1957 and recommended its enactment by all of the states.³⁶ At present, approximately 26 states have adopted some version of UDITPA.³⁷

UDITPA provides for the use of a standard three-factor apportionment formula to allocate the business income of a taxpayer and to determine the portion of that income which is attributable to California for tax purposes.³⁸

30. CAL. REV. & TAX. CODE § 25120(a) (West 1979).

31. *Id.* § 25120(d).

32. CAL. REV. & TAX. CODE §§ 25123-25127 (West 1979).

33. Bank and Corporation Franchise Tax Act, §§ 10, 1929 Cal. Stat. 19, 24.

34. Miller, *supra* note 29, at 132-33. See *El Dorado Oil Works v. McColgan*, 34 Cal. 2d 731 (1950), *appeal dismissed*, 340 U.S. 801 (1950), *reh'g denied*, 340 U.S. 885 (1950).

35. 1966 Cal. Stat. 176, 177. The version of UDITPA adopted by California deviated in several ways from the model act draft. The major differences are that California did not adopt section 1(d) of UDITPA, which includes a definition of "financial organizations," and did not adopt section 1(f), which includes a definition of "public utility." Because these differences are not pertinent to this discussion of UDITPA, references to the Act hereinafter will refer to both UDITPA and the California version.

36. See Keesling and Warren, *California's Uniform Division of Income for Tax Purposes Act, Part I*, 15 U.C.L.A. L. REV. 156 (1967).

37. State Tax Guide, All States, (CCH), ¶ 10-000 at 1020.

38. See generally Keesling and Warren, *California's Uniform Division of Income for Tax Purposes Act, Part II*, 15 U.C.L.A. LAW REV. 655 (1968).

The three factors are payroll, property, and sales, and these terms are defined in some detail in a complex statutory and regulatory scheme. In general, "payroll" includes all forms of compensation paid to employees.³⁹ "Property" generally includes all real and tangible personal property owned (valued at original cost) or rented (valued at eight times the net annual rental rate) by the taxpayer.⁴⁰ "Sales" generally includes all gross receipts of the taxpayer from the sale of tangible and intangible property.⁴¹ The apportionment formula places equal weight upon each of the three factors. The amount of unitary business income attributable to California is determined through the use of the formula which calculates the percentage of the taxpayer's payroll, property, and sales which are attributable to California, and then averages these three percentages.⁴²

UDITPA expressly recognizes that the standard formula may not be appropriate in all circumstances. Accordingly, a provision has been included in UDITPA which allows either a tax administrator or a taxpayer to employ in specified circumstances other allocation and apportionment methods if the provisions of the standard formula "do not fairly represent the extent of the taxpayer's business activity" in the taxing state.⁴³ This relief provision is also found in article IV, section 18 of the Multistate Tax Compact,⁴⁴ and is also codified in California Revenue and Taxation Code section 25137.⁴⁵

Section 25137 describes the circumstances in which discretionary adjustments may be made to California's allocation and apportionment provisions.⁴⁶ The scope of section 25137 appears quite broad. In accord with UDITPA, the provision may be invoked "if the allocation and apportionment

39. CAL. REV. & TAX. CODE §§ 25132-25133 (West 1979); CAL. ADMIN. CODE tit. 18, §§ 25132-25133 (1985).

40. CAL. REV. & TAX. CODE §§ 25129-25131 (West 1979); CAL. ADMIN. CODE tit. 18, §§ 25129-25131 (1985).

41. CAL. REV. & TAX. CODE §§ 25134-25136 (West 1979); CAL. ADMIN. CODE tit. 18, §§ 25134-25136 (1985).

42. The operation of the formula will be discussed, *infra*. See text accompanying note 66.

43. UDITPA, Section 18, State Tax Guide, All States (CCH), 1019.

44. State Tax Guide, All States (CCH), ¶ 351 at 360-61. The administrative agency for the Multistate Tax Compact is the Multistate Tax Commission ("MTC"), of which California is a member state. See Multistate Tax Compact, Article VI, *id.* at 361. See also Corrigan, *How Multistate Tax Commission Conducts Joint Audits and Controls Income Allocations*, 25 TAXATION FOR ACCOUNTANTS 108 (1980).

45. Section 25137 provides:

If the allocation and apportionment provisions of this act do not fairly represent the extent of the taxpayer's business activity in this state, the taxpayer may petition for or the Franchise Tax Board may require, in respect to all or any part of the taxpayer's business activity, if reasonable: (a) Separate accounting; (b) The exclusion of any one or more of the factors; (c) The inclusion of one or more additional factors which will fairly represent the taxpayer's business activity in this state; or (d) The employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income.

CAL. REV. & TAX CODE § 25137 (West 1979).

46. Appeal of New York Football Giants, Inc., Cal. Tax Rep. (CCH) ¶ 205-600 (Cal. St. Bd. of Equal., Feb. 3, 1977).

provisions of this act do not fairly represent the extent of the taxpayer's business activity in this state,"⁴⁷ and if the method employed is "reasonable".⁴⁸ Regulations of the California Franchise Tax Board⁴⁹ interpret section 25137 to permit departure from the standard provisions of the act "only in limited and specific cases," and provide that the section "may be invoked only in specific cases where unusual fact situations (which ordinarily will be unique and nonrecurring) produce incongruous results under the apportionment and allocation provisions contained in these regulations."⁵⁰ Case law reemphasizes that section 25137 may be used only in "exceptional circumstances" and that the party seeking to deviate from the use of the standard provisions must bear the burden of proving that such exceptional circumstances are present.⁵¹ Notwithstanding these limitations, relief under section 25137 does not appear to be restricted to situations where application of the standard provisions of the Act could be successfully attacked on constitutional grounds.

California recognizes that in certain industries, such as air, rail and ship transportation, trucking, television, radio, motion pictures, and various types of professional athletics, the application of the standard apportionment formula may produce inappropriate results.⁵² Accordingly, California, as well as the Multistate Tax Commission⁵³ and other states which have adopted UDITPA, have enacted regulations for the apportionment of income in certain special industries or situations. For example, the California regulations presently contain special apportionment formulas. These include, among others, formulas which specifically pertain to partnership income,⁵⁴ construction contractors and construction contracts,⁵⁵ franchisors,⁵⁶ banks

47. CAL. REV. & TAX. CODE § 25137 (West 1979); see *supra* note 46.

48. *Id.*

49. The California Franchise Tax Board is charged by statute with the administration and enforcement of the Personal Income Tax Law and the Bank and Corporation Tax Law. *Id.* The Franchise Tax Board is empowered to issue regulations with respect to these statutory schemes. *Id.* § 19253; *Id.* § 23004.

50. CAL. ADMIN. CODE tit. 18, § 25137(a)(4) (1985).

51. Appeal of Kikkoman Int'l, Cal. Tax Rep. (CCH) ¶ 400-257 (Cal. St. Bd. of Equal., June 29, 1982); Appeal of New York Football Giants, Inc., Cal. Tax Rep. (CCH) ¶ 205-600 (Cal. St. Bd. of Equal., Feb. 3, 1977); Appeal of Donald M. Drake, Cal. Tax Rep. (CCH) ¶ 205-598 (Cal. St. Bd. of Equal., Feb. 3, 1977); Appeal of American Telephone and Telegraph Co., Cal. Tax Rep. (CCH) ¶ 400-254 (Cal. St. Bd. of Equal., June 29, 1982); Appeal of Texaco, Inc., Cal. Tax Rep. (CCH) ¶ 205-822 (Cal. St. Bd. of Equal., Jan. 11, 1978). Commentators expressing these views include Pierce, *The Uniform Division of Income for State Tax Purposes*, 35 TAXES 747, 781 (1957); and Keesling and Warren, *supra* note 37, at 171-72.

52. CAL. ADMIN. CODE tit. 18, § 25137(a)(4) (1985).

53. The regulations of the Multistate Tax Commission include special apportionment formulas similar to those found in the California regulations. See State Tax Guide, All States, (CCH) ¶ 352.

54. CAL. ADMIN. CODE tit. 18, § 25137-1 (1985).

55. *Id.* § 25137-2.

56. *Id.* § 25137-3.

and financial corporations,⁵⁷ commercial fishing,⁵⁸ combined reports including foreign country operations,⁵⁹ and air transportation companies.⁶⁰

Thus, the California scheme, subject to section 25137, requires the use of the standard, three-factor apportionment formula to divide the income base of a taxpayer engaged in a unitary business. Neither the statutory language of section 25137 nor the special regulations promulgated by the Franchise Tax Board under section 25137, expressly addresses the issue of whether the section can be used to modify or abandon the use of the standard apportionment formula based upon differences in productivity and profitability among geographically separate components of a worldwide unitary business. Nevertheless, the broad language of section 25137 would seem to permit an administrative challenge to the formula on that basis, providing, of course, that the other criteria of the statute were met. Further, a challenge to the application of the standard formula would not require a showing of unconstitutionality in order for relief to be granted under the provisions of section 25137. This section thus provides an attractive vehicle for a taxpayer wishing to challenge the application of the standard formula. However, experience in California and other states has shown that the relief provisions of section 25137 and the UDITPA are rarely invoked and even more rarely result in relief for the petitioning party.⁶¹

II

THE ALLEGATION OF MISATTRIBUTION OF INCOME

A. *The Alleged Effects of Differences in Productivity and Profitability Within a Unitary Business*

As stated above, California generally uses the standard, three-factor apportionment formula to determine the portion of a taxpayer's unitary business income which is attributable to California for income tax purposes. The issue presented herein is whether this standard formula must be either abandoned or modified where differences exist in productivity and profitability among the components of a taxpayer's worldwide unitary business.

The California standard apportionment formula places values upon three aspects of a taxpayer's unitary business: payroll, property, and sales.

57. *Id.* § 25137-4.

58. *Id.* § 25137-5.

59. *Id.* § 25137-6.

60. *Id.* § 25137-7.

61. Extremely few judicial decisions have addressed the application of this relief provision of UDITPA. In California, *see, e.g.*, *Communications Satellite Corp. v. Franchise Tax Board*, 156 Cal. App. 3d 726, 747-48, 203 Cal. Rptr. 779, 792-93 (1984), *appeal dismissed*, 469 U.S. 1201 (1985), which discussed the Franchise Tax Board's authority to recalculate the property and sales factors of the taxpayer. Few other state courts have addressed the provision. *See, e.g.*, *Twentieth Century-Fox Film Corp. v. Dep't of Revenue*, 299 Or. 220, 700 P.2d 1035 (1985); *Amoco Production Co. v. Arnold*, 213 Kan. 636, 518 P.2d 453 (1974); *Donald M. Drake Co. v. Dep't. of Revenue*, 263 Or. 26, 500 P.2d 1041 (1972); *Kennecott Copper Corp. v. State Tax Comm'n*, 27 Utah 2d 119, 493 P.2d 632 (1972).

Each factor is a fraction, the numerator of which is the taxing state's (i.e., California's) portion of the dollar value of the factor, while the denominator represents the dollar value of the factor for the unitary business' total operations worldwide.⁶² The fraction for each of the three factors is reduced to a percentage, and the three percentages are then averaged.⁶³ The result represents the extent of the taxpayer's business in California for tax purposes. This California apportionment percentage is then multiplied by the taxpayer's unitary business income.⁶⁴ After certain adjustments are made (which are not relevant to this discussion), the amount of taxable income is multiplied by the applicable California franchise tax rate to determine the amount of tax owed. This portion of the standard, three-factor apportionment formula is illustrated as follows:⁶⁵

$$\begin{array}{l} \text{Total} \\ \text{Unitary} \\ \text{Business} \\ \text{Income} \end{array} \times \frac{1}{3} \left(\frac{\text{Cal. Payroll}}{\text{Total Payroll}} + \frac{\text{Cal. Property}}{\text{Total Property}} + \frac{\text{Cal. Sales}}{\text{Total Sales}} \right)$$

To demonstrate how the unitary method is applied, assume that a worldwide unitary business doing business in California has total unitary business income of \$200 for a given year. The taxpayer has California payroll of ten dollars and worldwide payroll of twenty dollars; California property valued at twenty dollars and worldwide property valued at forty dollars; and California sales of sixty dollars and worldwide sales of \$120. The standard formula would apportion \$100 of unitary business income to California in the following manner:

$$\frac{200}{200} \times \frac{1}{3} \left(\frac{10}{20} + \frac{20}{40} + \frac{60}{120} \right) = 100$$

Critics of California's standard apportionment formula contend that differences in productivity or profitability among portions of a taxpayer's worldwide unitary business result in a misattribution of income where the standard formula is used. Specifically, they argue that the underlying assumption of formula apportionment is that each dollar of payroll, property, and sales produces an equal amount of income or an equal quantity of the product. Critics argue that this rationale assumes at least roughly comparable economic and taxing conditions in the various jurisdictions in which the unitary business is located, and that while such comparability may reasonably be present among the states of the United States, this comparability does not exist on a worldwide basis. For these reasons, critics conclude, standard formula apportionment causes income distortion when applied to a worldwide unitary business

62. §§ 25129, 25132, 25134 (West 1979).

63. *Id.* § 25128.

64. *Id.*

65. For an overview of this process see generally *id.* §§ 25120-25140.

where differences exist in profitability and productivity among segments of that worldwide unitary business.⁶⁶

This argument can be illustrated as follows:⁶⁷ assume that a taxpayer is engaged in a unitary business enterprise which consists of a parent corporation and a wholly-owned subsidiary, Black Corp. and White Corp. Black Corp. conducts business only in Jurisdiction No. 1 and White Corp. conducts business only in Jurisdiction No. 2. Assume that each corporation produces an equal amount of net business income as shown on its separate books and records. Assume also that it takes ten units of payroll, ten units of property, and ten units of sales by each corporation to produce an equal amount of net income. Under these facts, the standard, three-factor formula would apportion the net income of the unitary business allotting fifty percent to Jurisdiction No. 1 and fifty percent to Jurisdiction No. 2 as follows:

$$\begin{aligned} 1/3 \times (10/20 + 10/20 + 10/20) &= .50 \text{ to Jurisdiction No. 1} \\ 1/3 \times (10/20 + 10/20 + 10/20) &= .50 \text{ to Jurisdiction No. 2} \end{aligned}$$

In this example, equal units of payroll, property, and sales generated an equal amount of net income from each of the two corporations, which, by assumption, conducted business only in a single jurisdiction. Now assume that while each corporation still produces an equal amount of net income as shown on its separate books and records, unequal units of payroll, property, and sales generate an equal amount of net income. For example, assume Black Corp. requires 100 units of payroll, ten units of property, and ten units of sales to produce the same (separate accounting) income produced by White Corp. using ten units of payroll, ten units of property, and ten units of sales. Under these circumstances, the standard, three-factor formula would apportion the net income of the unitary business unequally between Jurisdiction No. 1 and Jurisdiction No. 2, as follows:

$$1/3 \times (100/110 + 10/20 + 10/20) = .64 \text{ to Jurisdiction No. 1}$$

66. This argument has been raised in several forums. For example, the argument has been presented in California courts in *Gulf Oil Corp. v. The Franchise Tax Bd. of the State of Cal.*, No. 414285 (Super. Ct., San Diego Cty.), and is pending in court in several other cases. It has also been presented in other states, e.g., *Mobil Oil Corp. v. Dep't of Revenue of the State of Montana*, before the State Tax Appeal Board of the State of Montana, Docket Number CT-1882-2, and is pending in other cases. The argument has also been presented to the California Franchise Tax Board in several public proceedings requested by taxpayers seeking relief under CAL. REV. & TAX CODE § 25137 from the results of standard formula apportionment. Finally, the argument was made by numerous groups and taxpayers in *amicus curiae* briefs filed with the United States Supreme Court in *Container Corp.* 463 U.S. 159. The argument was particularly well developed in the Brief for Gulf Oil Corp. as *Amicus Curiae* in Support of Appellant, at 6-14. See also Brief of Colgate-Palmolive Company as *Amicus Curiae* in Support of Appellant, at 8-15; Brief of the Coca-Cola Company as *Amicus Curiae* in Support of Appellant, at 5-11; Brief of *Amicus Curiae* on the Merits in Support of Appellant submitted by Firestone Tire & Rubber Company, at 11-18; Brief of Financial Executives Institute as *Amicus Curiae*, at 24-27; Brief of the Committee on State Taxation of the Council of State Chambers of Commerce as *Amicus Curiae* in Support of Appellant, at 13-15. The argument was also presented in Appellant's Brief on the Merits, at 15-19.

67. Additional examples of these allegations of distortion and the misattribution of income under standard formula apportionment are found in Sheffrin, *Alleged Distortions in Factor Apportionment Methods in State Corporate Taxation*, 6 W. TAX L. REV. 115 at 118-19 (1985).

$$1/3 \times (10/110 + 10/20 + 10/20) = .36 \text{ to Jurisdiction No. 2}$$

In this second example, the increased payroll of Black Corp. needed to produce an equal amount of (separate accounting) income results in additional income being apportioned to Jurisdiction No. 1. Proponents of the misattribution of income position contend that Black Corp. is less productive than White Corp. because Black Corp. requires a larger number of payroll units than does White Corp., all else being equal, to produce the same amount of (separate accounting) income. Yet Black Corp., which produces fifty percent of the net income of the unitary business, will be taxed in Jurisdiction No. 1 upon sixty-four percent of the combined total income of Black and White corporations because it has more units of payroll than White Corp. It is argued that this result demonstrates the misattribution or distortion of income where differences exist between the productivity and profitability of the United States and foreign operations of a multinational enterprise engaged in a worldwide unitary business.

B. Two Proposed Solutions to the Alleged Misattribution of Income under the Worldwide Unitary Method

Taxpayers have proposed two solutions to redress the alleged income distortion caused by differences in productivity and profitability among components of a worldwide unitary business. One of these solutions calls for the abandonment of formula apportionment, while the other advocates the retention of the formula in a modified form.

The proponents of the abandonment of the standard three-factor apportionment formula favor replacing it with some form of separate accounting. Generally speaking, separate accounting carves out of the overall business of a taxpayer the activities taking place, the property employed, and the income derived from sources within a single state, and thereby treats the business within a state as if it were separate and distinct from the business carried on outside of that state.⁶⁸ Separate accounting is viewed as the antithesis of formula apportionment and unitary business approach.

It has also been argued that the standard, three-factor apportionment formula should be modified with the goal of making the factors roughly comparable with respect to productivity or profitability. While this argument has been presented in several forums, it has not yet been directly addressed by the United States Supreme Court, as discussed below.

Typically, the modification to the standard apportionment formula which is advocated by taxpayers consists of an adjustment of the denominators of the payroll and property factors in an attempt to make the productivity of these factors for the unitary business operations outside California comparable to their productivity for the unitary business operations inside

68. J. HELLERSTEIN, *I STATE TAXATION* (1983), § 8.3, at 323; see also G. ALTMAN & F. KEESLING, *ALLOCATION OF INCOME IN STATE TAXATION* 89-97 (1946).

California. This adjustment purportedly is made by calculating the amount of payroll or property required to produce a given amount of a specified product within California. The taxpayer then makes the same calculation for the product produced in some part or all of the unitary business operations outside California. The taxpayer then changes the apportionment factors so the factors for some or all of the unitary business operations outside California are equally "productive" as those inside California. Where the operations outside California are more productive than the unitary business operations within California, the denominators of the payroll or property factors in the standard apportionment formula would be increased by such modification of the standard formula. These increases, in turn, would reduce the apportionment factor and correspondingly reduce the amount of unitary business income which is attributed to California for income tax purposes.

III

THE SUPREME COURT AND THE MISATTRIBUTION OF INCOME ISSUE

A. The Pre-Container Corporation Decisions

Several decisions of the United States Supreme Court have directly addressed the issue of whether a taxpayer may challenge the results of formula apportionment by using some type of separate or component accounting which purports to show differences in productivity and profitability among various segments or separately incorporated business entities which constitute a unitary business enterprise. The first significant decision of the Court relating to this issue was *Hans Rees' Sons, Inc. v. State of North Carolina ex rel. Maxwell*,⁶⁹ decided in 1931.

Hans Rees, a New York corporation, was engaged in the business of tanning, manufacturing, and selling belting and other heavy leathers. As part of this business, the company operated a manufacturing plant in North Carolina. Evidence offered by Hans Rees indicated that for the four years in issue the income having its source in the company's manufacturing and tanning operations within North Carolina averaged seventeen percent of total income. Pursuant to the then prescribed statutory method, the North Carolina Commission of Revenue allocated to the state eighty-three, eighty-five, sixty-six, and eighty-five percent respectively of Hans Rees' total income for the four years in issue.⁷⁰

The Supreme Court concluded that the North Carolina statute, which imposed a tax on approximately eighty percent of Hans Rees' income, violated the Due Process Clause of the Fourteenth Amendment in view of the evidence offered by Hans Rees to show that only seventeen percent of the income was earned in North Carolina. The Court recognized the difficulty in

69. 283 U.S. 123 (1931).

70. *Id.* at 126-28.

making "an exact apportionment" of the income of a unitary business, but stated that "evidence may always be received which tends to show that a state has applied a method, which, albeit fair on its face, operates so as to reach profits which are in no sense attributable to transactions within its jurisdiction."⁷¹

Hans Rees may be read to stand for the proposition that an apportionment formula used to compute a state income tax will not be upheld if the taxpayer can demonstrate that the formula assigns to the taxing state "a percentage of income out of all appropriate proportion to the business transacted" by the taxpayer in that state.⁷² Unfortunately, the Court's opinion casts little light on how *Hans Rees* had shown that its North Carolina income was only seventeen percent of its total income. Also, the apportionment formula which was the subject of the case consists of only a single factor, which may have played a major role in the decision that the formula was unfair in its application. In any event, later decisions of the Court make a showing of misattributed income under the *Hans Rees* standard extremely difficult if not impossible for all practical purposes because of the Court's rejection in numerous later decisions of separate accounting as a means to impeach the results of formula apportionment.

After *Hans Rees*, the Court in *Butler Brothers v. McColgan*⁷³ next addressed the issue of how and when a taxpayer could successfully establish that formula apportionment results in income being misattributed to a taxing state. *Butler Brothers* was an Illinois corporation qualified to do business in California, and was engaged in the wholesale dry goods and general merchandise business, purchasing from manufacturers and others and selling only to retailers. The company maintained wholesale distributing houses in seven states, including one in San Francisco. Each of the company's houses maintained stocks of goods, served a separate territory, had its own sales force, and handled all its own sales and connected solicitation, credit, and collections arrangements. Each of the houses also kept its own books of account. For the years in issue, all receipts from sales in San Francisco were credited to the San Francisco house.⁷⁴

Butler Brothers maintained a central buying division through which goods for resale were ordered, and goods were shipped by manufacturers to the houses for which they were ordered. All purchases made by the company for sale at its various houses were made through the central buying division. The cost of the goods and the transportation charges were entered on the books of the house which received the goods. No charges were made against any house for the benefit of *Butler Brothers* or any of its other houses by reason of the centralized purchasing. However, the actual cost of operating

71. *Id.* at 133-34.

72. *Id.* at 135.

73. 315 U.S. 501 (1942).

74. *Id.* at 504.

the centralized buying division was allocated among the houses. Other operating expenses, including executive salaries, certain accounting expenses, and the cost of operating a central buying division and a central advertising division, were allocated among the houses.⁷⁵

The company computed its income from the San Francisco house for the period in question by deducting from the gross receipts from sales in California the cost of the merchandise sold, the direct expense of the San Francisco house, and the portion of the indirect expenses allocated to that house. Under this method of computation, which was based upon the separate books of account of the San Francisco house, the California operations showed a loss of \$82,851. In contrast, the California Franchise Tax Board applied its apportionment formula to Butler Brothers' total net income of \$1,149,677 from the operations of all of its houses, and apportioned to California approximately \$93,000 in income.⁷⁶

Butler Brothers argued that the apportionment formula used by California for the unitary business converted a loss of \$82,851 into a profit of more than \$93,000, and that the difference of approximately \$175,000 "has either been created out of nothing or has been appropriated by California from other states."⁷⁷ The Supreme Court applied the standard set forth in *Hans Rees* that the taxpayer has the burden of showing that "in any respect of the evidence," its income attributed to a state is "out of all appropriate proportion to the business" transacted by the taxpayer in that state. The Court then rejected the method relied upon by Butler Brothers in its attempt to show that the California apportionment formula resulted in extraterritorial values being taxed. In a direct attack upon the separate accounting method, the Court stated:

It is true that appellant's separate accounting system for its San Francisco branch attributed no net income to California. But we need not impeach the integrity of that accounting system to say that it does not prove appellant's assertion that extraterritorial values are being taxed. Accounting practices for income statements may vary considerably according to the problem at hand. . . . A particular accounting system, though useful or necessary as a business aid, may not fit the different requirements when a State seeks to tax values created by business within its borders.⁷⁸

Although the Supreme Court did not expressly overrule its earlier decision in *Hans Rees*, and, in fact, cited it as setting forth the standard of proof required, the continued vitality of the conclusions reached in *Hans Rees* were placed in considerable doubt by the *Butler Brothers* decision. The Court in *Butler Brothers* was highly critical of separate accounting, and rejected its use

75. *Id.* at 504-05.

76. *Id.*

77. *Id.* at 506.

78. *Id.* at 507.

by the taxpayer in that case to impeach the results of formula apportionment.⁷⁹

The next major decision in which the Court discussed this separate accounting concept was *Moorman Mfg. Co. v. Bair*, decided in 1978.⁸⁰ Moorman, an Illinois corporation, manufactured animal feed in Illinois and sold its products in Iowa. Iowa used a single-factor sales formula to apportion the income of an interstate business for purposes of Iowa income taxes. This formula was based upon the proportion of gross sales made within Iowa to the taxpayer's total gross sales. Moorman challenged the application of the Iowa formula and alleged that it resulted in a greater allocation of net income to Iowa than was "reasonably attributable" to Moorman's business within that state.⁸¹

The Court rejected Moorman's arguments, and held that Iowa's single-factor formula did not either violate the Due Process Clause or result in extraterritorial taxation. The Court was particularly critical of Moorman's argument that its operations in Illinois were responsible for some of the profits generated by its sales in Iowa. The Court attacked this assertion as being "speculative," and stated:

Appellant does not suggest that it has shown that a significant portion of the income attributed to Iowa in fact was generated by its Illinois operations; the record does not contain any separate accounting analysis showing what portion of appellant's profits was attributable to sales, to manufacturing, or to any other phase of the company's operations. But appellant contends that we should proceed on the assumption that at least some portion of the income from Iowa sales was generated by Illinois activities.⁸²

Two years after *Moorman* was decided, the Supreme Court in *Exxon Corp. v. Wisconsin Dept. of Revenue*⁸³ clarified its stance on the issue of separate accounting. The Court in *Exxon* was faced with the issue of whether the Due Process Clause of the Fourteenth Amendment prevented Wisconsin from applying its statutory apportionment formula to a taxpayer's total corporate income where the taxpayer's functional accounting system separated corporate income into the three major categories of marketing, refining, and exploration and production, and where the taxpayer performed only marketing operations in Wisconsin.⁸⁴

The Court analyzed Exxon's operations at length. Exxon was described as a vertically integrated petroleum company organized in Delaware and with its general offices in Houston. During the years in question (1965 through 1968), Exxon's corporate organizational structure consisted of three parts:

79. *Id.*

80. 437 U.S. 267 (1978).

81. *Id.* at 269-70.

82. *Id.* at 271-72.

83. 447 U.S. 207 (1980).

84. *Id.* at 210.

Corporate Management, Coordination and Services Management, and Operations Management. Operations Management was responsible for directing the functional departments of the company, which included Exploration and Production, Refining, Marketing, Marine, Coal and Shale Oil, Minerals, and Land Management. Each functional department was organized and managed as a separate unit operating independently of the other segments. These departments were treated by the company as separate investment centers, and a profit was determined by the company for each functional department.⁸⁵

During the years in issue, each of the operating departments was also responsible for its performance. Each department was separately evaluated by centralized management and competed with the other departments for investment funds. Further, there was no requirement that Exxon's crude oil go to its own refineries nor was it required that the refined products sold through its marketing operations be produced from Exxon's crude oil. Finally, transfers of products and raw materials among the three major functional departments of Exploration and Production, Refining, and Marketing were theoretically based upon competitive wholesale market prices.⁸⁶

The only activity carried out by Exxon in Wisconsin was marketing, and Exxon prepared its Wisconsin corporate income and franchise tax returns based upon separate accounting records which reflected only the Wisconsin marketing operations. No tax was shown as being due for any of the years in issue because each return showed losses. Upon audit, the Wisconsin Department of Revenue concluded that Exxon's Wisconsin marketing operations constituted an integral part of its unitary business, and recalculated Exxon's income tax liability based upon an apportionment formula.⁸⁷

Exxon argued to the Supreme Court that *Moorman* had sanctioned the use of separate functional accounting to show the extraterritorial reach of a state tax statute, and that its accounting system demonstrated that Wisconsin's use of the apportionment formula violated the Due Process Clause. The Court rejected these contentions, however, and declared that in several earlier cases, including *Butler Brothers*, a company's internal accounting techniques had been held to be not binding upon a state for tax purposes.⁸⁸ The Court in *Exxon* relied heavily upon its earlier opinion in *Mobil Oil Corp. v. Commissioner of Taxes of Vermont*,⁸⁹ repeating its observation in *Mobil* that "separate accounting, while it purports to isolate portions of income received in various States, may fail to account for contributions to income resulting from functional integration, centralization of management, and economies of scale."⁹⁰ Again quoting from *Mobil*, the Court in *Exxon* declared that because such factors arise "from the operation of the business as a whole, it

85. *Id.* at 210-12.

86. *Id.* at 212.

87. *Id.* at 212-14.

88. *Id.* at 221.

89. 445 U.S. 425 (1980).

90. Exxon Corp., 447 U.S. at 222-23, quoting Mobil Oil Corp., 445 U.S. at 438.

becomes misleading to characterize the income of the business as having a single identifiable 'source'. Although separate geographical accounting may be used for internal auditing, for purposes of state taxation it is not constitutionally required."⁹¹ The Court noted that the principles expressed in *Mobil* apply not only to a taxpayer's own "separate geographic accounting", but also to "separate functional accounting".⁹²

The Court also took the opportunity to resolve whatever confusion may have resulted from the references to separate accounting in its *Moorman* opinion:

The dicta in *Moorman* upon which appellant relies are not incompatible with these principles. In *Moorman* we simply noted that the taxpayer had made no showing that its Illinois operations were responsible for profits from sales in Iowa. This hardly leads to the conclusion, urged by Exxon here, that a taxpayer's separate functional accounting, if it purports to separate out income from various aspects of the business, must be accepted as a matter of constitutional law for state tax purposes. Such evidence may be helpful, but *Moorman* in no sense renders such accounting conclusive.⁹³

B. *The Container Corporation Decision*

The most recent pronouncement by the Court regarding the use of a separate accounting analysis to impeach the results of formula apportionment is its 1983 decision in *Container Corp. of America v. Franchise Tax Board*.⁹⁴

Container Corporation was a Delaware corporation headquartered in Illinois and doing business in California and elsewhere.⁹⁵ Container had a number of overseas subsidiaries incorporated in the countries in which they operated. During the years at issue (1963, 1964, and 1965), Container controlled twenty foreign subsidiaries located in four Latin American and four European countries. Its percentage of ownership of the subsidiaries, either directly or through other subsidiaries, ranged from 66.7% to 100%. Apart from one holding company and one inactive company, the subsidiaries were engaged, in their respective local markets, in essentially the same business as Container, which was the manufacture of custom ordered paperboard packaging.⁹⁶

Container argued that its foreign subsidiaries were significantly more profitable than the domestic parent corporation, and that California's standard three-factor apportionment formula ignored differences in productivity by its reliance upon indirect measures of income such as payroll, property, and sales. Container argued that the failure of the formula to account for differences in productivity distorted the true allocation of income between

91. 447 U.S. at 222-23, quoting *Mobil Oil Corp.*, 445 U.S. at 438.

92. 447 U.S. at 223, n.7.

93. *Id.* at 223.

94. *Container Corp.*, 463 U.S. 159.

95. *Id.* at 163.

96. *Id.* at 171-72.

Container and its foreign subsidiaries and resulted in a misattribution of income to California under the standard, three-factor apportionment formula.⁹⁷

Container's allegation of the breakdown of the standard, three-factor apportionment formula because of differing rates of productivity and profitability was based upon the premise that the unitary business principle should only be applied where all units of a combined group are operating in a common market with a common economic and political system.⁹⁸ The premise is based upon the commonly held assumption that a dollar of property, payroll and sales should earn approximately the same amount of net income anywhere within the geographic area to which the unitary system is applied. Container argued that this assumption does not hold true when applied on a worldwide basis and presented to the Court a comparison of the income attributed under a separate accounting analysis to the countries in which it operated with the income assigned to those countries under California's apportionment formula. This analysis represented that Container's foreign subsidiaries in Colombia, Venezuela, and the Netherlands were more profitable than its United States operations. Container argued that the greater profitability of its Colombian and Venezuelan subsidiaries as shown under this analysis was of added significance because eighty-four percent of the total net income earned by all its foreign subsidiaries was earned by the subsidiaries in these two countries.⁹⁹

In addition, Container argued that differences in the relative productivity of the three apportionment factors of payroll, property and sales resulted in a misattribution of income to California under the unitary method. In support of this contention, Container presented to the Court an analysis of the relationship between dollars of sales, of payroll and of property required to produce one dollar of net income as computed for Container on a domestic basis and for its foreign subsidiaries in each country. Container derived these figures for the years 1963-1965 "by dividing the net income produced in each country by the respective sales, payroll and property factors for that country."¹⁰⁰

<u>Country</u>	<u>Payroll</u>	<u>Sales</u>	<u>Property</u>
United States	\$3.34	\$10.65	\$4.83
Colombia	0.27	5.17	4.74
Mexico	1.53	10.69	6.29
Venezuela	0.81	4.73	3.40
Germany	3.95	17.62	9.73
Netherlands	0.96	7.98	1.59

97. *Id.* at 181.

98. Latcham, *Worldwide Combination and the Container Case: A Perspective on Unitary Taxation*, 2 INT'L. TAX & BUS. LAW. 29, 34 (1984).

99. *Id.* at 34-35. See also Appellant's Brief on the Merits, at 16-18, Container Corp., 463 U.S. at 159.

100. Appellant's Brief, *supra* note 100, at 18.

Container claimed that this analysis established that a misattribution of income to California could be traced primarily to a “dramatic difference” in the relationship of payroll cost to net income in the United States as compared to other countries, and to a lesser extent, to a difference in the relationship of sales to net income.¹⁰¹

The Supreme Court rejected Container’s argument that the application of the standard, three-factor apportionment formula to the worldwide operations of the taxpayer’s unitary business had resulted in a misattribution of income to California. The thrust of the Court’s opinion was that the statistical evidence presented by the taxpayer did not “by itself come close to impeaching the basic rationale behind the three-factor formula.”¹⁰² The Court emphasized that not only had the three-factor apportionment formula met with its approval, but that the formula had become “something of a benchmark against which other apportionment formulas are judged.”¹⁰³

In addressing the use by a taxpayer of formal geographical or separate accounting, the Court noted that formal accounting “is subject to manipulation and imprecision, and often ignores or captures inadequately the many subtle and largely unquantifiable transfers of value that take place among the components of a single enterprise.”¹⁰⁴ The Court recognized that while some methods of formula apportionment are “particularly problematic” because they focus only upon a small portion of the spectrum of activities by which “value” is generated, the standard, three-factor apportionment formula used by California has gained widespread approval precisely because its factors of payroll, property, and sales “appear in combination to reflect a very large share of the activities by which value is generated.”¹⁰⁵

The Court did not directly address Container’s allegation that the apportionment formula is premised upon a dollar of payroll, of property, and of sales earning approximately the same amount of net income anywhere within the geographic area to which the unitary system is applied. The Court did recognize, however, that the three-factor formula “as applied to horizontally linked enterprises, is based in part on the very rough economic assumption that rates of return on property and payroll — as such rates of return would be measured by an ideal accounting method that took all transfers of value into account — are roughly the same in different taxing jurisdictions.”¹⁰⁶ The Court noted that this “very rough economic assumption” has a “powerful basis in economic theory” because if true rates of return were radically different in different jurisdictions, one might expect a significant shift in investment resources to take advantage of that difference. On the other hand, the Court also noted the assumption has “admitted weaknesses” in that an

101. *Id.*
 102. *Container Corp.*, 463 U.S. at 182.
 103. *Id.* at 170.
 104. *Id.* at 164-65.
 105. *Id.* at 182-83.
 106. *Id.* at 183, n. 20.

enterprise's willingness to invest simultaneously in two jurisdictions with very different true rates of return could also be explained by such factors as difficulties in shifting resources, the decreasing marginal value of additional investment, and portfolio-balancing considerations.¹⁰⁷

In sum, the Supreme Court decisions discussed all directly address attempts by taxpayers to replace the unitary business and formula apportionment concepts with a separate accounting concept for determining the source of income. However, none of the cases directly addresses the related issue of whether a separate accounting approach which compares profitability and productivity of segments of the unitary business can be used to modify, rather than replace, formula apportionment.

IV

AN ANALYSIS OF THE PRODUCTIVITY/PROFITABILITY APPROACH TO IMPEACHMENT OF THE RESULTS OF STANDARD FORMULA APPORTIONMENT

A. *The Rejection of the Separate Accounting Approach*

As we have seen, the unitary business principle and formula apportionment are usually juxtaposed with some form of separate accounting analysis. That analysis attempts to treat a portion of a unitary business enterprise as if it were separate and distinct from the remainder of the unitary business. The cases described above demonstrate that taxpayers have been largely unsuccessful with this approach. *Hans Rees* appears once to have sanctioned the use of separate accounting to impeach the results of formula apportionment under a single factor formula and *Moorman*, in dicta, also suggested that separate accounting could be used for that purpose. However, the approach favored by the Court in *Hans Rees* was soundly rejected in the subsequent opinion in *Butler Brothers*. Furthermore, the Court in *Exxon* rejected the dicta in *Moorman* which had appeared to favor the use of separate accounting as a technique to discredit the results of formula apportionment.

The theme which runs throughout the Supreme Court opinions in this area is most cogently expressed in *Exxon*, where the Court, quoting from its earlier opinion in *Mobil*, states:

[S]eparate accounting, while it purports to isolate portions of income received in various states, may fail to account for contributions to income resulting from functional integration, centralization of management and economies of scale. . . . Since such factors arise 'from the operation of the business as a whole, it becomes misleading to characterize the income of the business as having a single identifiable "source". Although separate accounting may be useful for internal auditing, for purposes of state taxation it is not constitutionally required.'¹⁰⁸

107. *Id.*

108. *Exxon Corp.*, 447 U.S. 222-23.

This concept is echoed in California case law. The major decision by the California Supreme Court in this area is *John Deere Plow Co. v. Franchise Tax Board*.¹⁰⁹ In *John Deere*, the court held that differences in wage rates and productivity among multistate operations of a unitary business did not require the abandonment of the formula apportionment approach. John Deere was an Illinois corporation which sold a full line of agricultural machinery, implements, and tractors at wholesale to dealers. It maintained a number of jobbing houses throughout the country, including a jobbing house in San Francisco which served the states of California and Arizona, and part of Nevada, and did a certain amount of exporting to Asia. John Deere entered into a distribution arrangement with Caterpillar Tractor Company under which the two companies used common dealers who would sell the combined products of both operations.

John Deere claimed that this arrangement greatly affected the income and expenses of the San Francisco house, which resulted in material reductions of its income. John Deere challenged the assessment imposed upon it by the California Franchise Tax Board under a formula apportionment method, and argued that it had demonstrated by the use of separate accounting that formula apportionment resulted in extraterritorial (i.e. outside California) values being taxed by California. In support of its argument, John Deere presented accounting records that showed that when the operations of the company's various branch houses were compared, the profit ratio for the San Francisco branch was \$6.76 in wages and salaries for each \$100 in sales, whereas the average ratio for all United States houses was \$4.46 for each \$100 in sales, a difference of almost fifty percent.¹¹⁰

The California Supreme Court rejected this argument, and stated that the taxpayer's separate accounting approach "fails to take into account the underlying concept of formula apportionment, namely that the income of the unitary business activities is derived from the functioning of the business as a whole." The Court reiterated that, because the activities in the integrated overall enterprise were interrelated, the business conducted within California was not truly "separate and distinct" from the business done outside California so as to reasonably permit a segregation of income under the separate accounting method.¹¹¹

Case law has held that once a business has been found to be unitary, the use of separate accounting is not appropriate. An interesting example of the application of this principle is found in *Superior Oil Company v. Franchise*

109. 38 Cal. 2d 214, 238 P.2d 569 (1951).

110. *Id.* at 217-22, 238 P.2d at 570-73.

111. *Id.* at 223, 238 P.2d at 573-74.

Tax Board,¹¹² in which the Franchise Tax Board argued for separate accounting while the taxpayer argued for formula apportionment. The taxpayer was a California corporation with its principal place of business in California. The corporation derived its principal income from the production and sale of petroleum and petroleum products in numerous states (including California) and in foreign countries.¹¹³ The taxpayer realized large profits from its activities in California, and calculated its California franchise tax liability by apportioning the income from its petroleum operations based on payroll, property, and sales factors. The Franchise Tax Board issued a deficiency assessment after recomputing the taxpayer's California taxable income under a separate accounting method.¹¹⁴ The Franchise Tax Board contended that even where a unitary business exists, employment of formula apportionment is justified only when the various local operations of the taxpayer are so essential to its overall operation that it is impossible to make separate accounting computations.¹¹⁵ The Supreme Court rejected this argument and held that formula apportionment must be used by both the state and the taxpayer where the taxpayer is engaged in a unitary business, regardless of whether separate accounting computations were possible.¹¹⁶

Accordingly, a number of cases have rejected separate accounting as a constitutionally mandated alternative to formula apportionment and the unitary method. Of those cases, opinions, such as *John Deere*, specifically addressed the issue in the context of whether separate accounting was constitutionally mandated in light of differences in productivity and profitability among parts of a unitary business. However, few cases have addressed the issue in the context of a worldwide unitary business. The most notable of these decisions are *Anaconda Co. v. Franchise Tax Board*¹¹⁷ and *Container Corp.*¹¹⁸

Anaconda was a Montana corporation engaged in the production of copper and other basic metals. It conducted business in California and throughout the United States, and also operated several wholly owned subsidiaries in Latin America.¹¹⁹ Anaconda contended that California's standard three-factor apportionment formula, when applied to its worldwide unitary business, was arbitrary and unreasonable because it failed to take into account differences in production values between the United States and Latin America.¹²⁰

112. *Superior Oil Co. v. Franchise Tax Bd.*, 60 Cal. 2d 406, 386 P.2d 33, 34 Cal. Rptr. 545 (1963).

113. *Id.* at 408, 386 P.2d at 34, 34 Cal. Rptr. at 546.

114. *Id.* at 409, 386 P.2d at 35, 34 Cal. Rptr. at 547.

115. *Id.* at 413, 386 P.2d at 37, 34 Cal. Rptr. at 549.

116. *Id.* at 416-17, 386 P.2d at 39, 34 Cal. Rptr. at 551. See also *Honolulu Oil Corp. v. Franchise Tax Bd.*, 60 Cal. 2d 417, 386 P.2d 50, 34 Cal. Rptr. 552 (1963).

117. *Anaconda Co. v. Franchise Tax Bd.*, 130 Cal. App. 3d 15, 181 Cal. Rptr. 640 (1982), *appeal dismissed*, 463 U.S. 1221 (1983).

118. *Container Corp.*, 463 U.S. 159.

119. *Anaconda*, 130 Cal. App. 3d at 17-19, 181 Cal. Rptr. at 642.

120. *Id.* at 29, 181 Cal. Rptr. at 649.

Notwithstanding the fact that exhibits to a stipulation by the parties indicated that there was a marked difference between Latin American and domestic operations in the payroll, property, and sales factors as a function of productivity, the Court of Appeal held that the taxpayer had failed to justify an exception to unitary treatment for its Latin American operations. The court stated that Anaconda's argument "fails to account for the contributions to income which result from the functional integration and centralization of management which exist in a unitary operation."¹²¹ Quoting from an earlier Court of Appeal opinion, the court reiterated, "The very notion of a unitary business implies that the taxpayer's affairs within and outside the taxing jurisdiction cannot be measured without taking into account income from property and activities located elsewhere."¹²²

In *Container Corp.*, the taxpayer argued specifically that alleged differences in productivity and profitability between geographic segments of its worldwide unitary business should be used to impeach the results of California's standard formula apportionment and that a separate accounting system should be used in lieu of formula apportionment. The United States Supreme Court rejected these contentions and stated that the flaw in this approach was "obvious," as the profit figures relied upon by the taxpayer to demonstrate the alleged differences in profitability "are based on precisely the sort of formal geographical accounting whose basic theoretical weaknesses justify resorting to formula apportionment in the first place."¹²³

The *Container Corp.* opinion also addressed the related question of whether differences in wage rates between domestic and foreign operations could be used to impeach the results of standard formula apportionment. This contention was rejected as well. The Court noted that, in view of the fact that the taxpayer and its foreign subsidiaries had been determined to be a unitary business, California factors may have contributed to the same production, albeit more indirectly than foreign ones.¹²⁴ The Court concluded that there was no evidence demonstrating that the margin of error inherent in the standard, three-factor apportionment formula is greater than the margin of error inherent "in the sort of separate accounting presented by the taxpayer."¹²⁵

In review, the decisions in *Exxon*, *Mobil*, and *Butler Brothers* point out the fallacy of attempting to use separate accounting in a unitary business. The United States Supreme Court's opinion in *Container Corp.*, and, to a lesser extent, the California courts' decisions in *John Deere*, *Superior Oil*, and *Anaconda*, dealt a severe blow to proponents of the argument that differences

121. *Id.* at 31-32, 181 Cal. Rptr. at 650-51.

122. *Id.* at 32-33, 181 Cal. Rptr. at 651, (quoting *Luckenbach S.S. Co. v. Franchise Tax Bd.*, 219 Cal. App. 2d 710, 719, 33 Cal. Rptr. 544 (1963)).

123. *Container Corp.*, 463 U.S. at 181.

124. *Id.* at 182.

125. *Id.* at 184.

in productivity and profitability among segments of a worldwide unitary business can be used to establish the unconstitutionality of standard formula apportionment and to impose separate accounting.

A major flaw common to all attempts to use separate accounting is that separate accounting for a unitary business fails to take into consideration the interrelationship and interdependency among the parts of the unitary business. As one leading scholar has noted, the application of separate accounting to a unitary business "operates in a universe of pretense; as in Alice in Wonderland, it turns reality into fancy, and then pretends that it's the real world. For the essence of the separate accounting technique of dividing the income of a unitary business is to ignore the interdependence and integration of the business operations conducted in the various States, and treat them, instead, as if they were separate, independent, and nonintegrated."¹²⁶

However, the failure of separate accounting to recognize the nature of a unitary business is only one reason why it is not an appropriate alternative to formula apportionment and the unitary method. A second major flaw is the monumental and often impossible task of determining the imputed prices at which goods and services are deemed to be transferred between related parties. Absent such an imputation, transactions between related parties may be used to manipulate the separate accounting method. For example, assume that X, a United States corporation, owns 100% of Y, a corporation doing business in a low tax jurisdiction. X and Y are engaged in a unitary business enterprise. X sells a product to Y for \$100, and also sells the same product to Z, an unrelated corporation which does business in the same jurisdiction as Y, for \$150. X's cost for the product is \$90. Y and Z then both sell the product for \$170 in the same market. Z has a profit on the sale of \$20 (170 - 150) while Y has a profit on the sale of \$70 (170 - 100). X has a profit of \$10 (100 - 90) on the sale to Y, and a profit of \$60 (150 - 90) on the sale to Z. The X-Y business group has a total profit of \$80 (70 + 10) on the sale through Y. Unless there is an adjustment to the separate books and records of X and Y, X will have successfully shifted \$50 of its profit to Y, where it will be taxed in a low-tax jurisdiction, by making the sale to Y (a related party) at a lower price than that charged to Z (an unrelated party).

The difficulties in constructing the attributed prices for transfers between related entities have been aptly described as "the Achilles heel of separate accounting."¹²⁷ Freely established transfer pricing between related taxpayers allows multinational corporations to shift profits produced by subsidiaries with high tax burdens to other entities subject to more favorable tax treatment.¹²⁸ The federal income tax structure contains a mechanism, Internal

126. J. HELLERSTEIN, *I STATE TAXATION* (1983), 8.3, at 327.

127. *Id.* at 325.

128. Note, *Multinational Corporations*, *supra* note 6, at 1203.

Revenue Code section 482,¹²⁹ that purports to prevent such arbitrary income shifting by empowering the Internal Revenue Service to allocate income and deductions between two or more controlled entities when necessary to prevent tax evasion or to reflect income clearly.¹³⁰ Section 482 is designed to remedy the abuse of "the shifting of income from one commonly controlled entity to another."¹³¹ Its purpose is to place a controlled taxpayer at tax parity with an uncontrolled taxpayer.¹³² This is accomplished under the regulations by determining, according to the standard of an uncontrolled taxpayer, the "true taxable income" from the property and business of a controlled taxpayer.¹³³ The standard to be applied in making this imputation "is that of an uncontrolled taxpayer dealing at arm's length with another uncontrolled taxpayer."¹³⁴ Thus, in the previous example, an allocation would be made to clearly reflect the income of X and Y as if the transaction was made at arm's length. The amount of the allocation probably would be \$50, the difference between the \$100 charged by X to Y (related party) and the \$150 charged by X to Z (unrelated party) for the identical product. The section 482 adjustment probably would increase the income of X by \$50 and the cost of the product to Y by \$50.

Internal Revenue Code Section 482 has been the subject of much criticism as to its effectiveness in compensating for income shifting between controlled taxpayers. Some commentators view the arm's length pricing system as theoretically unsound and inferior to the unitary method.¹³⁵ Others adopt a more empirical view and point to strong evidence that the approach has proven ineffective in meeting its goals. Perhaps the most widely known criticism regarding the operation of section 482 came from a 1981 Comptroller General report, which found that based upon a review of IRS examination data on 519 multinational corporations engaged in transactions with their foreign subsidiaries, only three percent of the 482 adjustments to reported

129. "In any case of two or more organizations, trades, or businesses (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, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses." I.R.C. § 482 (1978).

130. "The legislative history [of § 482] parallels the general purpose of the statutory text to prevent evasion by 'improper manipulation of financial accounts,' 'arbitrary shifting of profits,' and to accurately reflect 'true tax liability.'" E.I. Du Pont De Nemours & Co. v. United States, 608 F.2d 445, 449-50 (Ct. Cl. 1979)(citations omitted); see also *Eli Lilly and Co. v. Comm'r.*, 84 T.C. 996, 1115-16 (1985).

131. *Your Host, Inc. v. Comm'r. of Internal Revenue*, 58 T.C. 10, 24 (1972), *aff'd*, 489 F.2d 957 (2nd Cir. 1973).

132. 26 C.F.R. § 1.482-1(b)(1).

133. *Id.*

134. *Id.*

135. See Langbein, *The Unitary Method and the Myth of Arm's Length*, 30 TAX NOTES 625, 627 (1986); G. HARLEY, *INTERNATIONAL DIVISION OF THE INCOME TAX BASE OF MULTINATIONAL ENTERPRISE* 18 (Multistate Tax Commission, 1981).

income were based upon a true arm's length price.¹³⁶ A more recent study, based upon a survey of select corporations, concluded that over half of the cases were resolved using methods other than the arm's length method.¹³⁷

The problems encountered in the implementation of section 482 illustrate the flaws of the separate accounting method. Ease of manipulation through the use of intercompany transfers and pricing, and the difficulty of reducing such transactions to an arm's length standard that clearly reflects the income of each entity on a separate accounting basis, support the conclusions and rationale of decisions such as *Butler Brothers*, *Mobil*, *Exxon*, *Container Corp.*, *John Deere*, *Superior Oil*, and *Anaconda* that separate accounting, in lieu of formula apportionment, is not constitutionally mandated for a unitary business. This conclusion also applies to instances in which it is argued that separate accounting is appropriate because of alleged differences in productivity and profitability among segments of a worldwide unitary business.

B. *The "Correction of the Formula" Approach and Its Flaws*

Neither the United States Supreme Court nor the California courts have directly ruled upon the specific issue of whether alleged differences in productivity and profitability among segments of a worldwide unitary business can be used to modify the standard apportionment formula.¹³⁸ Thus far, the only judicial decisions that have addressed this issue of differences in productivity and profitability have done so in the context of the taxpayer's request for separate accounting in lieu of formula apportionment.

The common point of departure for all arguments for modification of the standard formula based upon differences in productivity and profitability is the idea that standard formula apportionment and the unitary method only function properly where each dollar of payroll, property and sales produces a roughly equivalent amount of income or productivity in each of the jurisdictions in which a multinational corporate taxpayer operates.¹³⁹ This premise has been advanced not only by taxpayers in administrative and judicial proceedings, but has also been advanced at Congressional hearings involving state tax matters.¹⁴⁰

136. REPORT BY THE COMPTROLLER GENERAL TO THE CHAIRMAN, HOUSE COMMITTEE ON WAYS AND MEANS, IRS COULD BETTER PROTECT U.S. TAX INTERESTS IN DETERMINING THE INCOME OF MULTINATIONAL CORPORATIONS GGD-81-81 (1981) at i.

137. Schindler & Henderson, *Intercorporate Transfer Pricing, 1985 Survey of Section 482 Audits*, 29 TAX NOTES 1171, 1173 (1985).

138. See *supra* note 67.

139. See *supra* note 67.

140. See, e.g., STATE TAXATION OF INTERSTATE COMMERCE, REPORT OF THE SPECIAL SUBCOMMITTEE ON STATE TAXATION OF INTERSTATE COMMERCE OF THE COMMITTEE ON THE JUDICIARY, HOUSE OF REPRESENTATIVES, H.R. Rep. No. 1480, 88th Congress, 2nd Sess. 168-70 (1964); *State Taxation of Interstate Commerce and Worldwide Corporate Income: Hearings on S. 983 and S. 1688 Before the Subcomm. on Tax'n and Debt Management Generally of the*

The difficulty in basing an argument for modification of the standard apportionment formula on this premise is that, in the words of the Court in *Container Corp.*, such “rough” economic comparability is to be measured “by an ideal accounting method.”¹⁴¹ However, no bright line test exists for determining what degree of comparability is actually required.¹⁴² Some guidance is provided by the *Container* Court, which found that “for all of appellant’s statistics showing allegedly enormous distortions caused by the three factor formula,” the percentage of increase in California taxable income between the method employed by the taxpayer and the method employed by the Franchise Tax Board “comes to approximately 14%, a far cry from the more than 250% difference which led us to strike down the state tax in *Hans Rees Sons, Inc.*, and a figure certainly within the substantial margin of error inherent in any method of attributing income among the components of a unitary business.”¹⁴³

Calculations which attempt to show relative comparability under what *Container* referred to as “an ideal accounting method” present a number of pragmatic problems. First, productivity would have to be measured in terms of some standard unit produced in all the areas for which the comparison is to be made. The less similar the unit, the less accurate the comparison and the less accurate and persuasive the argument would be that productivity or profitability is not comparable. For example, where the standard unit used for comparison is a product, any differences in its ingredients or construction, or differences in its specifications or customization for a local market, would have to be taken into account in determining whether the product constitutes an accurate standard for comparison.

Furthermore, the mere attempt to segregate productivity and profitability for segments of a unitary business in order to modify the standard apportionment formula resembles attempts to use the separate accounting method to impeach the results of formula apportionment. As discussed above, case law clearly states that separate accounting may not be used as a substitute for formula apportionment for a unitary business, nor is separate accounting constitutionally required.

Although the taxpayer in *Container Corp.* sought separate accounting and not modification of the standard apportionment formula,¹⁴⁴ the reasoning of the *Container* decision applies with equal force to attempts to modify the formula. Both approaches begin with the same fundamental premise that a taxpayer’s unitary business can be divided into segments for purposes of making comparisons of productivity and profitability. Numerous decisions of the United States Supreme Court and the California courts have rejected such

Senate Comm. on Finance, 96th Congress, 2nd Sess. (1980) (statement of Donald C. Lubick, Assistant Secretary of the Treasury for Tax Policy).

141. *Container Corp.*, 463 U.S. at 183 n.20.

142. *See Id.*

143. *Id.* at 184.

144. *Id.* at 181 (citations omitted).

divisions. This is not to say that under all circumstances the finding of a unitary business enterprise will preclude, per se, all arguments against the use of standard, formula apportionment.¹⁴⁵ Indeed, Revenue and Taxation Code section 25137 provides a mechanism for departures from the use of the standard formula, and state tax administrative agencies have created numerous special formulas for certain situations or industries.¹⁴⁶ Also, *Container Corp.* itself impliedly recognized, by its reference to the percentage differences in taxable income between the parties' calculations, that, at some point, standard formula apportionment produces an unconstitutional result. Yet despite the fact that there may be instances in which the standard formula proves to be inappropriate, attempts to modify it under the guise of a separate accounting method clearly are not proper and should be rejected by the courts.

In addition, serious questions exist as to whether a taxpayer that purports to adjust some segment or portion of the factors for its unitary business must do so for all of the factors in every aspect of the unitary business to achieve truly equal profitability or productivity as a theoretical goal. Consider, for example, one method presented by a multinational enterprise which purported to correct the standard apportionment formula to compensate for differing levels of productivity and profitability between domestic and certain foreign operations.¹⁴⁷ The taxpayer, a vertically integrated petroleum corporation, first calculated the value of output (volume of production multiplied by a unit price in dollars) for inside and outside the United States. The taxpayer's payroll was then determined separately for exploration and production activities within and outside the United States. Calculations were then made to determine payroll per dollar of output. These calculations indicated that a dollar of exploration and production payroll for certain foreign operations was much more productive than a dollar of exploration and production payroll for certain domestic operations. The taxpayer then advocated the creation of a "corrected" payroll for these activities for certain of the foreign operations. This corrected payroll was created by assuming the same production levels for these foreign operations as for certain domestic operations. In other words, the taxpayer modified the payroll figures in the apportionment formula for certain foreign operations by pretending that the payroll of these foreign operations was as productive as that of certain domestic operations. The final step was to substitute this "corrected" payroll into the standard apportionment formula for the taxpayer's actual payroll for those foreign operations. Where the calculations showed the foreign operations were more "productive" than the operations in the taxing state, this modification increased the denominator of the standard three-factor apportionment formula,

145. *Id.* at 182-84.

146. *See supra* text accompanying notes 44-62.

147. This example of 'correcting' the standard apportionment formula is taken from Sheffrin, *supra* note 68.

and, in turn, reduced the percentage of the worldwide unitary business income apportioned to the taxing state.

Thus, a taxpayer typically will argue that income is misattributed to California because its unitary business operations in California are less productive or less profitable than operations elsewhere. Assuming that such differences can be accurately measured and that formula apportionment requires comparable productivity or profitability among the factors, a theory of equal productivity logically would dictate that adjustments also be made where the operations in California are more productive than other operations of the unitary business. For example, the taxpayer in *Container Corp.* argued that income was misattributed to California under the apportionment formula because of differences in wage rates between its operations. The taxpayer indicated that for its domestic operations, \$3.34 of payroll, \$10.65 of sales, and \$4.83 of property were required to produce \$1.00 of net income for the years on appeal. The taxpayer also indicated that for its Colombian subsidiary operations, \$0.27 of payroll, \$5.17 of sales, and \$4.74 of property were required to produce \$1.00 of net income for the same years. Container then argued that these figures demonstrated differences in productivity between its domestic and Colombian operations which were uncompensated in the standard apportionment formula and which justified the taxpayer's use of a separate accounting method.¹⁴⁸ In comparison, the figures presented also indicated that for Container's German subsidiary operations, \$3.95 of payroll, \$17.62 of sales, and \$9.73 of property were required to produce \$1.00 of net income for the subject years.¹⁴⁹

The point of this example is that, assuming the standard apportionment formula overtaxes a multinational enterprise if its California payroll, property and sales are less productive than its payroll, property and sales for certain of its foreign operations, then the "pure" formula can undertax that taxpayer where its California operations are more productive than certain of its foreign operations. In theory, an attempt to correct the apportionment formula to provide for equal productivity among the factors should apply to all aspects of the unitary business.

Problems also arise where a taxpayer seeks to correct only a part of the formula for equal productivity or profitability and to establish a misattribution of income to the taxing jurisdiction on the basis of this partial correction. The flaw in this approach is that the standard apportionment formula functions as a single element which cannot be dissected. As noted by the Court in *Container Corp.*, the standard formula used by California has gained widespread approval because the three factors of payroll, property, and sales appear "*in combination*" to reflect a very large share of the activities by which value is generated.¹⁵⁰ The Court also commented on the fact that the three-

148. Appellant's Brief on the Merits at 18, *supra* note 100.

149. *Id.*

150. *Container Corp.*, 463 U.S. at 183, emphasis added.

factor apportionment formula is able to avoid "the sorts of distortions" that were presented in *Hans Rees* where the formula focused upon only one factor.¹⁵¹ Recently, the California State Board of Equalization¹⁵² in Appeal of Evergreen Marine Corporation (Calif.) Ltd.¹⁵³ found, on the basis of California case law, that arguments which focus on only one factor of the apportionment formula have been rejected by the courts and that a challenge must attack each element and show that the formula as a whole unfairly apportions net income to California.

Finally, the economic doctrine of "joint costs" presents serious complications in attempting to establish a misattribution of income to a taxing state on the basis of differences in productivity and profitability among segments of a worldwide unitary business. This doctrine states that the costs of a multiproduct operation can be decomposed into the costs of producing each product separately only if the production of the products is "nonjoint". In other words, if there are important interdependencies in production of products, then the costs cannot be decomposed into the costs for each product.¹⁵⁴ Where there are joint costs, all the factors of production contribute to the costs of producing all products. For this reason, where joint costs exist, productivity of the factors of production cannot be determined by examining the accounting data for any one product.¹⁵⁵

The opinion in *Container Corp.* recognized this concept of joint costs by its references to the fact that California factors may contribute to production by the foreign subsidiaries.¹⁵⁶ In the case of a horizontally or vertically integrated multinational corporation, the presence of joint costs would seem clear. For example, expenses of a multinational petroleum corporation for research and development would, in all probability, constitute joint costs as would marketing and advertising expenses in the case of a multinational corporation engaged in the manufacturing and retail business. Assuming that such costs could be isolated with any degree of precision, they would have to be recognized and isolated when comparing the productivity and profitability of the factors of the standard apportionment formula.

151. *Id.*

152. The California State Board of Equalization hears and determines appeals of taxpayers from deficiency assessments and from the denial of claims for refund by the Franchise Tax Board. CAL. REV. & TAX. CODE §§ 18593-18596; *Id.* §§ 19057-19061; *Id.* §§ 25666-25667; *Id.* §§ 26075-26077 (West 1979 & Supp. 1986).

153. Appeal of Evergreen Marine Corp. (Calif.), Cal. Tax Rep. (CCH) § 401-271 (Cal. St. Bd. of Equal., March 4, 1986), (citing *Chase Brass & Copper Co. v. Franchise Tax Bd.*, 70 Cal. App. 3d 457, 131 Cal. Rptr. 901 (1977) and *Household Finance Co. v. Franchise Tax Bd.*, 230 Cal. App. 2d 926, 931, 41 Cal. Rptr. 565 (1964)). See also *El Dorado Oil Works v. McColgan*, 34 Cal. 2d 731 (1950), *appeal dismissed*, 340 U.S. 801 (1950), *reh'g denied*, 340 U.S. 885 (1950); *McDonnell Douglas Corp. v. Franchise Tax Bd.*, 69 Cal. 2d 506, 446 P.2d 313, 72 Cal. Rptr. 465 (1968).

154. Sheffrin, *supra* note 68.

155. *Id.* at 122-23.

156. *Container Corp.*, *supra*, 463 U.S. at 182.

In summary, attempts to modify the standard apportionment formula face many of the same theoretical objections successfully raised in the courts in opposition to taxpayers' attempts to abandon formula apportionment in favor of separate accounting. *Container Corp.* clearly rejected the use of alleged differences in productivity and profitability among segments of a worldwide unitary business to justify the use of separate accounting. If such a piecemeal analysis of a unitary business cannot be made to argue for abandoning apportionment and using separate accounting, the same type of analysis should not be permitted for the stated goal of modifying the standard formula.

C. *Future Prospects and the Water's Edge Election*

Legislation recently enacted in California will provide certain taxpayers engaged in a unitary business with an alternative to the worldwide combined reporting method currently in use.

Under Senate Bill 85 of 1986,¹⁵⁷ a qualified taxpayer, as defined, whose income is subject to the tax imposed under the Bank and Corporation Tax Law would be allowed to determine its income derived from or attributable to sources within California pursuant to a "water's edge" election.¹⁵⁸ A qualified taxpayer which chooses to make the election will exclude certain foreign operations from the combined report. The exclusion of these foreign operations, in many cases, will alleviate taxpayers' claims of distortion in the standard apportionment formula where it is alleged that differences in productivity and profitability between the foreign and domestic operations of a worldwide unitary business result in a misattribution of income to California.

S.B. 85 of 1986 is a complex legislative package which affects many aspects of California's method for determining the taxable income of a taxpayer engaged in a worldwide unitary business. The following overview, while not intended to provide a comprehensive description, presents a brief explanation of what would be included in the water's-edge group, who is a qualified taxpayer, the mechanism for making the election and the election fee, and the effective date of the legislation.

Under the legislation of 1986 a qualified taxpayer which makes the water's-edge election will take into account the income and apportionment factors of only certain specific affiliated entities.¹⁵⁹ For example, domestic international sales corporations (DISCs) and foreign sales corporations (FSCs), as well as Subpart F income, would be included in the combined

157. 1986 Cal. Stat. 660.

158. *Id.*

159. Section 25110(a) reads in relevant part:

(1) Affiliated banks or corporations which are eligible to be included in a federal consolidated return as described in §§ 1501 to 1505, inclusive, of the Internal Revenue Code.

report of an electing taxpayer. The so-called "80-20 corporations", which are generally defined as United States incorporated entities which conduct over 80 percent of their activities outside the United States, also would be included in the combined report of a taxpayer making the election. Foreign incorporated entities would be included in the combined report of a taxpayer making the election only if the average of their payroll, property, and sales factors within the United States is twenty percent or more.

Only a qualified taxpayer is eligible to make the water's-edge election. A "qualified taxpayer" is a bank or corporation which consents to the taking of

(2) Domestic international sales corporations, as described in §§ 991 through 994 of the Internal Revenue Code and foreign sales corporations as described in §§ 921 through 927 of the Internal Revenue Code.

(3) Any 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.

(4) Banks and corporations which are incorporated in the United States, excluding corporations described in §§ 931 to 936, inclusive, of the Internal Revenue Code, of which more than 50 percent of their stock is controlled directly or indirectly by the same interests, which are not included in paragraph (1).

(5) A Bank or corporation which is not described in paragraphs (1) to (4), inclusive, or paragraph (6), but only to the extent of its income derived from or attributable to sources within the United States and its factors assignable to a location within the United States in accordance with paragraph (3). Income of such a bank or corporation derived from or attributable to sources within the United States shall be limited to and determined from the books of account maintained by the bank or corporation with respect to its activities conducted within the United States as determined by federal income tax law.

(6) Export trade corporations, as described in §§ 970 to 972, inclusive, of the Internal Revenue Code;

(7)(A) The income and factors of the above-enumerated banks and corporations shall be taken into account only if the income and factors would have been taken into account under § 25101 of the California Revenue and Taxation Code if this section had not been enacted.

(B) The income and factors of a bank which is not described in paragraphs (1) to (4), inclusive, and (6) and which is an electing taxpayer under this subdivision shall be taken into account in determining its income only to the extent set forth in paragraph (5).

(8) Any affiliated bank or corporation which is a "controlled foreign corporation", as defined in Section 957 of the Internal Revenue Code, if all or part of the income of that affiliate is defined in Section 952 of Subpart F of the Internal Revenue Code ("Subpart F income"). The income and apportionment factors of any affiliate to be included under this paragraph shall be determined by multiplying the income and apportionment factors of that affiliate without application of this paragraph by a fraction (not to exceed one), the numerator of which is the "Subpart F income" of that bank or corporation and the denominator of which is the "earnings and profits" of that bank or corporation, as defined in Section 964 of the Internal Revenue Code. CAL. REV. & TAX CODE § 25110(a) (West Supp. 1987).

Section 25110(b) reads in relevant part:

An "affiliated bank or corporation", for purposes of this article, means a bank or corporation which is part of one or more chains of banks or corporations connected through stock ownership with a common parent if both of the following exist: (A) Over 50 percent of the voting stock of the bank or corporation is directly or indirectly owned or controlled by one or more of the other banks or corporations. (B) The common parent owns directly or indirectly over 50 percent of the voting stock of at least one of the other banks or corporations. CAL. REV. & TAX CODE § 25110(b) (West Supp. 1987).

depositions from key domestic corporate individuals and to the acceptance of subpoenas duces tecum requiring reasonable production of documents to the Franchise Tax Board as provided in California Revenue and Taxation Code, section 26423, by the State Board of Equalization or by California courts.¹⁶⁰ A "qualified taxpayer" must also agree that any "functionally related dividends" received shall be presumed to be apportionable business income.¹⁶¹

The election must be made by contract with the Franchise Tax Board in the original return filed by the taxpayer for the year at issue. Each contract must be for an initial term of 10 years, and the election may be changed by the taxpayer prior to the end of the 10-year period only with the permission of the Franchise Tax Board.¹⁶² The contract will automatically be extended on its anniversary each year for an additional period of one year. If a taxpayer files a notice of nonrenewal, the contract will expire at the end of its term.¹⁶³ A taxpayer must agree under the contract to pay annually, for the life of the contract, an amount to the Franchise Tax Board for deposit in the California Unitary Fund, created by the legislation.¹⁶⁴ The amount generally will be equal to .03 of one percent of the sum of the taxpayer's California property and payroll for 1986 and California sales for the current year.¹⁶⁵ This amount will be reduced by amounts expended by the taxpayer for new employees or for investment in new plants or facilities in California.¹⁶⁶ The amount will never be less than .01 of one percent of the taxpayer's payroll, property and sales within California for the current year,¹⁶⁷ except that no fee will be imposed for an income year in which a taxpayer incurs no tax liability under either a worldwide combination or an elective water's edge combination.¹⁶⁸

The legislation will be operative for income years beginning on or after January 1, 1988.¹⁶⁹ A qualified taxpayer which wishes to make the water's edge election allowed under this legislation would be able to exclude from the

160. CAL. REV. & TAX CODE § 25110(b)(2) (West Supp. 1987).

161. CAL. REV. & TAX CODE § 25110(b)(2)(B). Generally speaking, "functionally related dividends" are dividends received from either "(i) A bank or corporation of which more than 50 percent of the voting stock is owned, directly or indirectly, by members of the unitary group and which is engaged in the same general line of business"; or "(ii) Any bank or corporation which is either a significant source of supply for the unitary business or a significant purchaser of the output of the unitary business, or which sells a significant part of its output or obtains a significant part of its raw materials or input from the unitary business. "Significant," as used in this subparagraph, means an amount of 15 percent or more of either input or output." *Id.*

162. CAL. REV. & TAX CODE § 25111(a)-(b) (West Supp. 1987).

163. CAL. REV. & TAX CODE § 25111(d) (West Supp. 1987).

164. CAL. REV. & TAX CODE § 25115(a) (West Supp. 1987).

165. CAL. REV. & TAX CODE § 25115(b) (West Supp. 1987).

166. CAL. REV. & TAX CODE § 25115(b)(3) (West Supp. 1987).

167. CAL. REV. & TAX CODE § 25115(h) (West Supp. 1987). An error in S.B. 85 provided that the limit would be "ten-thousandths of the sum" of the taxpayer's property, payroll, and sales in California for the current year. A technical correction was made to S.B. 85 by A.B. 2815, 1986 Cal. Stat. 974, § 5, which fixes the limit at .01 of one percent of that sum.

168. CAL. REV. & TAX CODE § 25115(i) (West Supp. 1987).

169. 1986 Cal. Stat. 660 § 15.

combined report many foreign subsidiary operations which otherwise would be included. This ability to exclude certain foreign operations from the combined report may eliminate one of the most commonly cited examples of alleged distortion under California's worldwide unitary method. For example, a domestic corporation engaged in a unitary business with a wholly-owned foreign subsidiary (which does all of its business overseas) will be able to exclude the foreign subsidiary from the water's-edge group. If the income and apportionment factors of that foreign subsidiary are excluded entirely from the taxpayer's California combined report, there is no issue as to whether the inclusion of the income and factors of that foreign subsidiary in the California combined report would result in a misattribution of income to California. However, if the foreign subsidiary generates Subpart F income, a portion of the subsidiary's income and apportionment factors would still be included in the water's-edge combination under the legislation and may present the distortion issue to a more limited extent.

Thus, the legislation provides qualified electing taxpayers a means by which to exclude certain operations from their California combined report. However, non-electing taxpayers, nonqualified or disqualified taxpayers, and electing taxpayers which conduct foreign operations through entities which would still be included (in whole or in part) in the water's-edge combination, and all taxpayers for income years before 1988, no doubt will continue to raise questions of distortion and misattribution of income, based upon differences in profitability and productivity, under California's standard apportionment formula and unitary method of taxation.

CONCLUSION

The use of formula apportionment to attribute income to the states for income and franchise tax purposes is constantly under attack on the ground that the standard formula impermissibly taxes extraterritorial values. Traditionally, the most common line of attack for taxpayers has been to allege that income not "earned" in a state is taxed by that state by the use of an apportionment formula and the unitary business principle. This contention is usually supported by some type of separate accounting analysis, either by entity or geographic area, which purportedly demonstrates that a lesser amount of income should be attributed to the state. The decisions in *Butler Brothers*, *Exxon* and *Container Corp.* are illustrative of this type of challenge to formula apportionment, and of the notable lack of success by taxpayers who have presented this argument.

Perhaps because of the growth of foreign operations by domestic corporations, a new, more sophisticated version of the traditional argument is being presented to the states. This new approach argues that differing economic conditions throughout the world, and differences in productivity and profitability among segments or subsidiaries of a unitary business enterprise necessitate the use of a modified or adjusted apportionment formula which

purportedly compensates for these differences. However, this approach suffers from many of the flaws common to the more traditional attacks on formula apportionment based upon separate accounting.

The recent enactment in California of legislation providing for a "water's-edge" alternative to worldwide combined reporting, the ever present specter of federal legislation in the area of state income taxation of multinational corporations, and the pronouncement of the Supreme Court in *Container Corp.*¹⁷⁰ that many of these issues are best adjudicated in state courts all lead to the conclusion that this area of state taxation will continue to remain uncertain for many years. For all of these reasons, California's unitary method of taxation, when applied to the operations of a multinational enterprise, will continue to be the subject of administrative and judicial disputes.

170. "It will do the cause of legal certainty little good if this Court turns every colorable claim that a state court erred in a particular application of those principles into a *de novo* adjudication, whose unintended nuances would then spawn further litigation and an avalanche of critical comment. Rather, our task must be to determine whether the state court applied the correct standards to the case; and if it did, whether its judgment 'was within the realm of permissible judgment.'" *Container Corp.*, 463 U.S. at 176 (footnotes omitted).