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Customary International Law and State Taxation of Corporate Income: The Case for the Separate Accounting Method

By
Chantal Thomas

There has been a long and frequently rancorous conflict over the method by which the states of the United States tax the income of multinational corporations. This debate centers on whether a state should tax the income of a component entity of a multinational corporation residing within its borders according to the “separate accounting” approach or the “formulary apportionment” approach. The separate accounting method, also known as the “arm’s length” method, taxes the entity as though it were independent and separate from its corporate family. However, because “commonly controlled corporations . . . usually enter into transactions with each other for the good of the group but which may not maximize profit for each member individually,” transaction costs are adjusted to reflect “the income an entity would have realized had it dealt with its affiliates at arm’s length.”¹ In contrast, the formulary apportionment method, also known as the “unitary” approach, requires the entity to report the income of the entire corporate family, and then takes a percentage of that income that roughly represents the percentage of the family’s operations represented by the resident component entity. This formulary apportionment method rests on the theory that a corporate family functions actuarially as a “unitary business,” so that income from its component entities cannot accurately be calculated with the separate accounting method.²

1. Rosamaria Caballero, *Foreign Multinationals and the Commerce Clause: Should the States Mind Their Own Business?*, 41 *TAX LAW.* 785, 788 (1988).

2. Unitary taxation rests on the theory that activities in each of the [jurisdictions] where an enterprise operates contribute to its overall profit. . . . The system apportions that profit to the States based not on the company’s own internal—and manipulable—accounting conventions, but on a mathematical ‘rough approximation’ of the income ‘that is reasonably related to the activities conducted within the taxing [S]tate.’ The apportionment is generally based on a three factor formula that takes into account the proportion of the company’s property, payroll and sales attributable to its operations in each of the States.

Daniel L. Simmons, *Worldwide Unitary Taxation: Retain and Rationalize or Block at the Water’s Edge?*, 21 *STAN. J. INT’L L.* 157, 162-63 (1986). For an example of the three-factor formula, see COUNCIL OF GOVERNMENTS, *MULTISTATE TAX COMPACT*, art. IV, ¶ 9, reprinted in *ST. & LOC. TAX. SERV. (P-H)* ¶ 6310; see also *MULTISTATE TAX COMM’N, REGULATIONS & GUIDELINES* 2, 6 (1991).

While this debate encompasses all sources of corporate income potentially subject to state income taxation, apportionment of income earned outside the United States — “foreign-source” or “worldwide” income — is by far the most controversial and heatedly disputed issue. The separate accounting method does not necessarily exclude foreign income. For example, under United States federal tax law, income originating elsewhere is attributable to the resident entity if that entity owns some asset or has performed some activity that materially contributed to earning the income.³ The formulary apportionment method, however, automatically taxes income accruing to a resident entity’s foreign affiliates or parent, under the assumption that the very fact of affiliation between the resident and the foreign entity evinces a level of participation of the resident in the foreign entity’s income that justifies taxation of the resident.

Corporations and the states have historically occupied opposing positions in the state corporate income taxation debate. State officials often argue that the formulary apportionment approach more realistically approximates the income of any given component of the corporate family, and that it prevents a corporation from evading taxation by manipulating income between its various components.⁴ Business representatives counter that the formulary apportionment method unfairly extracts excess revenue from resident corporate entities.⁵ Increasingly, foreign corporations doing business in the United States and their respective governments have joined United States corporations in arguing against worldwide or foreign-source formulary apportionment taxation. With the frequent support of the United States government, which itself generally espouses the separate accounting approach,⁶ these actors have argued that the formulary apportionment method of taxing foreign-source income contravenes the international consensus on using the separate accounting method.⁷

Neither side of this dispute has been able to gain a satisfactory legal disposition of the issue. Although the legislature has the power to regulate state tax-

But see IOWA CODE § 422.33(2)(b)(4) (utilizing a single factor test based on sales); *see also* John K. Kane, 43 TAX LAW. 391, 394 (1990).

Note that the unitary approach does not automatically subject every corporate family to apportionment. A conglomerate of divisions that operate independently and without strong central management constitutes a series of separate trades or business that warrant separate taxation of each component. However, “if there is evidence” that corporate components “are integrated with, dependent upon or contribute to each other and the operations of the taxpayer as a whole,” the unitary method will be applied. MULTISTATE TAX COMM’N, REGULATIONS & GUIDELINES, *supra*, at 2. For further discussion of the proper definition of unitary business, see Charles E. McClure, Jr., *Operational Independence Is Not the Appropriate “Bright Line Test” of a Unitary Business—At Least Not Now*, TAX NOTES, Feb. 28, 1983; Jerome Hellerstein, *The Basic Operations Interdependence Requirement of a Unitary Business: A Reply to Charles E. McClure, Jr.*, TAX NOTES, Feb. 28, 1983; Charles E. McClure, Jr., *The Basic Operational Interdependence Test of a Unitary Business: Rejoinder*, TAX NOTES, Oct. 10, 1983.

3. See 26 U.S.C. § 864(c)(4)(B) (allowing tax on income earned outside the U.S. as long as that income is “effectively connected” to the resident entity).

4. See U.S. TREASURY DEP’T, THE FINAL REPORT OF THE WORLDWIDE UNITARY TAXATION WORKING GROUP 2-3 (1984).

5. See *id.* at 2.

6. As indicated, *infra* note 30, the U.S. excepts from this general approach interest deductions, credits and allowances.

7. See *infra* Part IV.

tion of multijurisdictional businesses under the Commerce Clause of the United States Constitution,⁸ Congress has neither explicitly affirmed nor expressly rejected state formulary apportionment taxation of corporate foreign income.⁹ Consequently, the Supreme Court has become the battleground. The Court, and the parties arguing before it in various cases, have treated the issue as one concerning solely domestic law with respect to the constitutional status of state formulary apportionment taxation. Without significant congressional guidance, the Supreme Court has been reluctant to adjudicate the considerable array of issues presented by this problem. Attempting to balance the numerous interests, including state autonomy, facilitation of interstate and international commerce and deference to Congress on issues of federal tax and foreign affairs policies, the Court has proceeded cautiously when it has had to decide whether a state formulary apportionment tax violates the Commerce Clause.¹⁰

Despite growing protest by foreign nations, the Court has remained curiously indifferent to the apparent status of the separate accounting method as an international standard. In the recent case *Barclays Bank PLC v. Franchise Tax Board*,¹¹ the Supreme Court carefully considered and ultimately rejected foreign multinational Barclays Bank's Commerce Clause challenge to California's formulary apportionment taxation.¹² The Court addressed the apparent international consensus on using the separate accounting method in the process of determining whether allowing the unitary method would harm the diplomacy and foreign relations concerns of the federal government, and therefore unduly burden foreign commerce.¹³ The Court concluded, "[w]e cannot agree that 'international practice' has such force as to dictate this Court's Commerce Clause jurisprudence."¹⁴

8. The Commerce Clause allocates to Congress the power "to regulate Commerce with Foreign Nations." U.S. CONST., art. I, § 8, cl. 3. Although state taxation of foreign multinationals does originate in the state power to tax activity within its borders, state taxation that burdens interstate or foreign commerce is deemed to the province of Congress. See LAURENCE H. TRIBE, *AMERICAN CONSTITUTIONAL LAW* § 6-15, 441-45 (2nd ed. 1988). Hence, any Congressional ruling on the matter would preempt conflicting state legislation.

9. See *infra* text accompanying notes 44-45.

10. The Court's determination in this respect reflects its long-standing principle that state regulation of foreign commerce "in the face of congressional silence" is not per se invalid but must comport with the "nationalizing policies perceived to underlie the congressional power delegated in the commerce clause itself" and the "inherently national character of most regulation of external affairs." TRIBE, *supra* note 8, § 6-21 at 468-69.

11. 114 S. Ct. 2268 (1994).

12. *Id.* at 2286. The Court also considered, and dismissed, the Commerce Clause and Due Process Clause challenges of *Colgate-Palmolive Co.*, a domestic multinational corporation. The Court essentially reaffirmed *Container Corp. of America v. Franchise Tax Bd.*'s holding validating the application of the unitary tax to the foreign-source income of domestic multinationals. See *id.* at 2274-76. As explained below, the Court also addressed applicability of the Due Process Clause. However, the bulk of the Court's analysis focused on the Commerce Clause, see *infra* text accompanying notes 54-76, and due process considerations were more or less folded into this analysis, see *infra* note 53.

13. See *Barclays*, 114 S. Ct. at 2281.

14. See *id.* The taxpayers in *Barclays* did not argue that international practice of the separate accounting method constituted a rule of customary international law, but rather that the practice demonstrated that foreign affairs policy militated against state unitary taxation. See *id.*

This article will explore the possibility, heretofore inadequately considered by the Supreme Court, that the "international practice" of the separate accounting method in fact constitutes a rule of customary international law,¹⁵ and therefore may very well bind the states to the separate accounting method. Part I briefly explains the practical and jurisprudential history of the formulary apportionment and separate accounting methods in state corporate income taxation. Part II argues why American courts should apply customary international law to bind the states. Part III sets out a paradigm for identifying a particular international practice as a rule of customary international law. Finally, Part IV applies this paradigm to the evidence surrounding the international application of the separate accounting method.

Establishing the separate accounting method as customary international law would not only properly incorporate valid customary international law into United States law, but would also solve a number of problems left unanswered by the *Barclays* decision. First, the application of such a rule would streamline a currently complicated and indeterminate body of jurisprudence. Second, the rule would resolve a longstanding source of tension between federal and state policy.¹⁶ Third, the rule would spare the United States from the negative reactions of its trading partners, which may range from friction and resentment to retaliation against American multinationals operating within their borders.

I. HISTORICAL AND LEGAL BACKGROUND

A. *A Brief History of the Separate Accounting and Unitary Methods of State Corporate Income Taxation*

"When corporation income taxation first developed in this country, separate accounting for multistate operations was regarded as the most precise and accurate method of determining the income derived from various States."¹⁷ Unfortunately, the separate accounting method gradually accrued several criticisms. First, the administrative expense required to both apply and enforce the method came to be viewed as disproportionate to the benefits of using the method.¹⁸ Second, because many multistate¹⁹ operations seemed to function in fact as "unitary businesses"²⁰ rather than separate entities, the separate account-

15. For a definition and discussion of customary international law, see Parts II and III below.
16. See *infra* text accompanying notes 30-49.

17. NATIONAL TAX ASSOCIATION, *Report of Committee on the Apportionment Between States of Taxes on Mercantile and Manufacturing Business*, in 1922 NATIONAL TAX ASS'N PROCEEDINGS 198, 214-15.

18. See Charles W. Gerstenberg, *Allocation of Business Income*, in 1931 NAT'L TAX ASS'N PROCEEDINGS 301, 306 ("Separate accounting could probably in some cases be made most accurate However, it is very expensive and in most cases would probably be so costly that the tax found to be due under any system of fractional apportionment would be less than the cost of arriving at the tax if this method were used.")

19. By "multistate," I mean multiple states of the United States of America.

20. For discussion of the best definition of unitary business, see Jerome Hellerstein, *Allocation and Apportionment of Dividends and the Delineation of the Unitary Business*, 14 TAX NOTES 155, 165-67 (1982); McClure, *supra* note 2, at 107; CHARLES E. McCLURE, JR., *Defining a Unitary Business*:

ing method appeared prone to artificiality and inaccuracy.²¹ Finally, the rise of multistate corporations amplified these concerns by drastically increasing the number of multijurisdictional taxable enterprises.²² As a result, many states ceased employing the separate accounting method to tax corporations with multistate operations and began to employ the formulary apportionment approach.²³

Although ultimately about half the states that levy corporate income taxes adopted the formulary apportionment method in taxing the interstate business of multistate operations,²⁴ even those states applied the separate accounting method to international business income.²⁵ Applying the formulary apportionment method to corporate income from foreign operations seemed incongruous with the idea that interstate business and international business were irreducibly different for tax purposes.²⁶ In addition, some of the earliest supporters of applying the separate accounting method to international business income and formulary apportionment to interstate business advanced the following arguments:

1. Differences in language in international business necessitating general differences in the financial records of the foreign divisions of a business.
2. Differences in methods of conducting foreign businesses and interstate businesses.
3. The different theories of profit realization upon which foreign branches and domestic branches are likely to be based.
4. Differences in the manner in which certain tax laws affect international but not interstate income taxation.
5. Differences in the competitive objectives and motives in domestic and foreign business involving in the case of international businesses.
6. Differences in constitutional limitations on the power to tax.²⁷

An Economist's View, in THE STATE CORPORATE INCOME TAX: ISSUES IN WORLDWIDE UNITARY TAX COMBINATION 89-124 (Charles E. McClure, Jr. ed., 1984).

21. See, e.g., COHEN, APPORTIONMENT AND ALLOCATION FORMULAE AND FACTORS USED BY STATES IN LEVYING TAXES BASED ON OR MEASURED BY NET INCOME OF MANUFACTURING, DISTRIBUTIVE AND EXTRACTIVE CORPORATIONS (1954) (report for the Controllershship Foundation); Jerome R. Hellerstein, *The Unitary Business Principle and Multicorporate Enterprises: An examination of the Major Controversies*, 27 TAX EXEC. 313 (1975).

22. See 1 WILLIS COMMISSION REPORT 160-67 (1965).

23. See JEROME R. HELLERSTEIN & WALTER HELLERSTEIN, STATE AND LOCAL TAXATION: CASES AND MATERIALS (4th ed. 1978); David M. Hudson & Daniel C. Turner, *International and Interstate Approaches to Taxing Business Income*, 6 NW J. INT'L L. & BUS. 562, 563 (1984). The unitary method of taxing multistate operations was adopted by the National Conference of Commissioners on Uniform State Laws. See UNIFORM DIVISION OF INCOME FOR TAX PURPOSES ACT (UDITPA) § 18 (1957). See Mark F. Somer, *The Unitary Filing Method in Kentucky: Dead or Alive?*, 10 J. ST. TAX'N 59, 60 & n.5 (1991).

24. See U.S. TREASURY DEP'T, *supra* note 4, at 1.

25. See *Hearings Before the Subcomm. on Taxation and Debt Management of the Comm. on Finance*, 99th Cong., 2nd Sess. 5 (1986).

26. See GERSTENBERG, *supra* note 18, at 301; see also David M. Hudson & Daniel C. Turner, *International and Interstate Approaches to Taxing Business Income*, 6 NW J. INT'L L. & BUS. 562 (1984); Joann E. Weiner, *Annex 9C, Tax Coordination and Competition in the United States of America*, in EC COMMITTEE OF INDEPENDENT EXPERTS ON COMPANY TAXATION, REPORT OF THE COMMITTEE ON INDEPENDENT EXPERTS ON COMPANY TAXATION, reprinted in 92 TAX NOTES INT'L 36-15 (1992) (noting that the Fiscal Committee of the League of Nations "issued two recommendations to avoid international and inter-state double taxation: (i) use separate accounting in international matters, and (ii) use formula apportionment in state matters").

27. GERSTENBERG, *supra* note 18, at 302.

Meanwhile, the separate accounting method of taxing foreign corporations gained increasing endorsement in the international arena.²⁸ The League of Nations first developed the separate accounting approach in a series of multilateral and bilateral “model treaties.” After World War II, the Organization for Economic Cooperation and Development (OECD) and the United Nations incorporated the principle of separate accounting into model bilateral treaties that both developed and developing countries implemented in thousands of agreements.²⁹ The United States embraced the separate accounting method in its Internal Revenue Code.³⁰ Despite a seemingly firm consensus both among nations and among a majority of the states within the United States, a few states began to apply the formulary apportionment method to corporate income earned in foreign countries.³¹ For what was apparently some time after the second World War, “the business community [attempted] to change the method by which a relatively small group of states taxed multinational corporations, and the states [fought] to maintain what they thought to be an extension of the unitary concept of taxation.”³²

28. For a dissenting view, see Stanley I. Langbein, *The Unitary Method and the Myth of Arm's Length*, 30 TAX NOTES 625 (1986). For a more extensive discussion of Langbein's disagreement, see *infra* at notes 150-57.

29. See *infra* text accompanying notes 161-177.

30. See 26 U.S.C. § 1482-1(b). This section instructs that “[i]n the case of a controlled taxpayer, the taxable income . . . [shall be the taxable income] which would have resulted to the controlled taxpayer, had it in the conduct of its affairs . . . dealt with the other member or members of the group at arm's length.” However, interest, deductions, credits and allowances are excepted from this general rule.

31. See Weiner, *supra* note 26 (stating that, presumably for both U.S. and foreign multinationals, “unitary taxation remained largely a domestic matter through the mid-1970s” but that after this point states began an “increasing use of world-wide unitary combination”). There are several possibilities as to the reasons for this change. The first is the most theoretically straightforward, and stems from the fact that both separate accounting and unitary methods seek to tax income according to source—that is the contention that the separate accounting method simply did not yield accurate results. However, this contention seems to rest not on a methodological disagreement, but on conceptual differences in the bounds of the term “source.” The State of California asserted as the theory behind the unitary method that “it is unrealistic geographically to isolate income derived from the intangible flow of value among the parts of a unitary business.” See *Barclays Bank Int'l, Ltd. v. Franchise Tax Bd.*, 275 Cal. Rptr. 626 (Cal. Ct. App. 1990). Thus, the unitary method begins with the premise that the term “source” transcends geographical boundaries. By contrast, separate accounting begins with the premise that it does not, and makes exceptions to that premise only when some evidentiary standard is met to show that foreign income can be attributed to a domestic entity. Another, less flattering description of the motivation behind state unitary tax centers on the widespread feeling among commentators that the unitary tax program results in significantly higher revenue. See, e.g., James C. Rosapepe & Gerald H. Goldberg, *The Revenue Effects of the Unitary Method: Two Responses to Shell's Views*, TAX NOTES, Jan. 9, 1984 (estimating that the prohibition of unitary tax would cost states “more than \$700 million in lost revenue”); Carl Hall, *Unitary Tax Gets Hearing: Losing Would Be Costly for State*, S.F. CHRON., Nov. 2, 1993, at B1; *Unitary Tax Upheld; Ruling Could Affect \$3 Billion in Revenue*, SACRAMENTO BEE, Nov. 24, 1992, at B6. But see Norman E. Rusch & J. Lloyd Kennedy, *Once Again, We Question the Alleged Revenue Effects of Restricting Use of the Worldwide Unitary Tax*, TAX NOTES, Feb. 20, 1984 (questioning the reliability of such estimates). The rationale seems to be that, if the resident entity plays a greater role in the corporation's worldwide income than is represented by its separately accounted income, the state's tax intake will be greater, but a reverse “shrinking” effect due to calculation of worldwide income is unlikely.

32. Fred E. Ferguson, *Worldwide Unitary Taxation: The End Appears Near*, 4 J. ST. TAX'N 241, 241 (1986). At the time *Container* was decided, 12 states employed the unitary method to-

The 1983 decision *Container Corp. of America v. Franchise Tax Board*³³ brought this struggle to national public attention. In *Container*, the Supreme Court affirmed the formulary apportionment taxation method.³⁴ The Reagan Administration reacted by taking a number of steps to eliminate state formulary apportionment taxation of multinationals. "In the wake of the *Container* decision, members of the business community and major trading partners of the United States renewed their objections to the worldwide unitary tax and urged the Administration to: (1) file a memorandum with the Supreme Court as amicus curiae in support of a rehearing in the *Container* case; and (2) support federal legislation that would limit or prohibit worldwide unitary taxation."³⁵ In order to seek a more consensual resolution of the issue, the Administration chose to refrain from direct intervention and instead established a task force comprised of "an equally weighted number of representatives from business (domestic and foreign-parent), the [S]tates (elected, administrative, and quasi-governmental), and the federal arena (administrative and quasi-governmental)."³⁶ The Administration emphasized that establishment of this voluntary task force, instead of more direct action, stemmed not from "any lack of authority."³⁷ Accordingly, Secretary of State Donald Regan "made it clear . . . that if he did not see a movement on the part of the States . . . he would recommend to the President that the administration open the subject of Federal legislation again."³⁸

In 1984, the Worldwide Unitary Taxation Working Group issued the Final Report discouraging the formulary apportionment method and advocating that the separate accounting method be applied to foreign-source income.³⁹ Nonetheless, some states continued to resist the separate accounting standard.⁴⁰ Thus, in November of 1985 President Reagan issued a detailed statement calling

wards foreign corporate income—Alaska, California, Colorado, Florida, Idaho, Indiana, Massachusetts, Montana, New Hampshire, North Dakota, Oregon and Utah. See 1984 DAILY TAX REPORT (BNA) No. 85, at G-9 (May 2, 1984).

33. 463 U.S. 159 (1983).

34. For a discussion of the *Container* decision, see *infra* text accompanying notes 63-65.

35. U.S. TREASURY DEP'T, *supra* note 4, at 3 (1984). These major trading partners included Japan and the members of the European Community. See *id.*

36. Ferguson, *supra* note 32, at 242.

37. 1985 Senate Hearings, at 44.

38. *Id.*

39. See generally *id.* The Working Group proposed a "water's edge" method similar to the one that California ultimately adopted, see *infra* at 47, which allowed unitary taxation of domestic income but required separate accounting to be applied to foreign income. See U.S. TREASURY DEP'T, *supra* note 4, at 9. The Group carefully laid out the opposing viewpoints (termed "concerns of critics of worldwide unitary taxation" and "concerns of critics of separate accounting," see *id.* at 7-8, but took equal care not to express any substantive justifications for the suggestions made in the Report. However, in the statements of individual working group members appended to the report, significant weight was given to the fact that "few issues have provoked so broad and intense a reaction" and "such sharp criticism from all of our major trading partners." *Id.* (statement of Allen Wallis, Under Secretary of State for Economic Affairs).

40. See Ferguson, *supra* note 32, at 250-54 (noting that despite the Administration's efforts, seven states—Alaska, California, Idaho, Montana, New Hampshire, North Dakota and Utah—continued to apply the worldwide unitary method).

for federal legislation to preempt state formulary apportionment taxation.⁴¹ In December of 1985, the Treasury Department introduced its "Unitary Tax Repealer Act."⁴² The Act sought to "prohibit the general use of worldwide combination" and "restrict state taxation of foreign-source dividends."⁴³ Congress considered the passage of the Act in 1985 and again in 1987.⁴⁴ Nonetheless, urgings by state representatives not to unduly disturb the balance of taxing power between the federal and state governments, as well as the repeal by all but one state of its worldwide unitary income legislation, ultimately persuaded Congress to decline from enacting preemptive federal tax law.⁴⁵

Thus, the legislative and executive branches of the federal government recognized the existence of an internationally accepted standard and recognized that the states were breaching that standard. They ultimately opted, however, to encourage the states to reform in ways that, at least formally, recognized the powerful constitutional interest in protecting state taxing power. Both in response to this activity, and to avoid losing corporate business,⁴⁶ most of the wayward states repealed their formulary apportionment multinational income tax legislation;⁴⁷ and some states took "preventive" action by passing laws prohibiting the method.⁴⁸ Today, only Alaska continues to practice formulary apportionment taxation.⁴⁹

Despite this capitulation by most the states, foreign multinationals continue to fear that formulary apportionment taxation might take hold again at some point in the future. This uncertainty has generated considerable frustration, prompting one foreign commentator to decry the United States tax system as "an

41. See Ferguson, *supra* note 32, at 241, 254; Anne Swardson, *Unitary Tax Ban Sought By Reagan*, WASH. POST., November 9, 1985, at C1.

42. See Ferguson, *supra* note 32, at 242-57.

43. *Id.* at 255.

44. See generally *Hearings Before the Subcomm. on Taxation and Debt Management of the Comm. on Finance*, 99th Cong., 2nd Sess. S361-25 (1986); *Hearings Before the Subcomm. on International Economic Policy of the Comm. on Foreign Relations*, 98th Cong., 2nd Sess. S381-20 (1984).

45. See Ferguson, *supra* note 32, at 260.

46. See Jerome Hellerstein, *Selected Issues in State Business Taxation*, 39 VAND. L. REV. 1033, 1034-36 (observing that many states were motivated to repeal unitary tax legislation by fear that their resident businesses would relocate). *But cf. id.* at 1036 (noting that empirical evidence suggests that tax legislation only minimally affects business location decisions).

47. See *id.* at 245. California abandoned its unitary approach in favor of a "water's edge" approach of the sort recommended by the Worldwide Unitary Taxation Working Group. See U.S. TREASURY DEP'T, *supra* note 4 at 9. The water's edge provisions allowed "taxpayers to elect to limit the reach of CA's taxing jurisdiction to those activities occurring within the boundaries of the United States." Thus, the water's edge approach allowed the combined reporting that formed the basis for formulary apportionment, but limited "the combined reporting group to include . . . only those entities having business activities within the geographic boundaries of the United States." Ruurd G. Leegstra et al., *The California Water's-Edge Election*, 6 J. ST. TAX'N 195, 197 (1987); see also Martin Helmke, *Analysis of California's Proposed "Water's Edge" Reform* (SB 671), 93 ST. TAX NOTES 165-5 (1993).

In addition to California, Idaho, Montana, North Dakota, and Utah allow a water's edge election; and New Mexico and West Virginia allow corporations to choose whether to be subject to formulary apportionment of worldwide income or domestic income. See Weiner, *supra* note 26, at TAN 18.

48. See Weiner, *supra* note 26, at TAN 18.

49. See *id.*

intolerable patchwork situation in which each state . . . devises its own tax laws . . . and each has its own tax bureaucracy.”⁵⁰ One consequence of this state of affairs was the reluctance of several countries to establish tax treaties with the United States, because it seemed irrational to “make a tax treaty with a nation which will contract to some of its major taxes but not as to others.”⁵¹

B. Supreme Court Jurisprudence on the Formulary Apportionment Method

Although Congress has preemptive power over the issue of state income taxation of multijurisdictional corporations,⁵² it has so far refrained from legislating this issue in the hope that the states will independently conform to the separate accounting standard. Consequently, the legal limits on state taxation have emerged almost entirely from decisions of the United States Supreme Court.⁵³ This jurisprudence originated in claims by domestic multistate — and ultimately foreign multinational — corporations against state use of the formulary apportionment method in levying income tax.

1. Multistate Corporations

The Court’s jurisprudence regarding the applicability of the Commerce Clause to state taxation has wavered over the decades.⁵⁴ In 1951, the Court held that states could not constitutionally levy income tax on corporate earnings derived exclusively from interstate business, “no matter how fairly [the income] is

50. Philip T. Kaplan, *Reasons, Old and New, for the Erosion of United States Tax Treaties*, 1986 BR. TAX REV. 211, 217-18.

51. *Id.* at 219 & n.29; see also Brief of the Committee on State Taxation as Amicus Curiae In Support of Petitioners, *Barclays*, 114 S. Ct. 2268 (No. 92-1389) (noting difficulties experienced by the U.S. in negotiating tax treaties with Denmark, Germany, Canada and France). Mr. Kaplan added that “much of the international furor created by unitary taxation of foreign-based groups derives from incredulity that such a result could be judicially imposed.” Kaplan, *supra* note 50, at 227.

52. U.S. CONST., art. I, § 8, cl. 3; *supra* note 8. Although it is generally true that the U.S. tax system is a federal and state “patchwork,” this heterogeneity of tax laws towards foreign companies is of special concern—to them, because it is the aspect of U.S. tax law which most affects them—and to the U.S. because of the policy of uniformity in federal affairs. See *infra* text accompanying notes 71-72.

53. The Court has applied the Due Process Clause as well as the Commerce Clause to State income taxation of multijurisdictional corporations. Under the Court’s jurisprudence, the Due Process Clause requires that a corporation must establish a “minimal connection” in the taxing state by engaging in “substantial income producing activity” before becoming constitutionally subject to state income tax. See *Northwestern States Portland Cement Co. v. Minnesota*, 358 U.S. 450, 464-65 (1959); *Stockham Valves & Fittings, Inc.*, 358 U.S. 450, 464-65 (1959). The Due Process Clause also requires that a rational relationship exist between the in-state activities of the enterprise and the income which the state taxed. See *Mobil Oil v. Commissioner*, 445 U.S. 425, 436-37 (1980); *Morrman Mfg. Co. v. Bair*, 437 U.S. 267, 272-73 (1978). The Court has interpreted this requirement as allowing [S]tates to apply the unitary taxation method to multistate corporations as long as the combined income of the corporation is “fairly apportioned.” See *Mobil Oil*, 445 U.S. at 436-37. The Court did not consider the applicability of this rule to a foreign corporation until *Barclays*, 114 S. Ct. at 2271-72. See *infra* at text accompanying notes 66-67. The essential elements of the Court’s Due Process Clause jurisprudence seem to have been incorporated into the Court’s Commerce Clause jurisprudence. See David M. Hudson & Daniel C. Turner, *International and Interstate Approaches to Taxing Business Income*, 6 NW J. INT’L L. & BUS. 562, 591 (1984).

54. For a fuller history of the Court’s jurisprudence on this subject, see Hudson & Turner, *supra* note 53, at 588-91.

apportioned to business done within the state.”⁵⁵ However, the Court came to reject this principle as bearing “no relationship to economic realities” of interdependence and integration in the modern corporate structure.⁵⁶ Accordingly, in 1977, the Court revamped its standard in *Complete Auto Transit, Inc. v. Brady*.⁵⁷ In *Brady*, the Court held that state taxation of a multistate corporation is valid if (1) “the tax is applied to an activity with a substantial nexus with the taxing state”; (2) the tax is “fairly apportioned”; (3) the tax “does not discriminate against interstate commerce”; and (4) the tax is “fairly related to the services provided by the State.”⁵⁸ In subsequent years the Court continued to reinforce the principle that the combined earnings of a multistate corporation could fairly be taxed by apportionment if the various component entities of the corporation functioned as a “unitary business,”⁵⁹ i.e. the “unitary business principle.”⁶⁰

2. Multinational Corporations

The Court applied more caution in determining the constitutionality of states’ formulary apportionment taxation of United States-based multinational corporations. Nonetheless, the Court upheld the “unitary business principle” in this context as well.⁶¹ In doing so, the Court dismissed the assertions that for-

55. *Spector Motor Service, Inc. v. O’Connor*, 340 U.S. 602, 609 (1951).

56. *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274, 279 (1977).

57. *Id.* The Court concluded, “[W]e now reject the rule of *Spector Motor Service, Inc. v. O’Connor*, that a tax on the ‘privilege of doing business’ is per se unconstitutional when it is applied to interstate commerce, and that case is overruled.” *Id.* at 591. The court upheld unitary taxation of multistate operations in contemporaneous cases. See, e.g., *Exxon Corp. v. Dep’t of Revenue of Wis.*, 447 U.S. 207, 227-30 (1980). This line of decisions should not be taken to mean that the Supreme Court strictly upheld the separate accounting method before the time that *Complete Auto* recognized the unitary method of state income taxation. The Court had in fact upheld the “taxability” of income from another state, noting the failure of separate accounting to recognize earnings resulting from “functional integration, centralization of management, and economies of scale.” *Mobil Oil*, 445 U.S. at 438 (citing *Butler Bros. v. McColgan*, 315 U.S. 501, 506-08 (1942); *Ford Motor Co. v. Beauchamp*, 308 U.S. 331, 336 (1939)).

58. *Brady*, 430 U.S. at 279.

59. For examinations of the Supreme Court’s definition of “unitary business,” see James A. Mirage, *A Solidification of the Unitary Business Principle: Allied-Signal, Inc. v. Director, Division of Taxation*, 46 TAX LAW. 541 (1993); Charles E. Watson, II, *Taxing the Fruit from Your Neighbor’s Vineyard: Amerada Hess Corp. v. Director, Division of Taxation*, 43 TAX LAW. 565 (1990); Mohan, *The Unitary Concept Today*, 5 J. ST. TAX’N 57 (1986).

60. See, e.g., *Allied-Signal Inc. v. Director*, 112 S. Ct. 2251 (1992).

61. See *Container Corp. of America v. Franchise Tax Bd.*, 463 U.S. 159, 175-80 (1983); *F.W. Woolworth Co. v. Taxation and Rev. Dep’t of N.M.*, 458 U.S. 354, 362 (1982); *ASARCO, Inc. v. Idaho State Tax Comm’n*, 458 U.S. 307, 317 (1982); *Mobil Oil*, 445 U.S. at 439 (“[T]he linchpin of apportionability in the field of [S]tate income taxation is the unitary-business principle.”). For more extensive analysis of the Court’s “unitary-business principle” to MNC, see generally Phillip I. Blumberg, *The Corporate Entity in an Era of Multinational Corporations*, 15 DEL. J. CORP. L. 283, 345-55 (1990); Valeri Collanton, *State Unitary Tax: The “Risk” of Container Corp.*, 9 HASTINGS INT’L & COMP. L. REV. 59 (1988); Lewis Kaden, *State Taxation of Multinational Corporations*, 32 CATH. U. L. REV. 829, 835-49 (1983). In “upholding” the unitary business principle, the Supreme Court never mandated it. Rather, “[a]lthough the high court [] refused to impose ‘national uniform rules for the division of income’ rooted in the Commerce Clause, it [] repeatedly validated the comparative empirical accuracy and constitutional adequacy of formulary apportionment.” *Barclays Bank International, Ltd. v. Franchise Tax Bd.*, Sacto. Super. Ct. No. 325059, reprinted in 92 ST. TAX NOTES 94-1 (1992).

eign source income could not constitutionally be taxed and that the danger of multiple taxation increased significantly with the apportionment of foreign source income.⁶² In *Container Corp. of America v. Franchise Tax Board*,⁶³ the Court closed the issue when it rejected the United States-based multinational corporation's claim that California's worldwide unitary income taxation violated the Commerce Clause.⁶⁴ In *Container*, the Court affirmed its previous holdings and further added that it need not defer to national foreign affairs concerns because the tax in question fell "not on the foreign owners of an instrumentality of foreign commerce, but on a corporation domiciled and headquartered in the United States."⁶⁵

3. Foreign Multinational Corporations

In adjudicating challenges by American corporations to state formulary apportionment taxation, the Court developed a complex jurisprudence. Without Congressional guidance, the Court was loathe to overturn state taxation methods. At the same time, it struggled to resolve the problematic aspects of the formulary apportionment tax. Nonetheless, by the 1980s the message of the Court seemed fairly straightforward: in the absence of Congressional stipulation otherwise, and barring gross misapportionment, the Court was not prepared to invalidate state formulary apportionment taxation of foreign income.

The Court, however, had never addressed the propriety of formulary apportionment taxation with regard to foreign multinational corporations. In *Barclays*,⁶⁶ which was decided during the 1994 Term,⁶⁷ the Court faced precisely this issue. Several considerations complicated the Court's analysis in this "unique context of foreign commerce."⁶⁸ To begin, the Court recognized an "enhanced risk of multiple taxation" in applying the formulary apportionment method to foreign multinationals.⁶⁹ Although the dissent objected to multiple taxation that contravened "international practice" and occurred as a result of a foreign corporation's "lack of access to the political process," the Court decided that the risk of multiple taxation of foreign multinationals offended the constitution no more than the risk of multiple taxation of American multinationals.⁷⁰

62. See, e.g., *Mobil Oil*, 445 U.S. at 446-49.

63. 463 U.S. 159, 175-80 (1983).

64. See *id.* at 184-97.

65. *Id.* at 188.

66. 114 S. Ct. 2268.

67. See *id.* at 2271-72. *Barclays* was tried together with the case *Colgate-Palmolive Co. v. Franchise Tax Board of California*, see *id.* at 2268, a challenge by a U.S.-based MNC to California's unitary tax, see *id.* at xx. The Court's holdings on *Colgate's* challenges more or less restated its *Container* opinion. See *id.* at 2276-77.

68. *Wardair Canada, Inc. v. Florida Dep't of Revenue*, 477 U.S. 1, 8 (1986).

69. See *Barclays*, 114 S. Ct. at 2279 (quoting *Container Corp.*, 463 U.S. at 185).

70. *Barclays*, 114 S. Ct. at 2279-81. It should be noted that other areas of U.S. law specifically affecting corporations recognize and affirm the difference between foreign and U.S.-based multinational corporations. For example, American and foreign multinationals are subject to markedly different sets of regulations in raising capital through securities. See generally Raymer W. McQuiston, *Rule 144A, Regulation S and Amending the Glass-Steagall Act: A New Look at Foreign Banks and Foreign Issuers Participating in the United States Securities Market*, 17 SYRACUSE J.

In addition, the Court took care to mind the importance that the United States act as a "single government with unified and adequate national power" in questions relating to international trade.⁷¹ In this light, the Court considered the degree to which the need for a uniform national approach towards foreign nationals, shaped by federal tax policy, should influence state tax policy. The Court examined numerous Congressional materials and concluded, because Congress had not explicitly discouraged state formulary apportionment taxation of foreign multinationals, federal tax policy did not preempt such state taxation.⁷² In addition, the Court scrutinized various presidential documents for evidence of a "clear federal directive"⁷³ against the state formulary apportionment tax. The Court found that the evidence of executive preference of the separate accounting method could not override state practices that were apparently "congressionally condoned," since Congress retained ultimate authority over this issue and had seemingly not delegated that power to the President.⁷⁴ Moreover, none of the materials had "the force of law" sufficient to place them in the realm of presidential activities that could preempt or displace conflicting state law.⁷⁵

Thus, in adjudicating the validity of state formulary apportionment taxation of foreign multinational corporations, the Court grappled with two core debates: (1) the conflict between the constitutional value placed on state fiscal sovereignty and the protection of foreign commerce; and (2) the conflict between the federalist structure and the need for a uniform, federally guided tax policy. Moreover, the Court was confronted with often indeterminate substantive taxation analyses and sensitive issues of foreign relations. Ultimately, the Court choose not to disrupt the legislative silence maintained by Congress. As a result, the Court's "rulings demonstrate the highest tolerance imaginable for [s]tate tax schemes, in conjunction with their characterization as policy questions that should be deferred to Congress."⁷⁶

INT'L L. & COMM. 171 (1991). The reasons for this difference probably stem primarily from some combination of a recognition of the significant differences in accounting and other recordkeeping practices in other countries and desire to encourage trade by minimizing political hostilities that might result from more constraining rules. *See id.* at 171.

71. *Japan Line, Ltd. v. County of Los Angeles*, 441 U.S. 434, 448 (1979) (quoting *Board of Trustees v. United States*, 289 U.S. 48, 59 (1933)); *see also Wardair*, 477 U.S. at 8.

72. *Barclays*, 114 S. Ct. at 2283-85.

73. *Id.* at 2285 (quoting Brief for Petitioner, No. 92-1839, at 36).

74. As the Court noted, "Congress may 'delegate very large grants of its power over foreign commerce to the President.'" *Id.* at 2286 (quoting *Chicago & Southern Air Lines, Inc. v. Waterman S.S. Corp.*, 333 U.S. 103 (1948)).

75. *Barclays*, 114 S. Ct. at 2286. The Court thus asserted that it "need not here consider the scope of the President's power to preempt state law pursuant to authority delegated by a statute or a ratified treaty; nor do we address whether the President may displace state law pursuant to legally binding executive agreements with foreign nations made 'in the absence of either a congressional grant or denial of authority, [where] he can only rely upon his own independent powers.'" *Id.* (citations omitted).

76. J. William McArthur, Jr. & Kendall L. Houghton, *In Barclays*, United States Supreme Court Finds for California, Which Was Banking on It, 81 J. TAX'N 176 (1994).

II. CUSTOMARY INTERNATIONAL LAW AND THE STATES

The argument that the separate accounting method constitutes a rule of customary international law and therefore must bind state taxation of multijurisdictional income might provide the Supreme Court with a solid basis upon which to build a more authoritative jurisprudence. However, it must first be established that customary international law is in fact binding upon the states.

The Restatement of Foreign Relations Law of the United States states that “[i]t is now established that customary international law in the United States is a kind of federal law, and like treaties and other international agreements, it is accorded supremacy over State law by Article VI of the Constitution. Hence, determinations of international law by the Supreme Court of the United States, like its interpretations of international agreements, are binding on the states.”⁷⁷ A court adjudicating an issue to which a rule of customary international law applies must heed that law “where there is no treaty and no controlling executive or legislative act or judicial decision.”⁷⁸

Although scholars of international law have generally affirmed this view,⁷⁹ some scholars have argued against it. In particular, Phillip Trimble’s arguments are representative of the view that customary international law is not binding upon the states.⁸⁰ Trimble asserts that as a normative matter Congress, not the

77. RESTATEMENT (THIRD) OF THE FOREIGN RELATIONS LAW OF THE UNITED STATES 41 (1987 & Supp.) [hereinafter RESTATEMENT]; see also *id.* § 111 cmt. d; *id.* § 112(2) cmt. a.

78. *The Paquete Habana*, 175 U.S. 677, 700 (1900).

79. See, e.g., RICHARD FALK, *THE ROLE OF DOMESTIC COURTS IN THE INTERNATIONAL LEGAL ORDER* (1964); Louis Henkin, *International Law as Law in the United States*, 82 MICH. L. REV. 1555 (1984). While it is generally agreed that customary international law is binding U.S. law, there has been some discussion of the precise doctrinal basis for that status. Many scholars have described customary international law as a type of federal or constitutional common law. See LOUIS HENKIN, *FOREIGN AFFAIRS AND THE CONSTITUTION* 222-23 (1972); Phillip R. Trimble, *A Revisionist View of Customary International Law*, 33 UCLA L. REV. 665, 671 & n.25 (1986). However, others have warned against describing customary international law in this manner, since “[u]nlike federal common law, customary international law is not made and developed by the federal courts independently and in the exercise of their own law-making judgment.” Henkin, *supra*, at 1561. Thus “federal courts find international law rather than make it.” *Id.* at 1561-62. Note, however, that customary international law can supersede prior conflicting federal law, but can also be superseded by subsequent conflicting federal law. Thus, a determination by Congress or the Supreme Court that the international rule of separate accounting did not bind the states would overturn the rule of separate accounting as U.S. law. However, neither the Supreme Court nor Congress has yet considered the method of separate accounting as a rule of customary international law. In addition, customary international law is U.S. law only insofar as it is consistent with the U.S. Constitution. See Henkin, *supra*, at 1566. Therefore, if the Constitution reserves a particular power to the states, and a rule of customary international law seeks to interfere with the states’ exercise of that power, the rule is not valid U.S. law. Accordingly, one might argue that the states possess a constitutional right to tax income within their borders, and therefore a customary international rule of taxation does not apply to the states. However, apart from the fact that the states’ power to tax is not enumerated in the Constitution but rather is inferred from common law, see TRIBE, *supra* note 8, § 7-4 at 554, the Supreme Court has established that the taxation of all interstate and foreign income is a power belonging to Congress under the Commerce Clause. See *id.* § 6-15, 441-45. Because this power is “dormant” unless affirmatively exercised, see *id.* § 6-3, at 404-08, a rule of customary international law is valid U.S. law and binding upon the states in the absence of conflicting Congressional action.

80. See generally Trimble, *supra* note 79, at 665; see also Phillip R. Trimble, *Foreign Policy Frustrated—Dames & Moore, Claims Court Jurisdiction and a New Raid on the Treasury*, 84

courts, should determine and apply customary international law in the United States context. "If the courts become capable of applying customary international law," Trimble worries, the distribution of power among the branches of the United States federal government might change for the worse.⁸¹ "[T]he judiciary will acquire another tool with which to strike down acts of Congress."⁸² As a result, "[t]he lawmaking power of Congress might shift to the President, in light of the Executive's primacy in foreign affairs, or to the judiciary, armed with the power to declare customary international law. Legislative power could even pass completely out of the government structure."⁸³

Though novel in the context of customary international law, Trimble's objection boils down to a familiar argument about the judiciary's role. In the domestic context, the controversy over the proper judicial role in law-making is an ongoing and perhaps unsolvable one which judges must face and decide anew in every case. Although the international context certainly demands more deference by domestic courts to their executive and legislative counterparts than is warranted with respect to domestic legal issues, Trimble does not explain why the international legal regime is so different that it leaves absolutely no room for domestic courts.

Trimble also argues that from a practical standpoint customary international law carries no force in American courts because these courts traditionally rarely apply it, for the most part, leaving it instead to the "political branch[es]" to resolve.⁸⁴ In reality, however, American courts have hardly seemed as hesitant to apply customary international law as Trimble suggests. Federal courts have a long, although discreet, history of assessing and applying customary international law. This is particularly true with respect to expropriations,⁸⁵ international human rights,⁸⁶ extraterritorial jurisdiction,⁸⁷ enforcement of treaties,⁸⁸ and commercial litigation.⁸⁹

When courts have deferred questions to the President or to Congress, they have primarily done so on grounds of comity, separation of powers, or judicial incompetence.⁹⁰ The doctrine of comity was primarily used to justify the enforcement of foreign government decisions in American courts.⁹¹ The doctrines of separation of powers and judicial incompetence were established during the

COLUM. L. REV. 317 (1984). For a similar view, see Scharpf, *Judicial Review and the Political Question: A Functional Analysis*, 75 YALE L.J. 517 (1966).

81. *Id.* at 684, 682-84.

82. *Id.* at 684.

83. *Id.* at 682.

84. *See id.* at 684-707 (describing various issues of customary international law in which the courts have deferred to "political branch direction").

85. *See generally* Lea Brilmayer, *International Law in American Courts: A Modest Proposal*, 100 YALE L.J. 2277, text accompanying notes 37-45 (1991).

86. *See generally id.* at text accompanying notes 46-51.

87. *See generally id.* at text accompanying notes 54-58.

88. *See generally id.* at text accompanying notes 59-65.

89. *See generally* Harold Hongju Koh, *Transnational Public Law Litigation*, 100 YALE L.J. 2347, text accompanying notes 103-08 (1991).

90. *See id.* at 2356.

91. *See id.* at 2357.

1930s and 1940s as a means of facilitating the executive branch's foreign affairs power in the increasingly international twentieth-century, largely by "'solidifying' executive branch authority to bind the states and private parties to its foreign policy decisions."⁹² Moreover, the doctrines of comity, separation of powers and judicial incompetence seem to incorporate Trimble's misgivings about judicial review of customary international law. As federal jurisprudential history demonstrates, however, American courts have only applied these doctrines in selective circumstances. When they have applied these doctrines, the courts seemed more concerned with issues about their judicial role rather than with axiomatic denunciations of adjudicatory authority.

In addition to using customary international law to decide issues brought before them, courts often apply it in interpreting United States law. A long-standing canon of legal interpretation holds that United States law "ought never to be construed to violate the law of nations if any other possible construction remains."⁹³ (If United States law were unavoidably violative of customary international law, it would essentially be held to have "overruled" that law in the domestic context, as explained above). For example, the courts have determined several issues of maritime law according to customary international law in the absence of clearly expressed congressional intent to the contrary.⁹⁴ It is largely through this legal canon that customary international law influences judicial decisions.⁹⁵

Thus, by no means do American courts always defer to the other branches of the government. Moreover, even if the courts usually defer to the congressional or executive branches, situations will undoubtedly arise in which those branches, perhaps precisely because of their political nature, will refuse to act. If the situation is as wide-sweeping and potentially disruptive in character as is the dispute over state income taxation of multinational corporations, the courts arguably must step in and resolve the difficulty, even if that resolution only entails putting forward a rule that forces the political branches to act.

III.

A PARADIGM OF CUSTOMARY INTERNATIONAL LAW

Assuming that courts can, and should where appropriate, apply customary international law to bind the states, the next step is to articulate a definition of customary international law that courts can use to ascertain and apply such law. The indeterminacy of existing scholarly work on customary international law, however, makes constructing a paradigm for ascertaining it more difficult than

92. *Id.*

93. *Murray v. The Schooner Charming Betsy*, 6 U.S. (2 Cranch) 64, 118 (1804). For a discussion of the general body of jurisprudence that has developed from *Charming Betsy*, see generally Ralph G. Steinhardt, *The Role of International Law as a Canon of Domestic Statutory Construction*, 43 *VAND. L. REV.* 1103 (1990).

94. *See id.* at 1110 n.29 (citing representative cases).

95. *See id.* at 1113.

might be expected.⁹⁶ Indeed, a review of customary international law authorities almost leaves the impression that there are as many different definitions and analyses of customary international law as there are commentators,⁹⁷ and perhaps, even as there are cases.⁹⁸ Consequently, building a coherent construct is not a task of inconsiderable proportions. With that caveat, the following definition seems to capture the essential characteristics of a rule of customary international law:

- (1) Practice requirement: The international law must be consistently practiced by nations whose interests it clearly affects, with the tacit consent or acquiescence by those nations whose interests it does not;
- (2) Force of law requirement: The international law must carry the "force of law." That is,
 - a) nations must clearly acknowledge an obligation to adhere to it; and
 - b) a high probability of "punitive action" — which may include a wide range of negative responses — must attach to its violation by any nation.

In the section that follows, I will briefly discuss and explain my reasons for utilizing this definition.⁹⁹

96. See KAROL WOLFKE, *CUSTOM IN PRESENT INTERNATIONAL LAW* xiii (2nd ed. 1993) (noting the "intangibility of custom, in the numerous factors which come into play, in the great number of various views, spread over the centuries, and in the resulting ambiguity of the terms involved. Consequent on this is the fact that international custom and customary law still raise the greatest number of doubts and controversies."); see also Josef L. Kunz, Editorial Comment, *The Nature of Customary International Law*, 47 AJIL 662, 663 (noting that "les idées des juristes sur le caractère de la coutume n'ont atteint ni à l'unité ni à la clarté") (quoting Jules Basdevant, *Règles générales de la paix*, 4 RECUEIL DES COURS 508 (1936)).

97. See, e.g., ANTHONY A. D'AMATO, *THE CONCEPT OF CUSTOM IN INTERNATIONAL LAW* 76-86 (1971) (defining customary international law as containing a "qualitative" and "quantitative" element); RESTATEMENT, *supra* note 77, at § 102 (defining customary international law as a general and consistent practice of nations followed by them from a sense of legal obligation); United Nations International Law Commission, Working Paper, *cited in* WOLFKE, *supra* note 96, at 30 (defining customary international law as containing elements of "concordant practice by a number of States," "continuation or repetition of the practice over a considerable period of time;" consistency with prevailing international law, and general acquiescence by other states).

98. For example, the founders of the International Court of Justice defined customary law to be "international custom, as evidence of a general practice accepted as law." See Statute of the International Court of Justice art. 38. This definition has subsequently achieved widespread recognition as the preeminent authority on the matter. See, e.g., IAN BROWNLIE, *PRINCIPLES OF PUBLIC INTERNATIONAL LAW* 2 (1966); HANS KELSEN, *PRINCIPLES OF INTERNATIONAL LAW* (2d ed. 1967); MALCOLM N. SHAW, *INTERNATIONAL LAW* 59 (3d ed. 1991). Nonetheless, the International Court of Justice has employed such disparate reasoning in its adjudication of cases that one commentator has asserted "that those decisions of the Court in cases in which it has ascertained the existence of customary rules of international law confirm the fact that little regard has been paid to the wording of the definition in the Statute of the Court." WOLFKE, *supra* note 96, at 23.

99. I should first, however, substantiate the methodology I will employ in doing so. The Restatement directs that in determining and interpreting international law, one should look to judgments and opinions of national and especially international tribunals, writings of scholars, and pronouncements by nations that undertake to state a rule of international law. See RESTATEMENT, *supra* note 77, § 112. My project here, in essence, is to determine from the writings of tribunals and organizations, as well as scholars, the proper means of ascertainment of customary international law—in other words, the customary international law which governs assessment of customary international law. Thus, in this context, customary law—the law of the ascertainment and interpretation of law—serves as a "secondary rule of law determination." See D'AMATO, *supra* note 97 (noting that custom can serve the function defined by H.L.A. Hart as "specify[ing] the ways in which the primary rules may be conclusively ascertained, introduced, eliminated, varied, and the fact of their violation conclusively determined") (quoting H.L.A. HART, *THE CONCEPT OF LAW* 226-41 (1961)).

A. Practice Requirement

Practice forms the bedrock of customary international law because without it the most highly touted legal norm cannot gain recognition as a binding rule of law.¹⁰⁰ It is clear that a nation's practice must be consistent and continuous in order to fulfill this component of customary international law analysis.¹⁰¹ However, the other necessary dimensions of the "practice requirement" remain unclear. In particular, much uncertainty surrounds the required scope of the practice (that is, the proportion of nations required to observe the practice), as well as the required duration of the practice.

With respect to the necessary scope, one might expect that a practice must first attain near-universality before it can support a conclusion of customary international law. With some consideration, however, this approach becomes impracticable because at any given moment only a few nations may be practicing a rule that is nonetheless recognized by the international community as legally binding. Perhaps to accommodate this nuance, the International Court of Justice has emphasized in its definition of practice the participation of those "[nations] whose interests are specially affected."¹⁰² Of course, this emphasis does not restrict the analysis of practice to only those nations. A definition restricted in that manner would describe something more akin to an implicit contract between specific parties than to a generally binding rule.¹⁰³

To avoid this pitfall, an ascertainment of customary international law must require tacit consent or acquiescence on the part of most other nations.¹⁰⁴ Perhaps the best example of this "doctrine of tacit consent" is the generally accepted notion that those customary international laws that evolved prior to the independence of many developing countries nonetheless applies to those countries.¹⁰⁵ If developing countries, who were not present during the formulation of a wide array of customary international laws can be so bound, it follows that the United States—at least as a normative matter—can likewise be bound.

The doctrine of tacit consent is not as oppressive as it may seem for a number of reasons. First, because nations are framers as well as subjects of international law, they in effect can change rules.¹⁰⁶ Thus, actions inconsistent with a rule of customary international law in effect constitute new legal

100. See, e.g., *North Sea Continental Shelf Cases*, 1969 I.C.J. 46. Indeed, some commentators have argued that international legal rules depend for their validity on practice alone. See, e.g., A. ROSS, *A TEXTBOOK OF INTERNATIONAL LAW* 83 (1947); M. SORENSON, *LES SOURCES DU DROIT INTERNATIONAL* 24 (1946).

101. See, e.g., BROWNLIE, *supra* note 98, at 12; D'AMATO, *supra* note 98, at 545.

102. *North Sea Continental Shelf Cases*, 1969 I.C.J. 43.

103. Indeed, developing countries have complained of being forced to recognize customary international law, for example as it pertains to expropriation, to which they never agreed. See Jonathan Charney, *The Persistent Objector Rule and the Development of Customary International Law*, 56 BR. Y.B. INT'L L. 1, 24 (1985).

104. See MacGibbon, *Customary International Law and Acquiescence*, 33 BR. Y.B. INT'L L. x, 131 (1957).

105. See Charney, *supra* note 103, at 13.

106. See G.M. DANILENKO, *LAW-MAKING IN THE INTERNATIONAL COMMUNITY* 79-80 (1993).

claims.¹⁰⁷ The adjudication and disposition of these claims turns on whether those claims are rejected or accepted (and followed) by other nations.¹⁰⁸ Second, “[e]ven though most authorities recognize that a [nation] is not required to have expressly consented to being bound by a rule of customary international law, virtually all authorities maintain that a [nation] which objects to an evolving rule of general customary international law can be exempted from its obligations.”¹⁰⁹ This allowance is known as the “persistent objector” exemption. “The toleration of the persistent objector” is precisely because “ultimately custom depends on the consent of [nations].”¹¹⁰

Another definitional question pertains to the duration of state practice necessary to establish customary international law. Though the length of time required to lend legality to a state practice has never been precise, in recent years the issue has provoked increasing controversy. Under traditional analysis, a rule of customary international law had to slowly solidify into a law over the ages.¹¹¹ However, with the rise of modern communications and the frequency of multi-lateral conventions, many commentators have argued that customary international law can develop much more quickly, even “instantly,” in the modern age.¹¹²

These difficulties have caused some authorities on international law to avoid imposing any particular time requirement and require only that a state practice be “general” and “consistent.”¹¹³ Such non-temporal definitions seem to tacitly affirm a case-by-case approach that inquires into the facts and circumstances surrounding a particular practice in order to determine the necessary duration.

B. Force of Law

A treatise commonly known as Viner’s Abridgment gives one of the oldest recorded definitions of customary international law: “A custom, in the intendment of law, is such as usage as hath obtained the force of law.”¹¹⁴ As will be

107. *See id.*

108. *See* BROWNIE, *supra* note 98, at 9 (asserting that “if a substantial number of [nations] assert a new rule, the momentum of increased defection, complimented by acquiescence, might result in a new rule” and citing the North Sea Continental Shelf cases).

109. Charney, *supra* note 103, at 2. However, Charney notes that the International Court of Justice seems not to have unequivocally accepted the persistent objector rule. *See id.* at 9-11. Charney also notes that even though a nation may seemingly have persistent objector status, it may still suffer pressure to comply from other states. *See id.* at 11-14 (citing examples of U.S. coastal practices and apartheid in South Africa and Rhodesia).

110. BROWNIE, *supra* note 98, at 8.

111. *See, e.g., The Paquete Habana*, 175 U.S. at 686 (describing the customary law prohibiting capture of fishing vessels as prizes of war as “an ancient usage among civilized nations, beginning centuries ago, and gradually ripening into a rule of international law”).

112. *See, e.g., Bin Cheng, United Nations Resolutions on Outer Space: “Instant” International Customary Law?*, 5 INDIAN J. INT’L L. 23 (1965). The law of the sea that emerged after World War II with regard to the proper mile limit beyond a country’s borders that should be reserved for that country’s fishing industry is another example.

113. *See, e.g.,* RESTATEMENT, *supra* note 77, § 102(2).

114. CHARLES VINER, GENERAL ABRIDGMENT OF LAW AND EQUITY 23 (1746).

discussed below, this definition may more authentically capture the essence of customary international law than more recent definitions. It both avoids the trap of circularity posed by the more well-known definition of customary international law as customs which are “accepted as law”; and incorporates the notion of negative consequences of violation that is omitted in the “accepted as law” definition.

1. *A Clearly Acknowledged Obligation to Adhere to the Rule*

The term *opinio juris sive necessitas*¹¹⁵ is universally acknowledged to refer to that sense of obligation nations hold towards an international rule which transforms the rule into a law, as opposed to some other sort of obligation.¹¹⁶ The dissonant scholarship on this subject, however, demonstrates the difficulty of defining this concept in a living language as opposed to a Latin term.

Article 38 of the Statute of the International Court of Justice (Article 38), widely accepted to be the preeminent authority on the matter,¹¹⁷ has defined customary law as “general practice accepted as law.” The Restatement has echoed this concept by defining customary international law as resting on a “sense of legal obligation.”¹¹⁸ Many theorists of international law have duly incorporated the notion that, to prove or ascertain a rule of customary international law, one must first prove that nations view that rule in some sense as law.¹¹⁹ I term this requirement the “legal prerequisite” requirement.

This “legal prerequisite” set of definitions has met with a great deal of criticism. To begin, the approach is circular. To define customary international law as that which is “accepted as law” reveals nothing of the factors which created that acceptance in the first place. Accordingly, courts or other actors who seek to determine whether a new rule of customary international law has emerged face an almost insurmountable evidentiary burden, since to qualify as customary international law a “practice must be exercised in the belief that it is already required by the existing norm of law.”¹²⁰

115. The term *opinio juris sive necessitas* was first coined by Gény. See GÉNY, MÉTHODE D'INTERPRÉTATION ET SOURCES EN FRUIT PRIVÉ POSITIF § 110 (1899). Since that time, countless commentators and law makers have employed the term in applying or ascertaining customary international law.

116. See BROWNIE, *supra* note 98, at 7 (distinguishing legal obligations from “motives of courtesy, fairness, or morality”); DANILENKO, *supra* note 107, at 16 (“[T]he major problem which arises in determining [the content of international law] is the question of the formal criteria of validity distinguishing legal rules from other normative prescriptions operating within the same socio-political environment.”).

117. Ironically, the statute was not originally intended as a comprehensive definition of international law. DANILENKO, *supra* note 107, at 33. This may explain why the Court itself has employed other definitions, and indeed rarely expressly invokes Article 38 in its opinions.

118. See RESTATEMENT, *supra* note 77, § 102.

119. See, e.g., GEORGE SCHWARZENBERGER & E.D. BROWN, A MANUAL OF INTERNATIONAL LAW 26 (6th ed. 1976).

120. DANILENKO, *supra* note 107, at 100; see also SHAW, *supra* note 98, at 74 (“[H]ow can new customary rules be created since that obviously requires action different from or contrary to what until then is regarded as law?”).

Along similar lines, the “legal prerequisite” definition of *opinio juris* ignores the “law-catalyzing” function that tribunals can play in adjudicating international law issues.¹²¹ As international law scholar J.G. Starke observed,

In certain cases, the court’s function may be more than purely declaratory; while not actually creating new customary rules, the court may feel constrained to carry to a final stage the process of evolution of usages so generally recognized as to suggest that by an inevitable course of development they will crystallize into custom.¹²²

Justice Cardozo of the United States Supreme Court eloquently summarized this dynamic as such: “International law. . . has at times, like the common law within [nations], a twilight existence during which it is hardly distinguishable from morality or justice, till at length the imprimatur of a court attests its jural quality.”¹²³ Thus, the “legal prerequisite” understanding of customary international law seems adequate for applying well-established rules, but not for identifying emergent law.¹²⁴

The weakness of the “legal prerequisite” requirement has caused some authorities, including the International Court of Justice, to seek and employ alternative definitions of the *opinio juris* element of customary international law. Thus, in the case *Nicaragua v. United States*, the International Court of Justice defined the *opinio juris* factor as “an acceptance of the validity of the rule or set of rules.”¹²⁵ Moreover, the court in *Nicaragua* elaborated that “instances of State conduct inconsistent with a given rule should generally have been treated as breaches of that rule, rather not as indications of the recognition of a new rule.”¹²⁶

A definition of the *opinio juris* element as “a clearly acknowledged obligation to adhere to the rule” at issue might resolve the “legal prerequisite” difficulty. However, such a definition, while solving the difficulties posed by Article 38, simultaneously reincarnates the problem that the “legal prerequisite” was designed to solve — the inability to distinguish international legal rules from other types of international rules. Thus, *opinio juris* analysis appears caught between a definition which unduly restricts the development of customary international law and one which erroneously legalizes all international rules.

121. Another criticism often leveled against conventional customary international law analysis is that the *opinio juris* requirement as conventionally required is hard to measure because it is almost entirely subjective. See, e.g., D’AMATO, *supra* note 97, at 17.

122. J.G. STARKE, INTRODUCTION TO INTERNATIONAL LAW 40 (10th ed. 1989). One might effectively counter, however, that this function has no place in the adjudication of international law, and that courts in fact should wait until nations have expressly affirmed the legal status of a rule before applying it as such.

123. *New Jersey*, 291 U.S. at 383-84.

124. Note, however, that international law scholar Ian Brownlie has asserted that, in the case of a tribunal’s attempt to ascertain a rule of customary international law, if one party has established the “general practice” of a rule “in a field which is *ex facie* governed by legal categories, the tribunal can be expected to presume the existence of an *opinio juris*,” and “the opponent on the issue has the burden of proving its absence.” BROWNIE, *supra* note 98, at 7.

125. 1986 I.C.J. 98.

126. *Id.* Professor Starke has offered his own alternative definition of this element as “a general acknowledgment by [nations] that the conduct or the abstention therefrom is a matter of both right and obligation.” See STARKE, *supra* note 123, at 59.

Without more, the *opinio juris* element therefore seems unable to capture that which must supplement state practice in order to make a rule customary international law.

2. *A High Probability of Punitive Action by Other States Towards Errant States*

In order to lessen this difficulty, the conventional definition of customary international law, which encompasses the elements of objective practice and subjective obligation, should perhaps expand to include an additional element dealing with the consequences of violating a rule. Incorporation of this factor may adequately distinguish customary international law from other rules, while at the same time allow for the development of new customary international law.

However, it is necessary to first establish why this additional element is not generally explicitly included in definitions of customary international law. Although punishment of law-breaking is a recognized and vital element of domestic legal systems, it is rarely articulated as a component of international law. This absence, to the lament of some international lawyers and legal scholars, seems to stem mainly from the lack of effective enforcement of much of what is deemed to be international law.¹²⁷ Nonetheless, the addition of a punishment factor to the definition of customary international law should not be so quickly discarded. First, a common perception is that the incorporation of punitive action into a definition of customary international law will undermine much of what is currently accepted as such. This perception, however, conflates the notion of punitive action against law-breaking with the notion of effective enforcement of laws. That is, such a perception confuses the response to law-breaking with the desired result of the response. In the domestic context, the effective enforcement of a law is not automatic, but rather depends on factors such as the perceived importance of the law to the government's vital interests and the level of administrative difficulty of enforcement. Thus, governments may employ relatively more effective enforcement mechanisms against treason, for example, than against illegal pollution. Similarly, a given nation may employ more effective, or at least more aggressive, enforcement attempts with regards to another nation's continuous violation of international trade laws than to the errant nation's continuous violation of international human rights law. Such disparity does not affect the validity of either law, but rather speaks to the level of resources the non-transgressing nation is willing to employ in punishing the violation of each law. What does indicate that the nation recognizes the legal status of both rules is that in both instances it is willing to undertake punitive action against the violator. Such punitive actions range from public condemnation to economic and diplomatic sanctions in the case of the human rights viola-

127. See, e.g., Trimble, *supra* note 80, at 665; see also J. BRIERLY, *THE LAW OF NATIONS* 71-76 (1963); LOUIS HENKIN, *HOW NATIONS BEHAVE* 25-26.

tion, and from economic and diplomatic sanctions to economic retaliation¹²⁸ or generalized aggression¹²⁹ in the case of trade violation.

Thus, the incorporation of deterrent action into customary international law analysis will not damage or undermine the legitimacy of international law as a system or as a discipline. To the contrary, such incorporation will add much needed coherence to the study of international law. Though some international law scholars claim that nations adhere to the vast majority of their obligations under international law simply out of a moral or psychological sense of obligation,¹³⁰ this claim pushes against our intuition for what makes law work. To address the issue simply and directly, even individuals who identify culturally and territorially with their nation, who can participate in clear and quantifiable ways in their nation's governance, and who depend on their nation for their protection, must nonetheless be subjected to punishment for law-breaking in order to secure lawfulness. This being the case, why would nations, who possess only tenuous links of this sort to each other, choose to uphold their obligations under international law in the absence of negative consequences accruing to those who violate them? The answer is: they would not because nations, like individuals, adhere to laws not only out of a sense of obligation but also out of a desire to avoid sanction.

C. *The Persistent Objector Exemption*

Although to some extent a distinct issue, a complete disposition of the status of the separate accounting rule as it applies to the United States must take into account the applicability of the persistent objector exemption. The persistent objector exemption operates to protect those nations who have "persistently" voiced their disagreement to a rule during the rule's formation. Thus, a nation which "opposes the rule in the early days of the rule's existence (or formation) and maintains its opposition consistently thereafter will probably not be subject to a customary international law."¹³¹ Some uncertainty surrounds the circumstances under which a nation may benefit from the persistent objector

128. See Alan O. Sykes, *Constructive Unilateral Threats in International Commercial Relations*, 23 LAW & POL'Y INT'L BUS. 263 (1992) (discussing § 301 of the U.S. Trade Act of 1974, which generally requires the U.S. Trade Representative to retaliate against violations of trade agreements or restrictions of U.S. commerce by other countries); Raymond F. Mikesell, *Antecedents of the ITO Charter and Their Relevance for the Uruguay Round*, 14 N. ILL. U. L. REV. 323 (1994) (noting the right of countries under the GATT to respond to GATT violations by other countries by retaliating with similar violations against those countries).

129. See John W. Head, *Making International Trade Less Foreign: A "Nutshell" for Non-specialists on the Changing Rules Governing International Trade* 61 DEC. J. KAN. B.A. 42 (1992) (observing the potential for conflict-strewn United States-EC negotiations to escalate into a "trade war").

130. See generally D'AMATO, *supra* note 97, at 169 (discussing the potential sources of the "authoritativeness" of customary international law).

131. *But see id.* at 261 (arguing against the persistent objector rule). Even in this instance, however, the nation may be subject to a rule if it is a "peremptory norm of general international law." Vienna Convention on the Law of Treaties art. 53.

exemption,¹³² including “how persistent the objecting state must be and by what means that objection must be made known.” Generally, “[e]vidence of objection must be clear and there is probably a presumption of acceptance which is to be rebutted.”¹³³ One commentator has further suggested that the required objection varies with the extent to which a given rule is accepted by other nations. In cases where a rule is “promoted as universally applicable and . . . indeed [is] supported by the majority of [s]tates,” the objector must “be especially vigilant in protecting its legal position,” lest it be held accountable through the doctrine of tacit consent after a “relatively short period of silence.”¹³⁴ Whether the United States or the individual states qualify for this exemption is discussed in the next section.

D. Evidence of Customary International Law

Determining what evidence is sufficient to prove the legal bases of international customary law may prove to be even more tenuous than determining the legal bases themselves.¹³⁵ One might presume that the proper evidentiary basis for fulfillment of the practice requirement is limited to evidence of actual state practice, performed either by individual nations or by nations grouped together into international organizations. Several courts and commentators, however, have increasingly turned to indirect evidence of state practice afforded by, among other things, codifying conventions or other multilateral agreements, and statements by government officials. Although these sources are evidence for the practice requirement, they appear to speak more directly to the evidentiary determination of *opinio juris*. Thus, although scholarly treatments of customary international law have delineated the requirements of practice and *opinio juris* with scrutiny, the distinction seem to deteriorate when actually proving customary international law. This is so because the same sources are generally accepted as evidence of either practice or *opinio juris*. Therefore, a better approach is to list accepted evidentiary sources together. Of course more direct evidence of actual practice will be more convincing in the practice requirement, as assertions of state obligation will be more effective with regard to the *opinio juris* requirement. The following are evidentiary sources of customary international law:

1. Treaties

International law courts and commentators have consistently affirmed the relationship between treaties and customary international law in two important

132. See Stein, *The Approach of a Different Drummer: The Principle of the Persistent Objector in International Law*, 26 HARV. INT'L L.J. 457, 457 (1985).

133. BROWNIE, *supra* note 98, at 8; see also Stein, *supra* note 133, at 478.

134. David A. Colson, *How Persistent Must the Persistent Objector Be?*, 61 WASH. L. REV. 957, 965, 967 (1986). Even where a state maintains a sufficiently persistent objection, “[t]he political cost of remaining a persistent objector in these situations is likely to increase at an exponential rate as the objector becomes more isolated and as the issue increases in political visibility.” *Id.* at 967.

135. DANILENKO, *supra* note 107, at 99.

ways. First, treaties can serve to declare or confirm the binding nature of a particular rule.¹³⁶ Second, treaties can generate customary international law by affecting both widespread practice and acknowledgment of the binding nature of a particular practice.¹³⁷ Although multilateral treaties more immediately fulfill these functions,¹³⁸ a series of bilateral treaties establishing the same rule, if extensive enough, can also provide important evidence of customary international law.¹³⁹

2. *International Organizational Activity*

The number and activity of international organizations has increased exponentially in the post-World War II era.¹⁴⁰ Nations are constantly participating in fora in ways that require them to assess and debate the propriety of various international rules. Thus, international organizations generate numerous documents — such as resolutions, model treaties, and declarations — that record their *opinio juris*, or lack thereof, with respect to international rules.¹⁴¹ The works of the OECD, the International Law Commission, and the various branches of the United Nations are among the more dispositive in this regard.¹⁴²

3. *Other Sources*

Besides multilateral and bilateral treaties and the documents resulting from international organizational activity, numerous other sources remain as potential evidence that a particular rule is customary international law. The more salient of these are:

- decisions of national and international courts;
- diplomatic correspondence;
- policy statements;
- press releases;
- opinions of official legal advisers;
- official manuals on legal questions;
- executive decisions and practices;
- newspapers;
- historical records;
- official statements;
- government publications;

136. See Dr. Ibrahim F.I. Shihata, *The Treaty as a Law Declaring and Custom-Making Instrument*, 22 EGYPTIAN REV. INT'L L. 51 (1966).

137. See Anthony D'Amato, *Treaties as a Source of General Rules of International Law*, 3 HARV. INT'L L.J. 1 (1962).

138. See Baxter, *Multilateral Treaties as Evidence of Customary International Law*, 41 BR. Y.B. INT'L L. 275 (1968).

139. See SHAW, *supra* note 98, at 82.

140. See GEORG SCHWARZENBERGER, *A MANUAL OF INTERNATIONAL LAW* 23-24 (6th ed. 1976); SHAW, *supra* note 98, at 67.

141. See Karol Wolfke, *Practice of International Organizations and Customary Law*, [1966/67] 1 PYIL 183-94 & chs. 2, 4.

142. See SCHWARZENBERGER, *supra* note 141, at 24; SHAW, *supra* note 98, at 67-69. Indeed, this perpetual source of deliberation has played a significant role in the reduction of the duration requirement in determinations of customary international law. See Interview with Professor Abram Chayes, Harvard Law School, (November 2, 1994).

- national laws; and
- national military or administrative practices.¹⁴³

IV.

SEPARATE ACCOUNTING AS A RULE OF CUSTOMARY INTERNATIONAL LAW

A. *Evidence of the Separate Accounting Method Constituting a Customary International Law*

This section will first examine treaties and international organizational activity as evidence that the rule of separate accounting constitutes a rule of customary international law.

1. *International Organizations, Model Treaties, and the Bilateral Treaty Network*

The world's most prominent multilateral organizations have a long history of activity in this area, most of it directed towards establishing the separate accounting standard in the international arena. Despite more or less widespread agreement among nations that the separate accounting method should be the uniform standard by which to tax foreign multinational corporations, various institutional and practical barriers prevented the creation of a multilateral treaty. First, "[d]ifferences in tax systems, languages, currencies, and accounting principles did not lend themselves to multilateral treatment."¹⁴⁴ Second, no government-like structure existed in which all nations could participate and agree to a treaty.¹⁴⁵ Nonetheless, international organizations did much to demonstrate a sense that the separate accounting method should operate as a binding international rule. Thus, although these institutions never established a binding multilateral treaty requiring the use of the separate accounting method, they did create "model" bilateral treaties that were intended to be comprehensively followed.¹⁴⁶

The League of Nations first began to study the issue of international taxation of business income when the aggressive tax policies of several nations following World War I engendered potentially serious problems of double taxation.¹⁴⁷ The League's first model bilateral treaty, drafted in 1927, directed countries to apply the separate accounting method in attributing income to a resident permanent establishment, but also allowed that "in the absence of accounts showing . . . income separately and in proper form," the countries could

143. See BROWNIE, *supra* note 98, at 4; SCHWARZENBERGER, *supra* note 141, at 26; SHAW, *supra* note 98, at 69-76.

144. David M. Hudson & Daniel C. Turner, *International and Interstate Approaches to Taxing Business Income*, 6 NW J. INT'L L. & BUS. 562, 563 (1984)

145. See *id.* at 607-09 (describing a series of international efforts to reach a uniform international standard and explaining that a multilateral treaty on the matter was institutionally implausible since the "most comprehensive institution is the United Nations," whose powers fall more to issuing resolutions and declarations than to forming multilateral treaties).

146. See *id.* at 609-10.

147. Stanley I. Langbein, *The Unitary Method and the Myth of Arm's Length*, 30 TAX NOTES 625, 630 (1986).

“come to an arrangement as to the rules for apportionment.”¹⁴⁸ In 1928, the League proffered a set of three revised model bilateral treaties. Unlike the 1927 model, however, these treaties left open the issue of the applicability of the separate accounting method.¹⁴⁹ In the meantime, the League embarked on an extensive study conducted under the auspices of Mitchell B. Carroll (and hence termed the Carroll Report) to determine the proper methodology for taxing income.¹⁵⁰ The Carroll Report concluded that the majority of nations taxing corporate income used the separate accounting approach.¹⁵¹ On the strength of this conclusion, the League prepared a multilateral treaty reflecting the separate accounting approach. However, for the reasons stated above as well as the ultimate demise of the organization, the League’s initiative did not reach fruition.

The OECD¹⁵² picked up the development of the separate accounting standard after World War II. The OECD issued recommendations and published—first in 1963 and then again in 1977—a model bilateral treaty.¹⁵³ Among the more important provisions of the model treaty with respect to the principle of separate accounting are Articles 7(2) and 9(1). Article 7(2) of the Treaty addresses the treatment of business profits, declaring that:

where an enterprise of a Contracting State carries on business in the other Contracting State through a permanent establishment situated therein, there shall in each Contracting State be attributed to that permanent establishment the profits which it might be expected to make if it were a distinct and separate enterprise . . . dealing wholly and independently with the enterprise of which it is a permanent establishment.

Article 9(1) of the Treaty provides the “authoritative statement of the arm’s length principle,”¹⁵⁴ stating that:

[when] conditions are made or imposed between . . . two [associated] enterprises in their commercial or financial relationship which differ from those which would be made between independent enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly.

148. DRAFT OF A BILATERAL CONVENTION FOR THE PREVENTION OF DOUBLE TAXATION art. 5, reprinted in Report of the Committee of Technical Experts on Double Taxation and Tax Evasion, League of Nations Doc. C.216 M.85 1927 II (1927).

149. *Id.* at 569; Langbein, *supra* note 148, at 631.

150. See *Taxation of Foreign and National Enterprises: A Study of the Tax Systems and the Methods of Allocation of the Profits of Enterprises Operating in More Than One Country*, League of Nations Doc. C.73 M.38 132 II A (1932).

151. See *id.* at 188-89.

152. “The OECD was established in 1961 to replace the Organization for European Economic Cooperation (OEEC) which, in turn, had been established in 1948 by countries which were recipients of the United States Marshall Aid Program.” Hudson & Turner, *supra* note 145, at 571 n.59.

153. See OECD, REPORT OF THE OECD COMMITTEE ON FISCAL AFFAIRS (1977). The first treaty is the REPORT OF THE OECD COMMITTEE ON FISCAL AFFAIRS, DRAFT DOUBLE TAXATION CONVENTION ON INCOME AND CAPITAL (1963); the second the OECD MODEL CONVENTION FOR AVOIDANCE OF DOUBLE TAXATION WITH RESPECT TO TAXES ON INCOME AND CAPITAL, reprinted in 1 TAX TREATIES (CCH) ¶ 151 (1977).

154. OECD *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations: Report of the OECD Committee on Fiscal Affairs*, 9 TAX NOTES INTERNATIONAL 155, 161 (1994).

The United Nations soon endorsed the OECD model treaty by forming its own model, but substantially reproduced the OECD terms insofar as the employment of the separate accounting standard.¹⁵⁵ The United Nations sought to facilitate the creation of bilateral tax treaties between developed and developing countries with the expectation that such treaties might foster or accompany developed country investment in developing countries on mutually agreeable terms.¹⁵⁶

The model treaties of the OECD and the United Nations "provided the pattern for the vast majority of tax treaties concluded in the post-war period."¹⁵⁷ The models have shaped literally thousands of bilateral treaties.¹⁵⁸ The prevalence of this type of treaty has led to the assertion that "[m]ore than perhaps any other international legal document," the model treaty established by the OECD and later by the United Nations "deserve[s] to be recognized and studied as a form of transnational legislation."¹⁵⁹

This activity is generally accepted as firmly establishing the separate accounting method as the international standard. However, in recent years, occasional commentators have attacked this characterization. Stanley I. Langbein's essay "The Unitary Method and the Myth of Arm's Length"¹⁶⁰ is a well-known example of this view.¹⁶¹ Langbein argues that "a careful review of the rather extensive history on this matter raises serious questions about whether, the extent to which, and in what way the 'arm's length' standard represents a true, comprehensive, 'accepted international' norm."¹⁶²

Langbein argues that the "career of the 'arm's length standard' as an international norm is based upon two largely separate and distinct historical episodes;"¹⁶³ the League of Nations' Carroll Report¹⁶⁴ and the "campaign" of the

155. See UNITED NATIONS DOUBLE TAXATION CONVENTION BETWEEN DEVELOPED AND DEVELOPING COUNTRIES art. 7(2) (1979), reprinted in 25 INT'L TAX TREATIES 551 (1992).

156. See DEPARTMENT OF INTERNATIONAL ECONOMIC AND SOCIAL AFFAIRS, INTERNATIONAL CO-OPERATION IN TAX MATTERS: REPORT OF THE AD HOC GROUP OF EXPERTS ON INTERNATIONAL CO-OPERATION IN TAX MATTERS ON THE WORK OF ITS THIRD MEETING 132-34 (1987) (catalogued by the United Nations under ST/ESA/185).

157. PHILIP BAKER, DOUBLE TAXATION AGREEMENTS AND INTERNATIONAL TAX LAW. v (1991). The member nations of the European Community described this phenomenon as an "extensive network of bilateral tax agreements." See Brief of the Member States of the European Communities (Belgium, Denmark, France, Germany, Greece, Ireland, Italy, Luxembourg, the Netherlands, Portugal, and Spain) and the Governments of Australia, Austria, Canada, Finland, Japan, Norway, Sweden, and Switzerland), *Barclays*, 114 S. Ct. 2268 (No. 92-1384) (available in LEXIS/NEXIS GENFED library, BRIEFS file) [hereinafter Brief of the Member States of the European Communities] (noting that among other, the U.K. has "over 90," France 80, and Canada 52); see also UNITED NATIONS, INTERNATIONAL COOPERATION IN TAX MATTERS: REPORT OF THE AD HOC GROUP ON EXPERTS ON INTERNATIONAL CO-OPERATION IN TAX MATTERS ON THE WORK OF ITS THIRD MEETING 5 (1987) (catalogued by the United Nations under ST/ESA/185).

158. These treaties are much too numerous to list here. However, the majority of these treaties can be found in the series INTERNATIONAL TAX TREATIES OF ALL NATIONS. A look at virtually all of the conventions or agreements "for the avoidance of double taxation and the prevention of fiscal evasion will find arts. 7(2) and 9(1) intact.

159. See *id.*

160. *Supra* note 148.

161. See also Reuven Avi-yonah, *The Rise and Fall of Arm's Length: A Study in the Evolution of United States International Taxation* (manuscript).

162. *Id.* at 627.

163. Langbein, *supra* note 148, at 628.

United States during the 1960s to “internationalize” its own separate accounting rules. Langbein’s leading criticism of the Carroll Report is that it incorrectly weighed the data on the use of the separate accounting and formulary apportionment methods.¹⁶⁵ More specifically, Langbein argues that the Carroll Report’s consideration of nations’ “administrative practices, rather than tax laws” was unjustified.¹⁶⁶ At the time of the Carroll Report, the only existing statutory tax laws specifying income attribution methods were an international agreement between Austria, Hungary and Czechoslovakia; a statute in Austria; and laws enacted in Wisconsin, New York and Massachusetts. All of these laws mandated the use of the formulary apportionment method.¹⁶⁷ In the rest of the nations surveyed, with the exception of Switzerland and Spain, the separate accounting method was preferred. However, in these nations, the use of the separate accounting method was a result of decisions by administrative agencies and statutory authority derived only from more general provisions.¹⁶⁸ Thus, Langbein concludes that the national administrative practices in question were *ad hoc* and not comparable to statutes “generated by the acts of sovereigns.”¹⁶⁹

Langbein’s conclusions, however, seem excessive for several reasons. First, it seems quite plausible that the administrative bodies enacting apportionment statutes did so precisely because the separate accounting standard was, even then, understood to be customary and therefore automatically applicable in the absence of an express indication otherwise. Second, Langbein’s dismissal of administrative agency practices is puzzling since legislatures delegate to administrative agencies both law-making power and sovereign authority. Thus, administrative practices — especially when they are not overturned by the legislature — may be held to embody at least some independent merit. Langbein strangely views the Carroll Report as in some sense coercing “sovereigns” into applying a practice to which they never truly consented. However, while it is true that the Carroll Report influenced to some degree the terms of the OECD and United Nations model bilateral treaties, such treaties and their terms can enter into force between two nations only through the express consent and contract of those nations.

In addition, Langbein also argues that as late as the 1960s “indirect methods,” including the formulary apportionment method, were often used as “secondary methods”¹⁷⁰ despite the predominance of the separate accounting standard. Langbein does demonstrate that both the letter and practice of the separate accounting method in international taxation did not exclude the use of alternative methods. Hence, when the separate accounting method is impracticable, alternative methods of taxation are acceptable.¹⁷¹ This argument, however, seems to

164. See *supra* text accompanying notes 151-152.

165. See *id.* at 634-35.

166. *Id.* at 634.

167. See *id.* at 632.

168. See *id.* at 634.

169. *Id.* at 635.

170. *Id.* at 641.

171. See *id.* at 653.

clarify the nature of the separate accounting norm, rather than to establish that no such norm exists. It is a very different matter to require the use of the separate accounting method, unless such use is impracticable, than to state that there is no such requirement so as to allow the automatic apportionment of income.

Furthermore, Langbein also argues that the international use of the separate accounting method was to some extent the result of pressure by the United States. During the 1960s, however, the United States developed its separate accounting taxation rules largely "because its nationals at this time were more actively involved in international commerce than were the nationals of any other state."¹⁷² The new rules could not work to the advantage of the United States without international cooperation. Accordingly, the sponsors of the separate accounting method campaigned to "internationalize the standard" by "persuad[ing] the international community that conformance to the general definition required basic conformity to their particular system."¹⁷³ Hence the proponents "oversimplified, if they did not distort, the picture of the actual state of international practice and the prevailing international rules," which according to Langbein were rather more equivocal.¹⁷⁴ Langbein goes on to suggest that the development of the OECD and United Nations model conventions were largely influenced by the United States' separate accounting rules.¹⁷⁵

If the United States did indeed influence the development of the post-war separate accounting norm to the extent to which Langbein claims, such influence would not be surprising. The United States played the primary role in shaping many international legal structures following World War II. In addition to developing customary rules, such as the separate accounting method, the United States played a central role in shaping entire treaty regimes, such as the International Monetary Fund, the International Bank for Reconstruction and Development, and the General Agreement on Tariffs and Trade. The possibility that the United States strong-armed the development of the separate accounting standard may prove distasteful, but to disavow the rule for that reason would arguably entail disavowing much of modern international trade and business law. Altogether, Langbein succeeds in dismantling the "myth of arm's length" only insofar that he demonstrates that the "international norm" of arm's length accounting did not develop in a linear and unequivocal way. This fact, however, would most likely not differentiate the arm's length standard from any other standard in international law.

Langbein's arguments are ultimately aimed less at demonstrating that countries do not believe the method to be an international norm and more at laying the groundwork from which to argue that they should not adhere to that norm. That is, Langbein asserts that weaknesses in the empirical data supporting the separate accounting method's normative status exist in order to buttress his own

172. *Id.* at 642.

173. *Id.* at 653.

174. *Id.* at 651.

175. *See id.* at 651-52.

normative argument for the formulary apportionment method.¹⁷⁶ Thus, while Langbein points to valid and indisputable problems with the separate accounting method, these problems do not speak to the actual status of the method as an international norm.

2. *The United States Treaties*

In 1976, the United States promulgated its own model convention which also embraced the separate accounting method.¹⁷⁷ The United States Model Treaty's Articles 7(2) and 9(1) contain substantially the same language as the corresponding articles of the OECD Treaty.¹⁷⁸ However, the United States Treaty adds a paragraph to the end of Article 9 providing that "paragraph 1 [— establishing the use of the separate accounting method —] shall not limit any provisions of the law of either Contracting State which permit the distribution, apportionment or allocation of income" Even though the United States "federal government has always used the arm's length method,"¹⁷⁹ the model treaty nonetheless leaves room for variation. Thus, the United States has neither completely embraced the separate accounting method nor uniformly rejected the method.

In addition to the question of whether the United States tax treaties sanction the use of worldwide income is the question whether the treaties in any way constrict the taxing practices of the states. The Supreme Court in *Container*

176. *See id.* at 654-73.

177. *See* Treasury Department's Model Income Tax Treaty, U.S. Treasury Press Release, May 18, 1976. The United States and OECD models are compared in Robert Patrick, *A Comparison of the United States and OECD Model Income Tax Conventions*, 10 L. & POL'Y INT'L BUS. 613 (1978). Also the notion that treaties of friendship commerce and navigation might bar. *See generally* A.W. Granwell et al., *Worldwide Unitary Tax: Is It Invalid under Treaties of Friendship, Commerce and Navigation?*, 18 L. & POL'Y INT'L BUS. 695 (1986).

178. The U.S. Treaty's art. 7(2) omits the last clause of the OECD provision, which provides that profits shall be attributed to a permanent establishment as though it were a "distinct and separate" enterprise "dealing wholly independently with the enterprise of which it is a permanent establishment." However, this omission does not bear on the present inquiry, but rather was intended only to "make it clear that the profits of the permanent establishment are to be calculated as if it were completely independent, not only of the home office, but of any of the related party with which it might deal." Patrick, *supra* note 172, at 649.

There is conflicting evidence as to whether the U.S. provision is or is not intended to include foreign source income. In interpreting the U.S.-U.K. tax treaty, the Treasury Department has indicated that "the 'attributable' concept encompasses foreign source income attributable to activities of a U.S. permanent establishment of a foreign company." *Id.* at 648 (citing I.R.C. § 864(c)(4) in conjunction with U.S. DEP'T OF THE TREASURY, TECHNICAL EXPLANATION OF THE PROPOSED TREATY BETWEEN THE UNITED STATES AND THE UNITED KINGDOM, reprinted in 2 TAX TREATIES (CCH) ¶ 81033DD).

However, other treaties tell a different story. For example, the U.S. treaty with Switzerland exempts foreign-source income of Swiss companies from taxation. Patrick, *supra* note 179, at 648 n.110. Patrick elaborates,

In construing the existing Swiss treaty, the IRS ruled that although § 864(c)(4)(B) contemplates that income from sources outside the United States may be taxed in the United States if effectively connected with the permanent establishment, article 3 of the Swiss treaty permits United States taxation of a permanent establishment of a Swiss enterprise only on United States source income, and, therefore, non-United States source income is exempt.

179. *Id.* 3 TAX TREATIES (CCH) ¶ 89,007.

Corp. of America v. Franchise Tax Bd. observed that “the tax treaties into which the United States has entered do not generally cover the taxing activities of sub-national governmental units such as states, and in none of the treaties does the restriction on ‘non-arm’s-length’ methods of taxation apply to the states.”¹⁸⁰

3. Other Sources

Foreign governments have generally been in favor of the separate accounting method.¹⁸¹ Again, the question centers on whether the United States has reflected this consensus. First, the United States endorses and applies the separate accounting method in its federal tax policy. The statements that the United States government has made in advisory publications and in public statements suggest a view that the separate accounting standard is a binding legal rule. Presidents Carter, Reagan, and Bush made several statements and took a number of legal initiatives seeking the elimination of the formulary apportionment practice.¹⁸² Despite the Clinton Administration’s straddling on the issue of state formulary apportionment income taxation,¹⁸³ the Solicitor General remarked in his amicus brief submitted to the *Barclays* Court that “[t]he United States has long taken the position that California’s application of the worldwide combined reporting method to [foreign corporations] is inconsistent with the ‘separate accounting’ or ‘arm’s length’ method under federal law and under established international practice.”¹⁸⁴ The Clinton Administration ultimately sided with California and reached the conclusion that California’s repeal of its formulary apportionment tax legislation “brought California into ‘acceptable harmony’ with federal and international practice.”¹⁸⁵

C. Application of the Evidence to the Paradigm of Customary International Law

This section will examine whether the evidence is sufficient to establish the separate accounting method as customary international law under the paradigm described above. It concludes by determining, if the separate accounting

180. *Container Corp.*, 463 U.S. at 196-97.

181. See U.S. TREASURY DEP’T, *supra* note 4, at Supp. (statement of Allen Wallis, Under Secretary of State for Economic Affairs).

182. For example, Carter Administration Assistant Secretary of the Treasury for Tax Policy Donald C. Lubick presented a bill that would essentially have barred the State’s use of the unitary method. See H.R. 5076, 96th Cong., 2d Sess. (1980). Under President Reagan, the Worldwide Unitary Taxation Working Group issued a report urging the States to reform unitary tax statutes, Reagan sought the national repeal of all unitary tax legislation, see Brief for the U.S. as Amicus Curiae for Solicitor General, *Barclays*, 114 S. Ct. 2268 (No. 92-1384) and *Colgate Palmolive Co. v. Franchise Tax Bd.* (No. 92-1839), at 10.; and the Treasury Department introduced a bill intended to do just that.

183. See, e.g., Dan Walters, *Unitary Taxes Snare Clinton*, SACTO. BEE, Aug. 29, 1993, at A3 (available in WESTLAW database PAPERS-MJ).

184. Brief for the U.S. as Amicus Curiae by the Solicitor General, *Barclays*, 114 S. Ct. 2268 (No. 92-1384), at 4.

185. *United States Backs California in Suit Over Unitary Tax*, SACTO. BEE, Oct. 8, 1993, at A6 (available in WESTLAW database PAPERS-MJ).

method does constitute customary international law, whether the United States and/or the individual states are covered by the persistent objector exemption.

1. Practice

The various treaties and international organizational activity described above strongly suggests international practice sufficient to satisfy the practice requirement. Nevertheless, a danger always exists that treaties and international organizational activity will constitute no more than lip service concerning an ideal goal, and that principles agreed upon will not be implemented into domestic legal systems. However, the ample documentation of the separate accounting method's widespread implementation minimizes this possibility.

Moreover, the nations themselves have attested countless times to the widespread practice of the method. In briefs to the Supreme Court,¹⁸⁶ as well as in independent statements and government publications, the member nations of the European Community, as well as the other industrialized nations, have confirmed that the separate accounting standard is widely practiced in the international arena.¹⁸⁷ Furthermore, outside commentators, including even Stanley Langbein, have observed that the separate accounting method prevails in the international arena.¹⁸⁸

2. Force of Law

a. *Opinio Juris*

In order to establish the *opinio juris* element, nations must clearly acknowledge an obligation to adhere to the rule of separate accounting. To begin, the sheer abundance of bilateral agreements that faithfully implements the separate accounting principles of the OECD and United Nations model treaties provide strong evidence of such a sense of obligation. In an amicus brief to the Court in *Barclays*, twenty industrialized nations affirmed that “[i]n their bilateral agreements, and as members of the OECD, [they had] uniformly and consistently upheld use of the ‘arm’s length separate accounting’ method of determining income as the proper method to be utilized for purposes of international income

186. See Brief of the Member States of the European Communities, *supra* note 158 (asserting “general agreement among nations” on the arm’s length principle, and elaborating that “[i]n their bilateral agreements, and as members of the OECD, the Twenty Nations have uniformly and consistently upheld use of the ‘arm’s length separate accounting’ method of determining income as the proper method to be utilized for purposes of international income taxation”); see also Brief of the Committee on State Taxation as Amicus Curiae In Support of Petitioners, *Barclays Bank PLC v. Franchise Tax Bd.*, 114 S. Ct. 2268 (1994) (No. 92-1389) (“Every nation in the world, including the United States, has chosen to assert its taxing jurisdiction over non-domiciliary corporations by reference to arm’s length/separate accounting.”).

187. See generally Hudson & Turner, *supra* note 26, at 562-589.

188. See Charles E. McClure, Jr., *State Taxation of Foreign-Source Dividends: Starting from First Principles*, 86 ST. TAX NOTES 108-76 (noting that “[m]uch of the controversy over worldwide combination can be traced to the belief that it deviates from accepted international practice”).

taxation.”¹⁸⁹ In addition to these nations, dozens of developing countries have affirmed the authority of the separate accounting method.¹⁹⁰

This vast network of bilateral treaties militates strongly in favor of a conclusion that separate accounting is a general rule of international law. Thus, there would appear to be a very persuasive general acknowledgment of a binding obligation to practice the separate accounting method.

b. Punitive Action

The final criterion necessary to prove that a particular practice constitutes customary international law is a high probability of negative response by other nations to a nation that has abridged the practice.

Several of the major trading partners of the United States reacted very negatively to state formulary apportionment taxation policy,¹⁹¹ and threatened vari-

189. See Brief of the Member States of the European Communities, *supra* note 158.

190. See generally United Nations, *supra* note 158.

191. The *Barclays* case offered strong evidence of this. The *Barclays* Court noted that: The governments of many of our trading partners have expressed strong disapproval of CA's method of taxation, as demonstrated by the amici briefs in support of Barclays from the Government of the United Kingdom, and from the Member States of the European Communities Barclays has also directed our attention to a series of diplomatic notes similarly protesting the tax. See, e.g., App. in No. 92-1384, pp. A-92 to A-123, A-127 to A-128, A-131 to A-138; see also p.A-603 (Letter from Secretary of State George Schultz to California Governor Deukmejian (Jan. 30, 1986)) (“The Department of State has received diplomatic notes complaining about state use of the worldwide unitary method of taxation for virtually every developed country in the world.”) The British Parliament has gone further, enacting retaliatory legislation that would, if implemented, tax United States corporations on dividends they receive from their United Kingdom subsidiaries. See Finance Act, 1985, Pt. 2, ch.1, Sec. 54, and Sch. 13, P 5 (Eng.), reenacted in Income and Corporation Taxes Act, 1988, Pt. 18, ch. 3, Sec. 812 and Sch. 30, PP20, 21 (Eng.).

Barclays, 114 S. Ct. at n. 22. The *Barclays* dissent, in turn, noted that:

Most of the United States' trading partners have objected to California's use of worldwide combined reporting. See Demarche from Danish Embassy, on behalf of the Governments of European Community (Mar. 26, 1993) (“The views of the EC Member States on worldwide unitary taxation are well known to the United States Government. All Member States have expressed their strong opposition to [the California] tax in a number of diplomatic communiques to the United States Government from 1980 to the present date”); Demarche from Belgian Embassy, on behalf of Governments of Member States of European Community and of Australia, Austria, Canada, Finland, Japan, Norway, Sweden, and Switzerland. (Sept. 23 1993). At least one country has already enacted retaliatory legislation. See Brief of Government of United Kingdom as Amicus Curiae 19-23.

Finally, the Member States of the European Communities argued that:

[S]ince the late 1970's the Twenty Nations have, sometimes individually and sometimes in concert, expressed their dissatisfaction with worldwide unitary taxation to the various United States Administrations. In addition to a considerable number of diplomatic notes and other formal communications, the UK has passed retaliatory legislation, the French and Canadian Governments have expressed their concerns when ratifying their double tax treaties with the United States, the Netherlands held up treaty negotiations with the United States from 1984 to 1988, and most recently, the Finance Committee of the German Bundestag requested the German federal government to consider retaliatory action if the unitary tax issue was not quickly resolved.

See Brief of the Member States of the European Communities, *supra* note 158.

ous sanctions,¹⁹² including pulling their corporate nationals out of the offending states' jurisdictions and retaliating through hostile taxation and other regulation against American corporations. In particular, flurries of headlines during the *Barclays* case hinted at serious conflict between the United States and its trading partners, especially the United Kingdom and Japan.

Nonetheless, the reactions of other countries never materialized to anything beyond mere threats. This raises the question: if the separate accounting method was so universally accepted and established, why did these countries fail to respond with more concrete action? To begin, although these threats did not cause Congress or the Supreme Court to strike down formulary apportionment taxation, they did cause the federal government to respond by encouraging the repeal of state formulary apportionment legislation. Because all the states except for the State of Alaska repealed their formulary apportionment tax legislation, the threats of foreign nations exacted practical, if not legal, recognition of and compliance with the obligation to refrain from formulary apportionment taxation of foreign source income.

In addition, the diffuse nature of international law may serve to explain why these other countries failed to take more concrete action. The potential for successful enforcement of sanctions in the international legal system is limited. Since World War I, even the most bitter trade disputes between countries have rarely resulted in severe retaliation by one or more of the disputing nations. The General Agreement on Tariffs and Trade (GATT) offers a particularly illustrative example. The GATT is one of the most comprehensive and clearly defined, as well as one of the most universally accepted, international legal regimes. Yet enforcement of the GATT's provisions has been notoriously ineffectual. Violation of the GATT's provisions has rarely engendered serious aggression. The United States and the European Community fought long and vehemently over the alleged GATT violations on the part of both sides and threatened a wide range of aggressions and retaliations upon the other's failure to cooperate.¹⁹³ Yet, outside of the GATT negotiations, neither side acted on these threats. Nevertheless, the GATT is still considered as binding international law for its members. This seeming reluctance to retaliate concretely against another country's violation of an international rule is not without logic. The profound danger of escalation, and all its results, militates heavily against any retaliation but for the most grave violations. Thus, the lack of concrete reaction against the United States' violation of the international rule of separate accounting should not automatically undermine that rule's legal status.

192. See Lee A. Sheppard, *Japan, Inc. Reinforces Complaints about the Unitary Method*, TAX NOTES, Feb. 20, 1984.

193. See Miguel Montana-Mora, *International and International Relations Cheek to Cheek: An International Law/International Relations Perspective on the United States/E.C. Agricultural Export Subsidies Dispute*, 19 N.C. J. INT'L L. & COMM. REG. 2, 3-4 (1993).

3. *The Persistent Objector Exemption*

Even where the separate accounting standard amounts to a customary international law, the ambiguous practice of the United States presents two potential obstacles to a conclusion to which the individual states are bound by the separate accounting standard. First, the United States may qualify as a persistent objector and therefore is exempt from the rule. In turn, the states are exempt as its political subdivisions. Second, even if the United States has sufficiently acceded to the rule to foreclose a persistent objector defense to the separate accounting method altogether, it might still be possible that the United States has adequately objected to the individual states being bound by that method.

The United States does employ the separate accounting method in its federal tax policy towards corporate foreign income.¹⁹⁴ Moreover, as noted briefly above, the United States federal government has acted on numerous occasions to evince a belief that the separate accounting method represents a binding legal standard. Therefore, even if the United States has occasionally tolerated the formulary apportionment method, it has not done so to an extent which would lend it protection under the persistent objector exemption.

A more difficult inquiry is whether or not the United States has “persistently objected” to the rule’s application to the states. First, United States tax treaties do not generally bind the states. Second, the Senate expressly provided in its tax treaty with the United Kingdom that the states would not be bound by the treaty. Much has been made of this reservation, which appeared to constitute an endorsement of the formulary apportionment method as applied to foreign source income in general and of the states’ use of the method in particular. However, the United Kingdom has pointed out that the way in which the reservation was adopted hardly constituted an unambiguous endorsement of formulary apportionment.¹⁹⁵

According to this history, a majority (but not necessarily two-thirds) of the Senate voted for the original version of Article 9(4), which prohibited states from employing the worldwide formulary apportionment taxation method. A reservation was then proposed, and failed on a separate vote. Nonetheless, the reservation was again added to the bill. The Senate then approved the reservation as part of the treaty due to opposition to placing any constraint on the states’ taxing power, as well to the belief that “a single bilateral tax treaty to be placed only before the Senate was the proper vehicle for considering a measure that should be acted on by both House[s] as part of a uniform policy to be applied to all nations.”¹⁹⁶ The United Kingdom has argued, “[t]he Government of the

194. See, e.g., *U.S. Steel Corp. v. Comm’r*, 617 F.2d 942, 947-48 (1980) (holding the arm’s length standard to be applicable whenever a taxpayer could demonstrate that the price paid or charged was the same or similar to the amount in “independent transactions with or between unrelated parties”); *Oil Base, Inc. v. Comm’r*, 362 F.2d 212, 213 (1966) (upholding the Commissioner of Internal Revenue’s application of the separate accounting standard to transactions between taxpayer and wholly owned foreign subsidiary).

195. See generally, Brief of the Government of the United Kingdom as Amicus Curiae in Support of Petitioner, *Barclays*, 114 S. Ct 2268 (No. 92-1384).

196. *Id.*

United Kingdom does not see how the equivocal actions of the Senate with respect to a single treaty . . . could be held to constitute Congressional approval of the states' use of worldwide unitary taxation."¹⁹⁷

Even if meaningful, it is unclear whether the Senate's decision not to bind the states was meant as a disposition of the substantive question of whether the states should adhere to the standard at all, or merely reflected a sentiment that the best way to gain adherence was not through a federal tax treaty. The same argument goes for the third point, that the United States Congress has never enacted any legislation requiring the states to apply the separate accounting method. As shown, the Administration and Congress, faced with the decision of whether to overrule *Container*, expressly refused not to do so through overt federal action, and instead sought a solution that would acknowledge the states' taxing power under the federal constitutional structure of the United States.

A final objection to the application of the rule might be that, regardless of whether the United States and its political subdivisions are held accountable to international law, in the context of domestic law the rule has been implicitly overruled by conflicting federal action. The Supreme Court held in *The Paquete Habana*, however, that only "controlling" federal acts overrule customary international law.¹⁹⁸ There have been very few "controlling" legislative or executive acts. Specifically, Congress has not legislated on the issue of the separate accounting method. Moreover, where the Administration has made definitive statements, it has either endorsed the separate accounting standard, or supported the sovereignty of the states to apply their own tax law with a strong implicit directive to conform that tax law to the international standard.¹⁹⁹ While the *Barclays* decision might be interpreted to implicitly overrule customary international law, a better interpretation is that the Supreme Court has not yet addressed the applicability of the international standard of separate accounting as a rule of customary international law. If none of these arguments succeed in exempting the United States and the states, then the separate accounting rule of customary international law would reach beyond the scope of United States international treaty obligations to bind the states.

It does not follow, however, that this result is an intolerably inequitable one. Although the United States maintains some ambiguity towards the international standard, it is, after all, a member of the OECD and the United Nations. These organizations have directed their members to uphold the separate accounting standard. More importantly, customary international law that develops partially, or even largely as a result of treaty agreements, will nonetheless almost always bind nations which were not previously bound under treaty regimes or other agreements. The argument for constraining the liberties of the not-previously-consenting states may be analogized to arguments made by courts applying common law principles — such as principles of contract based on industry practice — to parties who had not contracted for such principles, or for that

197. *Id.*

198. See *supra* text accompanying note 78.

199. See *supra* text accompanying notes 35-45.

matter to individuals who did not know or did not agree to those principles. That is, the development of a rule by a significant number of law-making entities in particularized circumstances — in the first instance nation-states, in the second instance courts — may reach a level whereby it demonstrates that the rule is essential enough to the just disposition of an issue that it must apply to all.

Of course, this analogy is not completely consistent, for whereas individuals within a judicial system may be said to have accorded at least tacit consent and legitimacy to that system, nation-states do not possess the option of exit in protest of the development of a particular law or set of laws. The persistent objector exemption to customary international law is intended to address this problem. If the United States does qualify as a persistent objector, then even if the separate accounting method constitutes a rule of customary international law the United States would be obliged to make that standard binding upon the states. If the United States has not articulated its reservation, either to the force of the standard in general or upon the states, then it has forfeited its right to an equitable protest against the application of that standard.

V.

CONCLUSION

There seems to be substantial evidence that the separate accounting method is in fact a rule of customary international law. However, there also seems to be at least some evidence that suggests that the United States may be a “persistent objector” to, and therefore exempt from, this rule as it applies to the states. Although the issue may currently be moot, as most states have repealed their formulary apportionment tax legislation, the possibility that they might at any time re-enact formulary apportionment legislation continues to frustrate and concern foreign nations.

Judicial recognition of the applicability of customary international law to the separate accounting standard might help to further the apparent stalemate reached among the states, the legislative, and executive branches of the United States, and the United States’ trading partners. If the Supreme Court were to heed the words of Justice Cardozo and endow the international separate accounting standard with its *imprimatur*,²⁰⁰ the force of the standard would simplify the Court’s jurisprudence, effectively cause welcomed certainty in state tax policy, and restore the United States’ good standing with its trading partners. But even if the Court were to simply rule on this issue, regardless of outcome, it would greatly benefit the debate. By casting the issue in the light of customary international law, the Court might lend a sense of urgency and perspicuity to the debate that might in turn foster a more satisfactory resolution.

The Court need not hesitate to consider customary international law. As shown above, it has often done so in other contexts. By doing so here it would not take away from the states any freedoms that have not already practically

200. See *New Jersey*, 291 U.S. at 383-84 (quoted *supra* at text accompanying note 125).

been removed by economic and political reality. Instead, the Court would clarify and legitimize the undeniably and historically international character of taxation of foreign corporate foreign income, and in turn legitimize the role that all nations have in shaping it.