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# Worldwide Combination and the *Container* Case: A Perspective on Unitary Taxation\*

by  
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## I

### INTRODUCTION: POLITICAL NATURE OF UNITARY TAX ISSUES

*Container Corporation of America v. Franchise Tax Board*<sup>1</sup> presented a court challenge to the imposition by California of the worldwide unitary tax method on a United States-based parent corporation and its subsidiaries operating in foreign countries. The basic issue in the case was whether California could establish a method of apportioning or allocating the income of multinational corporate groups other than the method adopted by the United States and the trading countries of the world, both in their internal tax laws and in a vast network of treaties established to eliminate double taxation.<sup>2</sup>

California's worldwide unitary method raises questions of double taxation and impairment of U.S. foreign policy because it differs substantially from the separate accounting, arm's-length method of the United States and the other trading countries. This is particularly the case since U.S. foreign policy is directed toward promoting the free flow of international commerce, and, as a part thereof, the elimination of double taxation.<sup>3</sup>

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1. 117 Cal. App. 3d 988, 173 Cal. Rptr. 121 (1981), *aff'd*, — U.S. —, 103 S. Ct. 2933 (1983), *reh'g denied*, — U.S. —, 104 S. Ct. 265 (1983).

2. For a list of double taxation treaties worldwide, see UNITED NATIONS INTERNATIONAL TAX AGREEMENTS, UN Doc. ST/ECA/Ser. C/9/Supp. 31.

3. See *Tax Treaties with the United Kingdom, the Republic of Korea, and the Republic of the Philippines: Hearings Before the Senate Comm. on Foreign Relations*, 95th Cong., 1st Sess. 28 (1977) (Statement of Laurence N. Woodworth, former Assistant Secretary of Treasury for Tax Policy). See also the Congressional policy declaration of promoting international trade in 22 U.S.C. §§ 2351(a), 2351(b)(3) (1982), and Remarks by President Reagan to the World Af-

These sensitive political issues should be decided by the Executive and Congress through legislation and treaties. However, the executive and legislative branches have been reluctant to require the states to conform to U.S. policies in the international area although urged to do so by foreign trading partners and the business community for many years. A major reason for federal inaction has been vigorous objection by many states to such conformity. The conflict between state apportionment policy and that of the United States and its trading partners has continued to grow as more states have adopted the worldwide unitary method.<sup>4</sup> Thus, it is inevitable that taxpayers, frustrated by federal inaction, would turn to the courts for a resolution of the problem.

The *Container* case presented the Supreme Court with the following issues:

1. Are Container Corporation (hereinafter Container) and its foreign subsidiaries members of a unitary group as required by the due process clause?
2. Does California's worldwide unitary method, through systemic distortion, tax income earned outside the state in violation of the due process clause?
3. Does California's worldwide unitary method cause double taxation of income in violation of the commerce clause?
4. Does California's worldwide unitary method impair the foreign policy of the United States in violation of the commerce clause?

In spite of the political nature of the problems, particularly as presented in the last two issues, the Court was not without precedents and guidance in its consideration of the case. The Court had recently given considerable attention to the due process issues, particularly the definition of a unitary group,<sup>5</sup> as well as to the commerce clause issues.<sup>6</sup> Furthermore, the Justice Department filed a memorandum in a case then pending, giving the Court its views on the commerce clause issues. Nevertheless, the majority of the Court gave a limited interpretation to those due process and commerce clause precedents, and ignored the memorandum from the Justice Department because it was not filed with the Court in the *Container* case itself.

The position of the executive branch in regard to the *Container* case presents an interesting episode in Court history and also illustrates the intensely political nature of the issues. The Justice Department spelled out its

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fairs Council of Philadelphia, October 15, 1981, *excerpted in* N.Y. Times, Oct. 16, 1981, at 12, col. 2.

4. Twenty-two states have adopted some form of unitary taxation by taxing U.S. earnings of companies. Twelve states tax worldwide earnings. *Wermiel, Justices Refuse Shell's Appeal on State's Levy*, Wall St. J., Dec. 6, 1983, at 4, col. 1.

5. *ASARCO v. Idaho State Tax Comm'n*, 458 U.S. 307 (1982); *F.W. Woolworth Co. v. Taxation and Revenue Dep't*, 458 U.S. 354 (1982); *Exxon Corp. v. Department of Revenue*, 447 U.S. 207 (1980); *Mobil Oil Corp. v. Comm'r of Taxes*, 445 U.S. 425 (1980).

6. *Japan Line, Ltd. v. County of Los Angeles*, 441 U.S. 434 (1979).

position in a memorandum filed in *Chicago Bridge & Iron Co. v. Caterpillar Tractor Co.*<sup>7</sup> The government did not reaffirm its position in *Container* and this proved fatal to the appellant. The Court considered the appeals filed in the *Container* and *Chicago Bridge* cases at the same conference, noting probable jurisdiction in *Chicago Bridge* on October 5, 1981, while taking no action in *Container*. Both cases raised the issue of state imposition of the worldwide unitary method on a U.S.-based parent company. In *Chicago Bridge*, the issue had not been raised by the primary corporate litigant, Caterpillar Tractor Company, but by intervenors, one of which was Chicago Bridge & Iron Company. Because of this fact, the record in the case was inadequate for a full presentation of the issues.

Prior to oral argument in *Chicago Bridge*, the United States through the Solicitor General filed a memorandum arguing that the worldwide unitary method contravened the commerce clause because it could not stand scrutiny under either of the two tests of *Japan Line, Ltd. v. County of Los Angeles*.<sup>8</sup> However, during oral argument in *Container*, members of the Court voiced concern about deciding the worldwide unitary issue on the record in *Chicago Bridge*.<sup>9</sup> Shortly thereafter, on May 3, 1982, the Court noted probable jurisdiction in *Container*.<sup>10</sup>

In view of the importance of the position of the United States on the worldwide unitary issue, counsel for Container sought to determine whether the Solicitor General would also file a memorandum in the *Container* case. Counsel were eventually informed that the Cabinet Council on Economic Affairs (hereinafter the Council)<sup>11</sup> had determined not to file a memorandum in the *Container* case, but that the Council had also determined not to withdraw the brief previously filed in *Chicago Bridge*.<sup>12</sup> Counsel for Container concluded from discussions with officials of the executive branch that the executive branch believed that the Court would accept the Solicitor General's memorandum in *Chicago Bridge* as presenting the

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7. Memorandum for the United States as Amicus Curiae, *Chicago Bridge & Iron Co. v. Caterpillar Tractor Co.*, 84 Ill.2d 102, 417 N.E. 2d 1343 (1981), *prob. juris. noted*, 102 S. Ct. 967, *appeal dismissed*, 103 S. Ct. 3562.

8. 441 U.S. 434 (1979) ((1) whether the tax, notwithstanding apportionment, creates a substantial risk of international multiple taxation and (2) whether the tax prevents the federal government from speaking with one voice when negotiating commercial relations with foreign governments). According to the Solicitor General, the method raised the risk of double taxation and impaired the foreign policy of the United States because it prevented the United States from speaking with one voice in international trade.

9. Transcript of Oral Argument, on April 19, 1983, *Chicago Bridge*.

10. — U.S. —, 102 S. Ct. 2034 (1982).

11. The Cabinet Council on Economic Affairs is composed of the Secretaries of Treasury, State, and Commerce, and the United States Trade Representative.

12. Elliot & Cohen, *Court Gives States Right to Tax Multinational Earnings*, Legal Times, July 25, 1983, at 42. For a discussion of the intensive efforts by the states to prevent the filing of a memorandum by the Solicitor General in the *Container* case, see Whitenack, *Container Case Could Benefit Foreign Multinationals*, 20 TAX NOTES 771 (1983).

government's position in *Container* since the *Chicago Bridge* case was still pending before the Court.

The *Container* case was briefed and argued by both parties as if the Solicitor General's memorandum in *Chicago Bridge* set forth the position of the United States. The memorandum was also discussed at some length during the oral argument in *Container*, both by the parties and by members of the Court. No member of the Court indicated a concern that the memorandum did not represent the position of the United States.<sup>13</sup>

The failure of the Solicitor General to file a memorandum in the *Container* case itself became an important issue for the Court. In its opinion the Court acknowledged the difficulties it faced both in determining whether the worldwide unitary method impaired U.S. foreign policy and the expertise of the executive branch in making that determination. Without the aid of the executive branch, the Court made a determination on its own that U.S. foreign policy was not implicated. Also, the Solicitor General's failure to file a memorandum in *Container* suggested to the Court that the executive branch did not believe that the worldwide unitary method impaired U.S. foreign policy. The Court acknowledged that the Solicitor General had filed a brief in *Chicago Bridge* opposing the worldwide unitary method. The Court explained, however, that "[a]lthough there is no need for us to speculate as to the reasons for the Solicitor General's decision not to submit a similar brief in this case . . . there has been no indication that the position taken by the Government in *Chicago Bridge & Iron Co.* still represents its views, or that we should regard the brief in that case as applying to this case."<sup>14</sup> Thus, between the time of the oral argument on January 10, 1983, and the decision on June 27, 1983, the majority apparently determined that the failure to file a brief in *Container* signalled a change in the position of the United States. The dissenters chided the majority on this point, noting that the United States communicates with the Court through the Solicitor General and "[a]s long as *Chicago Bridge & Iron* remains before us, we must conclude that the Government's views are accurately reflected in the Solicitor General's memorandum in that pending case."<sup>15</sup>

The majority's speculation as to the meaning of the government's failure to file a memorandum in *Container* leaves the decision in an unsatisfactory state. The majority acknowledged that the executive branch is in a much better position to know if state action impairs United States foreign policy. The government's only word to the Court on the effect of state worldwide unitary combination is contained in the Solicitor General's memorandum and oral argument to the Court in *Chicago Bridge*. The gov-

13. See, e.g., Transcript of Oral Argument on Jan. 10, 1983 at 19-20, 26-28, *Container*.

14. — U.S. —, 103 S. Ct. at 2956 n.33. In the footnote, the Court refers to the Brief *Amicus Curiae* for the National Governors' Association and the State of Hawaii as providing a possible explanation of the reasons for the failure of the United States to file a brief in *Container*.

15. *Id.* at 2960 (Powell, J., dissenting).

ernment unequivocally stated that the state action impaired United States foreign policy. Rather than ask if the government had changed its views, the majority assumed, without concrete evidence, that the government had done so.

Container sought to clarify the matter by asking the Court to rehear the case and to give the government a chance to state its views. Container and its counsel realized, of course, that such a course of action would require the United States to reconsider its policy not only in regard to the *Container* case but also in regard to pending legislation intended to prohibit worldwide combination.<sup>16</sup> Further, the decision to rehear would occur within the context of conflicting views expressed by state governments on the one side, and interested foreign governments and the international corporate community in general on the other side. Ultimately, the Cabinet Council on Economic Affairs recommended to the President that the United States file a memorandum supporting Container's petition for a rehearing and that the executive branch also support federal legislation preventing worldwide combination.<sup>17</sup>

On September 23, 1983, the President announced his decision not to follow the recommendation of the Cabinet Council in regard to filing a memorandum in the *Container* case. The President also announced that a high-level group would be appointed to study the problem and to make recommendations.<sup>18</sup> On October 11, 1983, the Supreme Court denied Container's petition for a rehearing.<sup>19</sup> The President's decision effectively removed the issues from the Court's consideration and returned them to the executive branch for decision. The President indicated that he hoped the conflicting views could be reconciled. It would seem, however, that the only reconciliation possible would be the adoption of a single apportionment policy in the area of foreign commerce by both the federal government and the states.

The foregoing events illustrate the intensely political nature of the issues before the Court. In effect, the Court was saying to Congress and the Executive that application of the worldwide unitary method by the states presents foreign policy issues which those branches should resolve. The Court's opinion, therefore, must be considered in light of its reluctance to determine the foreign policy issues without guidance from the executive branch and Congress.

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16. See S. 1225 and H.R. 2918, 98th Cong., 1st Sess. (1983).

17. Bernick, *Cabinet Council Recommends Anti-Unitary Position*, 20 TAX NOTES 901 (1983); Dion, *Foreign Governments Up in Arms Over State Taxation of Multinationals*, 15 NAT'L J. 2056 (1983) (the vote was unanimous, by some accounts).

18. Formation of the Worldwide Unitary Taxation Working Group was announced on October 2, 1983. The Group is composed of representatives of the federal government, state governments, and the business community. See Treasury News No. R-2393, Oct. 28, 1983, at 1.

19. 104 S. Ct. 265 (1983).

## II THE DISTORTION, DOUBLE TAXATION, AND IMPAIRMENT OF FOREIGN POLICY ISSUES

The issues of broadest consequence in *Container* involved the problems of double taxation of foreign commerce and impairment of United States foreign policy. Closely related is the important issue of distortion: whether the state is taxing income earned outside its jurisdiction. Following discussion of these issues, we will discuss the Court's treatment of the definition of a unitary business.

### A. *The Distortion Issue*

It is an axiom of constitutional jurisprudence that a state may tax only property located or earnings arising from within its jurisdiction; that due process is violated if a state attempts to tax property or income located outside the state. The rule is easy to state, but in the case of state taxation of income, taxpayers have found it difficult to prove to the satisfaction of the Court that a state is taxing income earned outside the state. The *Container* case is no exception.

*Container's* proof was based upon the premise that the unitary system should only be applied where all units of a combined group are operating in a common market with a common economic and political system. The underlying assumption is that a dollar of property, payroll, and sales will earn about the same amount of net income anywhere within the geographic area to which the unitary system is applied.<sup>20</sup> This assumption is basically true when applied to the United States; it is not true when applied on a worldwide basis. *Container* demonstrated that, as a general matter, foreign subsidiaries of U.S. corporations are more profitable than their parents.<sup>21</sup> Therefore, unitary combination will inevitably attribute some net income of foreign subsidiaries to the states employing the method.

*Container's* expert witness testified that multinational corporations utilize different "hurdle rates" in different parts of the world which set a minimum anticipated rate of return upon an investment. If the rate cannot be met, the investment will not be made. These hurdle rates vary from corporation to corporation, industry to industry, and country to country; however, an individual U.S. corporation will invariably have a higher hurdle rate for a foreign investment than for a similar domestic investment.<sup>22</sup> Thus, U.S. corporations expect to receive a greater rate of return on foreign investments. These expectations of a greater rate of return on foreign in-

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20. J. HELLERSTEIN & W. HELLERSTEIN, STATE AND LOCAL TAXATION 539 (4th ed. 1978).

21. Transcript of Oral Argument at 14, *Container*.

22. Joint Appendix, *Container Corporation of America v. Franchise Tax Board*, — U.S. —, 103 S. Ct. 2933 (1983), at 131-44, 154-67.

vestments are, by and large, actually achieved.<sup>23</sup> Several factors contribute to this success, the most important of which are lower labor costs, more rapidly expanding economies, greater market share, and governmental protection from competition.<sup>24</sup>

The evidence demonstrated that Container's foreign subsidiaries in Colombia, Venezuela, and the Netherlands were more profitable than its United States operations.<sup>25</sup> Container compared the income attributable to the various companies under a separate accounting analysis with that assigned to the countries under California's unitary system.<sup>26</sup> The greater profitability in the Colombian and Venezuelan subsidiaries was of particular significance because these subsidiaries earned eighty-four percent of the total net income earned by the foreign subsidiaries. The data demonstrated that the distortion produced by the formula method was particularly acute between third world countries such as Colombia and Venezuela and the highly industrialized countries such as the United States and West Germany. Thus, formulary apportionment attributed approximately one-half of the income produced in Colombia and Venezuela, according to separate accounting principles, to affiliates operating in other countries. In Colombia's case, approximately the same amount of income was apportioned by the unitary method to Colombia as the Colombian subsidiaries paid in income taxes to that country.<sup>27</sup> Most of this income (approximately four million dollars a year) was reassigned to the U.S. parent and was then available for taxation by California and other states.

23. *Id.* at 114. Schedule VII.

24. *Id.* at 168-83.

25. *See id.* at 109-14. Schedules VI & VII.

26. The results of this analysis were:

	Average Pre-Tax Income per Arm's-Length in Different Countries	Average Pre-Tax Income per Worldwide Apportionment
	1963/64/65	1963/64/65
Container (United States)	\$28,121,000	\$32,068,000
Colombia	4,254,000	2,203,000
Mexico	1,605,000	1,430,000
Venezuela	4,246,000	1,907,000
Panama	1,286,000	—
Austria	(13,000)	11,000
West Germany	1,793,000	2,906,000
Holland	384,000	197,000
Italy	34,000	968,000
Total Foreign	<u>13,588,000</u>	<u>9,642,000</u>
Total Combined	<u>\$41,710,000</u>	<u>\$41,710,000</u>

Appellant's Brief on the Merits at 17, *Container*.

27. *Id.* at 108-13. Schedules V & VI.

The evidence also demonstrated substantial differences in the return on the unitary factors between Container and the foreign subsidiaries. The data are summarized in the table reproduced below,<sup>28</sup> which compares the relationship between dollars of sales, payroll, and property required to produce one dollar of net income computed for Container domestically and for Container's foreign subsidiaries as a whole. As can be seen from the table, the distortion in the apportionment of Container's income can be traced primarily to the significant difference in the relationship of payroll costs to net income in the United States as compared to other countries and, to a lesser extent, to the difference in the relationship of sales to net income.

The lower cost of labor in the foreign subsidiaries was not offset by a difference in productivity.<sup>29</sup> It cost about two and one-half times as much to produce a thousand square feet of corrugated containers in California as it did in Colombia. A general study by the United States Tariff Commission confirms this conclusion.<sup>30</sup> In reviewing this evidence, it should be noted that the separate accounting method of determining net income was required for income tax reporting by each of the countries in which Container's subsidiaries operated.

28. Amount Required to Produce \$1.00 of Net Income for the Years 1963-65

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

(Source: Joint Appendix at 18)

29. Analysis of Hourly Labor Costs\* for Corrugated Plants

	Corona	Oakland	Fresno	Malt. Ave.	California Weighted Average	Colombia
Manhours per MSF	.41	.39	.33	.33	.39	.98
Labor Cost per Manhour	6.48	7.83	6.71	7.90	7.41	1.21
Labor Cost per MSF	2.64	3.09	2.20	2.64	2.85	1.19

\* Labor costs include all hourly wages, benefits, and payroll taxes. Joint Appendix, *supra* note 22, at 105, *Container*.

30. Percentage of U.S. Average Hourly Compensation Adjusted for Estimated Differences in Productivity

Country	1969	1970
Japan	40	40
West Germany	61	72
United Kingdom	65	68
Belgium	60	61
Canada	79	82
France	58	54
Italy	62	67
Netherlands	74	71
Sweden	72	74

Source: United States Tariff Commission, "Competitiveness of U.S. Industries," T.C. Publication 473, at 30 (1972).

In considering distortion arguments, the Supreme Court is fond of saying (as it did in the *Container* opinion) that the taxpayer's separate accounting analysis was made for the convenience of its own financial reporting purposes.<sup>31</sup> In *Container* that statement was not entirely accurate. Although *Container* and each of its subsidiaries determined net income on a separate accounting basis for financial reporting purposes, the companies were required to do so for income tax reporting by the countries in which they operated. Therefore, *Container's* complaint was that part of the income which California was taxing was defined under the tax laws of the countries in which the subsidiaries operated as earned in those countries. However, the fact that foreign governments defined taxable net income by using a separate accounting basis did not, at least so far as the Court was concerned, enhance *Container's* showing that California was taxing income earned outside the state.

Instead, the Court reiterated the position that it had adopted in earlier interstate commerce cases, namely that any proof of distortion produced by comparisons of formulary apportionment to separate accounting are basically suspect and that, in any event, in order to succeed under the due process clause the distortion must be enormous. Thus, the Court noted that *Container* was attempting to prove that California was taxing income earned outside the state through separate accounting techniques "whose basic theoretical weaknesses justify resort to formula apportionment in the first place."<sup>32</sup> Furthermore, the evidence showed that formulary apportionment increased *Container's* income earned in California by only fourteen percent, which was "a far cry" from the more than two hundred and fifty percent found in *Hans Rees' Sons, Inc. v. North Carolina*.<sup>33</sup> The Court ignored the fact that the fourteen percent differential was based upon a one hundred percent differential when the separate accounting income was attributed to the Colombian and Venezuelan subsidiaries by formulary apportionment.<sup>34</sup> More importantly, the Court's approach ignored the differences in the economic realities of operations in the United States and those in third world countries. The lower wages paid and higher profits earned by the Colombian and Venezuelan subsidiaries ensure that formula apportionment of *Container's* income cannot fairly be applied on a worldwide basis. The formula assures that the lion's share of the combined income of a unitary business will be apportioned to the United States members of that business, where it can be taxed by the states. The evidence clearly demonstrated that under any reasonable standard California was taxing income earned outside the state.

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31. 103 S. Ct. at 2948-49.

32. *Id.*

33. *Id.* at 2950; 283 U.S. 123 (1931).

34. See *supra* table in note 26. The dissent also emphasized the great difference between the income attributed to the Colombian and Venezuelan subsidiaries by separate accounting as compared to formulary apportionment. See — U.S. —, 103 S. Ct. 2958.

Furthermore, the Court's sole reliance on the percentage of distortion approach appears overly simplistic. One difficulty with using percentages is that the results can vary a great deal, depending upon the size of the parent and the size of the subsidiaries. In *Container's* case the parent's income was about seven to eight times greater than the income of either the Colombian or Venezuelan subsidiaries, so the unitary method reduced the income of the subsidiaries in Colombia by one hundred percent. Suppose, however, that *Container* was a Colombian corporation with a subsidiary in the United States and that the income of the parent was about seven or eight times greater than the income of the subsidiary. If *Container* was a large, highly profitable foreign corporation with a small U.S. subsidiary, application of the unitary method might well *increase* the taxable income of the subsidiary by one hundred percent or more. If the net income of the subsidiary is small in comparison to the net income of the parent, application of formula apportionment may have a much greater effect upon the subsidiary's net income than upon the income of the parent.<sup>35</sup>

Certainly, a hard look at the evidence demonstrating where profits are earned is preferable to reliance upon a percentage computation, which may not be illustrative of the underlying facts.

Does the Court's decision in *Container* overrule earlier cases in regard to proving that a state, through formula apportionment, is taxing income earned in other states? Probably not. The Court cited *Hans Rees* and *Norfolk & Western Ry. Co. v. Missouri State Tax Commissioner*<sup>36</sup> with approval. However, *Container* reiterated that separate accounting may be used to show that formula apportionment is taxing income earned in other states only where the distortion is substantial. The fact that part of the unitary group is operating in foreign countries where economic conditions differ greatly from those in the United States apparently makes no

35. The following example illustrates this point:

	<u>California</u>	<u>Foreign</u>	
		(1)	(2)
Property	\$1,000	\$100	\$10,000
Payroll	1,000	100	10,000
Sales	1,000	100	10,000
Income (separate accounting)	100	40	4,000
California apportionment percentage		(1) $\frac{1,000}{1,100} = 90.9\%$	
		(2) $\frac{1,000}{11,000} = 9.09\%$	
Income (formula)		(1) $.909 \times 140 = \$127$	
		(2) $.0909 \times 4100 = \$373$	
Percentage increase from combination		(1) $27/100 = 27\%$	
		(2) $273/100 = 273\%$	

36. 390 U.S. 317 (1968).

difference.<sup>37</sup>

### B. *The Double Taxation Issue*

Double taxation of foreign source income follows directly from the serious divergence between the separate accounting and formula apportionment methods. Because of those differences, the Supreme Court acknowledged that the tax imposed by California "resulted in actual double taxation, in the sense that some of the income taxed without apportionment by foreign nations as attributable to appellant's foreign subsidiaries was also taxed by California as attributable to the State's share of the total income of the unitary business of which those subsidiaries are a part."<sup>38</sup>

In view of such double taxation, it would appear that the Court's seminal opinion in *Japan Line, Ltd. v. County of Los Angeles*,<sup>39</sup> required a decision that the worldwide unitary method violated the foreign commerce clause. *Japan Line* concerned the imposition by California of a fairly apportioned property tax on cargo containers involved solely in foreign commerce but which were temporarily located in California ports. The containers in question were subject to a property tax on their total value in their home port of Japan. Furthermore, a Convention signed by the United States and Japan provided that neither national government could impose a tax on containers temporarily in a particular country where their home port was in the other nation.<sup>40</sup> The Convention did not, however, limit state taxation.

The *Japan Line* opinion noted that "[w]hen a State seeks to tax the instrumentalities of foreign commerce, two additional considerations, beyond those articulated in [cases involving the interstate commerce clause], come into play."<sup>41</sup> The first is the enhanced risk of multiple taxation. The second is the possibility that a state will "impair federal uniformity in an area where federal uniformity is essential."<sup>42</sup> The opinion explained why double taxation resulting from differing allocation and apportionment methods may be constitutionally tolerable in dealing with state taxation of interstate commerce, but is not tolerable in dealing with state taxation of foreign commerce. In invalidating the tax, the Court stated:

The basis for this Court's approval of apportioned property taxation, in other words, has been its ability to enforce full apportionment by all potential taxing bodies.

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37. For a discussion of distortion in defining a unitary business, see *infra* text accompanying notes 105-110.

38. 103 S. Ct. at 2951 (footnote omitted).

39. 441 U.S. 434 (1979).

40. Customs Convention on Containers, May 18, 1956, 20 U.S.T. 301, T.I.A.S. No. 6634, 338 U.N.T.S. 103, art. 2 (entered into force for the United States, Mar. 3, 1969); Convention for the Avoidance of Double Taxation, U.S.-Japan, March 8, 1971, 23 U.S.T. 967, T.I.A.S. No. 7365, art. 8.

41. 441 U.S. at 446.

42. *Id.* at 448.

Yet neither this Court nor this Nation can ensure full apportionment when one of the taxing entities is a foreign sovereign. If an instrumentality of commerce is domiciled abroad, the country of domicile may have the right, consistently with the custom of nations, to impose a tax on its full value. If a State should seek to tax the same instrumentality on an apportionment basis, multiple taxation inevitably results. Hence, whereas the fact of apportionment in interstate commerce means that 'multiple burden logically cannot occur,' the same conclusion, as to foreign commerce, logically cannot be drawn. Due to the absence of an authoritative tribunal capable of ensuring that the aggregation of taxes is computed on no more than one full value, a state tax, even though 'fairly apportioned' to reflect an instrumentality's presence within the State, may subject foreign commerce 'to the risk of a double tax burden to which [domestic] commerce is not exposed, and which the commerce clause forbids.'<sup>43</sup>

The *Container* case seemed to fit within the *Japan Line* Court's description of the multiple tax problem since California there sought to tax income through formula apportionment which a foreign government also taxed on a separate accounting basis. Since the Court could not ensure fair apportionment, foreign commerce was subject to a risk of double taxation to which domestic commerce was not exposed.<sup>44</sup> The Court also noted other similarities between the *Container* case and *Japan Line*. In both cases the risk of double taxation stems from a "serious divergence in the taxing schemes adopted by California and the foreign taxing authorities."<sup>45</sup> Furthermore, "the taxing method adopted by those foreign taxing authorities is consistent with accepted international practice," and the federal government "seems to prefer the taxing method adopted by the international community to the taxing method adopted by California."<sup>46</sup>

Nevertheless, the *Container* Court distinguished *Japan Line* on three grounds. First, *Japan Line* involved a property tax rather than an income tax, and double taxation is easier to demonstrate under the first type of tax than under the latter.<sup>47</sup> Second, the double taxation in the *Container* case is not "the 'inevitable' result of the California taxing scheme."<sup>48</sup> The Court here seems to mean that double taxation will not occur in every case in the income tax area as compared to a property tax such as that imposed by the state in *Japan Line*. Third, the tax was on a domestic corporation rather than on a foreign corporation.<sup>49</sup>

In substance, the Court concludes that the decisive distinction between *Container* and *Japan Line* is that in *Japan Line*, California could eliminate double taxation simply by not taxing any cargo containers owned, based, and registered abroad and used exclusively in international commerce,

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43. *Id.* at 447 (citations omitted).

44. 103 S. Ct. at 2951 (citing *Japan Line*).

45. *Id.* at 2951-52.

46. *Id.*

47. *Id.*

48. *Id.*

49. *Id.* at 2952.

while there is no feasible method by which California could eliminate the risk of double taxation in the present case.<sup>50</sup> This conclusion is based on the Court's assumption that state double taxation under the arm's-length method would be about the same as under the unitary method. This assumption, however, and the underlying analysis, were undertaken without significant argument by the parties. We believe this analysis is incorrect.

It is true that not every taxpayer subjected to the worldwide unitary method will experience actual double taxation.<sup>51</sup> However, because the rates of return on the unitary factors (property, sales, and payroll) are usually lower in the jurisdictions applying the unitary method, double taxation will usually result from its application.

In making its assumption regarding the equivalency of double taxation, the Court overlooked the evidence to the contrary in the record of the *Container* case and elsewhere. Indeed, the uncontroverted expert testimony introduced by Container established that taxation of income earned in foreign countries is the expected result of application of the worldwide unitary method, in contrast to the arm's-length, separate accounting method.<sup>52</sup> This "expected result" is acknowledged by the states themselves. California estimates that use of the worldwide unitary method enables it to collect five hundred million dollars in taxes which it could not collect if it applied the arm's-length, separate accounting method.<sup>53</sup> Because the California tax rate is approximately ten percent, this means that California is taxing about five billion dollars of income earned and subject to taxation in foreign countries. Other states assert that proportionately large amounts would be lost if the worldwide unitary method were to be prohibited.<sup>54</sup>

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50. *Id.* at 2953-54.

51. Although taxpayers may realize refunds through using the worldwide combination method as compared to separate accounting, the Court's reference to *Chicago Bridge* as an example of such a situation is misplaced. Actually, the taxpayer, Caterpillar Tractor Co., received a refund because the use of worldwide combination permitted the exclusion from income of dividends from its foreign subsidiaries. Otherwise, the total dividends would be taxed by Illinois, the state of commercial domicile. See Reply Brief of Appellant at 12, *Chicago Bridge*.

52. See, e.g., Testimony of Prof. John McDonald, Joint Appendix, *supra* note 22, at 188-94.

53. Lewin, *Unitary Tax Scope Widens*, N.Y. Times, Oct. 18, 1983, at 28, col. 1.

54. As the Brief *Amicus Curiae* of the Confederation of British Industry filed in *Container* noted at 10 n.11, seven states responding to a questionnaire distributed by the Multistate Tax Commission on behalf of the Treasury Department estimated revenue losses as follows: California: \$500 million; Colorado: \$12 million; Idaho: \$16-17 million; Montana: \$3 million; New York: \$75 million; North Dakota: \$3.5-5.5 million; and Utah: \$16 million. See Multistate Tax Commission, *Summary of State Responses to Treasury Department Questionnaire on Use of Unitary Method and Taxation of Dividend Income 5* (May 11, 1982). The questionnaire further asked the states to estimate what percentage of corporate taxpayers subject to the worldwide method suffered an increase in taxable income as a result of application of the unitary method. The three states providing a numerical estimate responded as follows: California: 75-85%; Colorado: probably 90%; and North Dakota: approximately 75-85%. *Id.* at 5-6. Cf. Rusch & Kennedy, *State Revenues That Would Be Lost By Prohibiting Worldwide Unitary Taxation Or The "Flaky Data" Caper*, 21 TAX NOTES 1035 (1983).

Equally revealing is Florida's recent adoption of the worldwide unitary method. Within three weeks after the *Container* decision, and in direct response thereto, the Florida Legislature enacted a unitary taxation scheme.<sup>55</sup> Florida expects to receive ninety-five million dollars annually through the worldwide unitary method.<sup>56</sup> Thus, by a switch from the separate accounting, arm's-length method to the worldwide unitary method, the state is able to tax large amounts of income earned and subject to taxation in foreign countries. Assuming that the state estimates of revenue losses are within a reasonable range of accuracy, the potential for double taxation through use of the worldwide unitary method is enormous.<sup>57</sup>

The Court's opinion also did not consider that double taxation resulting from the separate accounting method is subject to negotiation with foreign governments, while no negotiations can occur if the states use the unitary method. The dissent put the matter well when it stated:

In sum, the risk of double taxation can arise in two ways. Under the present system, it arises because California has rejected accepted international practice in favor of a tax structure that is fundamentally different in its basic assumptions. Under a uniform system, double taxation also could arise because different jurisdictions—despite their agreement on basic principles—may differ in their application of the system. But these two risks are fundamentally different. Under the former, double taxation is inevitable. It cannot be avoided without changing the system itself. Under the latter, any double taxation that exists is the result of disagreements in application. Such disagreements may be unavoidable in view of the need to make individual judgments, but problems of this kind are more likely to be resolved by international negotiation.<sup>58</sup>

Finally, the question arises as to whether the Court's opinion suggests a new limitation upon commerce clause protection from multiple state taxation. The Court has long followed the rule that interstate commerce must not "bear cumulative burdens not imposed on local commerce."<sup>59</sup> The Court's opinion appears to hold that such cumulative burdens may be imposed if the Court concludes that the state has no reasonable alternative method of taxation.

This limitation is new in commerce clause jurisprudence. If it is to be vigorously enforced, it could impose a severe burden upon the taxpayer, even in a case where multiple taxation of interstate or foreign commerce is clearly demonstrated. As we have seen, however, the Court came to this

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55. See 1983 Fla. Laws, ch. 83-349.

56. Wall St. J., July 19, 1983, at 29, col. 1.

57. California has about ten percent of the total United States population. It is not unreasonable to assume that about ten to twelve percent of U.S. business is conducted in that state and California's share of the total factors located in all states would range between ten to twelve percent. Using these assumptions and California's estimate of annual revenue losses of five hundred million dollars, if all of the states adopted the worldwide unitary method, foreign source income of forty to fifty billion dollars would be taxed by the states and total state taxes upon this income would be in the neighborhood of four to five billion dollars.

58. 103 S. Ct. at 2959 (Powell, J., dissenting).

59. *Western Live Stock v. Bureau of Revenue*, 303 U.S. 250, 256 (1938).

limitation through the mistaken notion that the same double taxation burdens would be imposed by California if it used the separate accounting method. There was no evidence in the case, nor were there other facts which the Court could note, to support its conclusion. Moreover, California clearly had the alternative of using the separate accounting method in regard to foreign corporations which the United States, our trading partners, and most other states have found to be a satisfactory solution. Indeed, it is difficult to visualize circumstances where states do not have reasonable alternatives to imposing multiple tax burdens upon interstate commerce. Perhaps the limitation may be confined to the *Container* decision, but litigants should certainly be aware of the problem in preparing future tax cases in which the commerce clause issue is involved.

In *Japan Line*, the Court held invalid a state taxing scheme which was contrary to international practice and resulted in double taxation of foreign commerce. Indeed, *Japan Line* declares that a state tax is invalid if it "creates a substantial risk of international multiple taxation."<sup>60</sup> The facts in *Container* and the claims of the states in regard to revenue losses amply demonstrate that worldwide unitary taxation results in actual double taxation in the bulk of the cases; certainly it "creates a substantial risk" of double taxation of foreign commerce. The majority opinion thus seems incorrect in its failure to apply the principles of *Japan Line* and thereby conclude that California's imposition of worldwide unitary taxation violates the commerce clause.

### C. *The Impairment of U.S. Foreign Policy Issue*

In considering whether the worldwide unitary taxation method impairs the foreign policy of the United States, the Court emphasized its own lack of expertise in making such a determination. "This Court has little competence in determining precisely when foreign nations will be offended by particular acts, and even less competence in deciding how to balance a particular risk of retaliation against the sovereign right of the United States as a whole to let the states tax as they please."<sup>61</sup> Further, the "nuances" of "the foreign policy of the United States . . . , are much more the province of the executive branch and Congress than of [the] Court . . . ."<sup>62</sup>

As noted above in Part I, the Justice Department had informed the Court that the "imposition of [a state tax] on the apportioned combined worldwide business income of a unitary group of related corporations, including foreign corporations, impairs federal uniformity in an area where such uniformity is essential."<sup>63</sup>

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60. 441 U.S. at 451 (1979).

61. 103 S. Ct. at 2955-56.

62. *Id.*

63. Memorandum, *supra* note 7, at 2, *Chicago Bridge*.

The elimination of the Solicitor General's memorandum from consideration was evidently fatal to Container's case. It withdrew from the Court's consideration the views of the very branch of government which the Court acknowledged had the expertise to determine the impact of the worldwide unitary method on U.S. foreign policy. Indeed, if the executive branch had specifically informed the Court that state action impairs U.S. foreign policy, it would seem extremely difficult for the Court to come to a different conclusion. Furthermore, the elimination of the Solicitor General's memorandum from consideration in *Container* gave the Court the opportunity to infer that the executive branch was not concerned about the problem and that "the foreign policy of the United States . . . is not seriously threatened by California's decision to apply the unitary business concept and formula apportionment in calculating appellant's taxable income."<sup>64</sup> The majority opinion viewed the absence of a further memorandum from the Solicitor General as providing affirmative support for its conclusion.

Having set aside the views of the executive branch, the Court was left to its own resolution of the problem. The Court concentrated on the question of possible retaliation by a foreign government and concluded that such retaliation seemed unlikely. In support of its position, the Court noted again that the tax in *Container* "does not create an *automatic* 'asymmetry' . . . in international taxation" and that the tax is imposed, not on a foreign entity, but on a domestic corporation.<sup>65</sup> The Court also concluded that foreign governments should not be offended at the increase in Container's tax liability because California could have increased the tax liability by simply increasing the tax rate.<sup>66</sup> However, as the dissent noted, "[t]he State could not raise the tax rate for appellant alone, or even for corporations engaged in foreign commerce, without facing constitutional challenges under the Equal Protection or the Commerce Clause."<sup>67</sup>

Additionally, the Court mentioned that the California tax may have foreign policy implications other than the threat of retaliation.<sup>68</sup> However, since the executive branch did not file a memorandum in the case, the Court found it difficult to determine what those implications might be. In sum, without a statement of position by the executive branch, the Court concluded that foreign governments will not be greatly concerned if U.S. corporations have to pay additional state tax because of the state's divergent taxing scheme.<sup>69</sup> The Court declined to consider other foreign policy problems which might arise from worldwide unitary taxation (*e.g.*, the de-

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64. 103 S. Ct. at 2956.

65. *Id.* at 2955.

66. *Id.* at 2955-56.

67. *Id.* at 2960 n.6 (Powell, J., dissenting).

68. *Id.* at 2956.

69. *Id.*

sire of the federal government to avoid double taxation of international trade) without direction from the executive branch or Congress.

The *Container* dissent, on the other hand, points out that "double taxation is the logical expectation in a large proportion of the cases."<sup>70</sup> Under *Japan Line* this should invalidate worldwide unitary taxation.<sup>71</sup> Furthermore, the fact that *Container* is "technically a domestic corporation," or that California could raise the tax rate for all corporations doing business in the state does not militate against the fact that California's taxation method prevents "the Federal Government from speaking with one voice in a field that should be left to the Federal Government."<sup>72</sup>

The Court's opinion recognized two fundamental points. First, the Court concluded that the issues of double taxation of foreign commerce and impairment of United States foreign policy are intertwined. Second, the Court determined that the views of the executive branch are of importance in deciding whether worldwide unitary taxation interferes with United States foreign policy. The Court assumed, however, that because no memorandum was filed in *Container* the executive branch no longer supported the views it advocated in *Chicago Bridge*. That assumption was certainly influential in its decision against *Container*. It is unfortunate that in a case of such importance the Court did not provide the executive branch with an opportunity to confirm the correctness of the Court's assumption.<sup>73</sup>

### III

#### POSITION OF FOREIGN-BASED MULTATIONALS

What does the *Container* decision tell us in regard to the validity of worldwide combination when applied to a foreign-based parent group? The opinion is careful to state that its analysis of the double taxation and impairment of foreign policy issues may not apply in the case of a domestic subsidiary and foreign parent.<sup>74</sup> In fact, the Court upheld double taxation and found no impairment of foreign policy partly because *Container* is a domestic parent corporation. In the Court's view, the burden of double taxation in the *Container* situation is essentially a domestic problem; foreign governments presumably will not be outraged if taxes of U.S. corporations are increased. The Court conceded, however, that this analysis might not apply to a foreign-based parent corporation.

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70. *Id.* at 2959 (Powell, J., dissenting).

71. *Id.*

72. *Id.* at 2961.

73. The Court also held that "the California tax at issue here is [not] preempted by federal law or fatally inconsistent with federal policy." *Id.* at 2957. The Court has, however, invalidated state legislation as being in conflict with federal policy under a somewhat less relaxed standard in *Hines v. Davidowitz*, 312 U.S. 52, 67 (1941). See also *McGoldrick v. Gulf Oil Corp.*, 309 U.S. 414 (1940).

74. See 103 S. Ct. at 2952 n.25, 2956 n.32.

The three dissenting Justices did not accept the Court's position in regard to a domestic parent corporation, and they made it clear that worldwide combination would certainly not be acceptable if applied to a foreign parent situation.<sup>75</sup> In this circumstance, asserted the dissenters, the risk of retaliation is even greater and United States foreign policy even more clearly implicated.<sup>76</sup>

A foreign parent case would put the constitutionality of the worldwide unitary method into a clearer focus. Any double taxation involved directly affects a foreign corporation's income (either that of the foreign parent or its foreign affiliates), since it is that income earned and taxed by foreign governments under separate accounting principles which the state is also taxing. Furthermore, the discriminatory effect of the compliance burden is more clearly drawn in the case of a foreign parent. A U.S. parent is at least familiar with the state's tax accounting concepts and unitary principles, however costly it may be to comply. A foreign parent is not familiar with those concepts and principles, making compliance much more burdensome.

The issue surrounding worldwide combination should be resolved by the executive branch and Congress in conjunction with our trading partners, the states, and the multinational community. The President's Working Group on Unitary Taxation<sup>77</sup> may be able to find a common ground which would be the foundation for a solution.

If this effort fails, however, and a case involving a foreign parent multinational group reaches the Supreme Court, the grounds for invalidating worldwide combination under the commerce clause will certainly be present. One must assume, of course, that the concern of the foreign governments will continue and that the threat of retaliation in some form will be manifest, so that the foreign parent can make a clear showing on the point to the Court. Indeed, the foreign government itself might file a brief giving its views directly to the Court. This has happened several times recently.<sup>78</sup> Under these circumstances it would be difficult for the executive branch to remain aloof from the case. Indeed, it would seem that the executive branch would almost certainly have to file a memorandum informing the Court that U.S. foreign policy is seriously impaired. In these circumstances the Court's analysis in *Japan Line* and *Container* would appear to require a holding that worldwide combination is invalid.<sup>79</sup> Such discrimination

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75. *Id.* at 2959-60 (Powell, J., dissenting).

76. *Id.* at 2960 & n.4.

77. See *supra* text accompanying note 18.

78. See, e.g., Motion of Belgium et. al. for leave to file brief as *amicus curiae* granted, *Shell Petroleum N.V. v. Franchetti*, cert. denied, 104 S. Ct. 537 (1983).

79. See Javaras & Browne, *Litigation Prospects After Container: The Foreign Parent Issue*, 21 TAX NOTES 1027, (1983). The *Container* case would not be a contrary precedent since a showing of impairment of United States foreign policy would be clearly made. A holding in favor of a foreign parent, however, might persuade the Court in a future case that a United States parent corporation is suffering an unconstitutional discrimination under the commerce

should be eliminated by Congress or state legislatures, however, thus obviating the need for a court challenge.

#### IV THE UNITARY ISSUE

##### A. *The Facts of the Case*

The *Container* case involves state taxation for the years 1963, 1964, and 1965. Container, a Delaware corporation, headquartered in Chicago, Illinois, owned a controlling interest in twenty subsidiaries organized and operating in foreign countries. Container's percentage of ownership in the subsidiaries ranged from 66.7% to 100%, and the remaining shares were independently owned. Container's operations were solely within the U.S. and involved the manufacture and sale of boxes and cartons. Container made a few sales outside the United States, but the subsidiaries were not involved. Since 1938, Container's organizational pattern has been one of regional decentralization. The subsidiaries were in the same general business as the parent, with the exception of one subsidiary holding company and one inactive company.<sup>80</sup>

Operating subsidiaries were located in Colombia, Venezuela, Mexico, West Germany, the Netherlands, and Italy. The foreign subsidiaries in each country operated as integrated self-sufficient units. In some countries the subsidiaries bought their own raw materials, manufactured pulp, produced the boxes and cartons, and sold them in the local countries. In other countries the subsidiaries did not manufacture pulp but bought the materials for producing boxes and cartons from independent sources.<sup>81</sup> There was no transfer of finished product and almost no transfer of raw material from the parent to the subsidiaries. The foreign subsidiaries did not sell any product manufactured by the parent. There were no transfers of raw material or finished product from the subsidiaries to the parent.<sup>82</sup> The foreign subsidiaries performed all their own advertising and solicitation. There was little transfer of technology or know-how from Container to the subsidiaries (the information was readily available otherwise) nor was there much help from Container in marketing and sales because of differences in

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clause, and, perhaps, the equal protection clause. The dissenting opinion seems to reach this conclusion:

[b]ut in my view, invalidating the tax only to this limited extent [to the extent of a foreign-based parent] also would be unacceptable. It would leave California free to discriminate against a Delaware corporation in favor of an overseas corporation. I would not permit such discrimination without explicit congressional authorization.

103 S. Ct. at 2960 (Powell, J., dissenting) (footnotes omitted).

80. Stipulation of Facts, Joint Appendix, *supra* note 22, at 6-19, *Container*.

81. *Id.* at 30-31.

82. *Id.*

products and customer needs from country to country.<sup>83</sup> There was little in the way of centralized services by the parent for the subsidiaries. The subsidiaries hired their own personnel, operated their own manufacturing facilities, purchased their own supplies, conducted their own personnel and accounting services, and employed their own law firms.<sup>84</sup> Generally, the parent provided about one-third of the long-term financing for the subsidiaries; two-thirds was obtained from local sources.<sup>85</sup>

There was very little transfer of personnel between the parent and the subsidiaries. During the years in suit, only twenty-six of the 6,800 employees of the subsidiaries were former employees of Container.<sup>86</sup> There was no United States training program for employees of the foreign subsidiaries although a few employees occasionally visited Container for short periods.<sup>87</sup>

Almost all of the top officers of the subsidiaries were local nationals. In nearly half of the subsidiaries a majority of the directors were local nationals. Capital expenditure guidelines were set by Container.<sup>88</sup> The daily operations of the subsidiaries were under the complete authority and control of local management.<sup>89</sup> Container's foreign operations staff, which consisted of one senior executive officer and four other officers (only one of which was employed full-time), was charged with overseeing the foreign subsidiaries. The staff acted as a steward for Container's foreign investments, as liaison between the parent and subsidiaries, and it communicated requirements for compliance with Container's standards of professionalism, profitability, and ethics. Container did not use the foreign operations staff as a means to dominate the management of the subsidiaries; it was a strictly observed policy to reach decisions through mutual understanding rather than domination.<sup>90</sup>

In a number of instances, Container acted as a broker in finding and purchasing machinery for the subsidiaries, mainly in Latin America. Such purchases amounted to approximately five to seven million dollars per year. Container also sold a small amount of its own used equipment and machinery to the foreign subsidiaries.<sup>91</sup> Container had Technical Service Agreements with at least six subsidiaries, but not with those located in Colombia or Venezuela, since blanket agreements were not permitted by these countries. Nonetheless, Container performed limited services for these subsidi-

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83. *Id.* at 35-37. There were no joint marketing efforts between Container and the foreign subsidiaries and no master contracts. *Id.* at 32-33.

84. *Id.* at 60-78.

85. *Id.* at 69-70.

86. *Id.* at 60-61.

87. *Id.* at 69.

88. *Id.* at 39-40. Even in decisions involving major capital expenditures, the initiative rested with the management of the subsidiaries. *Id.*

89. *Id.*

90. *Id.* at 65-67.

91. *Id.* at 76-77.

aries as well and was reimbursed to the extent allowed by local law. Where charges were unrecoverable, Container made book entries to reflect them. Fees paid to Container under these agreements averaged \$452,942 for the years at issue, and were based either on fixed amounts per month or on a percentage of the subsidiaries' sales.<sup>92</sup>

### B. Definition of a Unitary Business

In *ASARCO Inc. v. Idaho State Tax Commission*<sup>93</sup> and *F.W. Woolworth Co. v. Taxation and Revenue Department*,<sup>94</sup> decided one year prior to the *Container* decision, it appeared that the Court was moving toward a definition of a unitary business.<sup>95</sup> These cases, building upon the opinion in *Mobil Oil Co. v. Commissioner of Taxes*,<sup>96</sup> emphasized three criteria as standards for determining a unitary business: functional integration, centralization of management, and economies of scale. Although these are general terms, it appeared from the *ASARCO/Woolworth* opinions that the Court was attempting to give the terms some specific meaning. For example, functional integration seemed to refer to a true economic interrelationship between the businesses as exemplified by a substantial transfer of products manufactured by the parent and transferred to a sales subsidiary or purchased as inventory by a central office and transferred to a sales office. Centralization of management appeared to mean a situation where, for example, the management of the parent company was substantially involved in the actual operations of the subsidiary. Economies of scale seemed to mean a situation where, for example, the intercompany flow of products or the centralization of management was of such significance that there was a true savings for both operations.<sup>97</sup>

The direction of the Court's thinking was summarized in *Woolworth*:

There is a critical distinction between a retail merchandising business as conducted by Woolworth and the type of multinational business—now so familiar—in which refined, processed, or manufactured products (or parts thereof) may be produced in one or more countries and marketed in various countries, often worldwide. In operations of this character there is a flow of international trade, often an interchange of personnel, and substantial mutual interdependence. The uncontradicted evidence demonstrates that Woolworth's international retail business is not comparable. There is no flow of international business. Nor is there any integration or unitary operation in the sense in which our cases consistently have used these terms.<sup>98</sup>

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92. *Id.* at 75.

93. 458 U.S. 307 (1982).

94. 458 U.S. 354 (1982).

95. See generally Hedges, *State Power to Tax Enterprises as Unitary Businesses: U.S. Supreme Court Narrows the Reach*, 1 INT'L TAX & BUS. LAW. 254 (1983).

96. 445 U.S. 425 (1980).

97. Latcham, *The Unitary Business Concept as Defined in Recent Judicial Decisions and Administrative Rules*, 1982 N.Y.U./RIA Conference on State and Local Taxation ¶ 400.

98. 458 U.S. at 354 (footnote omitted).

In the *Container* case, appellant argued that because of the independent operations of Container and its subsidiaries, they could not be held unitary if the *ASARCO/Woolworth* standards were applied in the context of the opinions in those earlier cases. But the Court did not refer to the *ASARCO/Woolworth* standards. Instead the Court announced a new test for reviewing unitary cases (which presumably includes those standards):

The factual records in such cases, even when the parties enter into a stipulation, tend to be long and complex, and the line between "historical fact" and "constitutional fact" is often fuzzy at best. Cf. *ASARCO*, 458 U.S., at —, nn.22, 23, 102 S. Ct., at 3114-3115, nn.22, 23. It will do the cause of legal certainty little good if this Court turns every colorable claim that a state court erred in a particular application of those principles into a *de novo* adjudication, whose unintended nuances would then spawn further litigation and an avalanche of critical comment. Rather, our task must be to determine whether the state court applied the correct standards to the case; and if it did, whether its judgment "was within the realm of permissible judgment."<sup>99</sup>

With regard to standards, the Court asserted that "[t]he legal principles defining the constitutional limits on the unitary business principle are now well established."<sup>100</sup> In our view, however, they are not well established. *ASARCO* and *Woolworth* were the first cases in which the Supreme Court was really called upon to articulate a definition of a unitary business.<sup>101</sup> But instead of building upon its effort toward a definition in *ASARCO* and *Woolworth*, the Court distinguished between those cases and *Container* on fine shadings of factual differences. In this regard, the Court emphasized *Container's* assistance to its subsidiaries in obtaining new and used equipment; in filling the few personnel needs that could not be met locally; in making loans to the subsidiaries and guaranteeing loans; in the interplay between *Container* and the subsidiaries in the area of corporate expansion; in the "substantial" technical assistance by *Container* to subsidiaries;<sup>102</sup> and in "the supervisory roles played by *Container's* officers in providing general guidance to the subsidiaries."<sup>103</sup> The Court found that in these respects the facts in *Container* differed from those in *ASARCO* and *Woolworth*. "We need not decide whether any one of these factors would be sufficient as a constitutional matter to prove the existence of a unitary business. Taken in combination, at least, they clearly demonstrate that the state court reached a conclusion 'within the realm of permissible judgment.'"<sup>104</sup>

Although the Court found that the *Container* case differed from the *ASARCO* and *Woolworth* cases in these respects, a careful consideration of the facts in the three cases must lead to the conclusion that the differences were not as significant as the Court maintained. For example, in the

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99. 103 S. Ct. at 2946 (footnotes omitted).

100. *Id.*

101. Latcham, *supra* note 97, at ¶ 470.

102. Cf. *supra* text accompanying note 83.

103. *Id.*

104. 103 S. Ct. at 2948.

*ASARCO* case the Court found the Southern Peru subsidiary not unitary with the parent company although the parent owned 51.5% of the subsidiary's stock; the subsidiary sold about thirty percent of its production to the parent; the parent acted as a selling agent for another twenty percent of the subsidiary's production; and the parent provided substantial services to the subsidiary.<sup>105</sup> The one significant difference, perhaps, was that in *ASARCO* the parent company had given up, by contract with the other shareholders, the right to dictate action by the board of directors although it could veto any action which it did not approve. However, Container did not dictate board action as a matter of policy.

Furthermore, in *Woolworth* the parent company and its subsidiaries were all engaged in the retail selling business under the Woolworth name and there were substantial management contacts between the parent and the subsidiaries. A vice president of Woolworth served as a liaison with the smaller foreign subsidiaries and from time to time with the major subsidiaries. There were common directors with some of the subsidiaries, and the managing directors of the foreign subsidiaries came to New York for consultation perhaps once a year. Woolworth's chief executive officer and other officers occasionally visited the subsidiaries.<sup>106</sup> There was also frequent mail, telephone, and teletype communication between the upper echelons of management. Decisions about major financial matters such as dividends and the creation of substantial debt had to be approved by Woolworth. Woolworth's published annual reports were prepared on a consolidated basis.<sup>107</sup>

If one were to apply the three standards of functional integration, centralization of management, and economies of scale in a truly meaningful sense, it would appear that Container and its subsidiaries were not unitary. The parent and subsidiaries each were integrated businesses in the countries in which they operated, with almost no transfer of products between them.<sup>108</sup> The subsidiaries operated in geographical and economic areas which were much different from those of the parent, necessitating different methods of production and different marketing techniques.<sup>109</sup> The parent and subsidiaries did not depend upon each other in any functional sense; "the parent company's operations are not interrelated with those of its subsidiaries so that one's 'stable' operation is important to the other's 'full utilization' of capacity."<sup>110</sup> In fact, "[e]xcept for the type of occasional oversight—with respect to capital structure, major debt, and dividends—that any parent gives to an investment in a subsidiary, there is little or no integration of the business activities or centralization of the management of

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105. 458 U.S. at 304, 320-22 & nn.16-17.

106. 458 U.S. at 354, 367-69 & n.19.

107. *Id.* at 3137-38.

108. 103 S. Ct. 2933, 2943.

109. *Id.* at 2944 n.8.

110. *Woolworth*, 458 U.S. at 370.

[the corporations involved].”<sup>111</sup>

In sum, if the Court had utilized the standards developed in *ASARCO* and *Woolworth* it would have been difficult to distinguish those cases from *Container*. The Court chose to distinguish the cases based upon differences in the facts, but the differences had to be based upon very fine distinctions. One can appreciate the Court’s reluctance to review long records in order to resolve unitary cases. The Court in *Container*, in fact, relied heavily upon the California Court of Appeal’s review of the record in the case. The Court’s failure, however, to apply the standards developed in the *ASARCO* and *Woolworth* cases is unfortunate.

The Court’s interpretation of the unitary doctrine and its failure to provide a meaningful definition of what constitutes a unitary business mean that litigation will inevitably multiply, as taxpayers, tax administrators, and state courts try to establish guidelines for the application of the unitary doctrine, assuming, of course, the absence of congressional action in this area. As the likelihood of congressional action in defining a unitary business remains remote, a series of borderline unitary cases will most likely be litigated (*e.g.*, cases involving conglomerates, or severe distortion), forcing the state courts to establish clear standards. Although the Supreme Court has made clear its reluctance to examine further cases in this area,<sup>112</sup> it seems inevitable that at some later date the Court will have to re-enter the fray.

For the present, taxpayers, state tax administrators, and state courts are left with the problem of determining whether the facts in a particular case are closer to those in *Container* and other cases in which the Supreme Court upheld unitary application or are closer to *ASARCO* and *Woolworth*.<sup>113</sup> The latter cases were never overruled, and if the facts in a particular case come closer to *ASARCO* and *Woolworth*, the unitary doctrine cannot be applied.

## V

### ASPECTS OF UNITARY LITIGATION

The definition of a unitary business will be important in at least two types of litigation. The first involves attempts by states to combine conglomerates into a unitary group. The second involves cases in which unitary combination brings about severe distortion. Of course, these two areas tend to overlap, since attempts to combine conglomerates can often lead to serious distortion. On the other hand, serious distortion can arise in instances where the units being combined are nominally involved in the same

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111. *Id.* at 369.

112. The Court dismissed *Chicago Bridge* and recently denied *certiorari* in *Shell Petroleum N.V. v. Franchetti*, — U.S. —, 104 S. Ct. 537 (1983).

113. *Cf. Appeal of Mohasco Corp.*, 31 Cal. St. Bd. of Equalization 351 (1983); 4 Cal. Tax Rptr. (CCH) ¶ 400-396.

line of business. In addition, certain procedural considerations are important to successful unitary litigation.

*A. Combining Conglomerates in a Unitary Group*

The issue of combining conglomerates is addressed in California Franchise Board Regulation 25120, and it may be used to illustrate the problem:

(b) TWO OR MORE BUSINESSES OF A SINGLE TAXPAYER. A taxpayer may have more than one "trade or business." In such cases, it is necessary to determine the business income attributable to each separate trade or business. The income of each business is then apportioned by an apportionment formula which takes into consideration the instate and outstate factors which relate to the trade or business the income of which is being apportioned.

EXAMPLE: The taxpayer is a conglomerate with three operating divisions. One division is engaged in manufacturing aerospace items for the federal government. Another division is engaged in growing tobacco products. The third division produces and distributes motion pictures for theatres and television. Each division operates independently; there is no strong central management. Each division operates in this state as well as in other states. In this case, it is fair to conclude that the taxpayer is engaged in three separate "trades or businesses." Accordingly, the amount of business income attributable to the taxpayer's trade or business activities in this state is determined by applying an appropriate apportionment formula to the business income of each business.<sup>114</sup>

The basic rule of the regulation is that separate lines of business, in which fundamental operations relating to production and marketing of products are distinct and separate, should not be classified as one unitary business. This conclusion seems correct, and the regulation appears almost to presume that divisions or subsidiaries involved in separate lines of business cannot be combined. However, another provision in the regulation blurs this distinction. The regulation sets forth three situations in which it is presumed that the businesses are unitary.<sup>115</sup> It is the third situation, where the

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114. CAL. ADMIN. CODE, tit. 18, R.25120 (1973), [1 Cal.] St. Tax Rep. (CCH) ¶ 14-815. The fact that the regulation refers to divisions of one corporation, rather than to separate affiliated corporations, makes no difference because unitary combination ignores separate corporate lines.

115. Reg. 25120(2)(b) provides in pertinent part:

The following factors are considered to be a good indicia of a single trade or business; and the presence of any of these factors creates a strong presumption that the activities of the taxpayer constitute a single trade or business:

(1) SAME TYPE OF BUSINESS: A taxpayer is generally engaged in a single trade or business when all of its activities are in the same general line. For example, a taxpayer which operates a chain of retail grocery stores will almost always be engaged in a single trade or business.

(2) STEPS IN A VERTICAL PROCESS: A taxpayer is almost always engaged in a single trade or business when its various divisions are engaged in different steps in a large, vertically structured enterprise. For example, a taxpayer which explores for mines and copper ores; concentrates, smelts and refines the copper ores; and fabricates the refined copper into consumer products is engaged in a single trade or business, regardless of the fact that the various steps in the pro-

units are bound together by strong central management, which causes the problem. In this third situation, the regulation provides that true conglomerates could be members of a unitary group.

State courts and administrative tribunals are beginning to grapple with the unitary taxation problem. Recent court opinions from Montana, Alaska, and Massachusetts have upheld unitary combination where divisions or subsidiaries seemed to be involved in separate lines of business.<sup>116</sup> However, the facts in the cases are not clear as to the independent nature of the lines of business of the particular units, and the courts' opinions do not focus on the problems of combining truly independent businesses. The Montana court was also influenced by the fact that the diverse units were divisions of a single corporation rather than separate subsidiaries. The New Jersey Tax Court, on the other hand, has recently denied unitary treatment where separate lines of business were involved.<sup>117</sup>

The California State Board of Equalization, the appellate administrative tribunal in franchise tax cases, has taken a rather conservative approach to the problem. In its recent decisions involving attempts to combine units involved in separate lines of business, the Board has shown a reluctance to allow such combination unless the facts show, for example, that the parent is providing practically all of the management and central services required by the subsidiary.<sup>118</sup> On the other hand, where the facts showed the existence of truly separate lines of business and that there was little integration of operations or centralization of management, the Board has not hesitated to hold that the separate units should not be combined.<sup>119</sup>

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cess are operated substantially independently of each other with only general supervision from the taxpayer's executive offices.

(3) STRONG CENTRALIZED MANAGEMENT: A taxpayer which might otherwise be considered as engaged in more than one trade or business is properly considered as engaged on one trade or business when there is a strong central management, coupled with the existence of centralized departments for such functions as financing, advertising, research, and purchasing. Thus, some conglomerates may properly be considered as engaged in only one trade or business when the central executive officers are involved in the day-to-day operations of the various divisions and there are centralized offices which perform for the divisions the normal matters which a truly independent business would perform for itself, such as accounting, personnel, insurance, legal, purchasing, advertising, and financing.

116. *Ward Paper Box Co. v. Dep't of Revenue*, 638 P.2d 1053 (Mont. 1981), *vacated and remanded sub. nom.*, *Russell Stover Candies, Inc. v. Dep't of Revenue*, 103 S. Ct. 26 (1982), *aff'd*, 665 P.2d 198 (Mont. 1983), *appeal dismissed*, 104 S. Ct. 475; *Earth Resources Co. v. Alaska*, 665 P.2d 960 (1983) (as amended on reh'g); *Bectin, Dickinson & Co. v. Dep't of Revenue*, 1981 Mass. Adv. Sh. 1451.

117. *Silent Hoist & Crane Co. v. Director, Division of Taxes*, 2 N.J. Tax Rptr. (CCH) ¶ 201-070 (N.J. Tax Ct. 1983).

118. *Appeal of Wynn Oil Co.*, 27 Cal. St. Bd. of Equalization (1980), [1978-81 Transfer Binder] Cal. Tax Rptr. (CCH) ¶ 206-308.

119. *Appeal of Daniel Industries, Inc.*, 27 Cal. St. Bd. of Equalization (1980), [1978-81 Transfer Binder] Cal. Tax Rptr. (CCH) ¶ 206-393; *Appeal of Hollywood Film Enterprises, Inc.*, 29 Cal. St. Bd. of Equalization 302 (1982), 4 Cal. Tax Rptr. (CCH) ¶ 400-169.

The State Board has summarized its position in regard to conglomerate cases as follows:

[T]he mere fact corporations are engaged in diverse lines of businesses, standing alone, does not preclude a finding that such businesses are unitary. However, . . . in some instances involving diverse lines of businesses, the factual basis for a finding of unity may require a stronger evidentiary showing than would be required in situations involving vertical or horizontal integration, since in diversification situations, the advantages to be gained by centralization may be less than they are in the more typically vertically or horizontally integrated unitary business. Even [the Franchise Tax Board's] own regulations do not suggest a different approach.<sup>120</sup>

### *B. Unitary Combination and Distortion*

The connection between the definition of a unitary business and the fact of severe distortion of income apportionment has not been clearly made by the cases to date. It is obvious, however, that the problem of distortion must be a consideration in any case involving a unitary business. After all, the unitary doctrine is used as a reasonable means of apportioning income between the states. If the apportionment is not reasonable, then the application of the unitary doctrine must be subject to question. Perhaps the most that can be said in the debate on this question is that the fact of severe distortion must have influenced tribunals in particular cases involving a determination of whether a unitary business exists. Thus, in *Honolulu Oil Corporation v. Franchise Tax Board*<sup>121</sup> the Board argued that the company should be taxed on a separate accounting basis in California where it had a separate accounting net income in California of \$18,581,825.60, although the company had a national net income of \$16,744,397.70, and a net income in California on a unitary basis of \$8,868,039.00. Although the California Supreme Court did not emphasize distortion in its opinion, it was obvious at oral argument that the court was disturbed by the distortion and that it was a factor which influenced the court in holding the business to be unitary. Similarly, in *In the Matter of R.J. Reynolds Industries, Inc.*,<sup>122</sup> the record and taxpayer's briefs emphasized the severe distortion which would result if Reynolds and its diversified subsidiaries were held to be unitary. Again, although the hearing officer did not mention the distortion resulting from the unitary holding, one can assume that the hearing officer had the problem firmly in mind in holding the businesses not to be unitary. It is true that businesses have been held unitary even where net income was significantly increased by applying formulary apportionment,<sup>123</sup> but the truly egregious distortion cases provide a background to the unitary deter-

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120. Appeal of Wynn Oil Co., 27 Cal. St. Bd. of Equalization (1980), [1978-81 Transfer Binder] Cal. Tax Rptr. (CCH) ¶ 206-308 (citations omitted).

121. 60 Cal. 2d 417, 386 P.2d 40, 34 Cal. Rptr. 552 (1963).

122. Department of Revenue Decision No. 82-19 (Alaska, April 30, 1982).

123. *Butler Bros. v. McColgan*, 315 U.S. 501 (1942); *John Deere Plow Co. v. Franchise Tax Board*, 38 Cal. 2d 214, 238 P.2d 569 (1951), *appeal dismissed*, 343 U.S. 939 (1952).

mination which illustrates its inherent unfairness. It is in this connection that distortion may be an important factor in defining a unitary business.

### C. Procedure in Unitary Cases

The emphasis in the *ASARCO*, *Woolworth*, and *Container* cases on the state courts' determinations of fact illustrates the importance of properly developing the facts at the administrative and trial court level.<sup>124</sup> Of course, it is always best to prevail at the administrative level if that is at all possible. If not, and the matter is taken to court, prevailing at the trial court level and obtaining favorable findings of fact from the trial court are of great importance. Appellate courts, and particularly the United States Supreme Court, do not wish to review facts in the record *de novo*. Therefore, favorable findings by the trial court are greatly advantageous.

Counsel should consider the advantage of presenting evidence in unitary cases through live testimony rather than through stipulated facts. If the taxpayer prevails at the trial court level, there is then the opportunity for favorable findings of fact which may be conclusive on appeal. Most appellate courts are reluctant to overrule the trial court's findings of fact based upon live testimony, whereas the higher court may consider *de novo* a stipulation of facts. However, in some states the taxpayer must make its record before a hearing officer of the state revenue agency with an appeal to the courts solely upon that record. In such a situation, if the hearing officer's holding is adverse, stipulated facts may be an advantage because the hearing officer's findings of fact based upon a stipulated record are not generally accorded the same weight by the reviewing court as are findings of fact based upon live testimony.

## VI CONCLUSION

The Court's decision in *Container* viewed the State's use of worldwide combination as essentially a matter of domestic concern, at least where the parent is a United States corporation. However, our principal trading partners view the decision as having broad international repercussions. At the least, the decision meant to them that worldwide combination could be applied to foreign parent groups until prohibited by the executive branch and Congress or by Court decision, and a final Court decision, at least, would be years away.

By establishing the Worldwide Unitary Working Group, President Reagan has recognized that the issues involved are international in charac-

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124. See Peters, *Supreme Court in Container Upholds State's Broad Power Under Unitary Taxation Method*, 59 J. TAX'N 300, 305 (Nov. 1983).

ter.<sup>125</sup> Everyone can share with the President his hope for a reconciliation of views between the foreign governments, the states, and the international business community. If the Working Group cannot reconcile these problems to the satisfaction of all concerned, however, it is obvious that the executive branch and Congress must take the lead in providing a solution. Our trading partners have clearly indicated that they view worldwide combination as a barrier to world trade, which must be removed. These partners have threatened to retaliate if no resolution is found.<sup>126</sup> Unfettered international trade is of vital interest to the federal government, to the states, and to the public at large. It must not be subject to impediments because some states insist upon pursuing a tax policy which is unacceptable to the international community.

If the executive and legislative branches cannot resolve the issue, it is inevitable that the courts will be asked to do so again—this time in the context of a foreign parent case.

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125. See Treasury Dep't Press Release of Sept. 23, 1983, reprinted in 21 TAX NOTES 70 (1983); and Remarks by Assistant Secretary of Treasury for Tax Policy John E. Chapoton, excerpted in 21 TAX NOTES 439 (1983).

126. Wall St. J., Sept. 26, 1983, at 8, col. 2. See also *Container*, at 2960 n.4.