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Barclays Bank PLC v. Franchise Tax Board: California's Taxation of Foreign-based Multinational Corporations

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**NOTE, BARCLAYS BANK PLC v. FRANCHISE TAX BOARD:
CALIFORNIA'S TAXATION OF FOREIGN-BASED
MULTINATIONAL CORPORATIONS**

INTRODUCTION

International business is a vital part of the United States economy. Many foreign businesses invest in this country by establishing corporations in the United States. One primary concern of foreign-based multinational companies creating corporations in the United States is the tax consequences of doing so. For a number of years there have been disputes between foreign countries and the United States over how the fifty states should tax foreign-based multinational companies.¹

The method used to compute the taxes of a multinational corporation can drastically change the amount owed. Foreign-based multinational corporations located in the United States prefer to be taxed using Separate Accounting.² The foreign-based multinational corporations believe that when treated as a unitary business they are subject to multiple taxation because they are required to pay taxes in the United States on revenue also taxable in another country.³ Worldwide Combined Reporting (WWCR), used by California, is one of the most inclusive formulas used for calculating the taxes of a unitary business.⁴ Many foreign countries have informed the United States of their concerns about the use of WWCR. The United Kingdom has threatened to take retaliatory measures against United States-owned companies operating and located in the United Kingdom.⁵ To ensure foreign investment in the

1. See Brief of the Government of the United Kingdom as Amicus Curiae in Support of Petitioner at 23, *Barclays Bank PLC v. Franchise Tax Bd.*, 114 S. Ct. 2268 (1994) (No. 92-1384) [hereinafter Brief of the Government of the United Kingdom]. See also *United Kingdom-United States Double Taxation Treaty Debates*, 124 CONG. REC. 16892 (1978).

2. Separate Accounting treats the different subsidiaries of a company individually when computing the taxes owed. Each subsidiary must have its own accounting records and is taxed as if it were a single company not an extension of the parent company. *Barclays Bank PLC v. Franchise Tax Board*, 114 S. Ct. 2268, 2273 (1994). See generally 1 JEROME R. HELLERSTEIN & WALTER HELLERSTEIN, *STATE TAXATION: CORPORATE INCOME AND FRANCHISE TAXES* ¶ 8.03 (2d ed. 1993).

3. A unitary business consists of a parent company and its subsidiary corporations. The entity is considered a unitary business because of the close business relationship between the subsidiaries and the parent company. This can be evidenced by a subsidiary's dependency upon the parent company or contributions between the subsidiary and the parent company. HELLERSTEIN & HELLERSTEIN, *supra* note 2, ¶ 8.11[1].

4. An inclusive formula calculates tax of a corporation by including income earned by other subsidiary corporations located outside of the taxing jurisdiction. California uses not only income earned by a corporation in California, but also any income earned by the parent company and subsidiaries located outside of the states borders.

5. Brief of the Government of the United Kingdom, *supra* note 1, at 23. In 1981 the Chancellor of the Exchequer wrote to President Reagan expressing his belief that worldwide combined reporting conflicted with Separate Accounting used by the United Kingdom. The United Kingdom enacted legislation in 1985 which gave it the power to withdraw a partial tax credit to be given to United States companies with a "qualifying presence" in the United Kingdom. Also, in response to the pending *Barclays* case, the United Kingdom stated it may

United States continues, it is essential that the states use tax systems that do not overburden foreign corporations.

Recently, in *Barclays Bank PLC v. Franchise Tax Board*, the Supreme Court held California could use WWCR to compute the taxes of a foreign-based multinational corporation even though to do so would result in multiple taxation.⁶ *Barclays* was the first case to decide the issue of how foreign-based multinational corporations located in the United States should be taxed. This Note will discuss the *Barclays* case and present reasons for the use of Separate Accounting in place of WWCR. It will further analyze the function of the Commerce Clause as applied to foreign-based multinationals. Finally, this Note will look at the changes California has made in its taxation of foreign-based multinational corporations by including Water's Edge as an alternate choice of taxation.⁷

I. SEPARATE ACCOUNTING

Separate Accounting is used by the federal government and foreign countries. Separate Accounting imposes a tax on a corporation operating in a state only on the income that the corporation recognizes in its books for that state. It is not taxed on the earnings of any other subsidiary in the multinational company which does not operate in the taxing jurisdiction.⁸ Separate Accounting works well for companies that have independent operations among their corporate subsidiaries, spread across numerous states

have to take retaliatory measures if the Supreme Court did not offer a solution to the worldwide unitary tax problem. *Id.*

6. *Barclays* was combined with another case involving Colgate-Palmolive for review by the Supreme Court. This Note only discusses the *Barclays* case because the *Colgate-Palmolive* case involves a domestic-based multinational corporation. *Barclays Bank PLC v. Franchise Tax Board*, 114 S. Ct. 2268, 2273 (1994).

7. Water's Edge is a method of taxation which taxes corporations located in the United States as a unitary business, but only on the income earned between the water's edges. Yet, if the corporation has a foreign subsidiary that earns more than 20% of its income from the United States, that subsidiary can also be included in the taxation figures. CAL. REV. & TAX CODE §§ 25110, 25111 (West 1994).

8. *Barclays*, 114 S. Ct. at 2273. There are two ways of computing taxes using separate accounting:

- 1) Ascertain the actual cost of manufacturing and a reasonable profit, determined by reference to such standards as the profit made by other corporations and the opinions of businessmen. The manufactured goods are then deemed to have been sold by the manufacturing department to the selling department at the price indicated. Specific costs of each department are computed, and overhead, administrative, and other general expenses are charged to the various departments. Thereupon the profit allocable to manufacturing is determined.
- 2) Ascertain the price at which the articles manufactured may be purchased from other manufacturers in the categories and quantities desired. Utilize this figure as the cost of goods, and otherwise proceed as indicated in item 1 above.

HELLERSTEIN & HELLERSTEIN, *supra* note 2, ¶ 8.03.

and continents.⁹ When the subsidiaries function independently, the difficulties of pricing intercompany transfers are diminished.

Many critics of Separate Accounting believe that its greatest weakness is the method's ineffectiveness at measuring transfers among various corporations that are part of a larger economic enterprise. When an item is transferred from one corporation to another it is not sold on the open market, and determining a fair market value can be hard. The transfer between the parent company and its subsidiary must be treated as an arms-length transaction, and a dollar value must be assigned to the item transferred. It can be difficult to determine the fair market value of the transferred item, because the item transferred may also have an intangible benefit to the corporation that received it. In some cases where a price is not known, it may have to be calculated by considering the manufacturing costs and affixing a profit to those costs.¹⁰

Another inadequacy of Separate Accounting is the cost associated with maintaining data necessary to divide a corporation's business operations in each state and country.¹¹ For a corporation that does not keep the detailed accounting records necessary for Separate Accounting, the cost of assembling the information is staggering.¹² There is also a fear that a multinational company will manipulate transfers between its corporations to avoid paying taxes on items.¹³ In an effort to avoid these problems, some states, such as California, prefer treating companies as unitary businesses.

II. WORLD WIDE COMBINED REPORTING

When a company is treated as a unitary business, the California Franchise Tax Board can impose a tax using WWCR.¹⁴ WWCR calculates taxes by apportioning the business' total income between California and all other jurisdictions in which the company and its subsidiaries are subject to taxes.¹⁵ First, the property, payroll, and sales of all of the subsidiaries that

9. When the operations of a company are independent, the weaknesses of Separate Accounting that result from determining the prices of items transferred between the various subsidiaries and parent company is eliminated. HELLERSTEIN & HELLERSTEIN, *supra* note 2, at ¶ 8.11[6].

10. *Id.* at ¶ 8.03.

11. This is not a problem for foreign-based multinational companies because they use Separate Accounting, not Combined Reporting. *See infra* note 54 and accompanying text.

12. *Barclays*, 114 S. Ct. at 2277 n.11.

13. *Id.* at 2273.

14. WWCR is only one method of combined reporting. WWCR compiles all of the property, payroll, and sales from around the world for the unitary business, and divides the income among the subsidiaries and parent company. *See CAL. REV. & TAX CODE* §§ 25, 128-125, 137 (West 1994).

15. *Barclays*, 114 S. Ct. at 2272, 2273. The formula used to calculate taxes using WWCR is the unitary business' total property ("UB") divided by the taxpayer's property in California, plus the unitary business' total payroll divided by the taxpayer's payroll in California, plus the unitary business' total sales divided by the taxpayer's sales in California (the sales factor is

make up the worldwide company are totaled in one sum that represents the worth of the unitary business. Second, a formula is used to account for the percentage of the entity's worldwide property, payroll and sales that are located in the taxing state. Finally, the corporation in California is taxed on the percentage of the entire company's value that appears to be located in California.¹⁶

Foreign-based multinational companies believe this method is unfair because the subsidiary located in the United States may have to pay higher taxes than it would if Separate Accounting was used. A foreign corporation with a subsidiary in California could have a net loss for the year in question. However, if the costs for property and payroll in California are higher than the other places in which the company has subsidiaries, the subsidiary in California could show a taxable gain under the WWCR method of accounting.

The possibility of over-taxation increases when two different methods of accounting are used to compute the income of a corporation. Separate Accounting taxes each corporation based on its earnings. WWCR apportions the income of the entire unitary business based on the percentage of income earned by the corporation. Separate Accounting is used by foreign countries to calculate the income of subsidiaries located in their countries, but California uses WWCR to calculate the income of subsidiaries located in the state. It is likely that WWCR will include more income in the earnings of the subsidiary than Separate Accounting would have taxed. When this occurs there is overtaxation by the jurisdiction using WWCR.

Problems also arise from having to translate currency of foreign

multiplied by two before it is added to the property and payroll). This number is then divided by four, giving the California corporation's taxable income. The formula is expressed as follows:

$$\frac{UB \text{ total property}}{CA \text{ corp.'s property}} + \frac{UB \text{ total payroll}}{CA \text{ corp.'s payroll}} + \frac{2(UB \text{ total sales})}{2(CA \text{ corp.'s sales})}$$

4

CAL. REV. & TAX CODE §§ 25128-25137 (West 1994).

When WWCR was used to calculate the taxes of Barclays' income, the sales factor was not multiplied by 2, and the entire sum of property, payroll, and sales was divided by three rather than four. *Barclays*, 114 S. Ct. at 2273.

16. *Barclays*, 114 S. Ct. at 2272, 2273. For example: Corporation *C* is located in California. *C* is a subsidiary of *A*, located in Peru. Corporations *B* and *D* are also subsidiaries of parent company *A*, and each operate in different foreign countries. In calculating the taxes owed by subsidiary *C*, California will add the total of *C*'s property, payroll, and sales to the total property, payroll, and sales of *A*, *B*, and *D*. After ascertaining the aggregate total of all the property, payroll, and sales of *A*, *B*, *C*, and *D*, California will then determine what percentage of the entire corporation's income comes from the California subsidiary, *C*. This percentage is then taxed by California as the income *C* had in the state.

countries into dollars because of the changing currency rates.¹⁷ A corporation located outside the United States may make more money than a corporation located in the United States. However, when the earnings of the foreign corporation are translated into dollars, the foreign corporation may appear to have less earnings than it actually does. Due to this, a corporation located in California may be taxed on the income of a multinational company which is located outside the United States simply because California is a more expensive place in which to conduct business.

III. *BARCLAYS*

In *Barclays Bank PLC v. Franchise Tax Board*, two international corporations sued to recover money paid in taxes because of alleged overtaxation by California resulting from the use of WWCR. Two subsidiaries, Barclays Bank of California and Barclays Bank International, which belong to the Barclays Group (Barclays), a multinational banking company, brought an action to recover money paid in income taxes for 1977.¹⁸ Both of the corporations conducted business in California and were therefore subject to income tax by the Franchise Tax Board (FTB).¹⁹

After Barclays Bank of California and Barclays Bank International filed their income tax returns in 1977, the FTB audited the companies and determined they used the wrong method to compute their taxes. Both Barclays Bank of California and Barclays Bank International had not considered themselves to be unitary businesses when they calculated their income

17. One commentator has described the problems as follows:

[The staff of the Franchise Tax Board] readily acknowledged that the Board has not been able to develop an equitable method of converting foreign-based earnings into American dollars. This problem is greatly compounded when the foreign firm conducts operations in several countries. The distortive effect of foreign currency translation is very dramatically pointed out by Lever Brothers, a subsidiary of Unilever, N.V., a Dutch corporation, which shares a common Board of Directors with Unilever, Ltd., a British corporation. In the 1976 tax year, Lever Brothers' tax obligation to the State of California . . . depends entirely on the method used to convert Dutch guilders and British pounds to American dollars and the exchange rate at the time the calculations are made. In this case, the guilder, which is very strong in relation to both the pound and the dollar, produces a substantially different picture of Lever Brother's profitability than calculations based on the weaker pound. The staff of the Franchise Tax Board concedes that they have no existing method to deal with this problem on a uniform basis, and thus is forced to negotiate tax assessments on a case-by-case basis. . . .

Philip T. Kaplan, *The Unitary Tax Debate, the United States Supreme Court, and Some Plain English*, 10 J. CORP. TAX 'N 283, 287 (Winter 1984) (quoting Memorandum from Dennis G. Amundson, Deputy Director of the Department of Economic and Business Development of the State of California, to Richard T. Silberman, May 31, 1979).

18. Barclays Bank of California and Barclays Bank International are each separate corporations located in California. Both of these corporations are subsidiaries of Barclays, the multinational parent company.

19. *Barclays*, 114 S. Ct. at 2274.

taxes.²⁰ The FTB decided the corporations were unitary businesses under their parent company, Barclays, and should have used WWCR to compute their taxes. This resulted in additional tax of \$1,678 for Barclays Bank International and \$152,420 for Barclays Bank of California.²¹

Barclays argued that California should use Separate Accounting, the method of taxation employed by the federal government and foreign countries, when computing the taxes of international corporations.²² This method computes taxes based solely on the income of the corporation in that State. Barclays contended that the California tax system resulted in multiple taxation of foreign-based multinational corporations, violating the Dormant Commerce Clause²³ and the Due Process Clause²⁴ of the Constitution.²⁵ They further argued that WWCR violates the *Complete Auto* test because it discriminates against foreign-based multinational corporations that must translate their accounting records into English.²⁶

However, the Supreme Court held that California's use of WWCR to compute taxes is constitutional. The Court stated that overtaxation was not an unavoidable outcome of WWCR. Sometimes a corporation may be overtaxed, but this may also occur if Separate Accounting is used. There is no way to completely eliminate the risk of double taxation.²⁷

IV. PRIOR LAW

Apportionment, the basis of computing tax under WWCR, was first used as a replacement for Separate Accounting to calculate the taxes of interstate commerce in the United States. In *Complete Auto Transit, Inc. v. Brady*,²⁸ Mississippi taxed a corporation for doing business in the state. Complete Auto Transit, a Michigan corporation, with subsidiaries in Mississippi, was taxed because it transported cars to dealers in Mississippi.²⁹ The cars were manufactured by General Motors outside of Mississippi, and sent to Complete Auto in Mississippi for disbursement to the dealers.³⁰ Complete

20. *Id.* at 2274. Barclays and its subsidiaries did business in the United Kingdom and a total of 33 other "nations and territories."

21. *Id.* at 2274.

22. *Id.* at 2271, 2273.

23. U.S. CONST. art. I, § 8, cl. 3; *Gibbons v. Ogde*, 22 U.S. 1 (1824). See *infra* notes 44-46 and accompanying text.

24. U.S. CONST. amend. XIV.

25. *Barclays*, 114 S. Ct. at 2272.

26. *Id.* at 2277. See *infra* section V.A.1. The *Complete Auto* test is used to determine if taxation of commerce is constitutional. One prong of the *Complete Auto* test is that the tax must not discriminate against interstate commerce (and international commerce). *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 374 (1977).

27. *Barclays*, 114 S. Ct. at 2277, 2280.

28. 430 U.S. 274, 276-78 (1977).

29. *Id.* at 276-78.

30. *Id.*

Auto believed it was taxed unjustly because it conducted business only in the state of Mississippi. General Motors conducted interstate commerce, not Complete Auto.³¹ In *Complete Auto Transit, Inc. v. Brady*, the Court stated that a tax does not violate the Commerce Clause if the activity taxed, 1) has a substantial nexus with the taxing state, 2) is fairly apportioned, 3) does not discriminate against interstate commerce, and 4) is fairly related to the services provided by the state.³² The Court held Mississippi could tax the privilege of conducting intrastate commerce by applying the tax to a fair proportion of the Complete Auto's business in the state, including the interstate commerce and the intrastate commerce.³³ Today it is common practice for states to tax interstate commerce using apportionment rather than separate accounting.

In *Japan Line, Ltd. v. County of Los Angeles*, the Court considered the issue of whether the apportionment of interstate commerce in the United States could be extended to include foreign commerce.³⁴ California taxed containers used by Japan Line for the transportation of goods on its ships because the ships were in a Los Angeles harbor on the date California exacted state property taxes.³⁵ The Los Angeles harbor was a regular destination for Japan Line's ships while conducting foreign commerce. None of the containers taxed were in the Los Angeles harbor for more than three weeks at a time. However, there were always some containers in the harbor aboard different ships docked there.³⁶

The Court first analyzed the tax using the *Complete Auto* test, but decided that other areas needed to be considered because the tax involved foreign commerce. The Court stated that, where foreign commerce is concerned, two issues needed to be evaluated in addition to the *Complete Auto* test. First, taxes imposed on foreign commerce must not create an enhanced risk of multiple taxation. Second, the taxes must not impair the "federal government's ability to speak with one voice."³⁷ The Court found there was an enhanced risk of multiple taxation because California taxed the containers that were already taxed by Japan as the home port. The tax also prevented the United States from "speaking with one voice" because it created an irregularity in international taxation.³⁸ Thus, to pass constitutional muster, a state tax cannot violate either the *Complete Auto* test or the *Japan Line* test.

The Supreme Court has continued to apply the *Japan Line* test to

31. *Id.* at 277.

32. *Id.* at 279. See also *Barclays*, 114 S. Ct. at 2276.

33. *Complete Auto*, 430 U.S. at 283.

34. *Japan Line, Ltd. v. County of Los Angeles*, 441 U.S. 434, 435-36 (1979).

35. *Id.* at 436-37.

36. *Id.* at 436-37.

37. *Id.* at 446-49. The two additional factors considered by the Supreme Court in deciding the constitutionality of the tax are referred to as the *Japan Line* test.

38. *Id.* at 452-53.

determine if taxation of international corporations is constitutional. The test was used by the Supreme Court in *Container Corporation of America v. Franchise Tax Board*, a case challenging the apportionment of taxes imposed on a domestic corporation located in California.³⁹ Container Corporation was a domestic-based company involved in both interstate and foreign commerce; California included both types of commerce in calculating the taxes of the corporation under WWCR.⁴⁰ The Court held that the method of taxation was constitutional because it was fairly apportioned and satisfied the *Japan Line* test.⁴¹

Although there was multiple taxation, the Supreme Court found it was not an inevitable result of WWCR. The Court stated that Separate Accounting would not eliminate the risk of multiple taxation.⁴² The Supreme Court explicitly reserved decision on the issue of whether Combined Reporting can be used to tax foreign-based multinational corporations.⁴³

V. ANALYSIS OF *BARCLAYS*

The unitary business method of taxation has been used in the United States to calculate the taxes of domestic corporations that conduct interstate commerce for many years.⁴⁴ Taxing domestic corporations that conduct interstate business under Combined Reporting is very efficient. The various subsidiaries that make up a company are all located in the United States. Combined Reporting works because all of the states use the same method. When the unitary business is divided up based on the percentage of property, payroll, and sales located in each state there is very little risk of multiple taxation simply because all of the states derive their taxes from the same formula. Another feature that makes Combined Reporting successful when used for companies solely conducting business in the United States is that currency does not need to be changed. There are no problems with varying exchange rates because all of the company's assets are in dollars.

A. *The Commerce Clause*

The Commerce Clause⁴⁵ gives Congress power to ensure the states work in unison to promote the welfare of the country as a whole. It defines

39. *Container Corp. of America v. Franchise Tax Bd.*, 463 U.S. 159 (1983). The method of taxation imposed on Container Corporation is the same WWCR used to compute the taxes of Barclays Bank International Limited and Barclays Bank of California, except Container Corporation is a domestic-based company.

40. *Id.* at 162-63.

41. *Id.* at 184, 191, 195.

42. *Id.* at 191-93.

43. *Id.* at 189 n.26.

44. HELLERSTEIN & HELLERSTEIN, *supra* note 2, ¶ 8.06.

45. *See supra* note 23 and accompanying text.

the association that the states have to one another and clarifies how each state must treat the citizens of another state.⁴⁶ It also delineates the areas of law the state can enforce to protect its rights, while at the same time reserving powers for the federal government to ensure uniformity across the country.

When Congress has remained silent on a topic that relates to interstate commerce, the topic falls under the Dormant Commerce Clause.⁴⁷ Even though Congress has not enacted legislation in an area, the states can still violate the Commerce Clause if a court infers that Congress intended that the topic be subject to no regulation. Under the Dormant Commerce Clause, the courts must regulate the State's activities until Congress enacts legislation for that area.⁴⁸ Through the Commerce Clause, the federal government ensures the rights of people choose to conduct business in more than one state or in foreign countries. A state's actions are unconstitutional when the actions do not comport with the rights the Commerce Clause protects.⁴⁹

1. The *Complete Auto* Test

The first step in deciding if taxation of international commerce violates the Dormant Commerce Clause is to decide if it meets the criteria of the *Complete Auto* test. The tax must: (1) apply to an activity of the corporation that has a substantial nexus to the taxing state, (2) be fairly apportioned, (3) not discriminate against interstate commerce, and (4) be fairly related to the services provided by the state.⁵⁰

In *Barclays*, the Supreme Court found that California's use of WWCR did not violate the *Complete Auto* test because *Barclays* did not prove the income of its subsidiaries was improperly apportioned. *Barclays* could not "demonstrate the lack of a 'rational relationship between the income attributed to the state and the intrastate values of the enterprise.'"⁵¹ Nor could *Barclays* show that the anti-discrimination factor of the *Complete Auto* test was violated. *Barclays* attempted to show it was an "inordinate burden" for foreign-based multinational corporations to convert their accounting

46. LAWRENCE TRIBE, *AMERICAN CONSTITUTIONAL LAW* 401 (2d ed. 1988). "Congressional consent or ratification may suffice to validate otherwise unconstitutional state action . . . where the existence of a constitutional ban on state action is inferred entirely from a grant of legislative power to Congress, as in the case of the Commerce Clause." *Id.* at 521.

47. Nicholas Freud & Walter Kollings, *U.S. Supreme Court Upholds Worldwide Reporting and Unitary Business*, 5 J. INT'L TAX'N 340, 342 (1994).

48. TRIBE, *supra* note 46, at 401.

49. *Id.*

50. *Barclays Bank PLC v. Franchise Tax Bd.*, 114 S. Ct. 2268, 2276 (1994) (quoting *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274, 279 (1977)).

51. *Id.* at 2277 (quoting *Container Corp. of America v. Franchise Tax Bd.*, 463 U.S. 159, 180-81 (1983)).

records to the type necessary for WWCR.⁵²

The second requirement of the *Complete Auto* test, that taxes be fairly apportioned, is not met when a subsidiary located in California is paying taxes on income it did not earn. Under WWCR, the income of the entire unitary business is commingled and then separated out according to percentages. WWCR creates a misrepresentation of income because it assigns a monetary value to the California corporation based solely on the percentage of property, payroll, and sales of the entire parent company that is located in the state.⁵³ WWCR is not founded on the actual income of the corporation in California. If the corporation in California loses money, it may still be treated as having income under WWCR because its property and payroll may appear to be greater than the larger foreign-based multinational corporation. This cannot happen when Separate Accounting is used because each subsidiary is taxed separately on their individual earnings. Taxes are not fairly apportioned as required by *Complete Auto*, if a corporation pays taxes on income it has not earned.

Barclays also contended the anti-discrimination prong of the *Complete Auto* test was violated. When a foreign company has to, "convert its diverse financial and accounting records from around the world into the language, currency, and accounting principles of the United States," it creates a "prohibitive expense" on the multinational corporation.⁵⁴ The trial court, holding for Barclays, found that it would cost five million dollars to set up an accounting system to convert financial information of a foreign-based multinational corporation to WWCR standards, and two million dollars per year to maintain the system so the multinational corporation could file WWCR tax returns.⁵⁵

In reversing the trial court, the Supreme Court found that California allows the taxpayer to meet the WWCR reporting requirements in a number of ways. The state permits a multinational corporation to use "reasonable approximations" of the information needed for Combined Reporting. Many multinational companies do not keep the data California needs to tax the company as a unitary business, and would be forced to pay large sums of money if they were not able to use "reasonable approximations."⁵⁶

52. *Id.* at 2278. Foreign-based multinational corporations are accustomed to maintaining accounting records necessary for Separate Accounting because that is what foreign countries use. When a foreign-based multinational is forced to file taxes using WWCR the corporation must change to a different type of accounting, convert all of its property, payroll, and sales values into dollars, and all of its records into English.

53. HELLERSTEIN & HELLERSTEIN, *supra* note 2, ¶ 8.14[8].

54. *Barclays*, 114 S. Ct. at 2277 (quoting Brief for Pet'r at 44, *Barclays*, (No. 92-1384)).

55. *Id.* at 2277 n.11. The cost of changing the accounting records of a foreign multinational would be an additional cost to those the corporation already spends on maintaining Separate Accounting records. The foreign multinational must keep Separate Accounting records because both the United States federal government and other foreign countries use that method of taxation. Only the states use combined reporting.

56. *Id.* at 2278 (quoting tit. 18, § 25137-6(e)(1) (1985)). See also Brief for Pet. at 34, *Barclays* (No. 92-1384).

Barclays used the "reasonable approximations" method of computing the worldwide property, payroll, and sales of its multinational company. Barclays was not monetarily burdened by complying with WWCR, because Barclays in fact did not convert its records, it made approximations as permitted by California law.⁵⁷

One of the reasons California does not want to use Separate Accounting is the cost of having to maintain the detailed accounting records necessary would burden corporations.⁵⁸ For Barclays, and all other foreign-based multinational corporations, the opposite is the problem. A foreign-based multinational corporation is required to keep records for Separate Accounting, not the records necessary for WWCR.⁵⁹ Foreign-based multinational companies have to file taxes with their home country, the federal government, and other foreign countries, all of which use Separate Accounting. Contrary to what California believes, maintaining Separate Accounting records does not create any hardships on foreign-based multinational corporations because they have to use the formula regardless of the method of taxation used by California. In reality, a burden is imposed on foreign-based multinational corporations when they are required to change accounting records to those of a unitary business, as evidenced by *Barclays*.⁶⁰

It is actually more expensive for a foreign-based multinational corporation to maintain Combined Reporting records than it is for them to maintain Separate Accounting records. Foreign-based multinational companies must maintain Separate Accounting records regardless of which method of taxation California uses. When they are required to maintain Combined Reporting records also it is very expensive. Both Barclays Bank of California and Barclays Bank International are accustomed to keeping accounting records necessary for Separate Accounting because the federal government and foreign countries use Separate Accounting.

2. The *Japan Line* Test

When deciding the constitutionality of a tax on a foreign corporation, two other factors must be considered in addition to the basic four set forth in the *Complete Auto* test. First, there must not be an enhanced risk of multiple taxation. Second, the taxation must not interfere with the, "government's ability to speak with one voice."⁶¹

57. *Id.* at 2278. The Court stated, "Compliance burdens, if disproportionately imposed on out-of-jurisdiction enterprises, may indeed be inconsonant with the Commerce Clause." *Id.* at 2277. The Supreme Court did not state whether the cost of converting financial records from Separate Accounting to Combined Reporting would affect their decision. Barclays used "reasonable approximations" rather than converting their records to unitary business accounting. *Id.*

58. HELLERSTEIN & HELLERSTEIN, *supra* note 2, ¶ 8.03.

59. *Barclays*, 114 S. Ct. at 2273-74, 2277.

60. *Id.* at 2276-77.

61. *Japan Line, Ltd. v. County of Los Angeles*, 441 U.S. 434, 448 (1979).

a. Enhanced Risk of Multiple Taxation

Another reason Barclays felt WWCR should not be used by California was the increased risk of multiple taxation created for multinationals. Domestic-based parent companies of foreign subsidiaries are less likely to suffer multiple taxation because they are centered in the United States and derive a greater proportion of their income from the United States.⁶² Foreign-based multinationals generally have a higher proportion of income taxed by foreign countries because more of their operations are conducted outside of the United States than is the case with domestic-based companies. Only three of Barclays 220 subsidiaries are located in the United States.⁶³ Ninety-eight percent of the unitary business' income is earned outside of the United States.⁶⁴ The more activity a company has outside of the United States, the higher the risk of multiple taxation.⁶⁵

Another factor that increases the risk of multiple taxation for foreign-based multinational corporations is the high cost of conducting business in California.⁶⁶ Many foreign countries have lower costs for property, payroll, and sales than the United States, especially California. The rate of return on a dollar spent on numerous foreign countries is much higher than the rate of return for a dollar spent in the United States.⁶⁷ WWCR assumes

62. *Barclays*, 114 S. Ct. at 2279.

63. Freud & Kollings, *supra* note 47, at 344, n.15. See also Brief of Pet., at 2, *Barclays* (No. 92-1384).

64. *Barclays*, 114 S. Ct. at 2288.

65. Freud & Kollings, *supra* note 47, at 344, n.15.

66. *Barclays*, 114 S. Ct. at 2279-80.

67. One article has described the concept as follows:

Assume that a taxpayer is engaged in a unitary business that consists of Foreignco, a foreign corporation, and Domesticco, its wholly owned subsidiary. Foreignco conducts business only in foreign countries, and Domesticco conducts business only within the United States. Assume that each corporation produces an equal amount of net (apportionable business) income as shown on its books. Assume also that it takes ten units of payroll, ten units of property; and ten units of sales by each corporation to produce an equal amount of net income. Under these facts, the UDITPA formula would apportion the net (business) income of the unitary business as follows:

$$\begin{aligned} 1/3 \times (10/20 + 10/20 + 10/20) &= .50 \text{ to United States} \\ 1/3 \times (10/20 + 10/20 + 10/20) &= .50 \text{ to Foreign Countries} \end{aligned}$$

Now assume instead that while each corporation still produces an equal amount of net income as shown on its books, unequal units of payroll, property, and sales generate an equal amount of net income. For instance, the U.S. operations of the unitary business are more productive than those in foreign countries, and Domesticco requires 10 units of payroll, 10 units of property, and 10 units of sales to produce the same income produced by Foreignco using 100 units of payroll, ten units of property, and ten units of sales. Under these facts, the UDITPA formula would apportion the net income of the unitary business as follows:

$$1/3 \times (100/110 + 10/20 + 10/20) = .64 \text{ to Foreign Countries}$$

that there will be an equal rate of return on each dollar of assets.⁶⁸ This assumption is false, resulting in a distortion of corporate income when WWCR is used.⁶⁹ When looking solely at the monetary value of the company, a very large foreign corporation can appear to be equal to a small domestic corporation in California. This occurs because the cost of property in many foreign countries is less than the cost of property in California.⁷⁰ When the foreign property is treated as if it were owned in the United States the value of the foreign property appears to be less than it is actually worth.⁷¹ A state's method of taxation should not penalize a company simply because one of its subsidiaries is located in a more expensive geographic area.

The Court agreed with Barclays contention that multinational companies do face a high risk of multiple taxation but, stated that the risk is confined to situations where there is a high percentage of income from other countries that have lower wages, property values, and sales prices than California.⁷² The Court further agreed that foreign-based multinationals have a higher proportion of income from foreign countries than domestic companies owning foreign corporations.⁷³ In Barclays unitary business, Barclays Bank of California and Barclays Bank International Limited operating in California comprise two percent of the unitary business' income.⁷⁴ This compiled with the fact the per capita income of people in United States is double that of United Kingdom residents,⁷⁵ seems to place *Barclays* in the same high risk of multiple taxation category. Unfortunately, the Court did not agree, and there are no clues how the Court would remedy this problem.

$$1/3 \times (10/110 + 10/20 + 10/20) = .36 \text{ to United States}$$

In this second example, the higher payroll costs for Foreignco in the foreign operations of the unitary business results in less income being apportioned under the UDITPA formula to the United States. In other words, although Domesticco produces 50 percent of the overall net income of the unitary business on a book basis, it will be taxed in the United States on 36 percent of the combined total income of the unitary business. Thus, the formula seems to get it exactly backwards because common sense suggests that Foreignco is less, rather than more, profitable when its labor costs have increased without any corresponding increase in productivity.

Eric J. Coffill & Willson Prentiss Jr., *Federal Formulary Apportionment as an Alternative to Arm's Length Pricing: From the Frying Pan to the Fire?*, 59 TAX NOTES 1103, 1115 (May 22, 1993).

68. HELLERSTEIN & HELLERSTEIN, *supra* note 2, ¶ 8.10[3][b].

69. In 1986 the per capita income of people living in the United Kingdom was \$8,920. The per capita income of people living in Kenya, where Barclays has subsidiaries, was \$300. Contrast these with the 1989 per capita income of people living in the United States, \$21,082.37 CURRENT WORLD LEADERS, No. 5, ALMANAC at 115, 232-33 (Oct. 1994).

70. HELLERSTEIN & HELLERSTEIN, *supra* note 2, ¶ 8.14[8].

71. *Barclays Bank PLC v. Franchise Tax Bd.*, 114 S. Ct. 2268, 2288 (1994)

72. *Id.* at 2280.

73. *Id.*

74. *Barclays*, 114 S. Ct. at 2288.

75. 37 CURRENT WORLD LEADERS, No. 5, ALMANAC at 115, 232-33 (Oct. 1994).

Separate Accounting, like WWCR, can not insure a corporation will be free from multiple taxation, but it lowers the chances of over-taxation. If all of the taxing jurisdictions used the same method of taxation the risk of over-taxation would be greatly reduced. As it now stands, WWCR is likely to include the income of foreign subsidiaries in the taxable income of a domestic subsidiary, like Barclays Bank of California. This occurs because WWCR combines all of the unitary business' income, and then allocates a percentage of the income to the domestic subsidiary. When income of a foreign subsidiary is allocated to a domestic subsidiary there is over-taxation. The foreign subsidiary is taxed on its income using Separate Accounting, and then through WWCR the domestic subsidiary is also taxed on some of that income.⁷⁶

The Court stated that California was able to use WWCR to compute taxes because there is no method of taxation that can completely eliminate the risk of multiple taxation.⁷⁷ The Court did not believe the risk of multiple taxation warranted a change in California's method of computing taxes.⁷⁸ In *Container Corporation v. Franchise Tax Board*, the Court accepted the fact that multiple taxation occurs when WWCR is used.⁷⁹

In *Barclays*, the Court again felt California did not need to change from WWCR to Separate Accounting because no method of computing taxes would eliminate the risk of multiple taxation. In reaching its decision the Court relied on its knowledge of Combined Reporting and Separate Accounting from the use of these two formulas in computing the taxes of domestic-based companies with foreign corporations.⁸⁰ Because no case has demonstrated that Separate Accounting will, "dispositively lessen the risk of multiple taxation," for domestic based corporations, the Court believed the same would hold true for foreign-based multinational corporations.⁸¹

76. *Barclays*, 114 S. Ct. at 2288. Multiple taxation results in WWCR because of factors like the valuation of money from one country to another, and higher costs of property, payroll, and sale prices.

77. *Container Corp. of America v. Franchise Tax Bd.*, 463 U.S. 159, 188 (1983). The Court stated that it was not deciding the issue of how foreign-based companies with corporations in the United States should be taxed.

78. *Barclays*, 114 S. Ct. at 2280.

79. *Id.* See also *Container Corp. of America v. Franchise Tax Bd.*, 463 U.S. 159, 188 (1983) (citing *Japan Line, Ltd. v. County of Los Angeles*, 441 U.S. 434, 447, 452, 455 (1979)). The Court stated, "Double taxation in this case, although real, is not the 'inevitable[e]' result of the California taxing scheme." *Id.*

80. *Barclays* is the first case to challenge the use of WWCR for computing the taxes of a foreign-based multinational corporation. All the precedent relied on in the opinion evaluated WWCR as it has been used in the past to figure the taxes of a domestic company with or without multinational corporations.

81. *Barclays*, 114 S. Ct. at 2280. When Combined Reporting is used to compute the taxes of companies operating solely in the United States the problem of multiple taxation drastically decreases. All of the states use the same Unitary Business method of taxation which ensures the percentage of the property, payroll, and sales of the various subsidiaries are divided among the various states without the risk of over-taxation. When Separate Accounting and unitary business methods are used to compute the taxes of a company (as is the case with foreign-based multinational corporations) the risk of multiple taxation increases because under the Unitary

The Court did not consider the increased risk of multiple taxation that arises when foreign currency is changed into dollars. Nor did the Court consider the difference in the cost of property, payroll, and sales of foreign countries. Barclays only has three of its over 220 subsidiaries located in the United States, making it necessary to consider these factors when taxing the company as a unitary business.⁸²

The dissent felt that WWCR did create a substantial risk of double taxation because it is not compatible with Separate Accounting.⁸³ California, and most of the other states, use a method of taxation entirely different from the rest of the taxing world. Under the unitary business method the taxes are computed by applying a percentage (that is equal to the subsidiaries' percentage of the unitary business' property, payroll, and sales) to the unitary business' income. However, the federal government and foreign countries tax each subsidiary on their own income for the year, not on the percentage of the entire company the subsidiary represents. This disparity creates risks of double taxation for foreign-based multinational corporations simply because of the method of taxation.

The dissent also stated that multiple taxation is impermissible under the Dormant Commerce Clause because it burdens foreign corporations that are unable to make changes through the political process.⁸⁴ States enact laws that are beneficial to the domestic corporations located in that state. In enacting laws, a state does not protect the interests of foreign-based corporations. Foreign-based corporations can lobby the state in an effort to protect its own interests, but the state is likely to ignore the foreign-based corporations and protect the interests of the domestic corporations in the state.

The majority acknowledged the beliefs of the dissent in their opinion, stating that the foreign companies do have access to the United States political process through their respective governments. For example, in *Container Corporation* and *Barclays*, the United Kingdom threatened retaliatory legislation because California's WWCR method of taxation was not found to be unconstitutional.⁸⁵ There have also been a number of diplomat-

Business method a subsidiary can appear to have more assets than it actually does because of its property and payroll. Unlike the Unitary Business method, Separate Accounting only looks at the income of the single corporation during that year.

82. Freud & Kollings, *supra* note 47, at 344, n.15.

83. *Barclays*, 114 S. Ct. at 2288 (O'Connor, J., concurring in the judgment in part and dissenting in part).

84. *Id.* at 2289.

85. Brief of the Government of the United Kingdom, *supra* note 1, at 19-23. In stating the United Kingdom's support for Barclays and desire for the California WWCR method to be found unconstitutional the Chancellor of the Exchequer stated, "the UK will have to retain its retaliatory powers in reserve as a barrier against the possibility that States might damage UK owned companies by the imposition of unitary taxation at some time in the future." *Id.*

ic notes from foreign countries deploring WWCR.⁸⁶ Despite the disapproval of WWCR by many foreign countries and corporations in the United States, the Court felt the methods of taxation utilized throughout the world do not control the decisions of the Supreme Court in any area, even when it concerns the Commerce Clause.⁸⁷

It is true that WWCR should not be changed to Separate Accounting simply because foreign countries feel it should be changed. Rather, California should use Separate Accounting because the states' use of Combined Reporting interferes with the federal government's ability to speak with one voice, and because multiple taxation is more likely to result when Combined Reporting is used by the states. As a concession to foreign countries, in 1988 California began to allow multinational corporations to choose between WWCR and Water's Edge methods of taxation.⁸⁸ WWCR is no longer mandatory, corporations may now file their taxes using Water's Edge formulas if the FTB allows them to do so.⁸⁹

b. The Federal Government's Ability to Speak with One Voice

Barclays also contends that WWCR does not meet the second area considered by the test for constitutionality used in *Japan Line* because it impairs federal uniformity "in an area where it is essential."⁹⁰ WWCR does not allow the federal government to, "speak with one voice," when interacting with foreign countries because the method of taxation used among the fifty states is not the same as that of the federal government.⁹¹

The Court did not believe that California's use of WWCR affected the federal government's ability to "speak with one voice."⁹² In *Container Corporation of America v. Franchise Tax Board*,⁹³ the Court found no specific indications by Congress of its intent to stop California from using

86. Freud & Kollings, *supra* note 47, at 340, n.1. Even though twenty foreign countries have provided amicus curiae briefs in support of Barclays, and another thirteen groups provided amicus curiae briefs supporting both Barclays and Colgate, this is not the same as participating in the political process of the United States. The number of amicus curiae briefs that support an issue are not equal to the pull of one vote in an election. Amicus curiae briefs can be ignored, but a vote in the political process has an actual effect in the final decision.

87. *Barclays*, 114 S. Ct. at 2281.

88. Freud & Kollings, *supra* note 47, at 340. Water's Edge method of taxation allows a multinational company to limit their taxation to only the property, payroll, and sales in the United States. It generally includes everything from the east coast to the west coast, and does not extend beyond the water's edge unless a foreign subsidiary conducts 20% or more of its business in the United States. See *infra* section VI.

89. *Barclays*, 114 S. Ct. at 2281. See also HELLERSTEIN & HELLERSTEIN, *supra* note 2, ¶ 8.16[2]; CAL. REV. & TAX CODE § 25110 (West 1994).

90. *Barclays*, 114 S. Ct. at 2281 (quoting *Japan Line, Ltd. v. County of Los Angeles*, 441 U.S. 434, 448 (1979)).

91. *Id.* at 2281 (quoting *Japan Line*, 442 U.S. at 453).

92. *Id.* at 2281-82.

93. 463 U.S. 159 (1983).

WWCR.⁹⁴ The United States is a party in numerous treaties involving many foreign countries which require the federal government to use Separate Accounting. The taxation requirements of the federal government do not extend to the fifty states; the states are free to control their own activities.⁹⁵ Congress has been silent as to the constitutionality of the taxation formulas used by the states because they have been unable to reach a decision. The Court believes that if Congress wanted to regulate the method of taxation used by the states, it would have enacted legislation to that effect. Until Congress regulates the tax formulas used by the states, the states can use combined reporting.

The Supreme Court has interpreted congressional silence on the issue of WWCR to be approval.⁹⁶ The Senate did not require the states to use Separate Accounting when it was proposed as a part of the United States-United Kingdom treaty. When the treaty was presented to the Senate for ratification, the Senate was not able to reach a decision as to whether states should be required to use Separate Accounting.⁹⁷ This indecision was interpreted by the Court in *Wardair Canada, Inc. v. Florida Department of Revenue* to be acquiescence by the federal government to the states' use of combined reporting.⁹⁸ In *Barclays*, the Supreme Court felt it did not have the authority to make policy judgments concerning foreign commerce because that is the duty of the political branches of government.⁹⁹ If Congress is willing to endure California's use of WWCR, and the foreign policy of the United States is not threatened by WWCR, then there is no need for the Supreme Court to intercede where it should not.¹⁰⁰

Simply because Congress has been unable to decide whether the states should be required to use Separate Accounting does not mean that Congress has approved the states' use of combined reporting. It is often difficult for Congress to pass many different forms of legislation. Under the Dormant Commerce Clause congressional silence is not the explicit approval of Congress. While Congress has been aware that foreign countries are displeased with WWCR for a number of years, the issue of states' use of combined reporting to tax foreign-based multinational corporations was decided in June of 1994.¹⁰¹ The fact that Congress has not enacted legisla-

94. *Id.* at 188.

95. *Id.*

96. Brief of the Government of the United Kingdom, *supra* note 1, at 10.

97. *Id.* See also *Barclays*, 114 S. Ct. at 2282.

98. Brief of the Government of the United Kingdom, *supra* note 1, at 10-12. *Wardair Canada, Inc. v. Florida Dep't of Revenue*, 477 U.S. 1, 11-12 (1986).

99. *Barclays*, 114 S. Ct. at 2285. The argument of *Barclays* and the United Kingdom should be made to the political section of Government. *Barclays*, 114 S. Ct. at 2286.

100. *Id.* at 2284.

101. *Id.* at 2282-83. In the past 15 years a number of foreign countries have sent 20 notes and diplomatic communications to the United States informing it of the various problems of WWCR and stating the need for the states to use Separate Accounting. Brief of the Government of the United Kingdom, *supra* note 1, at 23.

tion to prevent states from using combined reporting to compute the taxes of multinationals is not a statement of what type of taxation should be used. Rather, it emphasizes the difficulty the question poses.

It is very likely that Congress cannot reach an agreement as to how to limit the method of taxation used by the states.¹⁰² In *Gibbons v. Ogden*, the Supreme Court recognized that even when Congress was silent about an issue of interstate commerce, the federal government still had the power to control the law in that area.¹⁰³ Silence by Congress, therefore, is not acquiescence to the states' ability to act without regulation. The Court should not refrain from finding that a method of taxation is unconstitutional simply because Congress has not been able to reach a decision on the topic. Rather, the Court has power to regulate under the Dormant Commerce Clause until Congress speaks.¹⁰⁴

B. Due Process

Barclays further contended that the "reasonable approximations" standard violated Due Process because it is impossible to determine what California will allow as approximations.¹⁰⁵ FTB decides on a case-by-case basis what will satisfy the "reasonable approximations" requirements. Not only will the items used to approximate income change from corporation to corporation, but from year to year the items accepted from the same company will change.¹⁰⁶ Barclays argued that this practice violates the Due Process Clause¹⁰⁷ because there is no set standard for foreign-based multinationals which, "a person of ordinary intelligence" can use.¹⁰⁸

The Court did not believe California's use of "reasonable approxi-

102. There is no evidence the mandatory use of Separate Accounting was excluded from the United Kingdom-United States treaty for any reason other than the inability of Congress to reach a decision the majority could agree on. Brief of the Government of the United Kingdom, *supra* note 1, at 7-8.

103. *Gibbons v. Ogden* 22 U.S. 1, 209-10 (1824).

104. Brief of the Government of the United Kingdom, *supra* note 1, at 7-12. During ratification of the treaty between the United Kingdom and the United States there was debate in Congress over limiting state's tax method for foreign-based multinationals to Separate Accounting.

During the debates on the treaty in June 1978, three distinct views on Article 9(4) emerged. There were those who would vote for it, those who would vote against it because they thought the states should have the unfettered right to tax foreign-owned multinational, and those who would vote against it because they did not believe 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 Houses as part of a uniform policy to be applied to all nations.

Id. at 8-9.

105. *Barclays*, 114 S. Ct. at 2278.

106. Brief for Pet., at 49, *Barclays* (No. 92-1384).

107. U.S. CONST., amend. XIV. See also *supra* notes 23-24 and accompanying text.

108. Brief for Pet., at 49, *Barclays* (No. 92-1384).

mations" violated the Due Process Clause of the Constitution. Calculating the income of multinational companies is a difficult task, and inaccuracy will sometimes result with every method of taxation. California has attempted to limit the compilation of "reasonable approximations" to documents a company would regularly maintain.¹⁰⁹

The problem is that no definition exists that delineates what regularly maintained documents are. This seems to imply that the FTB can select different documents to rely on for calculating taxes each year. This would change the tax owed by the corporation, not because the income had changed, but because the documents used to "reasonably approximate" the income of the corporations had changed.

VI. WATER'S EDGE ELECTION

After *Container Corporation of America v. Franchise Tax Board*, while *Barclays Bank PLC, v. Franchise Tax Board* was pending, California changed the method of taxation for multinational corporations to allow them the option of being taxed under Water's Edge taxation. If Water's Edge is used, a corporation is generally not taxed on income earned outside the United States.¹¹⁰ A corporation must include other subsidiaries in its unitary business if the subsidiary is domestic and can be included in a federal consolidated tax return or if the subsidiary is foreign and more than twenty percent of its average property, payroll, and sales are generated in the United States.¹¹¹ Even when Water's Edge is used, the income earned in the United States is still apportioned as it is in WWCR, using the property, payroll, and sales of the corporations in different states.

If the FTB allows a corporation to use Water's Edge taxation, there are numerous conditions that must be satisfied by the corporation.¹¹² When a corporation elects to use Water's Edge method of taxation all of its subsidiaries in the taxing jurisdiction must also use Water's Edge. If one of the subsidiaries in the unitary business does not use the Water's Edge method of taxation, then all of the other members of the unitary business group will be barred from making the election.¹¹³

Before a corporation is able to use the Water's Edge method of taxation they must sign a contract with FTB stating they will continue to use Water's Edge for seven years. Each year, on a date specified in the contract, another year will automatically be added to the term of the contract. If a corporation does not want to continue using Water's Edge method of taxation beyond the seven year period the corporation must notify the FTB that it does not want

109. *Barclays*, 114 S. Ct. at 2278-79. See also *Container Corp. of America v. Franchise Tax Bd.*, 463 U.S. 159 (1983).

110. HELLERSTEIN & HELLERSTEIN, *supra* note 2, ¶¶ 8.16, 8.16[1].

111. *Id.* at ¶ 8.16[2]. See also CAL. REV. & TAX CODE § 25110(a)(3) (West 1994).

112. HELLERSTEIN & HELLERSTEIN, *supra* note 2, ¶ 8.16[2].

113. 1 Cal. St. & Loc. Taxes, Research Institute of America ¶ 10,549, at 10,530-A (1994).

another year added to the contract.¹¹⁴

A corporation may stop using Water's Edge prior to the end of the seven year period for two reasons. First, if the taxpayer is acquired by a company that does not use Water's Edge, and the acquiring company is larger in terms of equity capital, then the corporation may elect to stop using Water's Edge. Second, a corporation may also stop using Water's Edge if notice is given in writing and the FTB permits the corporation to change back to WWCR. If a corporation elects to stop using Water's Edge the FTB may reevaluate a corporation's usage of Water's Edge to assure that the tax assessed through Water's Edge represents the corporations income.¹¹⁵ By doing so, the FTB may use WWCR to recalculate the past income which was taxed using Water's Edge, and include the foreign subsidiaries.¹¹⁶

A corporation electing to use Water's Edge rather than WWCR to compute the taxes of its unitary business group must also agree that dividends from other corporations are business income. A corporation is not able to separate the business from the non-business dividends to determine how they should be taxed.¹¹⁷ The dividends must be treated as business income if they come from either another corporation engaged in the same type of trade with fifty percent or more stock owned by the unitary business, or the corporation must be a significant supplier, purchaser, seller, or recipient of raw materials from the unitary business.¹¹⁸

When electing to use Water's Edge instead of WWCR a corporation must also give consent for depositions to be taken of "key domestic corporate individuals." A corporation must further agree to accept subpoenas duces tecum from FTB, the State Board of Equalization or California Courts.¹¹⁹

VII. FAULTS OF WATER'S EDGE

A corporation, like Barclays, may elect to use the Water's Edge method of taxation if all of the members of the unitary business in the Water's Edge taxing jurisdiction also make the election. California is a state that believes it is fair to tax a corporation using WWCR despite the fact the federal government and foreign countries use Separate Accounting. In *Barclays*, the FTB stated that the use of two different accounting methods did not increase

114. CAL. REV. & TAX CODE § 25111 (West 1994); 1 Cal. St. & Loc. Taxes at ¶ 10,549, at 10,530-A.

115. 1 Cal. St. & Loc. Taxes, ¶ 10,549, at 10,530-B (1992).

116. CAL. REV. & TAX CODE § 25111 (West 1994).

117. CAL. REV. & TAX CODE §§ 25110, 25110(b)(2)(B) (West 1994). In agreeing the dividends are business income the corporation using Water's Edge has given up the right to have the non-business dividends separated from the business dividends for tax purposes. HELLERSTEIN & HELLERSTEIN, *supra* note 2, ¶ 8.16[2].

118. CAL. REV. & TAX CODE § 25110(b)(2)(B)(ii) (West 1994). Significant, "means an amount of 15 percent or more of either input or output." *Id.*

119. *Id.* at § 25110(b)(2)(a).

the risk of multiple taxation for foreign-based multinational companies.¹²⁰ However, California does not allow each corporation in a unitary business to select between WWCR and Water's Edge. Although California offers multinational corporations a choice between WWCR and Water's Edge, the different corporations of a unitary business located in California must be taxed using the same method.¹²¹ If California feels the state is justified in imposing a method of taxation on corporations that differs from the method of taxation used by the federal government and foreign countries, then the various corporations of a unitary business located in California should also be able to use different methods of taxation.

A corporation electing to use the Water's Edge method of taxation may feel discriminated against by the disparity created when a subsidiary of the corporation is domestic rather than foreign. Under Water's Edge, a foreign subsidiary earning less than twenty percent of its income from the United States is not considered in the tax computations. However, a domestic subsidiary with less than twenty percent of its income generated in the United States must be included in the apportionment.¹²² When a corporation is forced to include such a subsidiary in computations for Water's Edge simply because the subsidiary is domestic rather than foreign, there is discrimination against the domestic subsidiary. The domestic subsidiary receiving less than twenty percent of its income from the United States could be excluded from the unitary business, as the foreign subsidiaries are. Separate Accounting could be implemented to compute the taxes of the subsidiary in place of Water's Edge or WWCR.¹²³ It would be easy to tax the domestic subsidiary using Separate Accounting because it must maintain Separate Accounting records for the federal government regardless of the method of taxation employed by California.

For a corporation to use the Water's Edge election it must enter a contract with the FTB for a seven year period. That contract provides that each year on a specified date a year will automatically be added to the length of the contract. If a corporation using Water's Edge does not wish to extend the contract beyond the seven year period the corporation must inform the FTB each year that it does not want another year added.¹²⁴ A corporation that does not want to continue using Water's Edge beyond its seven year contract should not have to inform the FTB of its position yearly. This provision of the Water's Edge election contract is not needed. The provision is likely to trap a corporation that may forget to inform the FTB each year that it does not want its Water's Edge contract to extend beyond the original

120. Brief for Resp., at 37-38. *Barclays Bank PLC v. Franchise Tax Bd.*, 114 S. Ct. 2268 (1994) (No. 92-1384).

121. Cal. St. & Loc. Taxes, ¶ 10,549, at 10,530-A.

122. HELLERSTEIN & HELLERSTEIN, *supra* note 2, ¶ 8.16[2][a].

123. *Id.* at ¶ 8.16[2][a].

124. CAL. REV. & TAX CODE § 25111(a) (West 1994); 1 Cal. St. & Loc. Taxes ¶ 10,549, 10,530-A.

seven years.

Forcing a corporation to sign a contract with the FTB is an attempt by the FTB to avoid liability for any unconstitutional aspects of Water's Edge.¹²⁵ When a corporation agrees by contract to the method of taxation, it is consenting to the state's use of a tax formula that may otherwise be found to discriminate. California does not have to contractually bind corporations that want to use the Water's Edge method of taxation. It is unconscionable that California is engaging in a practice to evade its constitutional obligations.

A corporation that decides Water's Edge is no longer the best method of taxation should not face the possibility of being penalized for switching to WWCR. As the requirements now stand, a corporation may be required to pay taxes on the items not included in taxation under Water's Edge that would have been included if WWCR was used in place of Water's Edge.¹²⁶ This is discrimination against a corporation for exercising the right to select between two alternate methods of taxation. There will always be a difference in the amount of taxes assessed when WWCR is used as opposed to Water's Edge. The entire unitary business' income is used to calculate taxes in WWCR. Yet, when Water's Edge is used, taxes are computed using only the domestic income of the unitary business. If a corporation has completed its taxes in a lawfully approved manner, like Water's Edge, it is not correct for California to go back years later and recompute the taxes under a different method.

There is no reason to require that corporations electing to use Water's Edge be required to treat all dividends as business income. Corporations using Water's Edge are not able to separate the business from the non business dividends.¹²⁷ It is not fair for a corporation using Water's Edge to be denied a possible tax deduction of a dividend simply because the corporation is using Water's Edge to compute its taxes rather than WWCR.

Many foreign countries welcomed Water's Edge as an alternate method of taxation. Foreign countries believed the Water's Edge method of taxation was a sign of California's willingness to work toward solving the problems of taxing foreign-based multinational corporations.¹²⁸ This opinion changed once foreign countries witnessed the actual effects of Water's Edge. Foreign countries do not like the numerous conditions a corporation must comply with when using Water's Edge. Even more disturbing is the ability of California to recalculate the tax of a corporation under WWCR, despite the fact the corporation lawfully elects to use Water's Edge.¹²⁹ Since the enactment of Water's Edge in 1986, foreign countries have been dissatisfied

125. HELLERSTEIN & HELLERSTEIN, *supra* note 2, ¶ 8.16[2][d].

126. CAL. REV. & TAX CODE § 25111(c) (West 1994).

127. HELLERSTEIN & HELLERSTEIN, *supra* note 2, ¶ 8.16[2][c].

128. Brief of the Government of the United Kingdom, *supra* note 1, at 22.

129. *Id.*

with the United States' efforts at solving the problems created by WWCR.¹³⁰

VIII. A UNIFORM METHOD OF TAXATION

Currently, the risk of multiple taxation is increased because there are two different methods of taxation imposed on foreign-based multinational corporations. When the states use combined reporting while the federal government and foreign countries use Separate Accounting it is easy for a company to be taxed twice on the same income.¹³¹ One way to avoid this problem and lower the risk of multiple taxation would be through the use of a single method of taxation by all taxing jurisdictions.

A. Global Use of Worldwide Combined Reporting

Proponents of WWCR believe that if all foreign countries and the federal government used combined reporting, there would no longer be the risk of multiple taxation that now exists. Each country would be calculating taxes based on the income of the unitary business. Every jurisdiction taxing a member of the unitary business would use its formula to apportion the percentage of the unitary business' income generated in its borders. Theoretically, the income of the unitary business would be divided proportionally among all of the taxing jurisdictions and there would be no over-taxation.¹³²

Unfortunately, there would still be a risk of over-taxation because each taxing jurisdiction, whether a country or a state, could compose their own formula. Even if all countries agreed to calculate taxes using property, payroll, and sales as the components of their formula, there would still be a viable risk of multiple taxation. Each country would put more emphasis on the component of the formula that was the strongest in their country, and it would be as if different methods of taxation were used by the various taxing jurisdictions.¹³³ For example, California's formula currently weights the sales factor twice as heavily as it does the property and payroll factors.¹³⁴ If each country altered the formula to provide it the most benefits, the result would be as if each country were using completely different methods of taxation.

130. There are numerous letters and statements by foreign countries expressing their discontent with the Water's Edge method of taxation. Brief for Pet., at 11-12, Barclays Bank PLC v. Franchise Tax Bd., 114 S. Ct. 2268 (No. 92-1384).

131. Benjamin F. Miller, *None Are So Blind as Those Who Will Not See*, 66 TAX NOTES TODAY 1023, 1025 (1995).

132. *Id.* at 1033.

133. *Organization for Economic Cooperation and Development; Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, 94 TAX NOTES TODAY 133-38. [hereinafter *OECD*].

134. CAL. REV. & TAX CODE § 25128(a) (West 1995).

The use of WWCR by all countries taxing multinational corporations could create the potential necessity of changing accounting records for each country.¹³⁵ Once a unitary business had compiled all of its accounting records for the entire economic enterprise, the records would have to be translated into the different languages and currency of the various countries in which the unitary business was filing tax returns.¹³⁶ If WWCR was used globally, then multinational companies would have to change their records into numerous languages and currencies.¹³⁷

The use of WWCR as a worldwide method of taxation seems unlikely. There would be difficulties with varying formulas and the high cost of translating accounting records. Numerous foreign countries are opposed to this method of taxation—so opposed as to threaten to take retaliatory measures against the United States for using WWCR to tax their multinational corporations.¹³⁸

B. Global Use of Separate Accounting

Many critics of Separate Accounting believe that one of its biggest flaws is that the method cannot accurately measure intercompany transfers. When subsidiaries transfer items between themselves, a price must be established.¹³⁹ Problems can arise when trying to determine the price of a transferred item. Specifically, when the item has some type of intangible benefit or quality that must be considered when calculating a price for the intercompany transfer.¹⁴⁰

Under Separate Accounting a subsidiary must calculate a value for the intercompany transfer which will be used to compute its taxes. At this point, opponents of Separate Accounting fear a corporation will not be honest in arriving at a value for the intercompany transfer, thus avoiding taxes. However, the federal government uses Separate Accounting successfully because section 482 gives it the ability to reapportion the income of a corporation if it believes the corporation is trying to avoid taxes.¹⁴¹ Corporations do not want the federal government to reapportion their

135. *OECD*, *supra* note 133, at 133-38.

136. *Id.*

137. This problem does not arise when Separate Accounting is used because each corporation is taxed only on the income it earns. There is no need to translate the currency or language of other subsidiaries accounting records because the records are not used. *Id.*

138. Brief of the Government of the United Kingdom, *supra* note 1, at 23.

139. *OECD*, *supra* note 133, at 138.

140. *Id.* An example is when an item that has recently been patented by subsidiary *A* is transferred to subsidiary *B* for use as a part in a bigger machine. It is necessary to ask: what benefit did *B* receive from the patented item, and how has that benefit increased the value of the machine the item was used in?

141. See Section 482 *White Paper; Service Develops New Method for Finding Comparable Price Intangibles*, 88 TAX NOTES TODAY 213-74 [hereinafter *White Paper*]. See also 26 C.F.R. § 1.482-3 (1994).

income, and therefore follow the methods set forth in the Treasury Regulations when pricing intercompany transfers.

The Federal Treasury Regulations provide corporations with a variety of methods that can be used to value intercompany transfers.¹⁴² The regulations recommend a corporation try to value the intercompany transfer using the Comparable Uncontrolled Price method.¹⁴³ Under this method, the IRS allows a corporation to value the item by calculating a price based on similar transactions between unrelated companies on the open market.¹⁴⁴ The corporation is able to assign the lowest value that would be paid by two unrelated corporations, because the IRS realizes that in an unrelated transaction the buyer is going to accept the best price that can be found.¹⁴⁵ In the event there is not a comparable item on the open market to use as a guide in determining a price, the IRS provides alternative methods that can be used to assign a value to an intercompany transfer.¹⁴⁶

The flaw in section 482 is the difficulty encountered when trying to assign a value to intangible items that are exchanged in intercompany transfers. An intangible benefit, is a benefit that is attached to the item which exceeds its material characteristics.¹⁴⁷ "The value of an item of tangible property may be affected by the value of intangible property, such as a trademark affixed to the tangible property. . . ." ¹⁴⁸ A trademarked item has an intangible benefit that makes a comparison with an untrademarked item, insufficient as a means of assigning a price to the intercompany transfer.¹⁴⁹

The federal government has been working to eliminate the weaknesses of Separate Accounting.¹⁵⁰ For instance, it has issued regulations that corporations can follow in determining the price of an intangible. Under the Comparable Uncontrolled Transaction method a corporation can assign a value based on what price would have been paid for the item in the open market.¹⁵¹ When using this method, it is therefore necessary to find a transaction between two unrelated corporations for substantially the same intangible item in substantially the same circumstances.¹⁵² In the event the

142. 26 C.F.R. § 1.482-1T (1994).

143. *OECD*, *supra* note 133.

144. 26 C.F.R. § 1.482-3T(b) (1994).

145. *Id.*

146. *Id.* See 26 C.F.R. § 1.482 (1995) and *OECD*, *supra* note 133, for more information of other methods that can be used to calculate the price of an intercompany transfer. Methods provided in the Treasury Regulations include the Resale Price method, Cost Plus method, Profit Split method, and Comparable Profits method.

147. 26 C.F.R. § 1.482-3T (1994). Examples of intangible benefits that accompany an exchanged item are patents, trademarks, copyrights, franchises, licenses, and know-how. *Id.*

148. 26 C.F.R. § 1.482-3(f) (1995).

149. *Id.*

150. See *White Paper*, *supra* note 141.

151. 26 C.F.R. § 1.482-4T(c) (1994).

152. 26 C.F.R. § 1.482-4T(c)(2) (1994).

Comparable Uncontrolled Transaction method is not applicable, a price for the intangible can be calculated using another method approved by the Federal Treasury Regulations.¹⁵³

Separate Accounting is recognized as the standard method of taxation applied to multinational companies. It is used as the accounting method in all of the tax treaties to which the United States is a party, and in a majority of the tax treaties that do not involve the United States.¹⁵⁴ Section 482 has proved to be satisfactory at ensuring corporations do not try to avoid taxes by falsely valuing intercompany transfers. Both the federal government and foreign countries accept Separate Accounting as a method of taxation, and both are working to improve it. If the states also used Separate Accounting the risks of over-taxation would be decreased because there would no longer be two incompatible methods of taxation used to tax foreign-based multinational corporations.

CONCLUSION

There is much debate as to how the fifty states should tax foreign-based multinational corporations. The states prefer to use combined reporting because it has been reliable when used to compute the taxes generated by interstate commerce. However, when used to compute the taxes of a foreign-based multinational corporation, combined reporting creates a greater risk of multiple taxation than does Separate Accounting. If all of the states agreed to use Separate Accounting the risk of multiple taxation would be significantly decreased.

Over the past several decades foreign countries have expressed their concerns to the United States about the use of combined reporting. The United States has ignored the concerns of foreign countries, thus causing them to retaliate. There appears to be no just reason why the United States cannot adopt some method of taxation that compliments Separate Accounting and reduces the risk of multiple taxation.

After *Container Corporation of America v. Franchise Tax Board*,¹⁵⁵ California realized the serious concerns foreign countries have about the use of Combined Reporting. In response to these worries, California implemented the Water's Edge method of taxation. The Water's Edge election is a step toward solving the problem, but it is not the final answer. There are many faults in Water's Edge that must be changed. A corporation that elects the Water's Edge method of taxation should be able to cease using it without the threat that the FTB may recompute the corporation's taxes using WWCR. Water's Edge requires that the corporation comply with numerous provisions, which may result in discrimination. Also, the Water's Edge election is not

153. 26 C.F.R. § 1.482-4T(d) (1994).

154. *White Paper*, *supra* note 141.

155. 463 U.S. 159 (1983).

easily accessible to all corporations because a corporation can be denied use of Water's Edge by the FTB.

Water's Edge is not the final solution to the problem arising from California's refusal to use Separate Accounting when computing the taxes of foreign-based multinational corporations. The risk of multiple taxation would decrease if all jurisdictions were using the same method to calculate taxes. The fifty states feel that Separate Accounting is unreliable because of the difficulties encountered when pricing intercompany transfers. Yet, the federal government has been able to use Separate Accounting successfully for numerous years, and has been working to develop better methods for pricing intercompany transfers. If the states directed their efforts towards solving the problems of Separate Accounting, rather than not using it, solutions to the problem of intercompany transfers might be easier to achieve.

The federal government has been working with foreign countries to develop methods of taxation that are agreeable to all countries. The states should join this effort to create a harmonious tax system. A fair method of taxation for foreign-based multinationals is important in today's globally oriented world. The foremost concern of the states and the federal government should be to encourage foreign investment in the United States rather than discourage it.

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