NOTE

PROPOSED CONGRESSIONAL LIMITATIONS ON STATE TAXATION OF MULTINATIONAL CORPORATIONS

I. INTRODUCTION

Unlike the federal government, which can tax the income of its corporate citizens regardless of source, a state is permitted to tax only that portion of a corporation's income derived from within its jurisdiction. The problem of dividing equitably an interstate corporation's business income among the states in which it operates has been a topic of long-standing concern to national businesses fearful of double state taxation. With the advent of the multinational corporation (MNC), the apportionment problem has drawn the attention of the entire international business community.

To determine what portion of an interstate or multinational corporation's business income is derived from a particular jurisdiction, the states have followed two general approaches: the separate accounting theory and formulary apportionment. The

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1 I.R.C. §§ 11, 61(a), 63(a).
2 The commerce clause, U.S. Const. art. 1, § 8, cl. 3, and the due process clause, U.S. Const. amend. XIV, § 1, permit a state to tax only that income derived from an activity with a substantial nexus to the taxing state. In addition, the tax must be fairly apportioned, nondiscriminatory, and fairly related to state services. Complete Auto Transit, Inc. v. Brady, 430 U.S. 274, 279 (1977).
4 The multinational corporation, a phenomenon of the post-World War II era, has been defined as "a cluster of corporations of diverse nationality joined together by ties of common ownership and responsive to a common management strategy." Vernon, Economic Sovereignty at Bay, 47 Foreign Affairs 110, 114 (1968). See generally Staff of Subcomm. on International Trade of the Senate Comm. on Finance, 93d Cong., 1st Sess., The Multinational Corporation and the World Economy (Comm. Print 1973); R. Vernon, Sovereignty at Bay (1971).
6 A third division of income method is specific allocation. States generally apply specific allocation only to those types of income that can be traced to a single source. For instance, most states specifically allocate rentals received from real estate to the state in which the real estate is located. Because income derived from the sales of an integrated manufactur-
separate accounting theory treats each member of a multicity-
porate group as a separate and independent entity. This method
isolates the income of each corporate group member, disregarding
the performance of the MNC as a whole. Therefore, intercor-
porate transactions are viewed as taxable events, just as if the
members were dealing with nonrelated corporations. Due to the
related nature of the group, transfer prices between group
members may not reflect accurately fair market prices. In these
instances, tax authorities must recalculate transfer prices to
reflect actual income.

The theory underlying formulary apportionment views the
overall success of an MNC as critical. It does not attempt to
isolate the income of each group member, but combines the in-
come of those members that participate in a unitary business and
apportions the total to the various jurisdictions within which the
business operates. First, the tax authority must determine which
members constitute a unitary business. The apportionable income of each of these members is then combined and a formula, designed to reflect the portion of total income attributable to the taxing state, is applied. Most states use a three-factor formula based upon the average ratio of state sales to total sales, state payrolls to total payrolls, and state property values to total property values. To illustrate, for an MNC that has one-fourth of its tangible property, one-half of its payroll, and three-fourths of its sales located within the taxing state, the average of these three factors (one-half) is applied to the combined income of the unitary business to arrive at the state’s taxable portion.

Most nations, including the United States, have adopted the separate accounting technique to divide an MNC’s worldwide business income. In the United States, Congress has initiated several attempts over the past fifteen years to bring state taxation of MNC income into conformity with federal and international standards.

11 Many controversies arise at this preliminary stage. See, e.g., Exxon Corp. v. Wisconsin Dept’t of Revenue, 447 U.S. 207 (1980). See generally J. Hellerstein, supra note 10, and text accompanying notes 40-46 infra.


13 See U.S. DEP’T OF TREASURY, MODEL CONVENTION ON INCOME AND CAPITAL (REVISED DRAFT) art. 9 (1977), reprinted in 1 TAX TREATIES (CCH) ¶153; ORGANIZATION FOR ECONOMIC COOPERATION AND DEVELOPMENT, MODEL CONVENTION FOR THE AVOIDANCE OF DOUBLE TAXATION WITH RESPECT TO TAXES ON INCOME AND ON CAPITAL art. 9 (1977), reprinted in 1 TAX TREATIES (CCH) ¶151.

This Note analyzes Senate Bill 65516 (hereinafter S.655), legislation limiting inclusion of foreign source income in the state tax base and restricting state taxation of foreign source dividends. In view of the traditional sovereignty granted states in determining their own fiscal affairs, this Note examines whether special policy considerations exist which justify federal intervention, and whether the legislation is tailored to resolve the actual problems raised by state taxation of MNC income.

II. STATE TAXATION IN THE FEDERAL SYSTEM

A. Framework for Analysis

The authority of the states to raise their own revenues and to determine their own fiscal policies has been viewed traditionally as an essential element of the states' separate and independent role in the United States federal system.16 As Alexander Hamilton stated in *The Federalist*:

"[T]he individual States should possess an independent and uncontrollable authority to raise their own revenues for the supply of their wants. . . . [A]n attempt on the part of the national government to abridge them in the exercise of it would be a violent assumption of power unwarranted by any article or clause of the Constitution."17

The Supreme Court has recognized repeatedly the authority of the states to impose taxes on income.18 In its most recent statement on the relationship between state and federal income taxa-

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17 *The Federalist* No. 32 (A. Hamilton).

tion powers, the Supreme Court noted that "[c]oncurrent federal and state taxation of income, of course, is a well-established norm. Absent some explicit directive from Congress, we cannot infer that treatment of foreign income at the federal level mandates identical treatment by the States."\(^9\) As long as the state tax "is applied to an activity with a substantial nexus with the taxing State, is fairly apportioned, does not discriminate against commerce, and is fairly related to the services provided by the State,"\(^20\) it is permissible.

In light of the extensive autonomy exercised by the states in the area of taxation, and the strong tradition of concurrent state and federal income taxation, congressional action intruding upon state taxation authority should be undertaken only when necessitated by special policy considerations, and in that event only to the extent necessary to conform to those considerations. Unwarranted legislation or legislation that is more expansive than necessary to meet special policy considerations is inconsistent with the United States federal system.

B. Foreign Commerce Considerations

Proponents of S.655 have asserted several foreign commerce considerations to justify federal limitations on state taxation of MNC income.\(^21\) Several U.S. Supreme Court decisions provide guidance in assessing whether foreign commerce concerns should outweigh the right of states to set their own tax policies.

In the *Japan Lines* case, the Supreme Court struck down under commerce clause analysis an ad valorem property tax imposed upon a foreign corporation's cargo shipping containers.\(^22\) The foreign corporation had already paid property tax upon the containers in its nation of domicile. Even though the state tax was fairly apportioned, the Court invalidated it. The Court stressed the special commerce clause analysis required in issues involving foreign commerce:

> [I]f the containers at issue here were instrumentalities of purely interstate commerce, *Complete Auto* would apply and be satisfied. . . . The premise of appellee's argument is that the Commerce Clause analysis is identical, regardless of whether in-

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\(^21\) See *House Hearings*, supra note 5, at 136 (statement of Sen. Charles Mathias).

terstate or foreign commerce is involved. This premise, we have concluded, must be rejected. When construing Congress' power to 'regulate Commerce with foreign nations,' a more extensive constitutional inquiry is required.23

Applying this stricter standard, the Court noted that because property is often taxed in full at the site of its foreign domicile, instrumentalities of foreign commerce are subject to a risk of double taxation, not faced by domestic commerce, in violation of the commerce clause.24 Under this analysis, evidence indicating that a higher tax burden might be imposed upon foreign commerce may be sufficient to invalidate the state tax. Additionally, the Court noted that "a state tax on the instrumentalities of foreign commerce may impair federal uniformity in an area where federal uniformity is essential."25 The need for federal uniformity is yet another yardstick with which to measure the permissibility of a state tax in a foreign commerce setting.

In McGoldrick v. Gulf Oil Corporation,26 the Supreme Court struck down a state sales tax on imported fuel under a preemption analysis. In that case, New York City had imposed a sales tax on fuel manufactured for sale to vessels active in foreign commerce. Fuel imported for this purpose had been exempted previously from import duties under a federal regulatory scheme adopted to place American refiners in a more favorable position vis-a-vis their foreign competitors. The Court held that the federal scheme operated as a regulation of foreign commerce, which preempted the sales tax. "It is evident that the purpose of the Congressional regulation of the [foreign] commerce would fail if the state were free . . . to impose a tax which would lessen the competitive advantage conferred on the importer by Congress. . . ."27 Under this analysis, the Court examined whether the state tax interfered with a foreign policy adopted by the federal government.

These decisions ruled upon the constitutionality of the state taxes involved. Although this Note does not address the constitutionality of the inclusion of foreign source income in a state's apportionable tax base,28 but rather the propriety of federal in-

23 Id. at 445-46.
24 Id. at 446-47.
25 Id. at 448.
26 309 U.S. 414 (1940).
27 Id. at 429. For discussion of preemption analysis in a state tax setting, see W. Hellersstein, supra note 16.
28 In Bass, Ratcliff & Gretton, Ltd. v. State Tax Comm'n, 266 U.S. 271 (1924), the Supreme Court upheld the constitutionality of applying formulary apportionment to the
tervention in state taxation issues, the strict discrimination and federal uniformity inquiries indicated in *Japan Lines* and the inquiry into state interference with federal foreign commerce policies undertaken in *McGoldrick* are, nonetheless, utilized as helpful reference points in examining the appropriateness of S.655.

III. FORMULARY APPORTIONMENT IN AN INTERNATIONAL CONTEXT

Several states that have adopted the formulary apportionment method do not stop at the water's edge in determining the combined income, sales, payroll, and property of a unitary business for tax purposes.\(^9\) That is to say, they require an MNC operating within their borders to report the income, sales, payroll, and property figures of all foreign affiliates that participate in the MNC's unitary business.\(^3\) Many arguments have been asserted against the extension of the formulary apportionment method to the worldwide income of a unitary business. Senator Mathias, sponsor of S.655, remarked that the bill was necessary to resolve the international double taxation resulting from worldwide combination and to meet the need for federal uniformity.\(^3\) At congressional hearings on state taxation of foreign source income, several other arguments were presented, including the assertion that states are taxing income without a sufficient nexus,\(^3\) that the determination of whether a business is unitary is unreasonable and arbitrary,\(^3\) that the method places substantial administrative burdens upon domestic and foreign MNCs,\(^3\) that the method causes distortion of income,\(^3\) and that the method is an international irritant with worldwide repercussions.\(^3\)

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\(^9\) Of the twenty-six states that use formulary apportionment, twelve apply it to the worldwide income of a unitary business. See *House Hearings*, supra note 5, at 359.

\(^3\) See *California Franchise Tax Board, Proposed Guidelines for the Preparation of Combined Reports* (1979) reprinted in *House Hearings*, supra note 5, at 91 [hereinafter cited as *California Guidelines*].


\(^3\) See *House Hearings*, supra note 5, at 145 (statement of Charles Wheeler).

\(^3\) Id. at 189 (statement of Thomas McHugh).

\(^3\) Id. at 7 (statement of Donald Lubick, Asst. Sec'y of Treas.).

\(^3\) Id. at 192 (statement of Dallas Hurston).

\(^3\) Id. at 137 (statement of Sen. Charles Mathias).
A. Nexus

A primary argument asserted by opponents of worldwide combination is the absence of a sufficient nexus between the taxing state and the foreign source income of the unitary business. The United States Supreme Court has held that a sufficient nexus does exist by virtue of the unitary nature of the business. If XYZ corporation, a unitary business with integrated and interdependent activities, conducts research in State A, manufactures its product in State B, and sells the product in Country C, it is apparent that the income arising from the sale of the product in Country C is derived in part from the activities carried on in States A and B. The formulary apportionment method is applied to worldwide income to ascertain what portion of the income is attributable to States A and B. The activities carried on by the unitary business in those states provide the necessary nexus between the states and the income produced in Country C.

B. Definition of Unitary

Opponents of worldwide combination have identified the problems surrounding the threshold question of whether a business is unitary as support for congressional action restricting application of formulary apportionment to worldwide income. The states have developed two general tests to determine whether a business is unitary: one based on "the three unities" and the other based on "interdependence of the basic operating activities of the enterprise." Both tests lack definite standards and place a power of discretion in the hands of tax authorities, who tend to classify a business as separate or unitary, depending upon which category will maximize state revenues. Resulting classifications

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37 Id. at 145 (statement of Charles Wheeler).
39 See House Hearings, supra note 5, at 189 (statement of Thomas McHugh).
40 The three unities include unity of ownership, unity of operation, and unity of use. Superior Oil Co. v. Franchise Tax Board, 60 Cal. 2d 406, 34 Cal. Rptr. 545, 386 P.2d 33 (1963).
41 See J. Hellerstein, supra note 10, at 501. One author has suggested that there is no such thing as a nonunitary business. See Keesling, supra note 10, at 109.
42 See House Hearings, supra note 5, at 183 (statement of James McGrath). Corporations, also, may tend to categorize themselves as unitary or separate depending upon tax consequences. For example, in unrelated hearings an Exxon official stated: "The petroleum industry is unitary in nature. [Accounting] breakdowns require many allocations and assumptions which could lead to erroneous comparisons of data between various companies and hence erroneous conclusions." The Petroleum Industry: Hearings Before the Subcomm. on
have led to substantial litigation. Multinational corporations are subject to inconsistent classifications among states and inconsistent classifications in the same state from year to year. This treatment requires MNCs to prepare records for tax purposes that satisfy both classifications, and the litigation arising over classifications imposes substantial costs and time delays on MNCs.

Arbitrary classification as unitary is indeed a problem associated with worldwide combination. However, because such classification is a problem faced by wholly intrastate and national corporations as well as MNCs, it does not discriminate against foreign commerce and does not in itself merit abandonment of worldwide combination. A better solution rests in the issuance of concrete guidelines for classification and a requirement of interstate and intrastate consistency. Failing state agreement on appropriate guidelines, classification is a proper subject for federal legislation.

C. Administrative Impact

States applying formulary apportionment to worldwide income require an MNC to prepare a worldwide combined report consisting of the income, property values, sales, and payrolls of the MNC's in-state operations as well as similar figures for each group member that has been identified as a part of a unitary business. Multinational corporations assert that these informational requests impose undue administrative burdens upon them which are not borne by totally intrastate or national corporations, and that for this reason federal restraints should be enacted.

The administrative burdens asserted by MNCs are a result of many factors. In the first instance, the MNCs claim that they usually do not keep the type of information required by the combined report, and that therefore they incur great costs in creating and maintaining appropriate records for the sole purpose of filling

Antitrust and Monopoly of the Senate Comm. on the Judiciary, 94th Cong., 1st Sess. 1817 (1975). However, in Exxon Corp. v. Wisconsin Dep't of Revenue, 447 U.S. 207 (1980), Exxon unsuccessfully attempted to be treated for tax purposes as a group of separate, nonunitary corporations operating along functional lines.

"See House Hearings, supra note 5, at 191-92 (statement of Thomas McHugh).
"Id."
"See generally California Guidelines, supra note 30.
out the combined report. The argument is weak. Such records are commonly kept for internal management purposes as well as for financial reporting purposes, and for other tax purposes. For example, MNCs maintain records of property values by region for property taxes imposed around the world. Little credence should be afforded the argument that the information requested is not available and that substantial costs are incurred in their creation.

A much more credible argument pertains to the requirement that records be kept in accordance with United States accounting principles. Multinational corporations located in foreign countries naturally will operate under that country’s accepted accounting principles, and therefore will keep records in accordance with those principles. The state requirement that the combined report data be readjusted to reflect United States principles imposes additional administrative burdens on foreign MNCs, which would not ordinarily make such readjustments. The burdens can be onerous. For example, property that has been depreciated at a faster rate than is acceptable under United States principles must be revalued. To readjust values, each piece of property must be identified, original cost reconstructed, useful life assigned, salvage value determined, and an eligible depreciation method chosen and applied. Current deductions taken for capital expenditures must be capitalized. Inventories, as well as valuation of assets and liabilities, must be accounted for according to United States principles.

These readjustment requirements, without doubt, place a heavy burden on foreign MNCs that would otherwise not make such readjustments. Domestic MNCs, however, cannot assert the same claim, as they must make such readjustments in any instance for federal tax purposes and for financial reporting purposes. Worldwide combination imposes no additional administrative burdens upon them.

Another undue administrative burden asserted by both United States and foreign MNCs is the need to translate the income, payroll, sales, and property values of their foreign affiliates into

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49 See generally CALIFORNIA GUIDELINES, supra note 30.
50 See House Hearings, supra note 5, at 170 (statement of Paul Cook).
51 Id. at 241 (statement of Valentine Brooks).
52 See generally CALIFORNIA GUIDELINES, supra note 30.
53 Id.
54 See, e.g., I.R.C. § 167.
United States dollars. The argument loses its strength in view of the fact that every MNC must express its foreign affiliates' accounts into the currency of its parent corporation for purposes of financial reports and national taxation. Therefore, state requests for this information are not an additional burden, unless they require the MNC to adopt currency translation methods not usually employed or require more information than is usually provided to the parent corporation. If, for instance, the state requires a foreign MNC to translate its affiliates' worldwide accounts into United States dollars when the affiliate accounts ordinarily would be translated into British sterling, an additional burden is imposed on the foreign MNC not faced by domestic MNCs, which ordinarily translate their worldwide accounts into United States dollars.

Foreign MNCs also have shown that information requested by the worldwide combined report may not be subject to disclosure under foreign laws. For example, if a foreign affiliate is engaged in highly confidential defense work with a foreign country, its records will be restricted information.

States have no jurisdiction to compel a production or an audit of the records of a foreign MNC. The state often attempts to coerce production from the parent by imposing penalties on the affiliate operating within its jurisdiction. If the information is still not forthcoming, the state extrapolates from the foreign MNC's annual report or other public financial records to calculate taxable income. This often leads to higher taxation, since annual reports are designed to paint a more favorable picture of the foreign MNC than would be indicated in a tax return.

From these facts it appears that data requirements associated with worldwide combination impose a higher administrative burden on foreign MNCs than the burden faced by domestic MNCs or wholly intrastate or national businesses. Referring to Japan Line's strict inquiry into discriminatory taxation burdens on foreign commerce, it would not be inappropriate for Congress to eliminate this discriminatory impact by prohibiting state ap-

56 "The required conversion of financial figures to dollars at scores of different rates of exchange with sharp fluctuations, devaluations, and other changes, is an operational nightmare." House Hearings, supra note 5, at 226 (statement of Kirby Scott).
57 See House Hearings, supra note 5, at 228 (statement of Kirby Scott).
58 Id.
plication of formulary apportionment to the foreign source income of foreign MNCs. However, S.655 does not limit its restrictions to foreign MNCs. The foreign source income of domestic MNCs is also excluded from apportionable state tax bases. Such legislative overextension is not justified and should be withdrawn.

The fact that worldwide combination imposes some administrative burdens on domestic MNCs is insufficient justification for federal legislation prohibiting its use. Administrative burdens cannot be viewed in a vacuum. First, additional administrative burdens are an inherent aspect of operating an MNC. Variances in language, currencies, and accounting principles naturally will cause a domestic MNC to face higher administrative burdens than a small intrastate business, regardless of what kind of taxation method is used. Second, the recordkeeping requirements imposed by the separate accounting technique are arguably as complex and burdensome as those required by worldwide combination. Finally, the administrative abilities of state tax authorities must be considered in deciding whether worldwide combination should be prohibited in regard to domestic MNCs. A special congressional committee has found that the separate accounting approach "already produces significant problems when applied at the federal level and would be virtually impossible to administer at the State level." Administrative burdens of compliance must be balanced against the administrative burdens of enforcement. Bearing in mind that worldwide combination does not impose discriminatory administrative burdens on domestic MNCs as it does on foreign

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60 California, the state which has suffered the most criticism for its application of formulary apportionment to the worldwide income of a unitary business, has introduced a bill that would prohibit state tax authorities from including the foreign source income of a foreign MNC in the state's apportionable tax base. California Assembly Bill No. 55, 1981-82 Session.
61 Proposed § 7518(a) provides that:
(a) In General—Where two or more corporations are members of the same affiliated group of corporations—(1) for purposes of imposing an income tax on any corporation which is a member of such group, no State, or political subdivision thereof, may take into account, or include in income subject to such tax, any amount of income of, or attributable to,
(2) any other corporation which is a member of such group and which is a foreign corporation. . . .
62 See I.R.C. §§ 861(b), 862(b); Treas. Reg. §§ 1.861-8; 1.862-1(b) (1960), 1.863-5(c) to 6 (1960); T.D. 7456 (Jan. 3, 1977); see Feinschreiber, Final Regulations for Allocating and Apportioning Deductions, 3 Int'l Tax J. 278 (1977).
63 HOUSE COMM. ON WAYS AND MEANS, RECOMMENDATIONS OF THE TASK FORCE ON FOREIGN SOURCE INCOME, 95th Cong., 1st Sess. 28 (1977).
MNCs, and in view of the documented and numerous difficulties that would be placed upon the states if forced to adopt the separate accounting approach with regard to the foreign source income of domestic MNCs, the assertion of undue administrative burdens on the part of domestic MNCs does not justify abandonment of worldwide combination with regard to domestic MNCs.

D. Distortion of Income

Worldwide combination is based on the assumption that regardless of location, a dollar of property, payroll, and sales will result in the same rate of return. Although this assumption may be valid in a homogeneous economy, when extended on a worldwide basis, which covers a wide spectrum of economic conditions, it loses its applicability. It may require twice the payroll, twice the sales, and three times the property values to produce a dollar of income in the United States as opposed to other regions of the world. The result is unfair apportionment.

No evidence of distortion of income has been offered by MNCs which assert this argument. Until proven, it should not be considered sufficient to justify federal restraints. In addition, if distortion is shown to occur by application of formulary apportionment to worldwide income, states should be given the opportunity to devise formulae that will take account of the variances in production levels. Until distortion of income has been shown factually and proven to be incorrectable by formula changes, this argument should not be used to justify federal limitations on worldwide combination.

E. Double Taxation

The argument most frequently asserted against worldwide combination is that it results in double international taxation. The argument is disturbingly lacking in analytical content. Its use represents a grave misunderstanding of the notion of double taxation and how it applies in a context where two levels of taxing authority are present.

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44 House Hearings, supra note 5, at 167 (statement of Paul Cook).
45 Id. at 194 (statement of Dallas Hurston).
46 In addition, there are variances in factor definitions. For instance, the U.S. definition of payroll may not include benefits conferred by a foreign MNC, which are included in another country's definition of payroll.
47 Id. at 136 (statement of Sen. Charles Mathias).
Theoretically, double taxation of income at a state level cannot occur because states can tax only that income derived from within their jurisdiction. In practice, however, double taxation among states can result due to the nonuniformity of apportionment methods applied. Double taxation can easily occur at a federal level, since the United States and most other nations can tax 100% of their citizens' income, regardless of source. For this reason, nations enter into tax treaties that generally cede primary taxing authority to the nation in which income is derived. The purpose of these treaties is to eliminate double taxation at a national level. In the absence of treaties, most nations grant their citizens a limited tax credit for foreign taxes paid to eliminate double taxation at a national level.

Double taxation is an inappropriate term when discussing concurrent federal and state taxation of income. As noted earlier, simultaneous taxation of income by state and federal governments is a recognized and accepted norm. The concept does not change when a foreign national government is substituted. State taxation is separate and independent from national taxation, regardless of the nation involved, and is permissible as long as constitutional requirements of substantial nexus, fair apportionment, non-discrimination, and fair relation are met. The double taxation argument is not applied properly in this context of concurrent taxation. The proposition does not justify federal limitations on state application of formulary apportionment to worldwide income.

F. Foreign Commerce

A very important issue raised in the controversy surrounding S.655 is whether the federal government's international tax policy should be determinative of the states' rights to tax foreign commerce. Ordinarily, a choice by the federal government to tax income in a certain way does not bind the states. To illustrate, the states are not bound to allow deductions for state income taxes

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68 See note 2 supra; see W. Hellerstein, supra note 28.
69 For a survey of the various apportionment formulae applied by the states, see STATE AND LOCAL TAXES, ALL STATES UNIT (P-H) ¶223. As discussed in note 6 supra, double taxation of nonbusiness income can also occur.
70 I.R.C. §§ 11, 61(a), 63(a).
72 See I.R.C. §§ 33, 642, 841, 874, 901, 931.
paid simply because the federal government permits such a deduction.\textsuperscript{73} States often tax a different income base than the federal government has chosen to tax. Under this analysis, it cannot be inferred that "treatment of foreign income at the federal level mandates identical treatment by the States."\textsuperscript{74}

As discussed earlier, in \textit{McGoldrick v. Gulf Oil Corporation}\textsuperscript{75} the Supreme Court considered whether a state tax interfered with a prior legislative scheme adopted by Congress to regulate foreign commerce. Although the \textit{McGoldrick} case is distinguishable from the present controversy because of the total absence of any federal tax imposed on the imported fuel, it nonetheless provides a useful standard of analysis in examining whether congressional limitations on state application of worldwide combination are appropriate.

The purpose of the federal government in entering tax treaties that incorporate the separate accounting theory is to avoid double taxation at a national level. Strongly influenced by the United States practice, numerous other nations have joined the United States in an effort to eliminate double taxation among nations.\textsuperscript{76} State application of formulary apportionment to the worldwide income of MNCs has confused and angered the governments that represent foreign MNCs operating within the states.\textsuperscript{77} These governments have attempted to protect the interests of these MNCs through their negotiations with the United States federal government. This has resulted in substantial interference with the United States federal government's plan to eliminate double taxation at a national level through bilateral tax treaties. It also has become a source of international irritation for the United States government.\textsuperscript{78}

For example, at the behest of the British government, the United States included a provision in the proposed U.K.—U.S. tax treaty that restricted state application of formulary apportionment.

\begin{itemize}
\item\textsuperscript{73} See I.R.C. § 164.
\item\textsuperscript{74} \textit{Mobil Oil Corp. v. Comm'r of Taxes}, 445 U.S. 425, 448 (1980).
\item\textsuperscript{75} 309 U.S. 414 (1940).
\item\textsuperscript{76} \textit{See}, \textit{e.g.}, \textit{Organization for Economic Co-operation and Development, Model Convention for the Avoidance of Double Taxation with Respect to Taxes on Income and Capital} art. 9 (1977), \textit{reprinted in 1 Tax Treaties} (CCH) ¶ 151.
\item\textsuperscript{77} \textit{See}, \textit{e.g.}, \textit{House Hearings}, \textit{supra} note 5, at 308 (statement of Joseph Guttentag).
\item\textsuperscript{78} \textit{See}, \textit{e.g.}, letter from Paola Pansa Cedronio, Ambassador of Italy, on behalf of the European Economic Communities, to the Department of State (Mar, 19, 1980), \textit{reprinted in House Hearings}, \textit{supra} note 5, at 359-60.
\end{itemize}
ment to worldwide income.\textsuperscript{79} Immediately, state tax authorities objected. The Senate gave advice and consent to ratification of the treaty with a reservation stipulating that the provision restricting state taxation be deleted.\textsuperscript{80} Extensive hearings on the proposed treaty were held, in large part focusing on the state limitation provisions.\textsuperscript{81} The treaty was approved by the Senate four and one-half years after its original signing, with the provision limiting state taxation deleted. A few months later the British House of Commons approved the revised treaty, but only when assured that the United States Congress would limit state usage of worldwide combination through legislation.\textsuperscript{82} Upon final execution of the treaty, the British Ambassador expressed his government's grave concern that the treaty failed to limit state usage of worldwide combination:

Her Majesty's Government has recognized . . . the difficult issues raised within the United States in seeking to limit State taxing powers through the double taxation conventions of the United States. . . . It must be emphasized however that the acceptance of the Senate reservation in no way implies approval of the unitary basis and it is the urgent request of Her Majesty's Government . . . that the Government of the United States should use its best endeavours to eliminate the international application of the unitary basis of taxation.\textsuperscript{83}

State application of formulary apportionment to the worldwide income of a unitary business was a principal cause of a five year delay in ratifying the U.K.—U.S. tax treaty. The delay constituted a substantial interference with federal attempts to negotiate a double taxation treaty in pursuance of its policy decision to eliminate double taxation at a national level.


\textsuperscript{80} Protocol to the Convention Between the Government of the United States and the Government of the United Kingdom of Great Britain and Northern Ireland for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital Gains, 94th Cong., 2d Sess. (1976), reprinted in \textit{2 Tax Treaties (CCH)} \| 8103DA.

\textsuperscript{81} \textit{Treaties with the United Kingdom, the Republic of Korea, and the Philippines: Hearings Before the Senate Comm. on Foreign Relations, 95th Cong., 1st Sess.} (1977).


\textsuperscript{83} Id.
In 1973, the government of the Netherlands prepared to negotiate a new tax treaty with the United States, but delayed in anticipation of the U.K.—U.S. tax treaty results. When it became apparent that the states were not going to be limited by the U.K.—U.S. tax treaty (and impliedly by no other future tax treaties), the Netherlands approached the United States Department of State with complaints on behalf of Dutch corporations in California. The Netherlands took the position that state application of formulary apportionment to the worldwide income of a unitary business violates the non-discrimination clause of the Netherlands friendship agreement with the United States.

In an exchange of notes accompanying a recent protocol to the tax treaty with France, France indicated its disapproval of the state usage of worldwide combination. However, no provision regarding state taxation was incorporated into the protocol due to the lack of success of the U.K.—U.S. tax treaty provision. Instead, France, along with the other EEC Member States, expressed its reliance on Congress to resolve the problem.

This evidence supports a conclusion that state application of the formulary apportionment method to the worldwide income of a foreign MNC interferes with the federal government's stated policy of eliminating double taxation at the national level through bilateral tax treaties. In addition, the practice has caused tension and friction between the United States and other nations of the world, as well as a fear of retaliation. For these reasons, federal legislation restricting inclusion of the foreign source income of foreign MNC's in the states' apportionable tax base is justified. However, there is no such justification for the additional prohibition against inclusion of the foreign source income of domestic MNCs in a state's apportionable tax base. Foreign governments are not interested in protecting the interests of United States
MNCs, and continued application of worldwide combination to United States MNCs will have no effect on United States international tax policy or international relations. Therefore, the legislation should be rewritten so as to apply only to the foreign source income of foreign MNCs.

IV. STATE TAXATION OF FOREIGN SOURCE DIVIDENDS

The second restriction incorporated into S.655 limits state taxation of foreign source dividends by permitting the state to tax dividends derived from foreign sources only to the extent that they are taxed under federal law.91 Two regimes govern taxation of dividends under federal tax law, depending primarily upon the payor corporation's status as domestic or foreign. The aim of both schemes is to prevent double corporate taxation at the federal level.

Federal tax law permits a corporation to deduct eighty-five percent or 100% of dividends received from other corporations to the extent the dividends represent income that has been taxed previously.92 In the absence of a dividends-received deduction, dividends would face double corporate taxation: once as earnings of the payor corporation and again when distributed to the payee corporation. S.655 adopts the dividends-received scheme and permits a state to tax dividends received from domestic corporations deriving less than twenty percent of their income from United States sources only to the extent allowed under federal law.93

Dividends paid by a foreign corporation out of foreign source earnings are not eligible for the federal dividends-received deduction, as the underlying foreign income is not subject to prior

91 S. 655, 97th Cong., 1st Sess. § a (1981) (new I.R.C. § 7518(e)). All but seven of the forty-five states with a corporate income tax tax foreign dividend income. House Hearings, supra note 5, at 359. Historically, states have treated dividend income as specifically allocable rather than apportionable. See Dexter, supra note 6. For example, under the Uniform Division of Income for Tax Purposes Act (UDITPA), promulgated by the Conference of Commissioners on Uniform State Laws in 1957, dividend income is subject to specific allocation. UDITPA is reproduced in State and Local Taxes, All States Unit (P-H) ¶ 91,409-A. However, several states have begun to treat dividend income as apportionable. See Dexter, supra note 6. In Mobil Oil Corp. v. Comm'r of Taxes, 445 U.S. 425 (1980), the Supreme Court upheld the inclusion of foreign dividends from a foreign affiliate, which participated in a unitary business with the taxpayer in the taxpayer's apportionable tax base. The Court noted that where the business activities of the dividend payor are not part of the payee's unitary business activities, due process might prohibit such inclusion. Id. at 442.
federal tax. However, the underlying foreign income generally is taxable by the government of the nation in which it is earned. To prevent international double taxation, domestic corporations receiving a dividend from a foreign corporation in which they have a ten percent or higher ownership interest are permitted to claim a foreign tax credit to the extent the foreign corporation has paid foreign taxes on the underlying income.\(^4\) Accordingly, S.655 prohibits a state from including in the apportionable tax base of a payee corporation foreign source dividends to the extent their underlying earnings have been subject to foreign tax.\(^5\)

Since the states treat dividends received from domestic corporations in a variety of ways, it is difficult to ascertain the impact of the imposition of the federal dividends-received deduction as regards foreign source dividends received from domestic corporations.\(^6\) The implications arising from the restrictions on state taxation of foreign source dividends received from foreign corporations are much more important. As most foreign nations impose a tax of at least 46% on the dividends' underlying earnings, the legislation will exclude the major portion of foreign source dividends paid by foreign corporations from the payee's apportionable tax base. The result will be a substantial decrease in state revenues.\(^7\) In addition, the limitation provides much more favorable tax treatment to foreign source dividends than dividends paid by totally interstate or intrastate corporations, which continue to bear concurrent federal and state taxation.\(^8\)

The few proponents\(^9\) of the dividend restrictions embodied in

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\(^4\) I.R.C. § 902.

\(^5\) S. 655, 97th Cong., 2d Sess. § a (1981) (new I.R.C. § 7518(e)(1)(B)). If underlying foreign earnings have borne foreign taxes at a rate of 46% or higher, the dividends would be excluded totally from the state tax base. For those dividends whose underlying foreign earnings have borne tax at a rate less than 46%, a complex formula allows a portion of the dividend representing the excess of the federal tax rate over the foreign tax rate to be included in the state tax base.

\(^6\) See W. Hellerstein, supra note 28, at 162-71.

\(^7\) Id.

\(^8\) See House Hearings, supra note 5, at 9 (statement of Donald Lubick, Asst. Sec'y of Treas.).

\(^9\) The dividends restrictions have received much less support than restriction of formulary apportionment. Domestic MNCs appear to be the only proponents of the dividend limitations. See, e.g., id. at 145. The U.S. Department of Treasury specifically disapproved of the dividend limitations. Id. at 9. Foreign MNCs were much less enthusiastic over the dividend limitations than over formulary apportionment. See, e.g., id. at 285 (statement of John Nolan). See also State Taxation of Interstate Commerce and Worldwide Corporate Income: Hearings on S. 983 and S. 1688 Before the Subcomm. on Taxation and Debt Management of the Senate Comm. on Finance, 96th Cong., 2d Sess. (1980) [hereinafter cited as Senate Hearings].
S.655 urge that such provisions are necessary (1) to eliminate international double taxation,\(^{100}\) (2) to ensure federal uniformity in an area in which it is necessary,\(^{101}\) and (3) because the states lack sufficient nexus to tax foreign source dividends.\(^{102}\)

Automatic application of a federal formula designed to prevent double taxation at a national level to the states is theoretically unsustainable. As noted earlier, double taxation at a national level is an entirely different problem than double taxation at a state level, and neither are synonymous with concurrent federal and state taxation.\(^{103}\) Dividend income, like operating income, is usually subject to both federal and state taxation.\(^{104}\) Exclusion of foreign source dividends from state tax bases on the rationale that they have already borne a foreign tax in place of the United States federal tax is an inexcusable disruption of the well-established norm of concurrent state and federal taxation of income.

The asserted need for federal uniformity in the taxation of foreign source dividends is unfounded. Unlike state application of formulary apportionment to the worldwide income of a foreign MNC, state inclusion of foreign source dividends in the payee corporation's tax base does not interfere with federal international tax policy.\(^{105}\) Nor does state taxation of foreign source dividends cause international tension and friction.\(^{106}\)

Finally, the United States Supreme Court recently has acknowledged that state taxation of foreign source dividends does meet constitutional nexus requirements.\(^{107}\) This is not to say that problems surrounding state taxation of dividends are nonexistent. Differing opinions among states as to whether dividend income should be apportioned or specifically allocated present a real threat of double taxation of dividend income at the state level. Additionally, inclusion of foreign source dividends in a state's appor-

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\(^{100}\) See House Hearings, supra note 5, at 150 (statement of Charles Wheeler).

\(^{101}\) Id. at 156 (statement of Ernest Christian).

\(^{102}\) Id. at 150 (statement of Charles Wheeler).

\(^{103}\) See text accompanying notes 68-73 supra.

\(^{104}\) Mobil Oil Corp. v. Comm'r of Taxes, 445 U.S. 425 (1980).

\(^{105}\) For instance, state taxation of foreign source dividends played no role in the delay of the U.K.-U.S. Tax Treaty. See House Hearings, supra note 5, at 287-92 (statement of John Nolan).

\(^{106}\) Throughout the hearings, foreign MNCs raised no complaints regarding state taxation of foreign source dividends. See generally House Hearings, supra note 5; Senate Hearings, supra note 99.

tionable tax base without corresponding adjustments in the apportionment formula to reflect related sales, property, and payroll factors may result in unfair apportionment. However, the answer to these problems is not the total exclusion of dividends from state tax bases, but rather legislative guidelines that resolve these issues.

V. CONCLUSION

The rights of states to determine their own fiscal policies play an essential role in the United States federal system. Congressional intervention in this area of state sovereignty should be undertaken only when necessitated by special federal policy considerations. The heavier administrative burden imposed upon foreign MNCs by state application of the formulary apportionment method to the worldwide income of a unitary business and the resulting interference in federal attempts to eliminate double taxation at an international level are sufficiently compelling policy considerations to justify federal legislation that prohibits the states from applying formulary apportionment to the foreign source income of foreign MNCs. It would be inconsistent with the federal system to enact legislation that goes beyond what is necessary to resolve these special policy considerations. Therefore, the legislation should not prohibit state application of formulary apportionment to the foreign source income of domestic MNCs, and should not restrict state taxation of foreign source dividends.

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