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It is an honor and a privilege to be invited to speak to the Commission on Worldwide Combined Reporting, a subject to which I have devoted considerable attention over the years. In that connection, I wanted to begin with the observation of U.S. Supreme Court Justice Oliver Wendell Holmes in a tax opinion handed down over a century ago, and one that I find myself quoting with increasing frequency, namely, that, in understanding the question before the Court, "[a] page of history is worth a volume of logic."[1] In my presentation, I will do my best to summarize both the logic and history of worldwide combined reporting as reflected in state legislation and the U.S. Supreme Court adjudication of the constitutionality of such legislation in an effort to assist the Commission in fulfilling its charge.[2]

## I. Apportionment of the Income of Multinational Corporate Unitary Businesses

One of the most contentious issues in the state tax field from the mid-1970s through the mid-1990s was the constitutionality of worldwide combined reporting. A number of states, including most notably California, had extended the combined reporting concept to affiliated unitary corporate groups including foreign corporations with operations abroad. Multinational

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[1] *New York Trust Co. v. Eisner*, 256 U.S. 345, 349 (1921)

[2] I have also provided the Commission with a more detailed examination of these issues, which are addressed in my treatise on state taxation. See Jerome R. Hellerstein, Walter Hellerstein, and Andrew Appleby, *State Taxation* ¶¶ 8.17, 8.18 (Thomson Reuters 3d ed. 2023) (updated tri-annually). See also *id*. ¶ 8.11 (containing general discussion of the application of the unitary business principle and combined reporting to multicorporate enterprises).

corporate taxpayers contended that the extension of the unitary business principle to foreign corporations violated the Commerce Clause as applied to foreign corporations because (1) it created the risk of international multiple taxation and (2) it prevented the United States from "speaking with one voice" in foreign commerce, because worldwide combined reporting violated the international norm of arm's–length separate accounting for attributing the income of affiliated corporate entities. In *Container Corp. of America v. Franchise Tax Board*[3] and in *Barclays Bank PLC v. Franchise Tax Board*,[4] the Court put an end to the constitutional controversy by sustaining the constitutionality of worldwide combined reporting as applied to a U.S.-based multinational corporation (*Container*) and as applied to a foreign-based multinational corporation (*Barclays*).

### A. Worldwide Combined Reporting of a U.S.-Based Multinational Corporation: *Container*

*Container* involved a U.S-based multinational corporation engaged in custom-ordered paper board packaging. Container was a Delaware corporation headquartered in Chicago that did business in California and elsewhere. It had a number of overseas subsidiaries incorporated in foreign countries that engaged in business in the countries in which they were incorporated. Asserting that Container and its subsidiaries were engaged in a unitary business, California applied its combined reporting regime to the unitary corporate group. After holding that Container and its subsidiaries were engaged in a unitary business and that the application of California's three-factor formula to Container's combined income was "fair" in a constitutional sense, the Court turned to Container's contention that California's worldwide combined reporting regime was nevertheless unconstitutional under Court's interpretation of the Commerce

[3] *Container Corp. of Am. v. Franchise Tax Bd.*, 463 U.S. 159 (1983).
[4] *Barclays Bank PLC v. Franchise Tax Bd.*, 512 U.S. 298 (1994).

Clause as applied to foreign corporations because it created the risk of international multiple taxation and impaired federal uniformity in areas in which federal uniformity was essential.

### 1. Risk of International Multiple Taxation

Container contended that because foreign commerce was involved in the worldwide combined reporting, there was a risk of international multiple taxation not present when combined apportionment of domestic enterprises was involved. The Court recognized, as it had its earlier case law involving the application of the Commerce Clause to foreign taxation (*Japan Line*[5]), that the Commerce Clause demanded a more searching inquiry than the traditional Commerce Clause inquiry undertaken in the context of state taxation of interstate commerce:

> Due to the absence of an authoritative tribunal capable of ensuring that the aggregation of taxes is computed on no more than one full value, a state tax, even though "fairly apportioned" to reflect an instrumentality's presence within the State, may subject foreign commerce "to the risk of a double tax burden to which [domestic] commerce is not exposed, and which the commerce clause forbids."[6]

In the Court's view, the problem of multiple taxation was readily eliminated in *Japan Line* by confining the property tax there at issue to the foreign jurisdiction. But no such solution was available with respect to the income tax. No one even suggested, by analogy to *Japan Line*, that California should avoid the double taxation problem by not taxing Container's income at all because of "its obvious unfairness."[7] Moreover, the Court recognized that compelling California to use the arm's-length separate accounting method (rather than formulary apportionment and combined reporting) to attribute Container's income to the state would not ensure the elimination

[5] *Japan Line, Ltd. v. County of Los Angeles*, 441 U.S. 434 (1979).
[6] *Container Corp. of Am. v. Franchise Tax Bd.*, 463 U.S. 159, 186 (1983) (quoting *Japan Line*).
[7] *Id*. at 190.

of double taxation, as the federal government's experience with Section 482 of the Internal Revenue Code revealed. The Court stated:

> A serious problem … is that even though most nations have adopted the arm's-length approach in its general outlines, the precise rules under which they reallocate income among affiliated corporations often differ substantially, and whenever that difference exists, the possibility of double taxation also exists. Thus, even if California were to adopt some version of the arm's-length approach, it could not eliminate the risk of double taxation of corporations to its franchise tax, and might in some cases end up subjecting those corporations to more serious double taxation than would occur under formula apportionment.[8]

The Court also considered the difficulties of apportioning income, as distinguished from property, among taxing jurisdictions as an undertaking that "bears some resemblance … to slicing a shadow,"[9] and it concluded:

> If California's method of formula apportionment "inevitably" led to double taxation … that might be reason enough to render it suspect. But since it does not, it would be perverse, simply for the sake of avoiding double taxation, to require California to give up one allocation method that sometimes results in double taxation in favor of another allocation method that also sometimes results in double taxation.[10]

**2. Other Concerns**

Having determined that California's worldwide reporting regime did not create an unconstitutional risk of international multiple taxation, the Court in *Container* then considered

[8] *Id*. at 191.
[9] *Id*. at 192.
[10] *Id*. at 192-193.

and rejected two other objections to California's worldwide combined apportionment. As to the contention that California's worldwide apportionment "was impermissible because it 'may impair federal uniformity in an area where federal uniformity is essential,' … and 'prevents the Federal Government from "speaking with one voice" in international trade,'"[11] the Court enumerated various factors that "weigh strongly against the conclusion that the tax imposed by California might justifiably lead to significant foreign retaliation."[12] The Court likewise rejected the contention that worldwide combined apportionment conflicted with established congressional policy or frustrated such policy.

### B. Worldwide Combined Reporting of a Foreign-Based Multinational Corporation: *Barclays*

In *Container*, the Supreme Court was careful to assert that it was not passing on "the constitutionality of combined apportionment with respect to state taxation of domestic corporations with foreign parents or foreign corporations with either foreign parents or foreign subsidiaries."[13] In *Barclays Bank PLC v. Franchise Tax Board*,[14] the Court resolved the decade-old controversy over the question left open by *Container*. The Barclays Group was a multinational banking enterprise including more than 220 corporations in some sixty nations. Two corporate members of the Barclays Group did business in California, and California sought to determine their California tax liability on the basis of worldwide combined reporting. Barclays conceded that it was engaged in a worldwide unitary business. Accordingly, apart from the

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[11] *Id*. at 193.
[12] *Id*. at 194. Specifically, the Court noted:

- The tax does not create automatic asymmetry.
- The tax is on a domestic entity, not a foreign entity as in *Japan Line*.
- Container can clearly be taxed by California, and the amount of its tax is more a function of rate than allocation.

*Id*. at 194-195..
[13] *Id*. at 189 n.25.
[14] 512 U.S. 298 (1994).

foreign nature of its operations, there was no question that California could require Barclays to report on a combined basis. The principal question before the Court, then, was whether worldwide combined reporting as applied to a foreign-based multinational was consonant with the Court's Foreign Commerce Clause jurisprudence.

At the outset, the Court described the separate accounting method employed by the United States as a "means of apportioning income among taxing sovereigns used by all major developed nations."[15] Barclays contended that California was required to use this method—rather than the state's combined method—of reporting the income of affiliated corporations that are part of a unitary business. In describing the separate accounting method, the Court observed that "[s]eparate accounting poses the risk that a conglomerate will manipulate transfers of value among its components to minimize its total tax liability."[16] It also noted that "[e]ffective enforcement of arm's-length standards requires exacting scrutiny by the taxing jurisdiction, and some commentators maintain that the results are arbitrary in any event."[17]

**1. "Domestic" Constitutional Issues**

Before turning to the central question in the case—whether worldwide combined reporting as applied to a foreign-based multinational was consonant with the Court's Commerce Clause jurisprudence as applied to foreign commerce—the Court first addressed and rejected two issues Barclays had raised under the Court's Commerce Clause jurisprudence applied to interstate commerce as well as its Due Process Clause jurisprudence. In response to Barclays's claim that California's worldwide combined reporting requirement imposed discriminatory compliance burdens on foreign as compared to domestic-based multinational corporations, the

[15] *Id*. at 305.
[16] *Id*.
[17] *Id*. at 305 n.14.

Court acknowledged that that "[c]ompliance burdens, if disproportionately imposed on out-of-jurisdiction enterprises, may indeed be inconsonant with the Commerce Clause."[18] However, the Court found the "factual predicate of Barclays' discrimination claim … infirm,"[19] because Barclays "has not shown that California's provision for 'reasonable approximations' systematically 'overtaxes' foreign corporations generally"[20] or Barclays in particular. Court likewise dismissed Barclays's contention that the "reasonable approximations" standard was so vague that it invested the franchise tax board with "standardless discretion"[21] in violation of the Due Process Clause.

### 2. "International" Constitutional Issues

#### a. International Multiple Taxation

Turning to the two additional factors that must be addressed when a state tax implicates Commerce Clause restraints on international taxation—the enhanced risk of multiple taxation and the requirement that the federal government speak with "one voice" in international trade—the Court addressed Barclays's contention that there was a more aggravated risk of international multiple taxation with a foreign-based, than with a U.S.-based, multinational (as in *Container*), because foreign-based multinationals typically have more of their operations outside the United States. Consequently, a higher proportion of their income is subject to tax abroad with a concomitantly enhanced risk of international multiple taxation when such income is included in California's apportionable tax base.

Without questioning Barclays's premises, the Court found that Barclays's multiple taxation contention, nevertheless, had been addressed by *Container*. The Court observed that

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[18] *Id*.
[19] *Id*.
[20] *Id*.
[21] *Id*. at 315 (quoting Barclays's brief).

Container's holding rejecting the taxpayer's multiple taxation argument rested on two considerations. First, the multiple taxation in *Container* though "real"[22] was not "inevitabl[e],"[23] because it resulted from the overlap of two different methods of dividing a tax base and could as easily result in undertaxation as in overtaxation. Second, the alternative method available to the taxing state (arm's-length, separate accounting) would not eliminate the risks of multiple taxation because different jurisdictions apply the arm's-length separate accounting method differently. The Court stated:

> And if, as we have held, adoption of a separate accounting system does not dispositively lessen the risk of multiple taxation of the income earned by foreign affiliates of *domestic*-owned corporations, we see no reason why it would do so in respect of the income earned by foreign affiliates of *foreign*-owned corporations. We refused in *Container Corp*. "to require California to give up one allocation method that sometimes results in double taxation in favor of another allocation method that also sometimes results in double taxation." The foreign domicile of the taxpayer (or the taxpayer's parent) is a factor inadequate to warrant retraction of that position.[24]

**b. The "One Voice" Doctrine**

Finally, the Court turned to the question "ultimately and most energetically presented,"[25] namely, whether worldwide combined reporting "impair[ed] uniformity in an area where federal uniformity is essential,"[26] and, in particular, whether the state's taxing regime prevented the federal government "from 'speaking with one voice' in international trade."[27] "Two decisions,"

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[22] *Container*, 463 U.S. at 188.
[23] *Id*.
[24] *Id*. at 319-320 (emphasis in original, citation omitted).
[25] *Id*. at 320.
[26] *Id*. (quoting *Japan Line*).
[27] *Id*.

said the Court, "principally inform our judgment,"[28] *Container* and *Wardair*.[29] Although in *Container* the Court had explicitly reserved the question whether its determination that worldwide combined reporting did not violate the "one voice" doctrine as applied to a domestic multinational corporation would likewise apply to a foreign-based multinational, the Court in *Barclays* concluded that the considerations that had led to its conclusion that the in *Container* likewise applied in the context of a foreign-based multinational. These considerations were that (1) California's method did not create an automatic asymmetry in international taxation;[30] (2) the taxpayers were plainly subject to tax in California in one way or another, and the amount of tax they pay is therefore "much more the function of California's tax rate than of its allocation method";[31] and, most significantly, (3) there were no specific indications of congressional intent to preempt California's tax.

Similarly, in *Wardair*, where the Court rejected a challenge to Florida's tax on the sale of fuel to foreign airlines on the ground that it "threaten[ed] the ability of the Federal Government to speak with one voice,"[32] the Court found its analysis relevant to the controversy now before it. Specifically, the Court in *Wardair* had examined international agreements that barred taxation of aviation fuel at the national level, but not at the subnational level. The Court concluded that "[b]y negative implication arising out of [these international accords,] the United States has at least acquiesced in state taxation of fuel used by foreign carriers in international travel."[33]

A critical lesson that the Court drew from *Container* and *Wardair*, in which the Court addressed and rejected the "one voice" argument only after determining that the tax was

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[28] *Id*.
[29] *Wardair Can., Inc. v. Florida Dep't of Revenue*, 477 U.S. 1 (1986).
[30] *Container*, 463 U.S. at 194-195; *Barclays*, 512 U.S. at 321 n.20.
[31] *Container*, 463 U.S. at 194-195; *Barclays*, 512 U.S. at 321 n.20.
[32] *Wardair*, 477 U.S. at 9.
[33] *Id*. at 12.

otherwise constitutional under Commerce Clause criteria applicable to interstate commerce, was this: "Congress may more passively indicate that certain state practices do not 'impair federal uniformity in an area where federal uniformity is essential'; it need not convey its intent with the unmistakable clarity required to permit state regulation that discriminates against interstate commerce or otherwise falls short under *Complete Auto* inspection."[34] Under this relaxed standard, the Court had little difficulty concluding that the "one voice" criterion was satisfied in *Barclays*. As in *Container* and *Wardair*, there were no specific indications of congressional intent to bar the state tax in question.

## II. Legislation Restricting Worldwide Combined Reporting

I arrive finally at the "page of history that is worth a volume of logic." In one of history's ironic twists, California's victory in *Container* sustaining the constitutionality of worldwide combined reporting actually led to its demise in some states and to its restriction in many others. The ink was hardly dry on the *Container* decision in 1983 when President Ronald Reagan responded to the pressure of multinational enterprises, supported by foreign governments, by convening a Worldwide Unitary Taxation Working Group to review worldwide combined reporting.[35] Although the Working Group did not reach agreement on various legislative options it considered, the Group did agree that three principles should guide the formulation of state tax policy in this area: (1) water's edge unitary combination for both U.S. and foreign-based companies;[36] (2) increased federal administrative assistance and cooperation with the states to

[34] *Barclays*, 512 U.S. at 323 (emphasis in original, citation omitted).
[35] Office of the Secretary, Department of the Treasury, Final Report of the Worldwide Unitary Taxation Working Group: Chairman's Report and Supplemental Views (1984) [hereinafter cited as Unitary Taxation Working Group Report].
[36] Water's edge combined reporting is based on the principle that the states' application of the combined reporting method should be limited to a specifically defined water's edge group. Although there was disagreement among the Working Group members as to the precise scope of the water's edge group, most definitions of the group embraced U.S. corporations included in the federal consolidated tax return, U.S possessions corporations, companies incorporated in the United States, Domestic International Sales Corporations, Foreign Sales Corporations, certain

promote full taxpayer disclosure and accountability; and (3) competitive balance for U.S. multinationals, foreign multinationals, and purely domestic businesses.[37] At the same time, the Working Group failed to reach agreement on two other issues: (1) whether so-called 80/20 corporations[38] should be included in combined reports and (2) whether foreign source dividends paid by corporations excluded from the combined report should be included in the state tax base.

In its 1984 report, the Working Group recommended that the states adopt legislation or administrative action that would limit combined apportionment of both U.S. and foreign-based multinationals to a U.S. water's edge combined group.[39] In the event "there are not sufficient signs of appreciable progress by the states" in adopting the agreed principles, Secretary of the Treasury Donald Regan stated that he would recommend "federal legislation that would give effect to a water's edge limitation."[40]

When the states did not promptly enact legislation adopting the principles of water's edge unitary combination and limitations on the taxation of foreign source dividends, the Treasury proposed legislation restraining worldwide combined reporting.[41] The proposed legislation would have precluded the states from imposing corporate income taxes on a worldwide unitary basis. It would have imposed a water's edge limitation on combined reporting defined as including principally (1) domestic corporations (other than 80/20 corporations); (2) foreign

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tax haven corporations, foreign corporations with a threshold of business activities in the United States, and U.S. corporations with more than 50 percent of their voting stock owned or controlled by another U.S. corporation. Unitary Taxation Working Group Report 30.

[37] *Id*. at 3-4.

[38] The term "80/20 corporation," as used by the Working Group, referred to a U.S. corporation with at least 80 percent of its payroll and property outside the United States. Broadly speaking, the problem of the 80/20 corporation is the problem of how the states should tax corporations whose operations are principally foreign.

[39] Unitary Taxation Working Group Report 9; Unitary Taxation Working Group Report ii (transmittal letter of Secretary of the Treasury Donald T. Regan to the President).

[40] Unitary Taxation Working Group Report iii (transmittal letter of Secretary of the Treasury Donald T. Regan to the President).

[41] S. 1974, 99th Cong., 1st Sess. (1985) (the "Unitary Tax Repealer Act"); HR 3980, 99th Cong., 1st Sess. (1985) (same).

corporations subject to taxation by at least one state and that exceeded a specified quantitative level of activity in the United States; and (3) certain foreign corporations located in tax havens. The legislation would also have prohibited the states from taxing "more than an equitable portion" of dividends received from corporations outside the water's edge group. Finally, the legislation would have satisfied the states' need for information as to how multinational enterprises report their income to other states by providing that "reporting corporations" annually file a return disclosing information relating to their income tax returns filed in other states.

Responding to the threat of federal legislation and to political pressure from multinational corporations, the states acted with unusual legislative speed. Although Florida had adopted worldwide combined reporting in 1983 within a few weeks after the Court's decision in *Container*,[42] a little more than a year later Florida reversed course and repealed its combined reporting provisions that permitted worldwide unitary apportionment.[43] In 1984, Oregon, one of the first states to employ worldwide combined reporting, and characterized by one observer as "an unlikely candidate to repeal worldwide combination … [as] a stronghold of the … MTC,"[44] responded to strong pressure brought particularly by Japanese business[45] by replacing its combined reporting regime with a state consolidated reporting regime based on the federal consolidated group,[46] thus eliminating foreign corporations from the state filing group.[47] The

[42] 1983 Fla. Laws, ch. 83-849.
[43] 1984 Fla. Laws, ch. 84-549.
[44] F. Ferguson, "Worldwide Unitary Taxation: The End Appears Near," 4 J. St. Tax'n 241, 245 (1986). See, e.g., Coca-Cola Co. v. Department of Revenue, 271 Or. 517, 533 P.2d 788 (1975); Zale-Salem, Inc. v. State Tax Comm'n, 237 Or. 261, 391 P.2d 601 (1964).
[45] Japanese businesses announced that they would locate no new plants or expand existing facilities in any state that applied worldwide apportionment to them. The Oregonian, Sept. 20, 1984.
[46] 1984 Or. Laws, ch. 1, 2d Spec. Sess. codified (in subsequently amended form) as Or. Rev. Stat. § 317.715 (Westlaw 2023).
[47] IRC § 1504(b)(3) (excluding foreign corporations from the affiliated group entitled to file a federal consolidated return).

result of the Oregon legislation was to exclude the income of non-U.S. corporations from the Oregon apportionable income base.

In 1985, Arizona[48] and Colorado[49] limited combined reporting to water's edge income. Idaho, Indiana, Montana, New Hampshire, North Dakota, and Utah also followed suit.[50] The actions of other states were too much for California, the once-feared "tiger" of worldwide apportionment. In 1986, California enacted legislation that granted taxpayers an option to limit apportionment to the U.S. water's edge.[51] In 1988, Minnesota likewise limited its unitary approach to domestic corporations, excluding both "[t]he net income and apportionment factors … of foreign corporations … which are part of a unitary business."[52] And in 1991, Alaska adopted water's edge legislation.[53] As a result, no state currently applies worldwide combination without an elective or mandatory water's edge or domestic corporation limitation, with the exception of Alaska's continuing application of mandatory worldwide combined reporting to taxpayers engaged in the production or transportation of oil and gas.[54] There are, however, considerable variations from state to state as to the composition of the water's-edge group, the definition of 80/20 corporations (e.g., whether the sales factor is included in determining the percentage), and the definition of tax havens.

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[48] 1985 Ariz. Sess. Laws, ch. 109, codified (in subsequently amended form) as Ariz. Rev. Stat. Ann. § 43-1101(5) (Westlaw 2023); see also Ariz. Admin. Code R15-2D-101 (Westlaw 2023).
[49] 1985 Colo. Sess. Laws, ch. 309, codified (in subsequently amended form) as Colo. Rev. Stat. § 39-22-303 (Westlaw 2020). See Hewlett-Packard Co. v. Department of Revenue, 749 P.2d 400 (Colo. 1988) (sustaining application of worldwide combined reporting to multinational group of corporations for pre-1985 years and explaining the post-1985 changes).
[50] See F. Ferguson, "Worldwide Unitary Taxation: The End Appears Near," 4 J. St. Tax'n 241, 245 (1986).
[51] 1986 Cal. Stat., ch. 660, codified (in subsequently amended form) as Cal. Rev. & Tax. Code § 25110 (Westlaw 2020).
[52] 1988 Minn. Laws, ch. 719, codified (in subsequently amended form) as Minn. Stat. Ann. § 290.17(Subd. 4(f)) (Westlaw 2023).
[53] Alaska Sess. Laws 1991 ch. 11, codified as Alaska Stat. § 43.20.145 (Westlaw 2023).
[54] Alaska. Stat. § 43.20.145(f) (Westlaw 2023).

As suggested above, the states' headlong rush to discard or restrict worldwide combined reporting did not grow out of the states' philosophical conversion from formulary apportionment to separate accounting as the appropriate methodology of taxing a worldwide multicorporate unitary enterprise. Rather, the states yielded to economic and political pressures and the threats of multinationals, particularly foreign-based enterprises, that they would not locate new plants in states that applied the unitary method to the apportionment of their incomes,[55] and the political threat of federal legislation that would restrict the use of worldwide apportionment by the states.

[55] See, e.g., F. Ferguson, *supra* note 44, at 245.