TAXING MULTINATIONALS
WHILE MINIMIZING ECONOMIC DISTORTION

BY

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Abstract

The emphasis on international trade implied by NAFTA, GATT and the WTO draws attention to the taxation of multinational companies, whether domiciled in this country or elsewhere. The states of the United States particularly have problems in that regard because of the difficulty of finding the right income to tax. The United States Supreme Court addressed these matters in the *Barclays* decision in 1994 and reviewed the law on the subject.

The *Barclays* case evidently played a part in inducing California to make separate accounting a realistic option. It is less likely to distort business decisions than the compulsory use of an arbitrary formula. New York has also shown some flexibility in this regard. The transfer pricing problems remain; hence, intense surveillance by tax authorities will undoubtedly persist. Paradoxically, the *Barclays* decision, in the context of the revised tax code that prevailed at the time, was a victory for the State but not a major defeat for the taxpaying companies. Within the prescribed limits, the multinationals can minimize economic distortion by selecting the tax method that is to their advantage.

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Many states have used a company's worldwide income as the base from which to compute the income attributable to, and taxable in, the state. This does not mean that the company actually pays at the regular tax rate on the full worldwide income: only a fraction of that income is taxed after having been determined to have been earned in the state. Is this unfair, or politically unwise, or economically harmful?

Some of the major problems in determining the appropriate income to tax are revealed in the practice of "unitary" taxation--a formular method of taxation of multinational corporations with regard to their worldwide income rather than their income in one country or state. The constitutionality of this approach was confirmed in the

Barclays decision. It became evident that the crucial question was that of transfer pricing---what prices the home company charges and pays the subsidiary for products and services going from the one to the other. Clearly, with unlimited discretion in transfer pricing, a company could modify the income it shows in any taxing jurisdiction. As a result of this fact, taxing authorities have imposed various curtailments on the exercise of such discretion. The "unitary" tax scheme is one vehicle for that. Yet various restrictions act on the taxing authorities--particularly the threat of tax retaliation or various other political threats or sanctions. All of this surrounded the origins, development, and perhaps the outcome of the *Barclays* case.

BACKGROUND OF THE BARCLAYS BANK CASE

California had been imposing the tax in dispute, the unitary tax, for some years. It had seemingly solved an insoluble problem. The tax had the effect of taxing a part of worldwide income in the sense that worldwide income was the basis or starting point for the calculation of the state tax. Many states allowed, as an alternative, the separate calculation of in-state income as if the subsidiary of the multinational firm in the state was a distinct entity. In California this was on "petition", sparingly granted. States that had formulae like or somewhat like California's when the case got to the U. S. Supreme Court included Idaho, Montana, North Dakota, Alaska, Tennessee and Utah.

The tax relies on the company's worldwide property, sales and payrolls to derive an appropriate tax basis. In 1988 a change was effective to allow a multinational company to use a "water's-edge" method by paying a fee that was a percentage of total California property, sales and payrolls. Some 30 foreign-based companies challenged the California tax anyway, claiming it was unconstitutional and seeking about $4 billion in refunds.

The California Supreme Court, in the case filed by Barclays Bank, had upheld the tax in 1992, on the basis that Congress had not barred the tax though it had ample opportunity to do so; hence, Congress had given implicit approval to it (a common constitutional argument). The U.S. Supreme Court took the case and asked the U.S. Solicitor General to file a brief. Britain had threatened in 1985 to retaliate, if the tax was continued, by revoking certain tax benefits to U. S. companies in Britain if the tax was not changed. In the meantime, the California Legislature had greatly relaxed the requirements.

It was reported on January 5, 1994 that the Justice Department would file a "friend of the court" brief though the department had once urged the Court not to hear the case; and that it would either back California or offer a compromise. It was also reported that California had changed the law under attack; and that an unfavorable ruling would cost the states more than $4 billion.

Two cases were consolidated before the U. S. Supreme Court: *Barclays Bank v. Franchise Tax Board of California* and *Colgate-Palmolive Company v. Franchise Tax Board of California*. Justice Ginsburg wrote the majority opinion; Justice O'Connor, joined by Justice Thomas, concurred in the Colgate decision and dissented in the Barclays decision; Justice Scalia concurred in part and concurred in the judgment; all the other Justices joined in Justice Ginsburg's opinion, with Justice Blackmun also writing a separate concurring opinion. The vote was thus 9-0 for the Colgate judgment and 7-2 for the Barclays decision.

THREATS OF RETALIATION

Foreign countries have understandably been deeply concerned with the tax treatment of their companies in the United States. Their interest has taken various forms, such as political pressure, judicial participation and threats of retaliation. In her concurring/dissenting opinion Justice O'Connor points out that, "Most of the United States' trading partners have objected to California's use of worldwide combined reporting."[2] The British threat of 1985 was mentioned above.

Foreign opposition simply demonstrates that the method is not felt to be in the best interests of foreign countries and their business enterprises. That in itself does not, of course, indicate that it is necessarily detrimental to American interests.

Justice O'Connor also mentions that "[a]t least one country has already enacted retaliatory legislation"[3] and that "the possibility of multiple taxation undoubtedly deters foreign investment in this country."[4]

Justice O'Connor concludes this point with the statement, "These adverse consequences, which affect the Nation as a whole, result solely from California's refusal to conform its taxing practices to the internationally accepted standard."[5]

In October 1993 Great Britain filed a brief with the U. S. Supreme Court indicating it was not satisfied with California's revisions in the unitary tax and asking that it be eliminated entirely. Representations were also made on the diplomatic front in a formal statement by the British Ambassador to the State Department.

A serious question is, What would have been the consequences for California if it had won the court cases in the old, stricter environment that prevailed when the case originated in California? A writer had said: "If Barclays loses, foreign countries will likely turn to retribution. The savings to California may be more than matched with retaliatory tax increases imposed on U.S. multinationals throughout the world. No doubt the U.S. will be sorely tempted to respond in kind. Given the troubles in the world economy, a tax-based trade war triggered by a political favor done for a single state is hardly the formula for struggling economies to regain prosperity."[6] California's method had in fact provoked protests and threats of retaliation by trading partners of the United States.

Even if politics (including fear of retaliation) were involved in arguing the case, it is does not follow that the Supreme Court would have decided the case on that basis or even have been influenced by it.

We must ask whether any retaliation is warranted by the facts. The aim of the unitary formula is to ascertain as nearly as possible what fraction of the national or world income of the company may reasonably be attributed to California. The law is not designed to charge the company more than California would receive from comparable earnings by totally intrastate or intranational companies. The aim is to deal with a virtually intractable situation. In absence of a showing of discrimination, the formula could stand as a reasonable approximation to what the company should pay on an equitable criterion. Some approximation, though, is unavoidable. Justice Ginsburg says in the Court's Opinion, "Every method of allocation devised involves some degree of arbitrariness." [7] And later, "Rules governing international multijurisdictional income allocation have an inescapable imprecision given the complexity of the subject matter."[8]

THE WAVERING FEDERAL POSITION

The position of the Federal Government had changed from support of the multinationals' contentions under Presidents Reagan and Bush to support of California's approach under President Clinton - "albeit with a tentative, narrowly-worded defense." [9]

Back in October, 1993 the White House had, in fact, urged the Supreme Court to uphold the tax on multinationals.[10] It had urged the Court to deny the appeal that challenged California's policy on taxing foreign-based multinational corporations. During the 1992 presidential campaign, President Clinton had promised that he would take the state's side in the case. The *Wall Street Journal* headlined the case thus: "California tax dispute forces Clinton to choose between vote-rich state and trading partners".[11]

In January, 1994 the federal government came to California's support. Newspapers carried headlines like "California tax policy on multinationals is backed by Clinton in High Court case".[12] It urged the U. S. Supreme Court to uphold the state's tax.

For some years in the past, as mentioned above, the U. S. Government had taken the taxpayers' side, maintaining that California's approach was unconstitutional and inconsistent with federal tax policy: the federal government and most states treat susidiaries as if they were separate companies and allow separate accounting to determine tax liability. Refunds back to 1977 were here at stake.

EXAMPLES OF INCOME ALLOCATION DISPUTES

There is no shortage of examples of the effects of transfer pricing on the avowed profit of multinational companies and on the tax revenues of the governments that act as their hosts. The proper allocation of income by a multinational company (or, for that matter, any company with several departments) is a well-known and longstanding accounting problem. It is not necessarily tied to the unitary tax. Two examples are given below--one in which the transfer pricing acts to the disadvantage of United States' tax receipts and another in which it acts to the disadvantage of Japan's tax receipts.

-Example: Income Allocation to the Disadvantage of United States

The following example was reported in the press in 1994.[13]

"FIRM SAYS IT WAS SUCCESSFUL IN TAX LITIGATION WITH IRS"

"Seagate Technology Inc. said it was successful in litigation with the Internal Revenue Service, and as a result believes it won't have to pay most of the $112.3 million in taxes sought by the IRS."

"The IRS claimed Seagate owed taxes on an additional $285 million of income for the fiscal years 1983 through 1987. At issue was the allocation of income between Seagate and its Singapore manufacturing facility."

Here the issue is the allocation of income between this country and Singapore, with the United States wanting a bigger share of the pie. In the following case, also reported in 1994, it is the foreign country that claims it is entitled to more.[14]

-Example: Income Allocation to the Disadvantage of Japan

"COKE UNIT TO APPEAL ON TAXES

"ATLANTA - Coca-Cola Co.'s Japanese subsidiary said it will appeal Japan's demand for $140 million in back taxes, and said any decision on the matter would have a 'negligible' financial impact.

"The National Tax Administration of Japan claims that royalties paid by the Coca-Cola subsidiary to its parent company from 1990 to 1992 were too high, and it demanded payment in additional taxes. The matter will be reviewed under the treaty signed by U.S. and Japan's tax authorities.

"A Coca-Cola representative said that if Japan prevails, the taxes would be shifted from the U.S. government to Japan, so there wouldn't be any real financial impact on the company."

What we have here is a zero-sum game: some governments lose while others gain even if the taxpayers themselves are indifferent because of offsetting tax credits. With disparate tax rates and tax enforcement in the respective states or countries, however, the company could be affected.

HOW TO TAX A MULTINATIONAL

As indicated above, there are several ways a state might tax the income of a multinational company. (1) Tax the income actually produced in that state, as determined by the accountants. (2) Use the nation-wide income as a starting-point to determine the fraction attributable to the state, by some appropriate formula, like the unitary formula, and then tax that portion. (3) Use the world-wide income, rather than the nation-wide income, as the starting point to determine the fraction attributable to the state, and then tax that portion. It should be noted that in the latter two cases the nation-wide or worldwide income itself is not actually taxed - that income is merely used as a starting point or base: only a portion of it is generally found to have arisen in the the state and taxable by it. It is misleading to say simply that the "the worldwide income is taxed".

Each one of the methods presents problems, for the taxpayer, or the state, or both.

THE SEPARATE ACCOUNTING METHOD

One approach is to use ordinary accounting methods to determine what profit was made in each jurisdiction - an onerous task. It is roughly analogous to deciding how much each department of a corporation contributes to the overall profit of the company. Among the intractable problems are the distribution of overhead and the pricing of specific goods and services transferred within the company.

The taxpayer might prefer this method even though it imposes a massive accounting burden. With all the interconnections of a nation-wide or worldwide company it could be hard to figure out the portion of income created in one state unless that state's activity occurs under a separate subsidiary or the books are kept as if it were such. The temptation would be tremendous to charge high prices to the subsidiary in the high-tax state and low prices in the low-tax state. This is the "transfer pricing" problem. It is precisely why a high-tax state would not be anxious to encourage this method of calculating taxable income. Justice Ginsburg recognizes the problem in saying: "Separate accounting poses the risk that a conglomerate will manipulate transfers of value among its components to minimize its total tax liability."[15]

This means that separate accounting is by no means a certain solution to the problem from the point of view of the tax collector. The transfer pricing problem is serious. By strategic pricing of goods and services sold to and purchased from California units by other units of the same company, the income attributed to California subsidiaries or departments can yield various results. Thorough tax auditing that goes beyond ordinary auditing but includes transfer pricing examination and reconstruction can control this problem. This is a very costly process. There is at least the possibility of a "true" result this way whereas any formular method has to be an approximation only.

THE WORLDWIDE COMBINED REPORTING METHOD

It is in order to avoid or at least minimize the "transfer pricing problem" in the case of multinational companies, that some states have developed a method of using the income of the company as a whole as the starting point or basis.

The basic formula--earlier known as the "Massachusetts formula"--uses property, sales and payrolls. A percentage is obtained of property held by the company in the state and world-wide (or nationwide); the same is done for sales and payrolls. Then a simple arithmetic mean is taken of the three percentages. This mean percentage is used to allocate the total income to the state. Weighting variations could readily be devised.

The same method as the above may be used whether the basis is worldwide income or nation-wide income. The reasoning of the tax collector is the same. This is the method used in California that provoked the Barclays court case. It was labelled an "aggressive method" by the Wall Street Journal.[16]

THE WATER'S EDGE METHOD

What is known as the "the water's edge" method would cover earnings only in the United States. A state adopting it would still need some formula to allocate a portion of the countrywide income to the state.

OTHER FORMULAE

The three-part Massachusetts formula is not the only one that may be used. One or two of the three factors might be enough. For instance, the allocation might be only on the basis of property or sales or payrolls or any two of these. Any small number of factors can cause anomalies.

ISSUES IN THE BARCLAYS BANK CASE

The U.S. Supreme Court agreed on November 1, 1993 to hear the challenge to California's unitary tax. Granting a hearing was considered a surprise development. California had, of course, asked the Supreme Court not to hear Barclays' appeal. Oral argument was held in March 1994 and the decision came down in June 1994.

The Court's decision to take the Barclays case was surprising because it represented a rejection of the Administration's advice not to take the case; and the Court suggested that it might reconsider its 1983 decision upholding the unitary tax when applied to units of U.S.-based multinationals. That case did not cover foreign-based companies. The main issue in the Barclays case was whether the states have the right to impose a unitary tax on a foreign-based multinational. The companion case involved the Colgate-Palmolive company, a New York-based multinational that does business in California. The attorney for Barclays, a British-owned unit, had argued that the court should declare California's unitary tax unconstitutional. A favorable decision for the bank could have meant refunds of $4 billion to corporations.

Many important economic and legal questions appear in the oral argument and the written decisions.

NOT FOR THE COURTS TO DECIDE?

During the oral argument, observers got the impression that the decision would go in favor of the states, namely, that a unitary tax by the states was constitutional. A press headline read: "Top court seems skeptical of challenges to California's taxes on multinationals".[17]

The impression left by the justices in their comments from the bench was that they felt the Congress, rather than the courts, had the authority to impose limits on the states' taxing policy. Justice David Souter was reported to have said that Congress could do a much better job of adjusting the balance on questions affecting corporate taxation and international competition.[18]

TAXING THE SAME INCOME TWICE?

Justice John Paul Stevens pointed out that he did not understand the taxpayer's contention that a company could be taxed twice on the same income under the California formula. A newspaper reported that the bank's lawyer admitted that she did not either: "..it's a complex point", she acknowledged.[19] Actually, double taxation could happen if two taxing jurisdictions had inconsistent formulae. For instance, to take an extreme example, if one country had a simple formula based on property (the "PROPERTY COUNTRY") and another based on sales (the "SALES COUNTRY"), the total income subjected to taxation in the two countries together could be greater, or less, than the actual total income of the two-jurisdiction multinational, depending on where the company's property and sales were located. If all the property were in the PROPERTY COUNTRY, the basis of taxation there would be 100% of world-wide income; and if all the sales were in the SALES COUNTRY, the basis of taxation there would also be 100% of world-wide income. Thus the company would be taxed twice on the full world-wide income. Whether offsetting credits could be taken is a separate question, depending on tax treaties, for instance.

Multiple taxation would not occur if every country used the same apportionment formula, with the same definitions and degree of enforcement. It definitely would occur, however, if one country, say, the home country, imposed its tax on full value. In that case, any tax imposed by any other country would cause multiple taxation. That would be a serious problem that could have serious economic consequences. It could perhaps be handled by an international tribunal or multinational agreement such as the World Trade Organization. It could also be handled by bilateral tax agreements.

Justice O'Connor expresses the view, in her dissenting opinion, that "the risk of multiple taxation created by California's use of worldwide combined reporting - a risk that has materialized with respect to Barclays - is sufficient to render the California tax constitutionally infirm."[20] Accordingly, she dissents in the Barclays case.

The difficulty with this position is that a worldwide combined reporting system is not really the cause of multiple taxation: if the home country uses full value taxation then any additional taxation must constitute multiple taxation. On the theory that the multinational company properly is taxed to get some contribution to the services each host country provides, it would be incumbent on the domiciliary country to impose less that full value taxation whether entirely on its own initiative or as a result of multinational negotiations.

IS THERE NOWHERE INCOME ANYWHERE?

In fact, the existence of multiple taxing jurisdictions can leave some income untaxed just as it can leave other income doubly taxed. The concept of "nowhere income" has arisen to portray the former. This refers to corporate profits that are earned in the United States but are not taxed anywhere for various reasons, including peculiarities in the allocation formula used. In the hypothetical case given above, if all the sales were in the PROPERTY COUNTRY and all the property in the SALES COUNTRY, the company would have "Nowhere Income": its tax base would be 0.00% of its worldwide income. The same could be true as between two states in the United States with inconsistent formulae.

DOES THE UNITARY FORMULA REALLY TAX GLOBAL INCOME?

It is easy to see why the multinational companies can plausibly argue that the states are taxing income that was not earned in the state. The outside income is, in fact, used to determine the tax liability to the state. The unitary (or similar) formula, however, is designed to estimate how much of that income was earned within the state. For instance, under the three-factor formula, suppose that the company had one-third of its property, sales and payrolls in the state, then only one-third of the global income would be subjected to the regular tax rate. The states are taxing global income, true, but only that portion of it that was earned within the state, as determined by a formula designed to estimate that part. Admittedly, the estimate could be far from the hypothetically "true" local profit on either side.

It is understandable that the companies might object that the formula could give an exaggerated answer; and anyway, the strict formula greatly limits the ability of the company to show the income it wants to show in any state. The formula blunts transfer pricing as an instrument of a company's tax-minimization policy. By the time of the decision California had, however, eliminated *mandatory* worldwide combined reporting.

The taxpayers argued that the state is actually taxing the firm's profits earned outside California. This is an ambiguous way of putting it since the worldwide income is used as a starting point only and then the apportionment formula is used in an attempt to approximate what was earned in California; conceivably, the result could be less than what was really earned in California, just as it might turn out to be more.

approach. This made it easier for the Federal Government to take the state's side, arguing that there was no longer any need for the Court to hear Barclay's appeal. At the time, it was felt, as expressed in a newspaper report, that the administration's action "made it less likely, although not out of the question, that the high court will agree to consider an appeal filed by Barclay's Bank PLC of Britain challenging the state tax."[21]

"SPEAKING WITH ONE VOICE" IN FOREIGN COMMERCE?

The taxpayers' prospects were strengthened by the fact that the United States had not made any commitment to any foreign country to ban California's formular approach in any treaty or agreement. Chief Justice Rehnquist and Justices Souter and Ginsburg emphasized this point in the hearing.[22]

Justice Blackmun concurred because the California tax did not "impair federal uniformity in an area where federal uniformity is essential"[23], quoting from a 1979 case.

The constitutional treatment of foreign commerce provided an occasion for some disagreement among the justices. Justice O'Connor (joined by Justice Thomas) concurred in the Colgate-Palmolive decision on the basis that a precedent had been established for domestic multinationals (though she had dissented in it). She dissented from the judgment in the *Barclays* decision, however, since a foreign multinational was here involved. She said, "In my view, the California tax cannot constitutionally be applied to foreign corporations."[24] Her reasons for a disparate treatment of foreign and domestic multinationals include the statements: "Domestic taxpayers have access to the political process, at both the state and national levels, that foreign taxpayers simply do not enjoy..../...It is all too easy, however, for the state legislature to fill the State's coffers at the expense of outsiders."[25]

This is perhaps too restricted a view of the political process. Foreign companies do not need the vote in order to influence domestic legislation at either the state or federal level.

As for "filling the State's coffers at the expense of outsiders", a possibility of abuse certainly exists, theoretically. A State could snatch some revenue that deprives another of the States of revenue that in some moral or economic sense rightfully belongs to the latter. Or a State could act to the detriment of a foreign country or, through multiple taxation, harm the company itself. As for multiple State or country taxing jurisdictions, there are certainly only so many feathers that can be plucked before harming the the weaker units, whether taxing jurisdictions or companies. In other words, a single State could derive the benefit of revenue while imposing harm on fellow States, or the country or other countries or the company itself. One State could be using a formula that grabs a disproportionate amount of the revenue compared with the economic harm it does to itself. The State might get all the revenue and the harm might be spread over other States, the country as a whole and foreign countries. The policy could also be a short-sighted one for the State. This economic argument is separate from the constitutional "one voice" doctrine.

Justice O'Connor's concerns seem to be well-founded as a practical matter. How can the Federal Government effectively handle trade relations if there are many "voices" in the background that implicitly---but actually---handle trade relations on their own through their individual tax rules? The U. S. Constitution tries to cover this problem.[26]

CONGRESSIONAL SILENCE SPEAKS VOLUMES?

Although the Congress has had ample opportunity to prohibit the states' unitary tax it has failed to do so. The U.S. Constitution says: "The Congress shall have the power...[t]o regulate commerce with foreign nations." [Article I Section 8 [3]]. The failure of Congress to act could be taken as a form of permission or at least a condonation of the states' actions.

The Court appeared to reject the companies' position during the 90-minute oral argument that the Court should act because neither the Congress nor the Treasury Department had acted. Justices Rehnquist, Souter, Scalia, Kennedy and Ginsburg appeared to be of the same mind on this.[27]

Justice Scalia, who concurred in the judgment but dissented from the "silence" part of the majority opinion, pointed out (quoting from his opinion in an earlier case) in his written opinion that he would "enforce a self-executing, 'negative' Commerce Clause..." in two specific circumstances not here present.[28] Justice Ginsburg said, in the Court's Opinion: "The numerous bills introduced [in Congress over the past three decades] have varied, but all would have prohibited the California reporting requirement here challenged.../...None of these bills, however, was enacted."[29]

CALIFORNIA'S TAX CHANGE

California had retreated somewhat from its original position: in 1993 it had, in practical effect, amended the tax law to allow units of foreign multinationals to elect to be treated as separate companies; hence, the tax question would seem to have been settled. Trade relations in the future would not be impaired even if they had been in the past.

The taxpayers involved in the suit still wanted a ruling in their favor so they could seek refunds from California (and the other states affected) for past taxes. They were also concerned that amendments like the one in California could be rescinded at some time in the future and make the companies liable under the old, much stricter, rules once again.

NEW YORK STATE'S APPROACH

New York is one of the states with a stake in the Supreme Court's decision although it does not literally use the same formula as California. The highest court in New York, the Court of Appeals, ruled in late 1993 that a U.S./U.K. treaty was not violated by a formula that takes a company's worldwide income and then imposes an income tax on the basis of property held in New York as a proportion of total property.[30]

The New York formula in assessing franchise [corporation income] taxes on multinational corporations determines a "business allocation" percentage for each corporation by comparing the value of its worldwide real and tangible personal property with the portion of the property held in New York. The percentage so computed is then applied to the company's worldwide business income. The result is the New York share of that income, which is then subjected to the franchise tax.

The New York court acknowledged that the treaty in question might be somewhat ambiguous. It held, though, that there was enough in its history before both the legislative and executive branches of government to sustain the formula as being consistent with the treaty. It cited U.S. Senate and Treasury Department reports showing the understanding that assets of out-of-state branches of the company may be considered in a tax formula, because a corporation is, as stated in the U.S. Senate report, "a single enterprise regardless of how many separate branches or businesses it has". The company had tried to have branches outside the state deemed, in effect, separate companies altogether. This would have excluded consideration of their assets and income. The Court rejected this contention.

The New York court also considered whether the commerce clause of the U.S. Constitution was violated by the formula. It held that it was not. The company argued that the "compliance costs" would unreasonably interfere with commerce: there would be a heavy burden on the company to provide all the proof of its international operations that would be necessary to apply the formula. As the *Digest* points out, "The [New York] Court finds no occasion to determine the issue, but cites the appellate division, which had observed that the company proved itself quite able to summon up the requisite figures when the occasion called for it, as evidenced right on the present record: when the deficiency was first assessed and the company wanted to get the deficiency reduced, it came up with the needed information in a flash".[31]

This decision of New York's highest court is of great consequence since it accepts the formular approach even if a separate accounting would show that the company actually lost money in the state. As the *Digest* puts it, "The consequence is that New York may be entitled to a tax even if the New York activities of the taxpayer bring it a loss in a given year (as was the case here): the overall international profit the taxpayer earns would still give New York a share of the profit under the formula."[32]

This case presents a dilemma. It is one thing to rationalize a formula on the basis of its attempt, within the limits of a reasonable effort, to estimate what is in fact the correct amount and another to justify an income tax liability if we know for a fact that the company had lost money in the state.

The New York court did, in fact, address this precise question in a 1995 decision. It issued a striking refusal to allow the use of a unitary formula where the locus of the loss is crystal clear. This decision of the highest court in New York has been reported as holding that, although the unitary formula that determines the New York share of a corporation's total activities is valid, a clearly disproportionate attribution of foreign income to the State in a given case may void the tax.[33].

The report continues:

> "Although the Court of Appeals sustains the basic scheme set up by Section 210(3) of the New York Tax Law, which in certain cases taxes a foreign corporation's income based on the New York proportion of its overall activities everywhere and may thus earn for New York a share of income generated for the corporation by activity outside the state, the Court also holds that the tax cannot be sustained if it ends by treating as New York income a sum 'out of all

appropriate proportion' [quoting the Court] to the business transacted by the corporation in New York. Citing U. S. Supreme Court cases, the Court strikes down a New York tax imposed on a foreign realty corporation based on profits attributable primarily to the sale of a piece of its Maryland property. *British Land (Maryland), Inc. v. Tax Appeals Tribunal, 85 N.Y.2d 139, 623 N.Y.S.2d 772 (Feb. 16, 1995).*

"The statutory formula that permits the state to base its tax on the New York share of overall (including foreign) income is applicable when the corporate entity is found to be conducting a 'unitary business' [quoting the Court] that includes several jurisdictions, and here there were two: Maryland and New York. When the sale of a Maryland building produced a $13 million gain for the year in question, the New York formula ended up attributing 2/3 of the gain to New York. That, holds the Court in an opinion by Judge Levine, runs afoul of the disproportionality rule."

"The corporation established that the gain on the Maryland property was attributable to special factors present in Maryland - improved economic climate in downtown Baltimore, sound management by the agency hired to run the building, renovation of the building, and acquisition of the land on which the building stood

- and that all of this occurred before any New York property had even been acquired."

"Under these circumstances [concludes the Court], the extremely marked difference in value inevitably had a distorting effect on the application of the statutory apportionment formula."

"The Court cancels the tax and remands the case for a tax 'more fairly reflecting...business activities in the State' [quoting the Court]."

Foreign multinationals in California can avoid the eventuality of a tax liability on a local loss under the amendment which provides the option of treatment as a separate company on reasonable terms. The *Barclays* case remained pertinent, though, for the $4 billion of potential refunds that were still at issue under the old law; and for any future revision of the law along the old lines. When California made the revision to allow for more liberal separate treatment the hope was that the changes would "appease" the multinationals. The court decision, though it was entirely for the State and did not order any refunds, was not really punitive under the circumstances.

ARE DOMESTIC MULTINATIONALS HOME FREE?

More than foreign multinationals have an interest in the *Barclays* case and its outcome. With the inclusion of Colgate-Palmolive, even domestic multinationals were affected by the final ruling. In 1983 the Court had issued a decision under which it upheld California's worldwide unitary method as applied to U.S.-based multinationals. With the inclusion of a U.S.- based multinational in the Barclays hearing, there was speculation that the justices might be contemplating a change in that ruling; but the hearing (and later decision) in the *Barclays* case left no such impression.[34]

With the relaxation of California's requirements it had become easy for the Administration to support the State's position on multinationals.[35] The final decision was in favor of the California tax code as applied to both domestic and foreign multinationals.

RELATION TO WORLD TRADE AGREEMENTS

The unitary tax case is intimately tied in with the constitutional status of world trade agreements. In June, 1994, before the Supreme Court handed down its unitary tax decision, there was much concern over the impact of world trade agreements on states' tax rights. The *Wall Street Journal* carried an item headed: "State tax officials see threat in trade accord".[36] It reported in the same item that an official of the Multistate Tax Commission had said that the World Trade Organization could overturn state tax laws if it finds discrimination against foreign entities, even if U.S. courts have found that no discrimination exists; and that a contrary view was expressed by Robert Bork who, in a letter to the Clinton administration, called claims that GATT could overrule U.S. laws an excuse for protectionism.

The issue, as we know, has been resolved politically in favor of approving GATT and adopting the WTO.

CONCLUSIONS

The issue is not the level of taxes as a whole but how an individual company fares. Some companies could do better in California or New York under a particular unitary formula than under separate accounting; some would do worse. Granted that a particular total of tax revenue is to be obtained, the economic question is, Which approach and which formula is least distortive of business decisions and least inefficient from an economic point of view? The taxpayers taking part in the Barclays case are, of course, better off having the option of separate treatment (since they can pick the method), but many companies not heard from may be better off with the unitary approximation than with a true, separate treatment. A little discretion, like that exercised by the New York court in 1995 (discussed above), also serves to prevent "a distorting effect", as that court labelled it.

In summary, the *Barclays* case evidently played a part in inducing California to make separate treatment a realistic option. It is less likely to distort business decisions than the compulsory (or heavy fee) requirement of an arbitrary formula. The transfer pricing problems remain; hence, intense surveillance by tax authorities will undoubtedly persist. Paradoxically, the *Barclays/Colgate* case, in the context of the revised tax code that prevailed at the time of the decision, was a victory for the State but not really a major defeat for the taxpaying companies: Within the requirements of the amended "Water's Edge Election"[37], the multinationals can minimize economic distortion by selecting the tax method that is to their advantage.

TAXING MULTINATIONALS

ENDNOTES

1 The cases involved are *Barclays Bank vs. Franchise Tax Board*, 92-1384 and *Colgate-Palmolive vs. Franchise Tax Board*, 92-1389.

The combined case is cited as 512 US---, 129 L Ed 2d 244, 114 S Ct--. The citations herein are to pages in the L Ed 2d printing; hereafter *Barclays*. The *Wall Street Journal* is cited as *WSJ*.

The provisions of the U. S. Constitution most directly involved are:

Article I

Section 8 [containing the "commerce clause" at clause 3]

[1] The Congress shall have Power
To lay and collect Taxes, Duties, Imposts and Excises,to pay the Debts and provide for the common Defence and general Welfare of the United States;but all Duties, Imposts and Excises shall be uniform throughout the United States;
* * * * *
[3] To regulate Commerce with foreign Nations, and among the several States, and with the Indian Tribes;

Article VI [including the "supremacy clause"]

[2] This Constitution, and the Laws of the United States which shall be made in Pursuance thereof; and all Treaties made, or which shall be made, under the Authority of the United States, shall be the supreme Law of the Land; and the Judges in every State shall be bound thereby,any Thing in the Constitution or Laws of any State to the contrary notwithstanding.

Amendment XIV [containing the "due process" clause for States]

Section 1. All persons born or naturalized in the United States, and subject to the jurisdiction thereof, are citizens of the United States and of the State wherein they reside. No State shall make or enforce any law which shall abridge the privileges or immunities of citizens of the United States; nor shall any State deprive any person of life, liberty, or property, without due process of law; nor deny to any person within its jurisdiction the equal protection of the laws.

2 Justice O'Connor, *Barclays*, p. 275

3 Ibid.

4 Ibid.

5 Ibid.

6 J. D. Foster (executive director and chief economist of the Tax Foundation), "Taxing Test for California", *WSJ*, March 24, 1994, p. A18.

7 Justice Ginsburg, *Barclays*, p. 253

8 Ibid. p. 261

9 *WSJ* March 29, 1994 p. B12

10 *WSJ* October 8, 1993 p. B6

11 *WSJ* August 19, 1993 p. A12

12 *WSJ* January 20, 1994 p. A16

13 *WSJ* February 11, 1994 p. B2

14 *WSJ* March 28, 1994 p. A7A [az/sc ed]

15 Justice Ginsburg, *Barclays*, p. 254

16 *WSJ* September 8, 1993 p. A1

17 *WSJ* March 29, 1994 p. B12

18 Ibid.

19 Ibid.

20 Justice O'Connor, *Barclays*, p. 276

21 *WSJ* October 8, 1993 p. B6

22 *WSJ* March 29, 1994 p. B12

23 Justice Blackmun, *Barclays*, p. 271

24 Justice O'Connor, *Barclays*, p. 272

25 Justice O'Connor, *Barclays*, pp. 274/5

26 See excerpts from the U. S. Constitution in Footnote 1, above.

27 *WSJ* March 29, 1994 p.B12

28 Justice Scalia, *Barclays*, p. 271

29 Justice Ginsburg, *Barclays*, pp. 267/268

30 The case is Reuters Limited v. Tax Appeals Tribunal,...N.Y.2d...,....N.Y.S.2d....(October 12, 1993). (Reported in *New York State Law Digest* [hereafter, *N Y Law Digest*], No.407 November 1993, p.3.)

31 *N Y Law Digest, loc. cit.,* pp. 2/3

32 *N Y Law Digest, loc. cit.,* p. 3

33 *N Y Law Digest*, No.426 June 1995, pp. 3/4

34 *WSJ* March 29, 1994 p. B12

35 *WSJ* October 8, 1993 p. B6

36 *WSJ* June 3, 1994 p. A16

37 Examples:

"The election is made by contract between the taxpayer and the FTB [Franchise Tax Board]."

* *

"Any taxpayer making the water's edge election and meeting certain foreign activity thresholds must file an information return with the FTB."

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