NYLS Journal of International and Comparative Law

Volume 5
Number 2 *Volume 5, Numbers 2 & 3, 1984*

Article 11

1984

Container Corporation of America v. Franchise Tax Board

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Recommended Citation

Schwartz, Karen (1984) "Container Corporation of America v. Franchise Tax Board," *NYLS Journal of International and Comparative Law*: Vol. 5 : No. 2 , Article 11.
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TAX LAW—UNITARY TAX METHOD—STATE TAXATION OF MULTINATIONAL CORPORATE INCOME—*Container Corporation of America v. Franchise Tax Board* — For nearly twenty years state taxation of multinational corporate income has continued to generate increasingly fierce controversy between the states, businesses, the Federal Government and foreign nations.[1] Recent intensified interest in this subject is the result of *Container Corporation of America v. Franchise Tax Board*,[2] in which the Supreme Court was presented with its first opportunity to consider the constitutionality of the international application of the unitary tax method.[3]

States use the unitary method to tax the profits a multinational company earns outside its borders, by applying a formula which allocates a portion of the company's total income to the taxing state.[4] The tax base of the company is determined by combining its in-state and

1. GEN. ACCT. OFF., REPORT TO THE CHAIRMAN, HOUSE COMMITTEE ON WAYS & MEANS, KEY ISSUES AFFECTING STATE TAXATION OF MULTIJURISDICTIONAL CORPORATE INCOME NEED RESOLVING 6-7 (1982) [hereinafter cited as G.A.O. REPORT]; J. HELLERSTEIN & W. HELLERSTEIN, STATE AND LOCAL TAXATION 542-43 (4th ed. 1978) [hereinafter cited as STATE AND LOCAL TAXATION].

2. 103 S. Ct. 2933 (1983).

3. Three prior cases presented this issue before the Supreme Court. In ASARCO, Inc. v. Idaho State Tax Comm'n, 458 U.S. 307 (1982) and F.W. Woolworth Co. v. Taxation & Revenue Dep't, 458 U.S. 354 (1982), the Court never reached this issue because neither business was found to be "unitary," which is a prerequisite for the application of the unitary tax method. Argued before the Supreme Court in 1982, Chicago Bridge & Iron Co. v. Caterpillar Tractor Co., 77 Ill. App. 3d 90, 395 N.E.2d 1167 (1981), *appeal dismissed*, 103 S. Ct. 3562 (1983) presented the identical issue as *Container*. Carried over to the 1983 Term, *Chicago Bridge* was dismissed without a rehearing for want of a substantial federal question after the *Container* decision was handed down. 103 S. Ct. at 3563. The domestic application of the unitary tax method was upheld by the Court in a series of cases which firmly established the validity of the formula method of apportioning net income from interstate business. *See, e.g.*, Hans Rees' Sons, Inc. v. North Carolina, 283 U.S. 123 (1931); Bass, Ratcliff & Gretton, Ltd. v. State Tax Comm'r, 266 U.S. 271 (1924); Underwood Typewriter Co. v. Chamberlain, 254 U.S. 113 (1920).

4. All of the forty-five states with a corporate income tax rely primarily on formulas to apportion corporate income among those states in which the corporation does business. G.A.O. REPORT, *supra* note 1, at 3. States also use the separate accounting system, which isolates a company's income and expenses on a state-by-state basis. *See generally* P. HARTMAN, FEDERAL LIMITATIONS ON STATE AND LOCAL TAXATION 522-24 (1981) (further explanation and comparison of the two methods).

out-of-state income and apportioning that combined income according to the three income-producing factors falling within the state—property, payroll and sales.[5] Most states with a corporate income tax limit combined reporting to income earned within the United States.[6] Thirteen states, however, have expanded to worldwide combined reporting, which enables them to tax income earned in foreign nations, as well as the United States.[7]

In *Container Corporation of America v. Franchise Tax Board*,[8] the Court ruled five to three that Container and its foreign subsidiaries constituted a unitary business,[9] that California's worldwide apportionment formula was fair,[10] and that California's tax did not violate the foreign commerce clause of the Constitution.[11]

A major victory for state tax authorities, this long-awaited decision, written by Justice Brennan, gives broad flexibility to state governments.[12] By expressly limiting its holding to the factual situation of this case,[13] however, the Court leaves one important question open to

5. Property, payroll and sales are the income-producing factors most commonly used because they are believed "to reflect the relative contribution of an MJC's [multijurisdictional corporation's] activities in various States to the production of total corporate income." G.A.O. REPORT, *supra* note 1, at 47. Although most states' apportionment formulas weigh the three factors equally, some states weigh them disproportionately or employ a one or two factor formula. *Id.*

6. Twenty-seven states apply combined reporting to corporate operations within the United States. *Id.* at 66. Formula apportionment originally applied only to single corporation unitary businesses, combining the income of various offices, branches and divisions located throughout the country. States, however, have gradually broadened this concept so as to permit inclusion of multicorporate enterprises composed of United States parent and subsidiary corporations. *Id.* at 4.

7. The thirteen states are Alaska, California, Colorado, Idaho, Illinois, Indiana, Florida, Massachusetts, Montana, New Hampshire, North Dakota, Oregon and Utah. *Id.* at 66. New York did apply worldwide unitary taxation only to oil companies, but at the time of the *Container* decision, Governor Cuomo announced that the state would be dropping its unitary tax as part of an out-of-court settlement with a group of oil companies in a tax dispute. *See* N.Y. Times, June 28, 1983, at D6, col. 4. In response to *Container*, Florida adopted worldwide unitary tax legislation in July, 1983. *See Cabinet Council Proposes "Water's Edge" Policy for Taxing Multinational Firms*, 2 WEEKLY TAX REP. (BNA) 341 (1983). Less than six months later, Florida was considering repealing or modifying the tax "to placate critics." *See* Ft. Myers News Press, Jan. 5, 1984, at B10, col. 3.

8. 103 S. Ct. 2933 (1983).

9. *Id.* at 2950.

10. *Id.*

11. *Id.* at 2952-53.

12. N.Y. Times, June 28, 1983, at A1, col. 5.

13. 103 S. Ct. at 2952 n.26. "We have no need to address in this opinion 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

future litigation—the even more controversial issue of state power to tax foreign parent companies with United States subsidiaries.[14]

Appellant Container Corporation was a Delaware corporation headquartered in Illinois and doing business in California.[15] A vertically integrated manufacturer of custom-ordered paperboard packaging, Container controlled twenty foreign subsidiaries during the tax years in question.[16] These subsidiaries were located in four Latin American countries and four European countries; all but two were engaged in essentially the same type of business as Container.[17]

Container's California tax returns for 1963, 1964 and 1965 reported corporate net earnings as derived from its federal tax forms,[18] but omitted all income from its overseas operations.[19] Consequently, the California Franchise Tax Board assessed approximately $70,000 of additional tax liability, based upon calculations which included earnings of the foreign subsidiaries.[20] Under protest Container paid the amount,[21] and subsequently sued for a refund in California Superior Court, where the state's assessments were upheld.[22] On appeal the California Court of Appeal affirmed[23] and the California Supreme Court refused to exercise discretionary review.[24]

Upon review before the Supreme Court, Container challenged the constitutionality of California's worldwide unitary tax system under both the due process clause of the fourteenth amendment and the foreign commerce clause.[25] Container additionally argued that the use of the formula apportionment system to allocate income to the state was prohibited, since Container and its foreign subsidiaries were not parts of a unitary business.[26]

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subsidiaries." *Id.*

14. On the two occasions after *Container* when this issue was presented to the Court, certiorari was denied. Alcan Aluminum Ltd. v. Franchise Tax Board, 558 F. Supp. 624 (S.D.N.Y. 1983), *cert. denied,* 104 S. Ct. 705 (1984); Shell Petroleum, N.V. v. Graves, 709 F.2d 593 (9th Cir. 1983), *cert. denied,* 104 S. Ct. 537 (1983).

15. 103 S. Ct. at 2939.

16. *Id.* at 2943.

17. *Id.*

18. *Id.*

19. *Id.* at 2944.

20. *Id.* at 2945 & nn. 11-12.

21. *Id.* at 2945.

22. *Id.* (unpublished memorandum opinion and judgment of California Superior Court available in Jurisdictional Statement, app. B at A-27, *Container Corp.,* 103 S. Ct. 2933 (1983)).

23. 117 Cal. App. 3d 988, 173 Cal. Rptr. 121 (1981).

24. 103 S. Ct. at 2945.

25. Appellant's Brief on the Merits at 9, *Container Corp.,* 103 S. Ct. 2933 (1983).

26. *Id.* at 10.

According to Container, worldwide formula apportionment violated due process since it "fail[ed] to account for the lower-wage rates and greater profitability of foreign operations," and therefore, "result[ed] in extraterritorial taxation of income earned in foreign countries."[27]

Container stated that the general acceptability of formula apportionment is based upon the underlying premise that every dollar of payroll, property or sales in one state produces the same amount of profit in all states.[28] State-by-state variations exist, yet these fall within the area of constitutional tolerance for "rough approximation."[29] When apportionment is extended abroad, "this premise is no longer viable," due to the dramatic differences in wages, property costs and sales.[30] "Hence the attempted extension of the three-factor formula beyond the borders of the U.S. violates the due process clause because it is 'inherently arbitrary' and produces an 'unreasonable result.' "[31]

Alternatively, Container contended that worldwide unitary taxation violated the foreign commerce clause on two accounts. First, it resulted in double taxation, as California taxed income which had al-

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27. *Id.* at 15.

28. *Id.* at 11 (citing STATE AND LOCAL TAXATION, *supra* note 1, at 539). The authors question the fairness of worldwide unitary taxation:

> Some companies may earn considerably higher rates of profit abroad than in the United States; relative ratios of property, payroll and receipts may be an extremely crude method of ascribing profits actually earned in the various countries. The large differences in wage rates paid in the United States and many foreign countries, particularly in Latin America, Africa and Asia, where wage scales for the same type of work may amount to as little as one-fifth or one-tenth of those in the United States, tend to produce serious distortions in the apportionment . . . Moreover, the difficulties of obtaining accurate and verifiable data from foreign countries as to assets, payroll and sales are multiplied; accounting techniques and methods frequently vary sharply from those prevailing in the United States, especially in the case of subsidiaries or branches of United States corporations operating in the developing countries.

STATE AND LOCAL TAXATION, *supra* note 1, at 538-39.

29. Appellant's Brief on the Merits at 19, *Container Corp.*, 103 S. Ct. 2933 (1983) (quoting International Harvester Co. v. Evatt, 329 U.S. 416, 422 (1947)).

30. *Id.* Container offered a number of statistics to support this point. For example, a study of the year 1974 demonstrated that Container's California employees were paid nearly two and one-half times more than their counterparts in Colombia. *Id.* at 13. Container also reported drastic differences in the rates of profitability between their domestic and foreign companies. From 1963 to 1965 Container's net income as a percentage of sales in the United States averaged 9.43%, while net income generated by sales in Colombia and Venezuela averaged 20.30% and 22.95%, respectively. *Id.* at 14.

31. *Id.* at 19 (quoting Underwood Typewriter Co. v. Chamberlain, 254 U.S. 113, 120 (1920)).

ready been fully taxed by the foreign country in which it was earned.[32] Second, it prevented the "Federal Government . . . [from] speak[ing] with one voice when regulating commercial relations with foreign governments," since the California tax method was inconsistent with the arm's-length tax method employed by both the Federal Government and foreign nations.[33]

Container's final argument was limited to the factual determination of whether a unitary business existed. In order for a state to apply formula apportionment, the company and its subsidiaries must constitute a single unitary business. According to Container, its foreign subsidiaries were not functionally integrated with their United States parent company, but were "highly decentralized so that the subsidiaries located in each particular country operated as a fully integrated autonomous business rarely crossing the borders of their own country."[34] To support these contentions Container presented evidence of its flow of goods, managerial relationships, exchange of technology, exchange of personnel, loans and centralized services.[35]

In answer to Container's allegations, the Franchise Tax Board contended that the California tax method violated neither the due process clause nor the foreign commerce clause, and that Container and its foreign subsidiaries were unitary.[36]

According to the Tax Board, Container provided its foreign subsidiaries with expertise, training, machinery, equipment, key personnel, direct loans, loan guarantees, raw materials and sales assistance; hence, Container and its foreign subsidiaries were not separate, discrete businesses, but a unitary enterprise.[37]

The Tax Board argued that Container had not met the due process burden of proof, which required Container to establish " 'by clear, cogent evidence' " that extraterritorial values were being taxed.[38] Container's use of the separate accounting approach "clearly apportions insufficient income to the U.S.A.";[39] its wage argument ignores the interdependency of the three apportionment factors;[40] and it has

32. Appellant's Brief on the Merits at 21, *Container Corp.*, 103 S. Ct. 2933 (1983).

33. *Id.* at 27 (quoting Michelin Tire Corp. v. Wages, 423 U.S. 276, 285 (1976)).

34. Jurisdictional Statement at 6, *Container Corp.*, 103 S. Ct. 2933 (1983).

35. *Id.* at 6-7.

36. Appellee's Brief on the Merits at 39-44 (vol. 1), *Container Corp.*, 103 S. Ct. 2933 (1983).

37. *Id.* at 68.

38. *Id.* at 41.

39. *Id.* at 42.

40. *Id.*

not shown that California has taxed "a palpably excessive amount of income."[41]

Rejecting Container's foreign commerce clause claims as well, the Tax Board stated that since taxation of the same income at federal and state levels is proper, the evidence "establishe[d] neither actual, nor a substantial risk of constitutionally prohibited double taxation."[42] Under the facts, there was no conflict between the California tax method and United States foreign relations policy, since the Federal Government had never expressed its disapproval of the California system during the tax years in question.[43] The Board added that all those who had spoken out so adamantly against worldwide unitary taxation had not objected to its appliction to a taxpayer in Container's situation—the domestic corporation with foreign subsidiary companies.[44]

On June 27, 1983, the Supreme Court upheld the constitutionality of the worldwide unitary tax method in a decision dismissing appellant's due process, foreign commerce and unitary business claims.[45]

Addressing the unitary business issue first, the Court prefaced its analysis by defining the limits of its review. "[O]ur task must be to determine whether the state court applied the correct standards to the case; and if it did, whether its judgment 'was within the realm of permissible judgment.' "[46] The Court rejected Container's challenge to the state's legal standard[47] and declined Container's invitation to adopt a

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41. *Id.*

42. *Id.* at 43.

43. *Id.*

44. *Id.*

45. *Container,* 103 S. Ct. at 2933.

46. *Id.* at 2946 (quoting Norton Co. v. Dept. of Revenue, 340 U.S. 534, 538 (1951)). At the same time the Court announced a warning to future litigants:

> It will do the cause of legal certainty little good if this Court turns every colorable claim that a state court erred in a particular application of [those principles defining the constitutional limits of the unitary business principle] into a *de novo* adjudication, whose unintended nuances would then spawn further litigation and an avalanche of critical comment.

Id. Suggesting that the Court may be weary of this issue, it stated: "It should go without saying that not every claim that a state court erred in making a unitary business finding will pose a substantial federal question." *Id.* at 2946 n.14.

47. *Id.* at 2946. Container argued that the state court had relied on the company's "mere potential" to control its subsidiaries' operations as the dispositive factor, but the Court stated that there had been "more concrete" evidence of the management relationship between the parent and the subsidiaries. *Id.* Container urged that the state court also erred in its endorsement of the administrative presumption that companies engaged in the same business are unitary. The Court, however, found this presumption reasonable, since it had been used only to a limited extent and had been one element considered among many. *Id.* at 2947.

bright-line unitary business rule.[48] After reviewing the factors upon which the California court had relied, the Court declared: "[T]aken in combination . . . they clearly demonstrate that the state court reached a conclusion 'within the realm of permissible judgment.' "[49]

Having found the unitary business prerequisite satisfied, the Court turned to the due process challenge to California's three-factor apportionment formula.[50] The problem with the misallocation of income argument was obvious:[51] Container's profitability figures were "based on precisely the sort of formal geographic accounting whose basic theoretical weaknesses justify resort to formula apportionment in the first place."[52] A similar argument had been considered and rejected by the Court in *Mobil Oil Corp. v. Commissioner of Taxes.*[53]

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48. *Id.* at 2947. Under this bright-line rule, a "substantial flow of goods" was required in order for a mercantile or manufacturing company to be determined unitary. The Court stated that "[t]he prerequisite to a constitutionally acceptable finding of unitary business is a flow of *value*, not a flow of goods," and noted that even though this test may be sensible, as a matter of policy there was "no reason to impose it on all the States as a requirement of constitutional law." *Id.* at 2947 & n.17.

49. *Id.* at 2948. It was not necessary, the Court said, to decide whether any of these factors alone would be "sufficient as a constitutional matter to prove unitary business." *Id.*

50. *Id.* In order for a state to tax the income of businesses operating in interstate commerce, the due process clause requires: (1) "a minimal connection or nexus between the interstate activity and the taxing state," and (2) "a rational relationship between the income attributed to the State and the intrastate values of the enterprise." Exxon Corp. v. Dept. of Revenue, 447 U.S. 207, 219-20 (1980) (quoting Mobil Oil Corp. v. Comm'r of Taxes, 445 U.S. 425, 436-37 (1980)).

51. 103 S. Ct. at 2948. Under the standard set in *Hans Rees' Sons*, Container was required to demonstrate that the income apportioned to the state was "out of all appropriate proportion to the business transacted . . . in that State." 283 U.S. at 135. The only time the Court has struck down a state tax on those grounds was in *Hans Rees' Sons*, where the Court recognized that formula apportionment was appropriate due to the unitary nature of appellant's manufacturing and selling enterprise. In *Hans Rees' Sons*, however, the state's formula consisted of only a single factor, property, which the Court found "operated unreasonably and arbitrarily" since it failed to account for the taxpayer's extensive extra-state activities. *Id.*

52. 103 S. Ct. at 2948. When separate accounting is used to assign income to a state, the company's operations within that state are treated as separate and distinct from operations in other states and foreign nations. This method is considered ineffective for a business which is an integral part of a multijurisdictional operation, since it never accounts for income earned in a series of interrelated transactions. In this situation, formula apportionment is much more appropriate, because it roughly approximates the portion of a unitary business' income which is reasonably related to the company's activities within the state. P. HARTMAN, *supra* note 4, at 522-24.

53. 445 U.S. 425 (1980). In *Mobil* the state sought to tax dividend income received by a domestic parent from its foreign subsidiaries. Mobil argued that since the dividend income lacked sufficient nexus with the company's domestic parent, it should be exempt from formula apportionment and taxed according to its source under the separate ac-

The Court gave little weight to the evidence that wage rates were substantially lower and profitability substantially higher abroad than in the United States.[54] This fact alone was insufficient to undermine the basic rationale of California's three-factor apportionment formula.[55] The wide acceptance of the formula was due to the combination of the three factors working together to reflect the activities which produce income.[56]

Conceding that the three-factor formula was "necessarily imperfect,"[57] the Court remained unconvinced that the separate accounting method proposed by the appellant was any less imperfect.[58] This argument was especially weak in Container's case since the difference in taxable income between the two methods was approximately fourteen percent, a "figure certainly within the substantial margin of error inherent in any method attributing income among the components of a unitary business."[59]

After concluding upon these bases that California's application of the unitary business principle to Container and its foreign subsidiaries was proper,[60] and that the use of the standard three-factor formula to apportion the income of that unitary business was fair,[61] the Court determined additional scrutiny under the foreign commerce clause was

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counting method. Rejecting this contention, the Court said that even though separate accounting is useful in identifying the source of income, it is not constitutionally required. When a business is unitary, the actual source of the income is irrelevant, since the profit factors actually result from the operation of the business as an entirety—from its interstate and extra-state activities alike. *Id.* at 438.

54. 103 S. Ct. at 2949. *See also supra* note 30.

55. 103 S. Ct. at 2949.

56. *Id.* The Court explained that both separate accounting and formula apportionment "are imperfect proxies for an ideal which is not only difficult to achieve in practice, but also difficult to describe in theory." *Id.* Formula apportionment can be especially troublesome if it considers just a fraction of the income-producing factors. An example of a distortive single-factor formula was challenged in *Hans Rees' Sons,* 283 U.S. at 123, *see supra* note 51, and struck down by the Court. In contrast, the widely accepted three factor formula avoids this pitfall, because the three factors "appear in combination to reflect a very large share of the activities by which the value is generated." 103 S. Ct. at 2949.

57. 103 S. Ct. at 2949. The Court identified three particular imperfections: (1) the one-third weight afforded each factor is "essentially arbitrary," (2) the three factors are not exhaustive of all relevant income-producing factors and (3) the relationship between each factor and a company's income is inexact. *Id.* at 2949 n.20.

58. *Id.* at 2950.

59. *Id.* In contrast, in *Hans Rees' Sons* there had been more than a 250% difference between application of the two methods. 283 U.S. at 123.

60. 103 S. Ct. at 2950.

61. *Id.*

required, since Container was an international business.[62] The nature of the Court's foreign commerce clause inquiry was defined by its prior decision in *Japan Line, Ltd. v. County of Los Angeles.*[63]

Japan Line involved a Los Angeles *ad valorem* property tax on Japanese-owned cargo containers. Based, registered and subject to property tax in Japan, these containers were temporarily located in California ports, but were used exclusively in foreign commerce.[64] In addition, there was a United States–Japan treaty stipulating that neither government could impose a tax on temporarily imported containers provided they were used exclusively in foreign commerce.[65]

Holding the tax unconstitutional,[66] the Court declared:

> When a State seeks to tax the instrumentalities of foreign commerce, two additional considerations, beyond those articulated in *Complete Auto,* come into play. The first is the enhanced risk of multiple taxation. It is a commonplace of constitutional jurisprudence that multiple taxation may well be offensive to the Commerce Clause. . . . Second, a state tax on the instrumentalities of foreign commerce may impair federal uniformity in an area where federal uniformity is essential. Foreign commerce is preeminently a matter of national concern.[67]

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62. *Id.* Under the commerce clause, an apportionment formula cannot discriminate against interstate or foreign commerce. Discrimination in the form of double taxation results when a number of taxing jurisdictions apply different allocation methods, creating a higher tax burden for companies located in more than one jurisdiction than a company confined to a single state. With businesses operating in interstate commerce, the Court will not strike down a tax on this basis, as long as it is fairly apportioned. *Id.* at 2943. In the instant case, however, Container operated in foreign commerce, and "[w]hen construing Congress' power to 'regulate commerce with foreign nations' a more extensive constitutional inquiry is required." Japan Line, Ltd. v. County of Los Angeles, 441 U.S. 434, 446 (1979).

63. *Container Corp.*, 103 S. Ct. at 2950; *Japan Line,* 441 U.S. at 434.

64. *Japan Line,* 441 U.S. at 436. Based upon these findings, the Court stated: "Japan has the right and the power to tax the containers in full." *Id.* In fact, Japan taxed the full value of the containers, so the imposition of the state tax resulted in actual multiple taxation. *Id.* at 451-52.

65. *Id.* at 446 n.10 (citing Convention for the Avoidance of Double Taxation, Mar. 8, 1971, United States–Japan, 23 U.S.T. 967, 1084-85, T.I.A.S. No. 7365).

66. *Id.* at 454.

67. *Id.* at 446. In Complete Auto Transit, Inc. v. Brady, 430 U.S. 274 (1977), the Court enunciated a four part standard for a valid tax on interstate commerce: (1) the tax must be "applied to an activity with a substantial nexus with the taxing state," (2) the tax must be "fairly apportioned," (3) the tax must "not discriminate against interstate commerce" and (4) the tax must be "fairly related to the services provided by the State." *Id.* at 279. The *Japan Line* Court explained that fair apportionment generally prevents multiple taxation: "The basis for this Court's approval of apportioned . . . taxation . . . has been its ability to enforce full apportionment by all potential taxing bodies. Yet

Comparing *Japan Line* with the instant case, the *Container* Court noted the two were similar in a "number of important respects."[68] Principally, the tax in both cases had resulted in actual double taxation;[69] the double taxation had occurred through "serious divergences" in the California and foreign taxing authority's taxing methods;[70] the foreign authority's tax method was consistent with accepted international practice[71] and, the United States Federal Government preferred the international community's taxing method over California's.[72]

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neither this Court nor this Nation can ensure full apportionment when one of the taxing entities is a foreign sovereign." 441 U.S. at 447. Although the Constitution grants Congress power to regulate interstate and foreign commerce in "parallel phrases," the *Japan Line* Court produced evidence that the framers intended the foreign commerce power to be broader. *Id.* at 447 n.12. To support this proposition, the Court recalled a number of cases decided over the past 100 years which, "stressing the need for uniformity, echo this distinction." *Id.* at 448-49 & nn. 13-14. As further illustration, the Court described several ways in which a state tax can frustrate federal uniformity:

> If the State imposes an apportioned tax, international disputes over reconciling apportionment formulae may arise. If a novel tax creates a [sic] assymetry in the international tax structure, foreign nations disadvantaged by the levy may retaliate against American-owned instrumentalities present in their jurisdictions. . . . If other States followed the taxing State's example, various instrumentalities of commerce could be subjected to varying degrees of multiple taxation . . . .

Id. at 450-51.

68. 103 S. Ct. at 2951.

69. *Id.* Some of the subsidiaries' income taxed without apportionment in foreign nations was also taxed by California as a portion of the state's share of Container's unitary worldwide income. *Id.* at 2951 & n.22.

70. *Id.* at 2951-52. While California employed formula apportionment, each of the relevant foreign jurisdictions applied the arm's-length approach, a variation of the separate accounting method. *Id.* at 2950.

71. *Id.* at 2952. The United States has income tax treaties in force with twenty-six countries, and all but one incorporate the arm's-length method. *See* Brief *Amicus Curiae* of the Confederation of British Industry at app. A (listing the treaties). Model tax treaties proposed by the United States, the United Nations and the Organization for Economic Co-Operation and Development all adopt the separate accounting, arm's-length approach. *See* Treasury Department's Model Income Tax Treaty (1981), 1 TAX TREATIES (CCH) ¶ 158; United Nations Model Taxation Convention Between Developed and Developing Countries (1980), 1 TAX TREATIES (CCH) ¶ 171; Organization for Economic Co-Operation and Development Model Convention for the Avoidance of Double Taxation With Respect to Taxes on Income and on Capital (1980), 1 TAX TREATIES (CCH) ¶ 151.

72. 103 S. Ct. at 2952. The Federal Government uses a separate accounting system to tax MJCs. Distinguishing between domestic and foreign multijurisdictional income, the Federal Government taxes domestic-based corporations without regard to income earned abroad. Foreign subsidiary income is not taxed until the subsidiary pays a dividend to the United States parent. Double taxation is eliminated by a foreign tax credit. To prevent tax evasion through improper shifting of income, the IRS is authorized under section 482 of the Code to monitor transactions between a United States parent and its foreign subsidiaries and reallocate income, deductions and credits. G.A.O. REPORT, *supra* note 1, at 32.

On the other hand, the Court said the cases were clearly distinguishable.[73] The tax with which the *Container* Court was concerned was a tax on income rather than on property.[74] Container's double taxation was not the "inevitable" result of the California taxing method.[75] Finally, this tax had been applied to a corporation domiciled and headquartered in the United States, not to the foreign owners of an instrumentality of foreign commerce.[76]

Emphasizing these factors, the Court held that the distinctions between the instant tax and the *Japan Line* tax "add[ed] up to a constitutionally significant difference."[77]

In its opinion, the Court cautioned that *Japan Line* did not represent an absolute prohibition against state-induced international double taxation.[78] Even though double taxation in foreign commerce demands close scrutiny, that scrutiny must take into account the context in which the double taxation occurred, as well as the alternatives reasonably available.[79]

The *Japan Line* Court was able to eliminate entirely the source of the double taxation by preventing the state from taxing the Japanese cargo containers altogether. Here, the Court said, there was no compa-

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73. 103 S. Ct. at 2952.

74. *Id.* This distinction was used by the Court in *Exxon* and *Mobil* to rebut the taxpayers' *Japan Line* arguments. According to the Court, this attempted analogy was "forced" because "the factors favoring use of the allocation method in property taxation have no immediate applicability to an income tax." *Mobil,* 445 U.S. at 448. *See also Exxon,* 447 U.S. at 228.

75. 103 S. Ct. at 2952. The Court explained that in *Japan Line* the combination of the two tax methods necessarily resulted in double taxation. In *Container,* conversely, "the combination of the two methods result[ing] in the same income being taxed twice or in some portion of income not being taxed at all is dependent solely on the facts of the individual case." *Id.* For example, in *Chicago Bridge* the taxpayer received a refund after its tax was recomputed under worldwide combined reporting. *Id.* at 2952 n.25.

76. *Id.* at 2952. In *Japan Line* the Court stated that it was considering the question of foreign-owned instrumentalities in foreign commerce subjected to state taxation and noted that "we do not reach the questions as to taxability of foreign owned instrumentalities engaged in interstate commerce, or of domestically owned instrumentalities engaged in foreign commerce." 441 U.S. at 444 & n.7.

77. 103 S. Ct. at 2953.

78. *Id.*

79. *Id.* According to the *Container* Court, when *Japan Line* proclaimed, "[e]ven a slight overlapping of tax—a problem that might be deemed *de minimis* in a domestic context—assumes importance when sensitive matters of foreign relations and national sovereignty are concerned," the Court did not intend to place an absolute bar on state-induced international double taxation. *Id.* (quoting 441 U.S. at 456). The existence of international double taxation had indeed triggered close scrutiny, but additional factors had prompted the final outcome. *Id.*

rable solution.[80] Total prohibition was obviously unfair, because much of the income was plainly domestic.[81] Adoption of the arm's-length method, as suggested by appellant, was not a guaranteed end to double taxation, since nations applying the arm's-length approach often employ different standards for reallocating income among affiliated corporations. For the Court, whenever such differences were present, the possibility of double taxation was also present.[82]

Had the California taxation method "inevitably" led to double taxation, the Court noted, it might have been more persuaded to "render it suspect."[83] Under different facts, however, it was possible for the apportionment formula to actually result in a refund for the taxpayer.[84] So, "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."[85]

Turning to the second *Japan Line* standard,[86] the Court determined that a state tax could impair federal uniformity in one of two ways—by implicating foreign policy issues which must be left to the Federal Government, or by violating a clear federal directive.[87]

The Court was not convinced that the California taxing scheme implicated any foreign policy issues.[88] Three distinct factors estab-

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80. *Id.*

81. *Id.* The bright-line rule which totally eliminated state taxation in *Japan Line* was not unfair because "the rule did no more than reflect consistent international practice and express federal policy." *Id.*

82. *Id.* at 2953-55; *see supra* note 72. Foreign nations employ the arm's-length method as well, yet "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." 103 S. Ct. at 2954.

83. 103 S. Ct. at 2954.

84. *Id.*

85. *Id.* at 2954-55. The Court cites Moorman Mfg. Co. v. Bair, 437 U.S. 267 (1978), in comparison, which held that the Constitution did not require a state to replace its single-factor formula with a three-factor formula in order to prevent duplicative taxation. Since risk of duplicative taxation is always present when states apply dissimilar formulas, "[a]ccepting appellant's view of the Constitution, therefore, would require extensive judicial law-making." *Id.* at 278. The *Container* Court added that even if the foreign commerce clause mandated the state to adopt a tax system free of double taxation, the arm's-length system would be totally unacceptable in the international context because the state "would be required to defer . . . to a variety of section 482-type reallocation decisions made by individual foreign countries in individual cases." 103 S. Ct. at 2955.

86. *See supra* note 67 and accompanying text.

87. 103 S. Ct. at 2955. The Court cautioned: "[W]e cannot infer '[a]bsent some explicit directive from Congress . . . that treatment of foreign income at the federal level mandates identical treatment by the States.'" *Id.* (quoting *Mobil*, 445 U.S. at 448).

88. *Id.* at 2955. Relying upon *Japan Line*, the Court stated that "[t]he most obvious

lished that the tax would not lead to significant foreign retaliation:[89] (1) the tax did not create an automatic "asymmetry" in international taxation,[90] (2) the tax was imposed on a domestic rather than a foreign operation as in *Japan Line*[91] and (3) the amount of tax appellant paid was more a function of the California tax rate than of its allocation method.[92] Furthermore, the Court found that the tax did not pose a serious threat to United States foreign policy, since the Executive Branch had not filed an *amicus curiae* brief in support of appellant.[93]

Finally, the Court considered specific indications of congressional intent, but was unable to conclude that the California tax was either "preempted by federal law or fatally inconsistent with federal policy."[94] According to the Court, "Congress has long debated, but has not enacted, legislation designed to regulate state taxation of income."[95]

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foreign policy implication of a state tax is the threat it might pose of offending our foreign trading partners and leading them to retaliate against the nation as a whole." *Id.* The Court identified a problem with considering this issue because it had "little competence in determining precisely when foreign nations will be offended by particular acts and even less competence in deciding how to balance a particular risk of retaliation against the sovereign right of the United States as a whole to let the States tax as they please." *Id.*

89. *Id.*

90. *Id.* (quoting *Japan Line,* 441 U.S. at 453). *See also supra* note 75.

91. 103 S. Ct. at 2955-56. While the "legal incidence" of the tax fell on a domestic corporation, the Court nevertheless recognized that this factor may not be so significant in the case of a domestic company with a foreign parent. *Id.* at 2956 n.32. With regard to this type of arrangement the Court stated, "[W]e need not decide here whether such a case would require us to alter our analysis." *Id.*

92. *Id.* at 2956. The Court minimized foreign interest in reducing a domestic company's tax burden because Container was undoubtedly subject to considerable state tax liability. *Id.*

93. *Id.* Noting that the Government had submitted a brief opposing worldwide unitary taxation in *Chicago Bridge,* the Court would not speculate as to why a similar brief had not been submitted in this case. Instead, the Court concluded, "there has been no indication that the position taken by the Government in *Chicago Bridge & Iron Co.* still represents its views, or that we should regard the brief in that case as applying to this case." *Id.* at 2956 n.33.

94. *Id.* at 2956-67. The Court applied two standards. One required an " 'explicit directive from Congress' " because the Court could not infer that "treatment of foreign income at the federal level mandates identical treatment by the States." *Id.* at 2955 (quoting *Mobil,* 445 U.S. at 448). The second was "a more relaxed standard which takes into account our residual concern about the foreign policy implications of California's tax . . . ." *Id.* at 2957.

95. *Id.* at 2956 (quoting *Mobil,* 445 U.S. at 448). According to *Mobil,* this fact indicated an absence of an explicit congressional directive. 445 U.S. at 448. Since 1965, bills dealing with state taxation of multistate and multinational corporations have been introduced in every session of Congress, but none has been enacted. *See* G.A.O. REPORT, *supra* note 1, at 6-7.

The tax treaties to which the United States is a party require adoption of the arm's-length method when taxing the domestic income of multinational corporations.[96] Generally, though, this requirement is waived for nations taxing their own domestic corporations, indicating to the Court that "such taxation is in reality of local rather than international concern."[97] In addition, none of these tax treaties covers the taxing powers of sub-national governmental bodies such as states.[98] On the one occasion when an attempt was made to include such a provision in a tax treaty, the Senate refused to give its consent.[99]

Justice Powell, joined by Chief Justice Burger and Justice O'Connor, limited the dissenting opinion to the foreign commerce clause issue, since under *Japan Line* worldwide unitary taxation "clearly violates the foreign commerce clause."[100] Neither the due process nor unitary business questions were considered.[101]

According to the dissent, the Court failed in its application of the "close scrutiny" standard of review.[102] While the Court recognized the relevancy and similarities of *Japan Line* to *Container*, it nevertheless found them constitutionally distinguishable and upheld the validity of the tax.[103] In spite of the factual distinctions, the dissent considered the two cases "identical on the critical questions of double taxation and federal uniformity."[104] Therefore, "the principles enunciated in [*Japan Line*] should be controlling here . . . ."[105]

Despite the fact that California's use of worldwide combined reporting had resulted in actual double taxation, the Court sustained the tax on the ground that double taxation would not necessarily be eliminated under the internationally accepted arm's-length method.[106] This contention, as the dissent pointed out, "fails to recognize the fundamental difference between the current double taxation and the risk that would remain under an arm's-length system."[107]

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96. 103 S. Ct. at 2956; *see supra* note 62.
97. 103 S. Ct. at 2956.
98. *Id.*
99. *See* 124 CONG. REC. 18,400, 19,076 (1978). A clause preventing the application of worldwide unitary taxation to non-United States multinational companies was included in a 1977 draft tax treaty between the United States and Great Britain, but was deleted in the ratification process by the Senate. *Id.*
100. 103 S. Ct. at 2957 (Powell, J., dissenting).
101. *Id.*
102. *Id.*
103. *Id.*
104. *Id.*
105. *Id.*
106. *Id.* at 2952.
107. *Id.* at 2957-58.

Double taxation had occurred here due to the differences in "basic assumptions" between the state's apportionment formula and the foreign nations' arm's-length system.[108] The arm's-length system identifies income according to its geographic source.[109] Formula apportionment disregards geographic source altogether.[110] As a result, since wage rates, property values and sales prices are considerably lower in Latin America than in the United States, the formula will systematically allocate a higher proportion of income to the state and a much lower proportion abroad than the arm's-length method.[111] As long as California's three income-producing factors continue to be greater, the state will necessarily tax income which has already been taxed abroad.[112] Double taxation is therefore "inevitable," and can only be prevented by one jurisdiction changing its basic tax practice.[113]

Under a uniform system double taxation could also occur if California were to adopt the arm's-length method.[114] This double taxation, however, would not be "inevitable" and would be caused only by differences in application of the same method, not differences inherent in the system itself.[115] Such divergences, argued the dissent, do not consistently favor one jurisdiction over another, are presently tolerated internationally and are more likely to disappear through international negotiation.[116]

On the federal tax level, the arm's-length method has served as a satisfactory solution to the international double taxation problem.[117] To this extent, the dissent suggested, a constitutionally acceptable alternative is available at the state level.[118] Justice Powell explained that he "would not reject, as the Court does, the solution to this constitutional violation simply because an international system based on the

108. *Id.* at 2958.

109. *See supra* note 4 and accompanying text and note 52.

110. *See supra* note 4 and accompanying text and note 52.

111. 103 S. Ct. at 2958 (Powell, J., dissenting). The dissent endorses the Hellersteins' view. *Id.; see supra* note 28.

112. 103 S. Ct. at 2958 (Powell, J., dissenting). For example, in the tax years in question more than 27% of Container's worldwide income was earned in Latin America and taxed by Latin American governments under the arm's-length method. Latin American wages, property and sales roughly represented 6%, 20% and 14%, respectively, of the worldwide total. Under California's formula system only 13% of Container's worldwide income—"less than half of the arm's-length total—was allocated to Latin America." *Id.* The remainder was taxed a second time by the state. *Id.*

113. *Id.*

114. *Id.*

115. *Id.* at 2959.

116. *Id.* at 2958-59.

117. *Id.* at 2957 n.1.

118. *Id.*

principle of uniformity would not necessarily be uniform in all of the details of its operation."[119]

Finding the factual distinctions relied upon by the Court unconvincing, the dissent determined that the state tax clearly violated the second *Japan Line* principle as well.[120] The tax, "[f]latly inconsistent with federal policy"[121] and one that "prevent[s] the Federal Government from speaking with one voice in a field that should be left to the Federal Government,"[122] is an unconstitutional "intrusion on national policy in foreign affairs."[123]

Even though double taxation may not result in every instance, "the fundamental inconsistency between the two methods of apportionment means that double taxation is inevitable."[124] "Double taxation is the logical expectation in a large proportion of cases," since California's wage rates, property values and sales prices are relatively high.[125] As the Court stated in *Japan Line*, "even a slight overlapping of tax—a problem that might be deemed *de minimis* in a domestic context—assumes importance when sensitive matters of foreign relations and national sovereignty are concerned."[126]

The taxpayer in *Container* is a domestic corporation, not a foreign one. Regardless of who is actually paying the tax, the dissent emphasized that the effect of the tax is identical—the state is unquestionably taxing income earned abroad.[127] "Even if foreign governments are indifferent about the overall tax burden of an American corporation . . . [i]f nothing else, such a tax has the effect of discouraging American investment in their countries."[128]

Although the Court avoided answering this question, the dissent found the tax obviously unconstitutional as applied to foreign-based corporations with United States subsidiaries.[129] "There can be little doubt that the parent's government would be offended by the State's action and that international disputes, or even retaliation against

119. *Id.* at 2959.

120. *Id.; see supra* note 67 and accompanying text.

121. 103 S. Ct. at 2961 (Powell, J., dissenting).

122. *Id.*

123. *Id.*

124. *Id.* at 2959. The Court found that California's worldwide unitary tax did not create an "automatic assymetry," which the dissent interpreted as not resulting in double taxation in every instance. *Id.*

125. *Id.*

126. *Id.* (quoting *Japan Line*, 434 U.S. at 456).

127. *Id.*

128. *Id.; see infra* notes 156-60 and accompanying text.

129. 103 S. Ct. at 2959-60 (Powell, J., dissenting).

American corporations, might be expected."[130] Restricting the unconstitutionality of the tax to this situation would be totally "unacceptable." "It would leave California free to discriminate against a Delaware corporation in favor of an overseas corporation. I would not permit such discrimination without explicit congressional authorization."[131]

Theoretically, the Court argued that the state could impose the same tax burden on Container under the arm's-length system by raising the general tax rate.[132] The rate would have to be raised for all corporations, however, in order to avoid further constitutional challenges.[133] In addition, this could only be accomplished through the political process, which would provide an opportunity for all California businesses to raise their objections.[134]

Although the Executive Branch had not submitted an *amicus* brief opposing worldwide unitary taxation in *Container*, it had done so in *Chicago Bridge*.[135] According to the dissent, this memorandum made the position of the Executive Branch "clear beyond question"[136] when it stated: "[T]he imposition of [a state tax] on the apportioned combined worldwide business income of a unitary group of related corporations, including foreign corporations, impairs federal uniformity in an area where such uniformity is essential."[137]

Argued in the previous Term, *Chicago Bridge* had been carried over to the 1983 Term, and was pending before the Court at the time of the *Container* decision.[138] *Chicago Bridge* raised precisely the same issues as *Container*,[139] so the Government's brief was directly on point. Nevertheless, the Court chose to dismiss it in a footnote which explained, "there has been no indication that the position taken by the

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130. *Id.* at 2960; *see infra* notes 156-60 and accompanying text.

131. 103 S. Ct. at 2960 (Powell, J., dissenting).

132. *Id.*

133. *Id.* If California were to raise its tax for Container alone, or only for corporations engaged in foreign commerce, constitutional challenges under the equal protection or commerce clauses would arise. *Id.* at 2960 n.6.

134. *Id.* at 2960.

135. *Id.* There are reports that the Administration's silence in *Container* was not an oversight. Apparently, the Government's position in the *Chicago Bridge* memorandum "evoked a storm of protest from Republican governors who charged the Administration with betraying the principles of the 'new federalism.' " *See* N.Y. Times, Oct. 17, 1983, at D17, col. 1. *See also* Wall St. J., June 28, 1983, at 3, col. 1.

136. 103 S. Ct. at 2960 (Powell, J., dissenting).

137. *Id.*

138. *Id.; see supra* note 3.

139. 103 S. Ct. at 2960 (Powell, J., dissenting). The dissent emphasized that the state tax in *Chicago Bridge* was imposed on a domestic parent company with foreign subsidiaries. *Id.* at 2960 n.7.

Government in *Chicago Bridge & Iron Co.* still represents its views, or that we should regard the brief in that case as applying to this case."[140]

Since the Solicitor General had neither withdrawn the memorandum, nor submitted another with a contrary view, the dissent saw no reason to ignore its position.[141] In fact, the Government had even suggested that *Container* might be more appropriate for deciding the worldwide unitary tax question, because double taxation had actually occurred there and not in *Chicago Bridge*.[142] "As long as *Chicago Bridge & Iron* remains before us, we must conclude that the Government's views are accurately reflected in the Solicitor General's memorandum in that pending case."[143]

The *Container* decision immediately prompted vigorous reaction from proponents and opponents alike.[144] Unfortunately, the decision did not resolve the worldwide unitary tax issue; instead, the issue now has been shifted to the President and Congress.

On September 3, 1983, Container filed a petition for rehearing,[145] asserting that the Court had erred in assuming the *Chicago Bridge* memorandum no longer represented the Government's position.[146] Container said counsel on both sides had regarded the memorandum as applicable to the case, based upon conversations with officials of the Executive Branch prior to oral argument.[147] "In fairness to the United States and to the parties the Court should grant a rehearing to determine whether the Court's assumption with respect to the government's position is correct."[148]

A number of foreign nations, including Japan, the Netherlands and the United Kingdom, joined Container in urging the United States Government to support the rehearing petition.[149] The Reagan administration, however, announced on September 23rd that it would "refrain"

140. 103 S. Ct. at 2956 n.33.

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

142. Memorandum for the United States As Amicus Curiae at A-20, *Chicago Bridge* (available in Appellant's Brief on the Merits at app. F, *Container Corp.*).

143. 103 S. Ct. at 2960 (Powell, J., dissenting).

144. *See Major Tax Decisions Come Fast as Justices Wind Down Current Term,* 2 WEEKLY TAX REP. (BNA) 17 (1983); N.Y. Times, June 28, 1983, at A1, col. 5; Wall St. J., June 28, 1983, at 3, col. 1.

145. *See Cabinet Council Proposes "Water's Edge" Policy for Taxing Multinational Firms,* 2 WEEKLY TAX REP. (BNA) 341 (1983).

146. *Id.* at 342.

147. *Id.*

148. *Id.*

149. *See Administration Won't Intervene in Court Rehearing, Will Set Up Study Panel,* 2 WEEKLY TAX REP. (BNA) 404, 405 (1983) [hereinafter cited as *Administration Won't Intervene*].

from asking the Court to overturn its decision.[150] Less than three weeks later the Court denied Container's request without comment.[151]

Under strong pressures from home and abroad, President Reagan established the Working Group on Worldwide Unitary Taxation in November, 1983.[152] Composed of representatives from state governments, the Federal Government and multinational businesses, this special commission was formed to recommend a consensus solution to this long-standing problem.[153]

To date, the task force has ruled out federal legislation overriding state tax laws as a consideration.[154] A voluntary approach seems to be favored, and would involve persuading states to adopt a method of taxing domestic- and foreign-based multinationals that is less objectionable than the worldwide unitary system.[155]

Meanwhile, international protest has become increasingly fierce. Foreign investments in the United States have already been deterred.[156] Japan has threatened to apply a similar method of taxation against United States corporations in its nation.[157] The United Kingdom announced that it will impose retaliatory tax restrictions on United States companies, and cut back on tax-free allowances for United States executives working in Britain.[158] In an unusual demonstration of unanimity, 230 members representing all ten member nations of the European Parliament signed a resolution recommending reprisals against the United States.[159] The Netherlands has refused to continue tax treaty negotiations with the United States, and several other nations have threatened to do the same.[160]

States argue that worldwide unitary taxation is necessary in order to prevent multinational corporations from avoiding taxes by hiding their profits abroad.[161] United States-based multinationals contend

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150. *Id.* at 404.

151. 104 S. Ct. 265 (1983). *See also* N.Y. Times, Oct. 12, 1983, at A17, col. 5.

152. *See Administration Won't Intervene, supra* note 149, at 404; Wall St. J., Sept. 26, 1983, at 8, col. 2; N.Y. Times, Sept. 24, 1983, at B2, col. 3.

153. *See Administration Won't Intervene, supra* note 149, at 405.

154. *See Commission Generally Rules Out Restrictive Federal Legislation,* 2 WEEKLY TAX REP. (BNA) 796 (1983).

155. *Id.*

156. *See Administration Won't Intervene, supra* note 149, at 405.

157. *See E.C. Parliament Member Blasts U.S. Position Against Legislation,* 2 WEEKLY TAX REP. (BNA) 828, 829 (1983).

158. *Id.* at 828-29.

159. *Id.* at 829.

160. *See Foreign Governments Resist Treaty Talks Due to Reagan Policy,* 2 WEEKLY TAX REP. (BNA) 582 (1983).

161. *See Reagan Administration Unitary Tax Strategy Under Intensive Study By Cabinet-Level Committee,* 2 WEEKLY TAX REP. (BNA) 247, 249 (1983) [hereinafter cited

that states take more than their fair share by taxing profits and subjecting them to double taxation.[162] Foreign nations believe that the tax reaches beyond the limits of legitimate United States jurisdiction.[163]

With the *Container* decision, the Supreme Court appears to have removed itself from the worldwide unitary tax issue. Congress is at a standstill until the Administration makes its recommendations. The Administration "would like to accommodate business and foreign governments, but they also see the whole federal issue heating up."[164] For the President, it has become difficult to oppose "because it has been framed in terms of states' rights . . . and because [the President's] own policies have been largely responsible for the declining revenues that have made states dependent on the unitary tax method. . . . The whole question has become something of a political hot potato."[165]

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as *Reagan Administration Unitary Tax Strategy*].

162. *See* N.Y. Times, June 28, 1983, at D8, col. 6.

163. *See supra* notes 156-60 and accompanying text.

164. *See Reagan Administration Unitary Tax Strategy, supra* note 161, at 247.

165. Lewin, *Business and the Law: Unitary Tax Scope Widens*, N.Y. Times, Oct. 18, 1983, at D2, col. 3.