STATE TAXATION OF MULTINATIONAL CORPORATIONS

Advisory Commission on Intergovernmental Relations
Washington, DC 20575
April 1983
A-92

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PREFACE

Conflict exists between state and national rules for taxing multinational corporations. Several states use the worldwide combination approach for determining the taxable income of multinational firms. In the past, the Treasury Department has taken the position that these state practices do not conform to internationally accepted standards which are based on separately accounting for the income of corporations located in each country. It followed, then, that these state tax practices worked against a national interest—international tax harmonization.

For students of our federal system this conflict between national and state interests has far-reaching implications. It forces policymakers to balance two equally important constitutional concerns: promoting the free flow of foreign and domestic commerce, and granting states wide leeway in charting their own tax policies.

This report attempts to break new ground in this contentious field. It develops a "serious national harm" test to determine when the state concern for tax sovereignty should give way to the national interest in harmonizing international tax practices.

After examining the relevant documentation and consulting with knowledgeable practitioners, the Commission staff could find no evidence of harm to the nation caused by the fact that state taxing practices were not in harmony with generally accepted international practices.

This study also points up that two self-correcting forces—interstate tax competition and the courts—should prevent state tax practices from causing serious national harm in the foreseeable future. Therefore, the Commission recommends that the Congress pass no law to limit state tax practices with respect to multinational corporations or "foreign source" income.

Robert B. Hawkins
Chairman

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TABLE OF CONTENTS

Page

Preface iii
Acknowledgments v
Introduction 1
The Competing National and State Interests 1
  The National Interest 2
    Constitutional Issue 2
    Congressional Response 2
    Tax Treaties 3
    Benefits of Tax Harmonization 3
    Internationally Accepted Standards 3
    Conflicts with State Practice 4
  The State Interest 4
    History 4
    State Argument for Continued Use of Unitary Principles 4
      1. Revenue Losses 5
      2. Administrability of Separate Accounting 5
      3. State Sovereignty 5
      4. No Serious Demonstrated Harm 6
      5. Adequate Judicial Remedies are Available 6
      6. Self-Correcting Influence of State Competition 7
Major Findings and Conclusions 7
Recommendations 8

Appendix A
  Objections of Foreign Governments to State Unitary Taxation 9
Appendix B
  State Positions from National Governors' Association *Amici Curiae* Brief in *Container Corporation* Case 19

STATE TAXATION OF MULTINATIONAL CORPORATIONS

INTRODUCTION

Differences between state and national rules for taxing multinational corporations have always been a potential source of conflict in the federal system. However, in recent years, the problems that can result when each state and the national government apply different rules for taxing income arising from international commerce have been accorded increasing prominence due to court decisions, state legislative actions, deliberations on international tax treaties, and proposed national legislation.

The Senate debate on the United States-United Kingdom tax treaty during the period 1977-1979 illustrates the conflict. The controversial article 9(4) of the proposed U.K. treaty would have prohibited state tax practices that defined as unitary businesses the combination of U.K. parent corporations and U.S. subsidiaries and then apportioned a share of the worldwide income thus derived to individual states to be subject to state corporate income taxes.

The Treasury Department claimed during the debate that this prohibition on state tax practices was required to conform state law to internationally-accepted standards that are based on separately accounting for the income of corporations located in each country. The states opposing this prohibition made several counterclaims. At one level, they argued that separate accounting, which requires that all transactions between affiliated corporations be calculated on an arm's length basis, is virtually impossible to administer and is not an appropriate mechanism for distinguishing domestic from foreign source income in today's world of highly interconnected corporations operating under common management and control. In addition, they took the position that the proposed prohibition was an unwarranted attack on state sovereignty in the field of taxation.

The central questions in this debate were: what are the national and state interests in the taxation of multinational corporations and how can they be reconciled? Although the controversial restriction on state taxation was deleted in the final version of the U.S.-U.K. Treaty, the questions raised above have not yet been satisfactorily answered. In fact, some observers considered the treaty negotiating process an inappropriate forum for resolving a major intergovernmental tax policy issue. For example, Ferdinand Schoettle, Professor of Law at the University of Minnesota Law School and a student of state taxation, thought it:

> very unwise for the Treasury to allow federal policy to be dictated by the exigencies of a treaty negotiation. State taxation of United Kingdom income is relatively unimportant. However, the future use by the states of the unitary business doctrine is one of the more important issues concerning state taxation of interstate business that has to be resolved.[1]

THE COMPETING NATIONAL AND STATE INTERESTS

This section will outline the national and state interests in state taxation of multinational corporations. The appropriate treatment of such state taxation will thus be seen to require the accommodation of competing state and national interests. The national interest can be viewed from the perspectives of constitutional jurisprudence, congressional concerns, and the network of bilateral treaties with other countries around the world.

At the outset, it should be noted that the authority of Congress to legislate a uniform set of rules for states to follow in international tax policy is unquestioned. The Constitution empowers Congress "to regulate commerce with foreign nations" (Article I, section 8, clause 3) and even forbids the states from making separate arrangements with foreign governments (Article I, section 10, clause 1).

In Federalist 42, Madison provides further elaboration on this subject:

[1]Ferdinand P. Schoettle, "The U.K. Treaty and the State Taxation of Corporate Income," *Tax Notes*, Vol. 5, No. 14, April 4, 1977, p. 4.

The second class of powers lodged in the general government consist of those which regulate the intercourse with foreign nations... This class of powers forms an obvious and essential branch of the federal administration. If we are to be one nation in any respect, it clearly ought to be in respect to other nations.[2]

The National Interest

Constitutional Issue. In constitutional terms the national interest in state taxation of interstate and foreign commerce has three elements: (1) to assure that excessive state taxation does not impede the free flow of commerce among the states (the interstate commerce clause); (2) to assure that strictly lawful procedures are followed by the states (the due process clause of the 14th amendment); and (3) to assure that states do not infringe upon the authority of the nation to regulate commerce with foreign nations (the foreign commerce clause).

The national concerns about preserving due process and maintaining a free flow of interstate commerce have been interpreted quite similarly by the Supreme Court. Commerce clause standards, however, are somewhat more comprehensive.[3] Here the landmark case is *Complete Auto Transit v. Brady*, 430 U.S. 274 (1977), which provided some measure of needed uniformity and consistency to commerce clause jurisprudence by overruling a prior court decision that looked more to the language of state tax law than to its substantive effects.[4] In *Complete Auto Transit*, the court set forth a four-part test, providing that a state tax will pass constitutional muster if it is "applied to an activity with a substantial nexus within the taxing state, is fairly apportioned, does not discriminate against commerce and is fairly related to the services provided by the state."[5] In other words, "interstate commerce must bear its fair share of the state tax burden."[6]

In the strictly domestic context, a fair apportionment method has not been a major source of conflict between state and national interests, although by no means have all the issues of state taxation of interstate commerce been resolved.[7]

In the international sphere, however, differences between national and state interests have become quite contentious. It is also in the international arena where the constitutional tests for permissible state taxation appear to be more rigorous. In addition to the four tests in *Complete Auto Transit*—nexus, apportionment, nondiscrimination, and a fair relation to services provided—the Court noted in *Japan Line* that a tax on the "instrumentalities of foreign commerce" must take account of two "additional considerations."[8] "The first is the enhanced risk of multiple taxation"[9] that may result from the simultaneous application of state taxes and taxes imposed by a foreign government. "Second, a state tax on the instrumentalities of foreign commerce may impair federal uniformity in an area where federal uniformity is essential."[10] This latter point was elaborated in the Court's reference to its earlier statement in *Michelin Tire Corp. v. Wages*, 423 U.S. 276 (1976), that "the federal government must speak with one voice when regulating commercial relations with foreign governments."[11] In the case of foreign commerce, then, state taxation may have a higher barrier to overcome to be judged constitutionally acceptable.

Congressional Response. From the congressional perspective, expressions of concern began with the Willis Report, named for the chairman of the Subcommittee of the House Judiciary Committee and released as a four-volume study in 1964 and 1965 entitled *State Taxation of Interstate Commerce*.[12] This report stated:

> In keeping with the basic structure of our federal system, the committee is of the view that international tax policy should be formulated by the federal government and not by individual states. Therefore, with respect to income earned by corporations which operate either wholly or partially outside of the United States, the committee recommends that state apportionment rules be required to conform to the international policies that have been formulated for federal income tax purposes.[13]

Later, in 1976, the House Ways and Means Committee appointed a special task force on foreign source income headed by Congressman Rostenkowski to study this issue. In a report filed in 1977, the task force recommended that federal income tax rules apply to state taxation of foreign source income.[14] Legislation has been introduced

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[2] *The Federalist Papers*, New York, The New American Library, 1961, p. 264.

[3] Of the four tests discussed below in the text, the first two are required for satisfying the due process clause. For example, in *Exxon Corp. v. Wisconsin Department of Revenue*, 447 U.S. 207, 219-220 (1980), the court stated that "state taxation required a 'minimal connection' or 'nexus' between the interstate activities and the taxing state and 'a rational relationship between the income attributed to the state and the intrastate values of the enterprise,'" quoting Mobil Oil Corp. vs. Commissioner of Taxes of Vermont, 445 U.S. 425, 436.

[4] The case overruled was *Spector Motor Service Inc. v. O'Connor*, 340 U.S. 602 (1951).

[5] 430 U.S. 274, 279.

[6] *Japan Line, Ltd. v. County of Los Angeles*, 441 U.S. 434, 444 (1979) quoting *Washington Revenue Dept. v. Association of Washington Stevedoring Companies*, 435 U.S. 734, 750 (1978).

[7] The major remaining controversy in the domestic area surrounds the question of what constitutes a unitary business operation. See Comptroller General of the United States, Report to the Chairman of the House Committee on Ways and Means, *Key Issues Affecting State Taxation of Multijurisdictional Corporate Income Need Resolving* (GGD-82-38), Washington, D.C., U.S. General Accounting Office, July 1, 1982. The 45 states (including the District of Columbia) which levy a corporate income tax differ in the rules regarding jurisdiction to tax, apportionment formulas, the allocation of income items that are not apportioned by formula, and the use of combined reporting.

[8] 441 U.S. 434, 446.

[9] *Ibid.*

[10] *Ibid.*, 448.

[11] *Ibid.*, 449, quoting 423 U.S. 276, 285.

[12] Published as H. Rept. No. 1480, 88th Congress, 2nd Session, June 15, 1964; H. Rept. No. 565, 89th Congress, First Session, June 30, 1965; and H. Rept. No. 952, 89th Congress, First Session, September 2, 1965, Washington, D.C., U.S. Government Printing Office, 1964 and 1965.

[13] *Ibid.*, H. Rept. 952, p. 1155.

[14] House Committee on Ways and Means, *Recommendations of the Task Force on Foreign Source Income*, Washington, D.C., U.S. Government Printing Office, 1977, p. 30.

almost annually since 1965 to conform state and federal practices, most recently as H.R. 5076 and S. 1688 in the 96th Congress and H.R. 1983 and S. 655 in the 97th Congress.

Tax Treaties. With respect to this country's tax treaty network, the very existence of some 30 independently-negotiated income tax treaties bespeaks a strong national interest in international tax harmonization to promote an efficient flow of international trade and investment. In testimony before the Foreign Relations Committee of the United States Senate, the late Laurence Woodworth, then Assistant Secretary of the Treasury for Tax Policy, articulated this national interest.

> We view tax treaties as an important element in the international economic policy of the United States. One of our fundamental objectives is to minimize impediments to free international flows of capital and technology, and this objective is fostered by having the broadest possible network of income tax treaties.
>
> Among the major impediments to freer capital and technology flows are the rules of national tax systems and their interaction with the systems of other countries. Tax treaties seek to eliminate, or at least mitigate the impact of, these impediments.
>
> Treaties accomplish this minimization of impediments by a variety of means, the principal ones being the elimination or reduction of double taxation and the elimination, to the extent possible, of discriminatory tax rules which distinguish unreasonably between domestic and foreign investment.
>
> At the same time, tax treaties also serve other policy objectives—for example, the prevention of tax avoidance and evasion, and the fostering of international cooperation between the tax authorities of Contracting States.[15]

Benefits of Tax Harmonization. The stakes in tax harmonization, or coordination of the tax systems of various countries, involve more than a desire for orderliness in international tax matters. Without such harmonization, double taxation of income could easily occur, resulting in a loss of international investment and income flows. In 1981, U.S. firms' direct investments abroad increased by $11.8 billion to a level of $227.3 billion, and these firms received 1981 income of $31.9 billion from this cumulative direct foreign investment. That same year, foreign firms' direct investment in the U.S. increased by $21.3 billion to a level of $89.6 billion, and these firms received 1981 income of $7.8 billion from this cumulative investment.[16]

These capital investments and income flows contribute significantly to increasing worldwide standards of living. The capital importing or host country benefits from the use of foreign capital in its production processes because the resulting higher capital-to-labor ratios can increase productivity and raise real earnings. The capital exporting country benefits from the rate of return that can be earned on capital employed abroad. Excessive taxation of the income generated from foreign investments through failure to harmonize national tax systems could undermine this beneficial flow of capital.

International tax harmonization is not dissimilar to arrangements that states have worked out for taxing the income of people working in one state and living in a neighboring one. If the state of employment asserts its right to tax income on a source or where-earned basis, the state of residence generally allows the employee a credit against its own tax levied on a residence basis. Thus, at the state level, double taxation of the same income is eliminated. At the same time, individual households benefit because their choices of work places and residences are not restricted by tax considerations. Similar benefits to U.S. citizens occur through tax harmonization on an international level.

International tax harmonization, however, cannot occur without an internationally accepted set of standards that can serve as the foundation for all tax treaty negotiations.

Internationally Accepted Standards. Internationally accepted standards establish principles for taxing foreign-owned enterprises operating in the United States and U.S. owned enterprises operating abroad. Two important sets of rules for this purpose are: (1) those defining a *permanent establishment*, such as a branch or subsidiary corporation, that can be taxed by the host country; and (2) those specifying the procedures to be used to account for transactions between related parties in measuring the income of a permanent establishment. Under these latter rules, the permanent establishment is to be regarded as a *separate entity* and transactions between related parties are calculated on an *arm's length basis*; that is, as if the related parties were dealing with each other as independent enterprises at arm's length.

These standards have evolved from about 50 years of effort on the part of both technical experts and tax treaty negotiators.[17] The Organization for Economic Cooperation and Development (OECD) treaty, most recently revised in 1977, and the United States model income tax treaty, last issued in June 1981, reflect a "water's edge" rule. Permanent establishments in foreign countries are considered separate entities. Even if transactions occur between related foreign and domestic corporations, the income attributable to the foreign entity is calculated by

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[15] Statement of Assistant Secretary of the Treasury, Laurence N. Woodworth, *before the Senate Committee on Foreign Relations, Hearings on Tax Treaties with the United Kingdom, the Republic of Korea, and the Republic of the Philippines*, July 19 and 20, 1977, 95th Congress, First Session, Washington, D.C., U.S. Government Printing Office, 1977, p. 28.

[16] Direct investment excludes investment in bonds, notes or so-called "portfolio" stock investments through which no controlling interest is obtained. See Obie G. Whichard, "U.S. Direct Investment Abroad in 1981," and Ned G. Howenstine and Gregory G. Fouch, "Foreign Direct Investment in the United States in 1981," both in U.S. Department of Commerce, Bureau of Economic Analysis, *Survey of Current Business*, Vol. 62, No. 8, August 1982. The figures appear in Table 1, p. 12; Table 8, p. 17; Table 1, p. 31; Table 6, p. 34.

[17] Statement of H. David Rosenbloom, International Tax Counsel, Department of the Treasury, before the Subcommittee on Oversight, House Committee on Ways and Means, *Hearings on Income Tax Treaties*, April 29, 1980, 96th Congress, 2nd Session, Washington, D.C., U.S. Government Printing Office, 1980, p. 61.

reference to transactions *between independent parties.*[18]

Conflicts with State Practice. These water's edge rules contrast sharply with the procedures used by 12 states that apply a unitary apportionment approach to worldwide combinations of affiliated firms. Under this approach, income from all firms believed to be part of a unitary business enterprise—whether domestic or foreign firms—is added together to determine the combined income of the entire enterprise. The share of this combined income attributable to a particular state is measured by taking the ratios of the in-state values of the standard apportionment factors—sales, property, and payroll—to their worldwide values.

The Treasury Department, during the Carter Administration, took the position that the conflict between state use of worldwide combination and apportionment practices and the water's edge rules used by the U.S. government and in international practice can have serious implications. First, as noted, it can interfere with national tax harmonization objectives.

Second, conflict between national and state rules can be a substantial irritant in international tax and trade policy. A number of foreign governments have transmitted to the United States their formal objections to the states' using worldwide combination rules for taxing corporations owned by citizens in their countries. Belgium, Canada, France, Italy, the United Kingdom, and the nine governments of the European Economic Community (EEC), among others, have voiced such objections.[19]

Also, testimony during Senate consideration of the U.K. treaty offered several examples of taxpayer objections to worldwide combination practices.[20] Although the facts of these cases are undoubtedly subject to dispute and the testimony displays states in the worst possible light, there is legitimate concern about the potential for interference with the free flow of international commerce.[21]

The federal government is also concerned that foreign governments, wanting to help their own corporate taxpayers, could retaliate against the United States. Countries believe the unitary approach as applied to worldwide combinations imposes inequitable state tax burdens on foreign-owned corporations and entails state taxation of out-of-state, or extraterritorial values. The countries could, therefore, conclude that some appropriate response is required to demonstrate their concern. U.S. corporations with subsidiaries located abroad could be targets.

However, a more likely result of continuing foreign governments' concern with state unitary taxation would be the inability of the United States to negotiate tax treaties on as favorable terms to American multinational corporations as could otherwise be achieved. Although the exact way that any particular issue enters into a complex treaty negotiation is difficult to determine, state action would have the effect of restricting federal flexibility in ongoing treaty negotiations.

The State Interest

Against this national interest must be set the states' interest in continued use of worldwide combined reporting.

History. First, a brief history of state use of formula apportionment may be instructive. In the early days of state income taxation, separate accounting was considered the preferred approach for determining within-state income of a multistate firm, even though implementation of this approach required detailed records for calculating income on either a functional or a geographical basis.[22] Formula apportionment came to be applied to the activity of a single multistate firm as a practical solution to the need for a workable and inexpensive dividing-up rule, that is to say, "out of sheer necessity."[23] The technique was first used to apportion intangible property values—such as good will—for railroads operating across state lines by employing such crude devices as the number of track miles of railroad property in each state. Eventually, the technique evolved into the apportionment of income by factors believed to give rise to that income. It was also a small step from apportioning the income of a single firm among the several states in which it operated to apportioning the combined income of a group of related firms deemed to be operating as a single unitary business. And also, in the view of many states, it was not a much larger step to view affiliated firms operating worldwide in the same way as such firms engaged in solely domestic activity. From the states' perspective unitary apportionment on either a domestic or a worldwide basis is but a logical corollary of the growing complexity of contemporary corporate financial arrangements. The same motive "of sheer necessity" that impelled states to replace the early unworkable separate accounting scheme for determining the income of a single multistate firm is operative today.

State Argument for Continued Use of Unitary Principles. The position of the states regarding the continued use of worldwide unitary combination procedures may be found in the statements of numerous revenue officers, other state officials, state organizations (such as the National Governors' Association and the National Association of Tax Administrators), and the Multistate Tax Commis-

[18]The United States taxes residents on worldwide income—from both domestic and foreign sources. Double taxation is eliminated, however, by providing a credit for foreign taxes on foreign-source income. Hence, there is still a need to determine foreign-source income from establishments located abroad to calculate the allowable foreign tax credit, and this is where the federal government uses the water's edge rule to avoid double taxation of foreign source income.

[19]Examples of the statements of foreign countries are reproduced in Appendix A.

[20]It should be noted, however, that not all corporations offered objection to worldwide combination. The Caterpillar Corporation, for example, favored that approach.

[21]See, for example, the testimony of Valentine Brookes before the Senate Committee on Foreign Relations, *Hearings on Tax Treaties with the United Kingdom, op. cit.*, pp. 212-221, and the testimony of William D. McKee, pp. 291-5.

[22]See Jerome R. Hellerstein, "The Unitary Business Principle and Multicorporate Enterprises: An Examination of the Major Controversies," *Tax Executive*, July 1975, p. 314; and Jerome R. and Walter Hellerstein, *State and Local Taxation*, 4th edition, St. Paul, Minn., West Publishing Co., 1978, pp. 432-433.

[23]Proponents of worldwide combined reporting also point up theoretical advantages, i.e., accounting for intangible factors such as good will and management strength.

sion—a compact of 20 states.[24] The states make several general arguments in support of using worldwide combination.

1. Revenue Losses. At the most pragmatic level, states are concerned about the revenue losses that would result if they were prohibited from applying unitary principles on a worldwide basis. For example, the Multistate Tax Commission estimates that legislation before the 97th Congress[25] disallowing both worldwide combination procedures and the state taxation of foreign source dividends would involve revenue losses to the states of over $700 million or over 6 percent of total state collections from corporate income taxes in 1981.[26] At a time of increased fiscal responsibilities, cutbacks of federal grants-in-aid, and limitations on their abilities to raise revenues from other sources, states feel genuinely aggrieved by the prospect of significant revenue losses.[27]

2. Administrability of Separate Accounting. It is also contended that another consideration is relative difficulty in administering separate compared to unitary accounting.[28] States claim that separate accounting is an unworkable device for distinguishing between domestic and foreign source income and that only worldwide apportionment can effectively deal with the income measurement problems arising from transactions between related corporations. An article on separate accounting in the 1976 *Harvard Law Review* suggested that multinational corporations (MNCs) have considerable flexibility in shifting income among countries due to the rules they use for pricing transfers between affiliated firms:

> While tax avoidance may enter into a MNC's determination of transfer prices, there are many important non-income tax influences on such decisions. Whatever the motivation, however, freely established transfer pricing represents a means whereby MNC profits produced by subsidiaries in countries with high tax burdens may be shifted to other entities subject to more favorable tax treatment. Whenever transfer pricing has the effect of shifting income in this way, a country in which economically significant activities took place is deprived of some portion of its fair share of the taxable income of the MNC.[29]

The recently-issued report by the General Accounting Office on the Internal Revenue Service's administration of arm's length pricing rules under section 482 of the tax code supports this position.[30] The GAO report is highly critical of IRS enforcement procedures under section 482 and found that the IRS has been able to use a true arm's length standard in only a small minority of cases.[31] Furthermore, the GAO recommends that serious attention be given to using worldwide combination and formula apportionment practices for measuring the income of multinational corporations.[32]

3. State Sovereignty. On a philosophical level, the states argue that they should be able to determine their own fiscal structures without outside interference.[33] This traditional position against federal encroachment on state prerogatives is buttressed by the view that the authority to

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[24]The sources cited below are illustrative rather than exhaustive. Numerous other examples could have been selected.

[25]The legislation is H.R. 1983 and S. 655, 97th Congress, 2nd Session.

[26]These revenue loss estimates are reported in Multistate Tax Commission, "Summary of State Responses to Treasury Department Questionnaire on Use of Unitary Method and Taxation of Dividend Income," (unpublished response to Teasury Department Survey, May 11, 1982), p. i.; cited in *Tax Notes*, 15, No. 8 (May 24, 1982), p. 696. Collections from state corporate taxes in 1981 were $14.1 billion dollars according to the Bureau of the Census. These estimates of revenue loss have not been accepted in all quarters. The Committee on State Taxation of the Council of State Chambers of Commerce has estimated revenue losses of under $100 million. See Committee on State Taxation, "Revenue Impact on States of H.R. 5076;" Press release date April 24, 1980.

[27]For examples of this argument see letter of December 30, 1981 from Governor Babbitt of Arizona to President Reagan on behalf of the Western Governors Policy Office (WESTPO) and enclosed WESTPO resolution of April 5-7, 1981; Ferdinand P. Schoettle, "The U.K. Treaty and the State Taxation of Corporate Income," *Tax Notes*, vol. 5, no. 14 (April 4, 1977), pp. 3-8; statement of William Craven, president, National Association of Tax Administrators and Director, Audit Division, Department of Taxation and Finance, State of New York, including the position paper of the National Association of Tax Administrators on interstate taxation of business adopted June 10-13, 1979, in *State Taxation of Foreign Source Income*, Hearings on H.R. 5C76, before the 96th Congress, 2nd Session, March 31, 1980, pp. 11-17. In this same hearing see also statements by the following: Byron Dorgan, past chairman, Multistate Tax Commission and Tax Commissioner, State of North Dakota, p. 19; Theodore W. de Looze, chief tax counsel, Department of Justice, State of Oregon, pp. 36 and 44; James E. Zagel, director, Department of Revenue, State of Illinois, p. 51; James Hamilton, assistant chief counsel, California State Franchise Tax Board, p. 56.

A more fundamental question, of course, is whether revenue considerations should play such a prominent role in the policy debate. In the words of Charles McLure, "One can, after all, think of many bad taxes that would raise substantial revenue." See his "Toward Uniformity in Interstate Taxation: A Further Analysis," *Tax Notes*, vol. 13, no. 2 (July 13, 1981), footnote 21, p. 55.

[28]For a discussion of this position, see letter of December 30, 1981, from Governor Babbitt, *op. cit.*; William D. Dexter, "An Analysis of and Comment on, H.R. 1983 and S. 655 of the 97th Congress," Multistate Tax Commission, processed, undated; Jerome R. Hellerstein, *op. cit.*, pp. 316-317, 319-320; Natonal Association of Tax Administrators, Resolution No. 18, adopted at annual meeting, May 31-June 4, 1982, New Orleans, La.,; and the following statements in *State Taxation of Foreign Source Income*: William Craven, pp. 14-15; Byron Dorgan, pp. 21-22; Theodore W. de Looze, pp. 37, 42-43; James Hamilton, pp. 58-59, 62; and Ferdinand P. Schoettle, pp. 337-338.

[29]"Multinational Corporation and Income Allocation Under Section 482 of the Internal Revenue Code," *Harvard Law Review*, Vol. 89, No. 6, April 1976, pp. 1203-1204.

[30]The Comptroller General of the United States, Report to the chairman of the House Committee on Ways and Means, *IRS Could Better Protect U.S. Tax Interests in Determining the Income of Multinational Corporations* (GGD-81-81), Washington, D.C., U.S. General Accounting Office, September 30, 1981.

[31]*Ibid.*, p. 29.

[32]*Ibid.*, pp. 50-52.

[33]See Walter Hellerstein, "State Income Taxation of Multijurisdictional Corporations: Reflections on *Mobil, Exxon*, and H.R. 5076," *Michigan Law Review*, vol. 79, no. 1 (November 1980), pp. 160, 169-170; and the following statements in *State Taxation of Foreign Source Income*: William Craven, pp. 11-17; Byron Dorgan, p. 18; and Theodore W. de Looze, p. 40.

tax is critical to the very existence of states as constitutionally protected sovereign governments within the federal system. Therefore, doubts should be resolved in favor of wide leeway for state tax policymakers.

4. No Serious Demonstrated Harm. A less dogmatic interpretation of this federalism position is that there has been no demonstration of harm as a result of state taxation of multinational corporations, and, therefore, no compelling reasons to restrict state action.[34] Foreign corporations still want to invest in the U.S.; foreign governments have not tried to impose retaliatory taxation on U.S. corporations operating abroad; and foreign governments still wish to conclude tax and other treaties with the United States. In short, while acknowledging that foreign governments have formally objected to the use of worldwide apportionment procedures, the states claim that it has not been possible to marshal evidence of serious national harm resulting from state tax practices.

5. Adequate Judicial Remedies are Available. Other arguments against imposing restrictions on state taxing authority are based on the dynamics of the federal system and the tendency for excesses to be self-correcting in the absence of direct federal intervention. For example, the courts can insure that constitutional limitations on state taxing authority, as discussed above, are adhered to. Supreme Court decisions in *Japan Line*[35] and more recently in *ASARCO Inc. v. Idaho State Tax Commission*[36] and *F. W. Woolworth Co. v. Taxation and Revenue Department of New Mexico*[37] are cited as positive examples.

The latter two cases *ASARCO* and *Woolworth* require further elaboration. In these two cases, the states of Idaho and New Mexico, respectively, wanted to include in the apportionable income of corporations doing business within their states dividend income received from subsidiary foreign corporations. The Supreme Court, relying on its position in *Mobil Oil Corp. v. The Commissioner of Taxes of Vermont* that "the linchpin of apportionability in the field of state income taxation is the unitary-business principle,"[38] had to address the critical question of whether the payor corporations, in fact, had a unitary business relationship with the dividend receiving corporations. This question was decided affirmatively in *Mobil*, thereby giving Vermont the authority to tax foreign dividends received by a corporation doing business in the state. In *ASARCO* and *Woolworth*, the fact patterns led the Court to a different conclusion, and on due process grounds, the Court rejected the right of Idaho and New Mexico to tax the foreign dividend receipts. In *ASARCO*, for example, the Court stated that "the record establishes that each of the three partial subsidiaries in question operated a 'discrete business enterprise' having nothing to do with the activities of (ASARCO) in the taxing state'."[39] Idaho, therefore, could exercise no tax claim on the dividends received by ASARCO from these subsidiaries.

Additionally, in *Woolworth* the Court declared that the "gross up" element of foreign dividends to reflect foreign taxes deemed paid could not be taxed by New Mexico.[40]

These decisions still leave unanswered questions. Perhaps most important is the exact contours of a constitutionally acceptable definition of a unitary business operation. In *ASARCO*, the Court struck down Idaho's contention that "corporate purpose should define unitary business,"[41] declaring that "this definition of unitary business would destroy the concept."[42] While no definitive guidelines were offered to the states, the Court suggested in *ASARCO* that in *Mobil* and *Exxon* "the states prevailed because it was clear that the affiliated corporations operated unitary businesses with a continuous flow and interchange of common products."[43] Furthermore, since no unitary relationship was found to have existed in *ASARCO* and *Woolworth*, no light has been shed on the question of whether state taxation on the basis of worldwide unitary combination is itself unconstitutional.[44]

The Supreme Court, in its current term, has the opportunity to decide this issue because it will be raised in both *Chicago Bridge and Iron* and also *Container Corporation of America v. Franchise Tax Board* (81-253).

The judicial process may move at a slow pace and not always provide conclusive answers, but there is no denying its role in the federal system in delimiting state tendencies toward an over-reaching tax system.[45]

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[34]This view may be found in William D. Dexter, "Analysis of H.R. 1983 and S. 655," p. 21; Walter Hellerstein, "State Income Taxation of Multijurisdictional Corporations," pp. 159-160; and the following statements in *State Taxation of Foreign Source Income*: Byron Dorgan, p. 18 and Theodore W. de Looze, pp. 41-42.

[35]441 U.S. 434 (1979).

[36]50 U.S. L.W. 4962 (U.S. 1982).

[37]50 U.S. L.W. 4957 (U.S. 1982).

[38]444 U.S. 425, 439 (1980).

[39]50 U.S. L.W. 4962, 4968 m. 24 (U.S. 1982), quoting *Mobil* U.S. 425, 442.

[40]This "gross up" element arises from provisions of national tax law explicitly designed to eliminate double taxation by the U.S. and foreign governments of the income from which foreign dividends are paid. The process entails three steps. First, cash dividends received by the domestic corporation are "grossed-up" to reflect the foreign taxes paid on these dividends; next, the U.S. tax is assessed on the grossed-up dividends; then, a credit is allowed against the federal tax liability for foreign taxes deemed paid. In this way, foreign taxes reduce U.S. taxes dollar for dollar, and international double taxation is prevented.

[41]50 U.S. L.W. 4967.

[42]*Ibid.*

[43]*Ibid.*, p. 4968, n. 24. A similar view was offered in *Woolworth* where "no flow of international business" was found, 50 U.S. L.W. 4957, 4961 (U.S. 1982).

[44]In his amicus brief in *Chicago Bridge and Iron Company v. Caterpillar Tractor Co.*, et. al. no. 81-349, the Solicitor General contended that worldwide unitary combination for state tax purposes is unconstitutional because it prevents the national government from speaking with one voice on matters of international double taxation. It should also be noted that the Solicitor General has not resubmitted that amicus brief for reconsideration by the Supreme Court in the current term—a clear signal that the Reagan Administration no longer wants to be a party to any litigation designed to restrict state taxing powers. See Appendix B.

[45]Some have expressed dissatisfaction with the case-by-case approach to dealing with policy issues involved in conflicts between federal and state tax practice, and have concluded that federal legislation is, therefore, needed. For example, the General Accounting Office in *Key Issues*... (page 22) commented that "although the Supreme Court has rendered decisions on some of the issues affecting state taxation of MJC's (multijurisdictional

6. Self-Correcting Influence of State Competition. Another impetus for self-correction is the competition among the states for new industry, including firms that are affiliated with multinational groups. Some states, such as Virginia, have been revising their tax structures to be more congenial to multinational businesses. Evidence has also been cited of affiliates of foreign parents choosing to locate in states that are less aggressive in applying the unitary system on a worldwide basis.[46] In such a competitive environment, states will be constrained in setting up tax rules that are much out of step with sister states.

MAJOR FINDINGS AND CONCLUSIONS

1. Conflict has arisen between state and national rules for taxing multinational corporations. Several states have used the worldwide combination approach for determining the taxable income of multinational firms. During the Senate consideration of the U.K. Treaty, the Treasury Department took the position that these state practices did not conform to internationally accepted standards that are based on separately accounting for the income of corporations located in each country. Therefore, it was argued that these state tax practices worked against a national interest—international tax harmonization.

2. Conflicts between the interests of the national government and those of the states cannot easily be resolved without specific criteria or tests with which to evaluate the merits of the competing claims. In the present instance, either one of two tests can be applied to determine whether or not federal constraint of state authority to tax multinational corporations is appropriate.

3. The first test may be termed the *predominant national interest test*. Here, national intervention is appropriate if a state activity falls so clearly within the domain of the national interest that reasonable doubts must be resolved in favor of action by the national government. It is not necessary under this test to show that the nation has been seriously harmed by the failure of the national government to act, but only that the national government must be free to pursue the national interest (i.e., international tax harmonization) without hindrance or obstruction by the states. Where the national interest can be identified as predominant, state interests must give way "beyond the water's edge."

corporations), the inherent limitations of the judicial process have prevented and will continue to prevent the comprehensive treatment of the issues which their scope and complexity demand." Support for this view may be found in the cases in which the Supreme Court itself has invited Congress to act: for example, *Moorman Manufacturing Company v. Bair*, 437 U.S. 267, 280-1 (1978); *Washington Revenue Department v. Association of Washington Stevedoring Companies*, 435 U.S. 734, 749 (1978).

[46]See, for example, statement of Honorable Charles McC. Mathias, Jr., U.S. Senator from the State of Maryland in *State Taxation of Foreign Source Income, op. cit.*, pp. 142-14; also the reply by the Committee on State Taxation (COST), Council of State Chambers of Commerce to a Treasury Department questionnaire, "Questions to COST Pertaining to S. 655 and H.R. 1983," June 10, 1982, pp. 16-18.

4. A second and far more stringent alternative test for justifying federal intervention is the *serious national harm test*. Here, restrictive national action could be taken only after persuasive evidence shows serious economic or political harm being done to the nation by the failure of states to harmonize their tax practices with those of the federal government and foreign countries. Such national harm could be incurred, for example, if many foreign corporations failed to invest in the U.S., if foreign governments imposed retaliatory taxation on U.S. corporations operation abroad, or if foreign governments declined to conclude tax or other treaties with the United States when such treaties would clearly serve U.S. interests.

5. *In the Commission's judgment, the rigorous serious national harm test is clearly superior to the predominant national interest test because it forces federal policymakers to balance two equally important constitutional concerns: promoting the free flow of foreign and domestic commerce and insuring states wide leeway in charting their own tax policies.*

6. Because foreign governments have formally objected to state use of worldwide apportionment procedures, the staff conducted a thorough investigation of the grounds for these objections by examining relevant documentation and interviewing practitioners and students of international tax practices. *This staff investigation produced no evidence that state use of worldwide combination had caused harm to the nation.* As noted earlier in this report, there has been no cut-back in foreign investment in the United States, no retaliatory taxation imposed by foreign governments on U.S. corporations operating abroad, and no refusal by foreign governments to conclude tax treaties with the U.S. government.

7. There are two self-correcting forces at work that should prevent state tax practices from causing serious national harm in the foreseeable future. First, business enterprises in our federal system are free to locate in states that provide the most congenial tax climate. Thus, interstate tax competition should prevent most states from pursuing state tax policies that are clearly hostile to their economic development fortunes. Second, our judicial system provides the process for determining whether state tax practices conflict with the constitutional interest in achieving a free flow of interstate and foreign commerce and for insuring that no person is deprived of property without due process of law.

RECOMMENDATION

It is clear that (a) our federal system allows the states the widest latitude in determining their own tax structures, (b) the judicial system provides processes for determining whether state tax practices conflict with constitutional standards, (c) business enterprises in our federal system are free to locate in states that provide the most congenial tax climate and (d) there is no evidence that state tax practices cause harm to the nation. Therefore, the Commission recommends that the United States Congress pass no law that will limit state tax practices with respect to multinational corporations or "foreign source" income.

Appendix A

Objections of Foreign Governments to State Unitary Taxation

AMBASCIATA D'ITALIA,
Washington, D.C., March 19, 1980

To the Department of State, Washington, D.C.:

The Italian Embassy presents its compliments to the Department of State and, on behalf of the Nine ECC Governments, of which the Italian Government has now the presidency, it has the honor to forward the attached note on the problems of the unitary method of taxation.

The Italian Embassy welcomes the opportunity to renew to the Department of State the assurances of its highest consideration.

[SEAL]

PAOLA PANSA CEDRONIO
Ambassador of Italy

1. Our Governments are concerned about the application to US subsidiaries of foreign companies of the unitary basis of taxation as applied in California and in varying degrees by certain other States.

2. The unitary basis makes no attempt to examine the profits generated by the subsidiary. It looks to the total profits of the worldwide operations of the group of which the subsidiary is a part, and claims a portion of those profits on the basis of the assumption that certain specified factors, such as the fixed asset values, turnover and payroll, affect the profits of the subsidiary in the same way and to the same extent as the profits of the group as a whole, irrespective of where the corporations of the group operate. This means that, whenever the group as a whole makes a profit the subsidiary will be taxed on a portion of this profit, even if the subsidiary is actually making a loss, or in the reverse situation, that the subsidiary may not be taxed if the group as a whole has made a loss, although the subsidiary is actually in a profit making position.

3. This method is incompatible with the principles accepted by all OECD member states and recommended to all states as a basis for the taxation of subsidiaries or permanent establishments of foreign enterprises. These principles require that a subsidiary should be taxed only on the profits it actually has made, provided that these are based on dealing at "arm's length" between the subsidiary and related enterprises, i.e. that the transactions between the subsidiary and related corporations are on the same or on a comparable basis as transactions between wholly independent parties. This is intended to arrive at a fair measure of profit and rule out artificial pricing between members of the group for the sole purpose of minimizing tax liability.

4. Unless the same basic rules for calculating taxable profits are followed generally by the main trading nations it will be impossible to achieve the essential objective of providing a consistent and coherent international tax framework for trade and investment.

5. The unitary tax basis can give rise to obviously inequable tax liabilities, and to a form of double taxation which often cannot be relieved, or can be relieved only if countries, which follow generally accepted practices, bear an unfair burden of relief.

6. Unitary taxation, because it requires worldwide reporting of the group's activities in the state where the subsidiary operates imposes very heavy compliance costs, in addition to the costs of compliance and reporting for non-US corporations in their "home countries".

7. The Federal Government uses the arms-length basis for its taxation of subsidiaries of foreign corporations.

8. The problem was addressed in the US/UK Double Taxation Treaty, Article 9(4) of the Treaty, which was supported by the Administration, would have disallowed the imposition of unitary taxes on subsidiaries of UK companies. When the Senate voted on the Treaty in 1978 the majority approved the Treaty with Article 9(4) in its original form, although the necessary two-thirds majority was not achieved. Subsequently, the Senate approved the Treaty with the necessary two-thirds majority, but subject to the reservation that Article 9(4) was not to apply for the purpose of state taxation. Article 9(4) remained in the Treaty, but only for the purpose of national taxation.

9. There are currently four relevant bills in Congress, S983, S1688, HR 5093 and HR 5076, the last of which is scheduled for hearings on the 31st of March.

In view of the strong arguments against unitary taxation, our Governments urge you to support this legislation in so far as it relates to the unitary tax issues raised above, with a view to early enactment.

BRITISH EMBASSY
Washington, D.C., June 23, 1980

Hon. HARRY F. BYRD, Jr.,
Russell Senate Office Building
U.S. Senate, Washington, D.C.

MY DEAR SENATOR BYRD. In the context of the hearing of your Taxation Subcommittee tomorrow on S. 983 and S. 1688, may I bring to your attention the views of my Government on the application of unitary taxation to the U.S. subsidiaries of British companies, set out in a note (copy attached) communicated to the Administration on March 25, 1980.

J. ANSON, *Minister, Economics*

[Press release issued by the British Embassy Information Department]

U.K./U.S. DOUBLE TAXATION CONVENTION

The ratification by the Exchange of Instruments of the UK/US Double Taxation Convention took place in Washington on 25 March 1980.

The Convention enters into force on 25 April 1980.

Attached is a note of the details together with an outline of the views which have been communicated by Her Majesty's Government to the US Administration at the time of ratification.

The Double Taxation Convention between the UK and the US, which was signed in London on 31 December 1975, and the three supplementary Protocols which were signed in London on 26 August, 1976, 31 March 1977 and 15 March 1979 respectively were ratified by the Exchange of Instruments in Washington on 25 March 1980.

The Convention, as amended by the Protocols, will enter into force on 25 April 1980.

The following views have been conveyed by Her Majesty's Government to the US Administration.

It is a matter of regret to Her Majesty's Government that difficulties over one aspect of the Convention, although it is an important one, should have tended to obscure the achievement of the two Governments in reaching a fair and balanced agreement.

Among double taxation treaties, that between the British and United States Governments has a pre-eminent position. The economic and financial links between the two nations are so strong and the areas covered so diverse that, apart from its intrinsic importance to the United Kingdom and the United States of America, the Convention attracts wide interest internationally and is a source of authority in its field.

Her Majesty's Government is therefore gravely concerned that as a result of the amendment resulting from the United States Senate reservation on Article 9(4) the Convention does not comprehensively restrict the application of the unitary basis of taxation. That Article in its original form would have prevented the United States Government and the individual States of the United States of America from applying this basis to United Kingdom corporate groups which have subsidiary companies in the United States. In its final form the Article applies only for the purposes of United States federal tax, where the unitary basis is not employed, and does not cover individual States of the Union. This is not only a set-back for British corporate investment in the United States. It may also be interpreted as awarding some approval for the unitary basis of taxation and could have wider repercussions.

Her Majesty's Government is convinced that the unitary basis of taxation with combined reporting, particularly as applied in the international field, is entirely

unsatisfactory. The Organisation for Economic Co-operation and Development has explored, encouraged and developed the "arm's-length" principle for regulating the taxation of multinational enterprises operating through subsidiary companies or branches. This principle requires that the subsidiary or branch should be taxed only by reference to the profits which its own activities generate. Where these activities involve transactions with related enterprises and these transactions are not on the basis which would be made between wholly independent enterprises, the profits are to be adjusted for tax purposes by reference to the independent enterprise test, i.e., the "arm's-length" basis. This is intended to achieve a fair measure of the profit by cancelling the effect of any artificial pricing between related enterprises. The "arm's-length" approach has been internationally accepted and is a vital features of double taxation conventions throughout the world.

The unitary basis with combined reporting is a quite different approach. It makes no attempt to examine the profits made by the locally based subsidiary company. It may look to the total profit of the world-wide operations of the group and claim a proportion of that total by reference to arbitrarily defined criteria. The problems associated with this technique are many and have been well rehearsed. The tax consequences are unpredictable and arbitrary. The widely varying commercial and economic climates in different countries produce inequitable results. Under this system it can lead to a demand for tax by reference to group profits earned from unconnected activities in other parts of the world where they are already taxed, even although the local subsidiary is incurring substantial losses. On the unitary basis there is likely to be unrelieved and unrelievable double taxation. In addition the compliance costs are unacceptably high.

Apart from these inherent problems associated with the unitary tax basis, its incompatibility with the internationally accepted "arm's-length" basis would generate conflicts between the international investing and trading nations and disruption of international business if the precedent implicit in the Convention were to be followed by other countries. Unless common rules for determining the allocation of profits between different taxing jurisdictions are followed internationally it will be impossible to preserve the essential objective of providing a consistent and coherent international tax framework for business and investment, for which the United States and the United Kingdom have striven together with their fellow members of the Organization for Economic Co-operation and Development. It is the view of Her Majesty's Government that the unitary basis, which is not a practical international alternative to the "arm's-length" basis, could undo the important and patient international work that has been achieved in regulating international tax practices, and that every effort is required to discourage the use of the extension of that basis. It is to this end that the British and United States Governments have expressly prohibited its use for the purpose of the respective national tax systems under Article 9(4); and the issue will be an important aspect of the proposed annual review of the Convention.

Her Majesty's Government has recognised, in ratifying this Convention with the approval of the United Kingdom Parliament, and in its acceptance of the United States Senate reservation against Article 9(4) of the Convention, the difficult issues raised within the United States in seeking to limit State taxing powers through the double taxation conventions of the United States. It has also recognized the importance of the Convention in its many other aspects for the two Governments and for the business and investment communities on each side. It must be emphasised however that the acceptance of the Senate reservation in no way implies approval of the unitary basis and it is the urgent request of Her Majesty's Government for the reasons given above that the Government of the United States should use its best endeavours to eliminate the international application of the unitary basis of taxation.

EXCERPT FROM THE LETTER OF GEORGE S. VEST, ASSISTANT SECRETARY OF STATE FOR EUROPEAN AFFAIRS, TO FRANCOIS DE LABOULAYE, AMBASSADOR OF FRANCE, ON THE SIGNING OF THE PROTOCOL BETWEEN THE UNITED STATES AND FRANCE, ON NOVEMBER 24, 1978.

Excellency:

In connection with the Protocol signed today, I should like to state our understanding with respect to two important unresolved issues and certain other matters concerning the application of the Protocol.

. . . . . .

2. It is the position of the Government of France that the so-called "unitary apportionment" method used by certain states of the United States to allocate income to the United States offices or subsidiaries of French corporations, results in inequitable taxation and imposes excessive administrative burdens on French corporations doing business in those states. Under that method the profit of a French company on its United States business is not determined on the basis of arm's length relations but is derived from a formula taking account of the income of the French company and its worldwide subsidiaries as well as the assets, payroll, and sales of all such companies.

For a French multinational corporation with many subsidiaries in different companies to have to submit its books and records for all of these corporations to a United States state, in English, imposes a costly burden.

It is understood that the Senate of the United States has not consented to any limitation on the taxing jurisdiction of the states by treaty and that a provision which would have restricted the use of unitary apportionment in the case of United Kingdom corporations was recently rejected by the Senate. The Government of France continues to be concerned about this issue as it affects French multinationals. If an acceptable provision on this subject can be devised, the United States agrees to reopen discussions with France on this subject.

3. The Explanatory Note issued by the French and American Governments will cease to have effect for periods to which this Protocol applies. With respect to the taxation of American residents in France under this Convention, the two governments have agreed that:

a. Contributions to pension, profit-sharing, and other retirement plans which qualify under the United States Internal Revenue Code will not be considered income to an employee and will be deductible from the income of a self-employed individual, to the extent that such contributions are required by the terms of the plan and are comparable to similar French arrangements;

b. Payments received by the beneficiary in respect of the plans referred to in (a) will be included in income for French tax purposes, to the extent not exempt under subparagraph (2)(a)(ii)(c) of Article 23 of the Convention, at the time when, and to the extent that, such payments are considered gross income under the Internal Revenue Code;

c. Benefits received by reason of exercise of stock options will be considered compensation for French tax purposes at the time and to the extent the exercise of the option or disposition of stock gives rise to ordinary income for United States tax purposes;

d. United States state and local income taxes imposed in respect of income from personal services and any other business income (except income which is exempt from French tax under the Convention) shall be allowed as business expenses;

e. The French Government will attempt to reach a reasonable solution with American residents of France regarding the taxation of employer-provided benefits which are not considered income by the United States;

f. In applying the provisions of French law referred to by paragraph 2(c) of Article 23, the French Government clarified how the exemption with progression provision applies. The tax due is that proportion of the tax on total income which taxable (non-exempt) income bears to total (exempt plus taxable) income. For example, if a taxpayer has a total income of $20,000 of which by reason of this Convention only $12,000 is taxable by France, the French tax will be 60 percent (12,000/20,000) of the tax computed on a total income of $20,000.

If this is in accord with your understanding, I would appreciate a confirmation from you to this effect.

Accept, Excellency, the renewed assurances of my highest consideration.

George S. Vest
Assistant Secretary
for European Affairs

September 26, 1980

The Honorable
Allan J. MacEachen,
Deputy Prime Minister and
Minister of Finance of Canada.

Sir:

I have the honor to acknowledge receipt of your note of September 26, 1980, which reads as follows:

"I have the honour to refer to the Convention between Canada and the United States of America with Respect to Taxes on Income and on Capital, signed today, and to confirm certain understandings reached between the two Governments with respect to the Convention.

1. In French, the term "societe" also means a "corporation" within the meaning of Canadian law.

2. The competent authorities of each of the Contracting States shall review the procedures and requirements for an organization of the other Contracting States to establish its status as a religious, scientific, literary, educational or charitable organization entitled to exemption under paragraph 1 of Article XXI (Exempt Organizations), or an eligible recipient of the charitable contributions or gifts referred to in paragraphs 5 and 6 of Article XXI, with a view to avoiding duplicate application by such organizations to the administering agencies of both Contracting States. If a Contracting State determines that the other Contracting State maintains procedures to determine such status and rules for qualification that are compatible with such procedures and rules of the first-mentioned Contracting State, it is contemplated that such first-mentioned Contracting State shall accept the certification of the administering agency of the other Contracting State as to such status for the purpose of making the necessary determinations under paragraphs 1, 5 and 6 of Article XXI.

It is further agreed that the term "family," as used in paragraphs 5 and 6 of Article XXI, means an individual's brothers and sisters (whether by whole or half-blood, or by adoption), spouse, ancestors, lineal descendants and adopted descendants.

3. It is the position of Canada that the so-called "unitary apportionment" method used by certain states of the United States to allocate income to United States offices or subsidiaries of Canadian companies results in inequitable taxation and imposes excessive administrative burdens on Canadian companies doing business in those states. Under that method the profit of a Canadian company on its United States business is not determined on the basis of arm's-length relations but is derived from a formula taking account of the income of the Canadian company and its world-wide subsidiaries as well as the assets, payroll and sales of all such companies. For a Canadian multinational company with many subsidiaries in different countries to have to submit its books and records for all of these companies to a state of the United States imposes a costly burden. It is understood that the Senate of the United States has not consented to any limitation on the taxing jurisdiction of the states by a treaty and that a provision which would have restricted the use of unitary apportionment in the case of United Kingdom corporations was recently rejected by the Senate. Canada continues to be concerned about this issue as if affects Canadian

multinationals. If an acceptable provision on this subject can be devised, the United States agrees to reopen discussions with Canada on this subject.

4. I have the honour to propose to you that the present Note and your reply thereto shall constitute an agreement between our two Governments on these matters."

I confirm these understandings on behalf of the Government of the United States of America. These understandings constitute an agreement between our two Governments on this matter, which will enter into force on the date of entry into force of the Convention between the Government of the United States of America and the Government of Canada with Respect to Taxes on Income and on Capital which was signed today.

Accept, Sir, the renewed assurances of my highest consideration.

(Signed by: G. William Miller
Secretary of the Treasury)

Appendix B

State Positions from National Governors' Association *Amici Curiae* Brief in *Container Corporation* Case

NATIONAL GOVERNORS' ASSOCIATION

February 25, 1982

The President
The White House
Washington, D.C. 20500

Dear Mr. President:

Several Governors have expressed concern about a position taken by the Department of Justice against state revenue systems which incorporate the unitary tax method. In view of the serious nature of their concern, I am writing, as chairman of the committee of the National Governors' Association with jurisdiction over the issue, to ask for a review of the Department's action.

Chicago Bridge & Iron Company vs. Caterpillar Tractor Co., et al (Docket Number 81-349) is currently before the Supreme Court of the United States on appeal from the Illinois Supreme Court, which upheld Caterpillar's right to report its income for state tax purposes on a unitary accounting basis. The Department of Justice has recently filed an *amicus curiae* brief in this case against the states' ability to tax on a unitary basis. We believe that the Department's intervention is unnecessary and constitutes a serious federal infringement of the power of the states to tax as they choose.

For some time, the Governors have been concerned about federal restrictions on traditional state functions. In August 1980, the National Governors' Association adopted policy stating that "the principle of avoiding preemption by the federal government in areas of primary state responsibility is applicable across the board. . ." Clearly state taxation of our own citizens is such an area. Last fall, the Western Governors' Policy Office urged your Administration to oppose legislative restrictions on the unitary method (S. 655/H.R. 1983), pointing out that they "would be inconsistent with efforts to sort out responsibilities and with the New Federalism."

If they prevail, the Department of Justice's position in the *Chicago Bridge & Iron* case and the proposed legislative restrictions will cause serious damage to our mutual efforts to restore balance to the federal system and to protect traditional state tax sources. In the short run, the legislation will cost 33 states a minimum of $709

million. In the years to come, all states would lose an important part of their ability to set their own fiscal policies.

We know that you are deeply committed to strengthening the state role in the federal system. We believe that the brief filed by the Department of Justice in this case and the proposed federal legislation are at substantial variance with your commitment. Accordingly, we respectfully request that this brief be withdrawn and that your Administration oppose S. 655 and H.R. 1983. Thank you for your consideration of our concerns.

Sincerely,

/s/ Lamar Alexander
GOVERNOR LAMAR ALEXANDER
Chairman, Committee on Executive Management and Fiscal Affairs

NATIONAL GOVERNORS' ASSOCIATION

August 3, 1982

The President
The White House
Washington, D.C. 20500

Dear Mr. President:

It is our understanding that the Cabinet Council on Economic Affairs will be meeting on Thursday, August 5 to discuss the Administration's position on state utilization of the "unitary apportionment method" of taxation of multinational corporations. Governor Lamar Alexander, on behalf of the National Governors' Association, wrote to you on February 25, 1982 on this matter. At that time he requested that you join the National Governors' Association in opposing two pending Congressional bills, S. 655 and H.R. 1983, that would restrict states' ability to tax multinational corporations and that you have the Department of Justice withdraw the *amicus curiae* brief it filed in the case of *Chicago Bridge and Iron Company v. Caterpillar Tractor Company, et al.*, still pending before the Supreme Court of the United States.

I would like to reiterate the concerns expressed in Governor Alexander's letter. At a time when the states are being asked to assume significantly expanded responsibilities under New Federalism, we need access to appropriate revenue sources.

In our opinion the Constitutional question concerning the use of the "unitary apportionment method" of state taxation of multinational corporations and the taxation of intracorporate dividends is more a question of federalism than foreign commerce. Certainly one power reserved to the states under the Tenth Amendment is the power to design a fair tax system. Absolutely integral to the functioning of a state government is its ability to raise revenues and provide incentives for economic development.

In utilizing the "unitary apportionment method", twenty-two states include domestic subsidiaries in their definition of a unitary business, and twelve states include foreign subsidiaries in that definition. These latter referenced twelve states have estimated that a prohibition on the inclusion of foreign subsidiaries would result in a loss of state revenues of not less than $600 million. For the thirty-eight states which do not include foreign-based

subsidiaries in their definition of the taxable corporation, the omission has been used as a state inducement for economic investment and development by foreign corporations. It is the position of the National Governors' Association that states should continue to have the choice to include foreign subsidiaries within their definition of unitary corporation in utilization of the "unitary method of apportionment" on a world-wide basis.

When the National Governors' Association meets in Oklahoma next week, it will be considering a revision to an extant policy position in order to address more directly the question of federal preemption of state revenue systems. One reason for the proposed policy revision is the controversy over state taxation of multinational corporations. The Committee on Executive Management and Fiscal Affairs chaired by Governor Alexander, with the support of the Committee on Community and Economic Development chaired by Governor Bond, has proposed the following amendment to policy position B.-5 entitled "Avoiding Federal Preemption of State Laws and Policies":

> Integral to the operation of state government is the freedom to structure state revenue systems. It is essential that the federal government not preempt, either directly or indirectly, sources of state revenues, state tax bases or state taxation methods.

In light of the above discussion, we respectfully ask that you support a position which will permit states to: a) utilize the "unitary method of apportionment" with regard to multinational corporations which have foreign subsidiaries, and b) tax intracorporate dividends of multinational corporations.

Thank you for your attention to this matter.

Sincerely,

/s/ Richard A. Snelling
GOVERNOR RICHARD A. SNELLING

cc: Secretary Donald T. Regan, Chairman pro tempore
Cabinet Council on Economic Affairs

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