

THE NEED FOR A UNIFORM UNITED STATES SEPARATE ACCOUNTING POLICY: THE AFTER EFFECTS OF THE BARCLAYS BANK CASE AND HOW IT HINDERS INTERNATIONAL BUSINESS TRANSACTIONS

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I. Introduction

As the world begins the twenty-first century, advancements in technology and communications have caused the corporate sector to evolve constantly, resulting in the increased globalization of the marketplace. Through mergers, acquisitions and other types of transactions, a plethora of multinational corporations have emerged in the corporate arena. In order for these multinational corporations to maintain their presence in several countries, the corporations must comply with each country's laws and regulations.

While there have been numerous areas in corporate affairs in which a majority of countries have agreed regarding regulation, one topic that has been at the center of a heated global debate is international accounting methods. The accounting methods of a corporation dictate disclosure materials, such as the balance sheet, income statement and cash flow statement, and determine the amount of taxes owed to certain jurisdictions. Under the latter area of concern, corporations that maintain subsidiaries and earn income in multiple countries are subject to certain taxes in various jurisdictions.

One common form of taxation is the income tax. Most jurisdictions seek to obtain funds, in the form of an income tax, from companies who conduct business within their borders. Considering the vast growth of companies on an international scale, companies may be subject to income taxation from several different countries. Hence, it is optimal to the global business world to have similar accounting systems in the countries within which they are subject to income taxation.

Since most countries encourage economic growth, the countries in the global market should work together to make it easier and more cost-effective for companies to expand across borders. However, the United States has maintained an adverse position that poses a serious threat to the future of global expansion and has placed itself as the potential subject of retaliatory measures from the majority of countries across the globe.

The accounting measures in question concern the separate accounting method and the worldwide combined reporting method (hereinafter "WWCR"). Almost all countries use the separate accounting method with regard to income taxation of companies. However, some states within the United States have enacted statutes calling for the WWCR to be utilized in income taxation. Opponents of the WWCR contend that this method of accounting for income taxes substantially increases the risk of multiple taxation and produces

discriminatory effects on foreign-owned multinational corporations. This debate has caused a series of objections from several countries, resulting in the issue being taken to the United States Supreme Court in 1994 in *Barclays Bank PLC v. Franchise Tax Board of California*¹ (hereinafter "*Barclays*").

In *Barclays*, the Court held that the state of California could legally tax the income of foreign corporations under the WWCR method.² A multitude of countries voiced their dissent with the United States' position on WWCR and made several threats of retaliatory measures in response to usage of the WWCR by the US. Any of the suggested measures could seriously hinder international business within the US and abroad. In response to these declarations, California modified its income tax position through Senate Bill 671,³ but has allowed itself the opportunity to re-enact WWCR at its discretion. In addition, Congress has refused to offer its guidance on this matter and remains silent. Therefore, countries outside the United States view its position on WWCR as adverse to international business and in opposition to the globalization of the world's economy.

This article discusses the debate surrounding the international accounting methods for income taxation. It presents the argument that the United State's refusal to take a direct and solid stance on this issue has caused serious injury to the international business markets and will continue to do so in the future. This article concludes that in order for the United States to be in full cooperation with the global marketplace and in order to protect the interests of all domestic and foreign corporations, it is imperative that Congress pass legislation rebutting WWCR.

Section II of this article discusses the differences between the separate accounting and WWCR methods. Section III presents the usage history of both methods. Section IV outlines the United States Supreme Court's decision in *Barclays*. Section V analyzes the errors in the *Barclays* decision and the serious nature of the Court's oversights. Section VI argues that the United States must take a firm position against WWCR. Section VII concludes with a demand for the new federal legislation on WWCR.

II. *Separate Accounting Versus WWCR*

The majority of countries in the world use the separate accounting method for measuring income tax liability. The United States has both federal and state income taxes, thereby allowing individual states to choose which accounting

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¹ 512 U.S. 298 (1994).

² *Id.* at 330-31.

³ See S. B. 671 1993 Leg., Reg. Sess. (Cal. 1993).

method to utilize for state income taxes. In the past, some states have chosen to use the WWCR method. There are important and sometimes drastic differences in these methods, which warrant further examination into the basics of separate accounting and WWCR.

A. Separate Accounting

The separate accounting method treats each corporate entity as an individual entity separate from all related entities in other jurisdictions when measuring the income tax liability of that entity. This method taxes entities operating within the taxing body's jurisdiction only on the income recognized on their own books.⁴ Basically, separate accounting is a "technique of carving out of the overall business of the taxpayer, the activities taking place, the property employed in, and the income derived from, sources within a single State, and by accounting analysis ascertaining the profits attributable to that portion of the business."⁵

Under the separate accounting method, "a foreign corporation. . .only reports income sufficiently connected with the entity's engagement of a United States trade or business and income derived from a United States source."⁶ Hence, subsidiaries of corporations are treated as separate companies and not as parts of a whole. Each subsidiary files its own income tax statement and computes its income tax liability according to its own book records from its (the subsidiary's) accounts. There is no accumulation of all the subsidiaries and the parent corporation under the separate accounting method.

B. WWCR

The WWCR is different from the separate accounting method in that it centers around the unitary business. According to this method, a business is defined as unitary if it exhibits "functional integration, centralization of management, and economies of scale."⁷ Essentially, if the operational part of the "business [performed] within the state is dependent on or contributes to the operation of the business without the state, [then] the operations are unitary."⁸

A complete examination of all the entities determines which entities are part of the unitary business. Under this method, subsidiaries of parent corporations and related entities are usually found to all belong to the unitary business. Hence, all the subsidiaries are combined with one another and with the parent, regardless of their separate locations, to form one large unitary business. For example, if a business is a subsidiary of a larger business and is located in a

⁴ Raymond G. Russell, Note, *Is a State's Taxation of Foreign Corporations Constitutionally Limited to U.S. Water's Edge: Application of Worldwide Combined Reporting*, 16 MISS. C. L. REV. 247, 249 (1995).

⁵ *Id.*; see generally JEROME R. HELLERSTEIN & WALTER HELLERSTEIN, STATE TAXATION: CORPORATE INCOME AND FRANCHISE TAXES (2d ed. 1993).

⁶ Russell, *supra* note 4.

⁷ *Allied Signal, Inc. v. Director, Division of Tax'n*, 504 U.S. 768, 781 (1992).

⁸ *Edison California Stores, Inc. v. McColgan*, 183 P.2d 16, 21 (Cal. 1947).

WWCR state, that business will likely be found to be part of a unitary business and that business along with all the others, within and without that state, which comprise the entire unitary business are subject to income taxation from that state.

Once the unitary business has been established, the taxing jurisdiction applies a formula which apportions the income of that unitary business within and outside of that jurisdiction.⁹ This formula is commonly known as the "three-factor" formula because it focuses primarily on the payroll, property and sales of the unitary business that are present in the taxing jurisdiction. The jurisdiction then taxes the income of all the entities comprising the worldwide unitary business based on a percentage derived from the three-factor formula.¹⁰

Under the WWCR, information from all of the entities included in the unitary business must be gathered and collaborated, regardless of country of origin, language or currency. Hence, WWCR requires the interpretation of varying foreign languages, currencies and bookkeeping methods into one composite. Considering the potential for a unitary business to be formulated by a multitude of entities, there can be an overwhelming amount of information required in order to satisfy WWCR regulations.

III. Usage History of Accounting Methods

Throughout the history of the corporate entity and accounting, the separate accounting method has been the method of choice. When the corporation income tax first developed in the United States, "separate accounting... was regarded as the most precise and accurate method of determining income derived from various States."¹¹ Separate accounting allowed various corporate entities, which were considered distinct and individual, to be taxed separately. This resulted in subsidiaries or other corporate entities, which had a parent corporation in another state or nation, being taxed solely on their own income and not based on income related to the parent corporation or other entities. The United States encourages the separate accounting method in its Internal Revenue Code.¹²

Countries outside the United States have also embraced the separate accounting method for calculating income taxes. After World War II, the Organization for Economic Co-operation and Development (hereinafter "OECD") and the United Nations ("U.N.") incorporated separate accounting into model bilateral treaties which have been implemented in thousands of agreements.¹³

⁹ See Russell, *supra* note 4, at 250.

¹⁰ See *id.* at 251.

¹¹ Chantal Thomas, *Customary International Law and State Taxation of Corporate Income: The Case for the Separate Accounting Method*, 14 BERKELEY J. INT'L L. 99, 102 (1996) (referring to NATIONAL TAX ASSOCIATION, *Report of Committee on the Apportionment Between State of Taxes on Mercantile and Manufacturing Business*, 1922 NAT'L TAX ASS'N PROCEEDINGS 198, 214-15).

¹² *Id.* at 104; see 26 U.S.C. §1.482-1(b).

¹³ Thomas, *supra* note 11, at 104.

However, within the United States, opposition to the separate accounting method has surfaced. The main criticism of the separate accounting method is that it cannot effectively measure transfers among various corporations that are part of the same enterprise. Since an item that is transferred from one corporate entity to another is not technically sold on the open market, the corporate entities must report the fair market value of the transfer. "The transfer between a parent company and its subsidiary must be treated as an arm's-length transaction, and a dollar value must be assigned" to the transfer.¹⁴ Some feel that the separate accounting method is inadequate in assuring the true fair market value of transfers between entities, and that various corporate entities will manipulate the system by making transfers which may not produce positive outcomes for separate entities but are overall beneficial to the entire corporate base. This manipulation may result in disguised transfers, which should be subject to a higher tax, or transfers which deliberately deface the jurisdiction's taxing institution.

Objectors to the separate accounting method fear that as part of tax planning, "companies [will] avail themselves of tax savings . . . by locating their services, production, or other facilities in regions with more favorable tax systems."¹⁵ It is a major goal of companies to minimize the amount of tax liability for all entities, and transfers provide a method by which to achieve this goal. One way of performing this function is "when the pricing of goods, services and intangibles or other elements is artificially increased or decreased in order to shift income and/or expenses between entities" through transfers.¹⁶

California has been the main objector to the separate accounting method and initiated the movement towards WWCR. California began to move away from separate accounting and toward WWCR in the 1930s. California produced a combined reporting method, "which enabled it to cross traditional corporate boundaries and add out-of-state distribution income to the in-state income to create a combined tax base. [It] then applied apportionment . . . to determine the amount of the combined income attributable to California."¹⁷ Hence the emergence of WWCR. As time progressed, California and other states adopted WWCR for myriad of income taxation situations, including related corporations and foreign entities. In the early 1970s, California instituted WWCR as the rule for all corporate income taxation.¹⁸

The majority of nations in the world have voiced outrage over California's use of WWCR. Considering California's large geographical size and prime location, it is likely that it has more potential profitability than many smaller countries across the globe. Therefore, a multitude of nations have a vested

¹⁴ Robin Sabransky, Note, *Barclays Bank PLC v. Franchise Tax Board: California's Taxation of Foreign-Based Multinational Corporations*, 31 CAL. W. L. REV. 317, 319 (1995).

¹⁵ Pamela L. Kayfetz & Leo B. Helzel, *Transfer Pricing: Achieving Fair National Taxation of International Transactions*, 3 ANN. SURV. INT'L & COMP. L. 193, 194 (1996).

¹⁶ *Id.* at 194-95.

¹⁷ Douglas S. Pelley, Note, *Victory for a World Pariah: Analysis and Criticism of Barclays Bank v. Franchise Tax Board of California*, 29 CORNELL INT'L L.J. 607, 610 (1996).

¹⁸ *Id.*

interest in the regulation of foreign business conducted in California.

WWCR poses two main threats to these foreign countries. One, through the apportionment method and unitary business collaboration, foreign-owned corporations with subsidiaries in a WWCR jurisdiction are increasingly subject to double taxation. This is due to the taking of the unitary business under WWCR, which is comprised of entities both within and outside of the WWCR jurisdiction.

Those entities outside of the WWCR jurisdiction are also subject to income taxation by the governments of the jurisdictions in which they are located. Therefore, not only does a WWCR jurisdiction tax the income of the company located in the WWCR nation, but also the income of its related unitary business entities which are located all over the globe and which may have no ties to the WWCR jurisdiction.

The other major downfall of WWCR is that it is only used within certain jurisdictions within the United States. Considering the fact that all other nations utilize the separate accounting method, WWCR legislation requires a country to conform and translate all of its records into a new accounting system. This can be financially burdensome and time consuming.

Realizing the potential harm from WWCR, various foreign governments have directed their complaints at and to the entire United States. In 1980, the United Kingdom (hereinafter "U.K.") and the European Union (hereinafter "EU") urged the United States government to pass legislation ending WWCR.¹⁹ In 1982 Canada voiced its complaints to the United States Department of State and declared that "WWCR results in inequitable taxation and imposes excessive administrative burdens on international companies doing business in those [unitary method] states."²⁰ Other countries, many of which are United States allies in other international affairs, have expressed opposition to the United States views on WWCR. Among them are Greece, Japan, Australia, Switzerland, Germany, Italy, and Belgium.²¹

Several nations proclaimed not only their dislike of WWCR, but also released promises of retaliatory measures against the entire United States, if the issue was not resolved. Both the U.K. and the EU both declared that if California did not abandon WWCR but rather continued its use, there would be no other choice than to take retaliatory measures against American companies.²²

As foreign disapproval of the WWCR grew rapidly and with the increased attention on the *Barclays* case, California slightly altered its position on WWCR. On October 6, 1993, California Senate Bill 671 was enacted permitting multinational corporations to freely elect the water's edge method in lieu of

¹⁹ *Id.* at 616 (referring to Diplomatic Note, Italy-U.S., Mar. 19, 1980; Diplomatic Note, U.K.-U.S., No. 51, Mar. 25, 1980).

²⁰ *Id.* at 617 (quoting Diplomatic Note, Canada-U.S., No. 283, June 14, 1982).

²¹ *Id.* at 617-18 (referring to Diplomatic Note, Greece-U.S., Aug. 1, 1983; Diplomatic Note, Japan-U.S., Aug. 11, 1983; Diplomatic Note, Switzerland-U.S., No. 461.20, Nov. 15, 1983; Diplomatic Note, Germany-U.S., Nov. 18, 1983; Diplomatic Note, Belgium-U.S., Jan. 25, 1984).

²² Pelley, *supra* note 17, at 620-21.

WWCR when calculating income tax liability.²³ However, this type of water's edge method differs from the traditional form. In most instances, the water's edge method acts more like separate accounting in that it treats separate corporate entities as independent of each other and not as a unitary business. Hence the reach of state corporate income tax is strictly limited to income within the United States boundary related to that particular entity. Under California's water's edge method, a unitary group is still established, like under WWCR, to include specified affiliate entities with defined relationships to the United States.²⁴

California's revised version of the water's edge method has still met resistance with other nations. Congress has refused to pass legislation banning the use of WWCR in the United States. Therefore, because Congress is silent on the issue, WWCR is still a viable and legal option for any state. This angers and worries foreign countries with subsidiaries in the United States. It has been speculated that California only changed its position on WWCR in order to preserve WWCR's status as a legal option should it choose to enact it again.²⁵

Therefore California's water edge election may not have been merely a bowing to international pressure to solve the crisis, but rather a strategic move by California to preserve its state court victory in the case at the center of this debate, *Barclays*.²⁶

IV. The Barclays Case

Barclays involved two international corporations who sued the Franchise Tax Board of California for a refund on their 1977 income taxes due to over and multiple taxation under WWCR. The spotlight of this case rests on the Barclays Group, a multinational banking enterprise incorporated in the United Kingdom²⁷

Two subsidiaries of the Barclays Group, Barclays Bank of California (hereinafter "Barcal") and Barclays Bank International (hereinafter "BBI"), conducted business in the state of California and were thus subject to income taxation under the WWCR.

For the 1977 tax year, Barcal reported only the income from its own operations because it did not believe that it was part of any unitary business. BBI reported income on the assumption that it participated in a unitary business composed of itself and its subsidiaries, but not of its parent corporation, the Barclays Group, or the other subsidiaries of the Barclays Group.²⁸ BBI was a U.K. corporation which conducted business in over thirty-four nations.

The Franchise Tax Board audited both Barcal and BBI and concluded that both were part of a worldwide unitary business, the Barclays Group, and assessed an additional tax liability for 1977 at over US\$154,000.²⁹ After paying

²³ S.B. 671..

²⁴ *Id.*; Pelley, *supra* note 17, at 619-20; see CAL. REV. & TAX. CODE § 25110(a)(1)-(7).

²⁵ Pelley, *supra* note 17, at 621.

²⁶ *Id.*

²⁷ *Barclays*, 512 U.S. at 302.

²⁸ *Id.* at 307.

²⁹ *Id.*

the additional taxes, the Barclays Group sued the Franchise Tax Board of California for a refund.

The Barclays Group claimed that through the use of WWCR, California violated the Dormant Commerce and Due Process Clauses of the United States Constitution as well as discriminated against foreign-based multinational corporations because it increased their risk of multiple taxation and required burdensome hardships in order to be in compliance.³⁰ In the California Superior Court, the Barclays Group prevailed on its Commerce Clause claim, thus invalidating California's use of WWCR for determining income tax liabilities of foreign-owned multinational corporations.³¹

The California Court of Appeals held that the application of WWCR to a non-U.S. parent multinational corporation posed a significant threat to the United States international commercial interests and violated the one voice test.³² After "examining the international ramifications of WWCR," the Court of Appeals found that WWCR had offended United States trading partners and had created a danger of retaliation against U.S. businesses.³³

The California Supreme Court reversed the Court of Appeals decision and held that there was a heightened sensitivity to congressional pronouncements on external policy issues.³⁴ Since Congress had failed to pass legislation that would curtail the states' usage of WWCR, Congress' silence on the issue presents justifiable evidence to the court of its warranted use by states such as California. In light of this congressional conduct, the California Supreme Court concluded that Congress, by negative implication, had affirmatively allowed the states to use WWCR-based taxation.³⁵

Eventually, this case found itself before the United States Supreme Court in 1994 after the California Supreme Court held that WWCR did not impair the federal government's ability to speak with one voice in regulating foreign commerce.³⁶ After examining all issues raised by the parties, the United States Supreme Court concluded that WWCR did not violate the Due Process or Commerce Clauses of the United States Constitution. The Supreme Court further held that WWCR did not produce discriminatory effects on foreign-owned multinational corporations. The Court left the decision as to whether WWCR was

³⁰ See *id.* at 312-13.

³¹ *Barclays Bank Int'l Ltd. v. Franchise Tax Bd.*, Nos. 325059 & 325061 (Super. Ct., Sacramento Cty., Ca. 1990), *aff'd* 275 Cal. Rptr. 626 (Ct. App.), *rev'd*, 829 P.2d 279 (Cal. 1992), *cert. denied*, 113 S.Ct. 202 (1992); see Zain E. Husain, *Barclays Bank PLC v. Franchise Tax Board of California: Does the Application of Worldwide Unitary Taxation to Non-U.S. Parent Corporate Groups Violate the Commerce Clause?*, 18 *FORDHAM INT'L L.J.* 1475, 1505 (1995). For further discussion of the one voice test, see *infra* Section IV(C).

³² *Barclays*, 275 Cal. Rptr. at 637; see Husain, *supra* note 31, at 1507.

³³ *Barclays*, 275 Cal. Rptr. at 637-38; see Husain, *supra* note 31, at 1507.

³⁴ *Barclays*, 829 P.2d 279 at 295; see Husain, *supra* note 31, at 1511.

³⁵ *Barclays*, 829 P.2d at 294; see Husain, *supra* note 31, at 1511.

³⁶ *Barclays*, 829 P.2d at 308.

in the best interest of the country to Congress and felt that it was neither the duty nor the function of the court to act as overseer of the government.³⁷

V. *Errors in the Barclays Case*

One key argument raised by the Barclays Group, as well as voiced by other nations in objection to WWCR, was that WWCR discriminated against foreign-owned multinational companies in two ways: (1) WWCR caused foreign-owned multinational corporations to be subject to an increased likelihood of multiple taxation; and (2) WWCR required a total restructuring of foreign-owned multinational corporations' accounting methods.

A. Multiple Taxation

Although the Court "did not question Barclay's assertion that multinational enterprises with a high proportion of income taxed by jurisdictions with wage taxes, property values, and sales prices lower than California's face[d] a correspondingly high risk of multiple international taxation,"³⁸ it concluded that the Barclay Group did not provide convincing evidence to rule it discriminatory.

The Court reasoned that since multiple taxation was also possible under the separate accounting method, adoption of the separate accounting system did not dispositively lessen the risk of multiple taxation relative to WWCR.³⁹ However, the Court based this analysis on the fact that separate accounting did not eliminate a risk of multiple taxation for domestically-owned multinational corporations being taxed in the United States. The Court assumed the same reasoning for a foreign-owned multinational corporation, such as the Barclays Group, being taxed in the United States.

These are entirely two different scenarios and the Court refused to consider any variation. Considering that the United States has been the only nation to utilize the WWCR, a foreign-owned multinational corporation operates under the separate accounting system. Therefore all of the corporation's income in all the countries where it operates is already subject to a tax based precisely on the amount of income related to each nation. When WWCR governs the tax liability, a unitary business is comprised of all of the affiliates, subsidiaries, and entities of a corporation located all over the world. An aggregate income is then calculated and an apportionment based on an estimated percentage is determined which dictates the tax amount. Hence there is a significant likelihood that the percentage will include income that is already subject to tax in other countries, constituting multiple taxation.

When income of a foreign subsidiary is allocated to a domestic subsidiary, there is multiple and over taxation.⁴⁰ Foreign-based multinational corporations are more likely to have more entities outside the United States than

³⁷ *Id.* at 330-31.

³⁸ *Id.* at 318.

³⁹ *Id.* at 319.

⁴⁰ Sabransky, *supra* note 14, at 329.

a domestically-owned multinational company.⁴¹ The more activity a company engages in outside the United States, the higher the risk of multiple taxation.⁴²

B. Discriminatory Hardships

When foreign-based multinational companies are required to recalculate their income taxes under the WWCR system, they are forced to undertake extreme financial hardships and timely costs, unlike a domestically-owned multinational corporation. Considering that at the time of *Barclays*, the United States had been the only country to require WWCR for income tax calculations, one can conclude that all foreign-based multinational corporations were regulated by separate accounting methods in their home territories as well as in all other nations in which they operate.

The only exception is the United States. Therefore, all of the foreign-based multinational corporations that are subject to tax in states like California, that have WWCR, must recalculate and restructure their entire accounting files in order to determine the unitary business and the apportionment amount. Foreign-owned multinational corporations must file taxes with their home country, the U.S. federal government, and other foreign countries, all of which use separate accounting.⁴³ By imposing WWCR on a foreign-based multinational corporation like the Barclays Group with operations in a multitude of countries, the time and expense in converting the files of a myriad of enterprises from individual separate accounting entities into one unitary business under WWCR can be astronomical. When a foreign company has to convert its diverse financial and accounting records from around the world into the language, currency and accounting principles of the United States, it creates a prohibitive expense on the multinational corporation.⁴⁴

In addition, WWCR assumes that there is an equal rate of return on each dollar of assets. This theory is distorted when collaborating different currencies and attempting to assign monetary value to assets and income in differing countries into one single format, such as the U.S. dollar. When looking solely at the monetary value of a company, a very large foreign corporation can appear to be equal to a small domestic corporation in a state like California, due to the fact that the cost of property in most foreign countries is less than the cost of property in the United States.⁴⁵ Under the WWCR, when foreign property is combined and treated as if it were owned in the United States, penalization occurs for geographic locations and aggregate values are distorted.⁴⁶ Therefore WWCR is basically unable to provide an accurate account of a unitary business' value, worth and income, which it then taxes.

By contrast, a domestically-owned multinational corporation in the

⁴¹ Pelley, *supra* note 17, at 623.

⁴² Sabransky, *supra* note 14, at 328.

⁴³ *Id.* at 327.

⁴⁴ Barclays; Sabransky, *see supra* note 14, at 326.

⁴⁵ Sabransky, *supra* note 14, at 328.

⁴⁶ *Id.*

United States already keeps most of its records in English, U.S. currency and under the U.S. accounting principles.⁴⁷ The majority of its assets are parred to the U.S. dollar for return on assets and property value. Domestically-owned multinational corporations are less likely to have a unitary business comprised of as many foreign entities as a foreign-owned multinational company. The domestically-owned companies have substantially less burden and a significantly lower cost to incur in calculating tax liability.

These advantages afforded to domestically-owned multinational corporations over foreign-owned under WWCR equate to discrimination against foreign owned multinational corporations. The United States Supreme Court erred when it failed to adequately examine the differences between foreign and domestic ownership and should not have made the assumptions that results for one are automatically true for the other.

C. The Foreign Commerce Clause

Barclays was not the first case to raise the issue of Foreign Commerce Clause violations with regard to taxation of multinational companies. *Japan Line Ltd. v. County of L.A.* (hereinafter "*Japan Line*") established a two prong test for applying the Foreign Commerce Clause with regards to a state tax scheme.⁴⁸ To violate the Foreign Commerce Clause, the state tax in question must either "create a substantial risk of international multiple taxation . . . or prevent the federal government from speaking with one voice when regulating commercial relations with foreign governments."⁴⁹

Both elements of the *Japan Line* test have been proven in the *Barclays* case. WWCR taxes the income of an entire corporate group, which is comprised of all parents, subsidiaries and other entities. The more parts of that unitary business that are located outside of the United States, the more likely the income of the unitary business will include funds that are not related to the company's business in the United States and should not be subject to taxation by any U.S. government. In addition, all of the funds of the entities of the unitary business located outside of the United States are regulated by separate accounting and are liable for taxes from the various nations in which they reside. If any of these incomes which are taxed by other countries are also taxed under WWCR, multiple taxation occurs. Therefore, a foreign-owned multinational operation, which is likely to have more non-U.S. entities than a domestic-owned one, is at an extremely high risk of multiple taxation under the WWCR.

In addition, when any state, such as California, enacts WWCR as the accounting method for state income taxation, the federal government is prevented from speaking with one voice (hereinafter "the one voice test"). The U.S. federal government upholds the separate accounting method in its Internal Revenue

⁴⁷ *Id.*

⁴⁸ *Japan Line Ltd. v. County of L.A.*, 441 U.S. 434, 451 (1979); Pelley, *supra* note 17, at 612.

⁴⁹ *Japan Line*, 441 U.S. at 451-452.

Code.⁵⁰ The OECD and U.N., where the United States is a member, encourage the usage of separate accounting for tax treaties and income tax regulation.⁵¹

When states utilize the WWCR, they directly take a position adverse to that of the federal government and distort the United States foreign policy on accounting methods. Since the difference in calculating tax liability under WWCR and separate accounting can result in drastically different amounts, foreign nations are extremely concerned with the tax liabilities owed to U.S. jurisdictions by their foreign-owned corporations. Other countries are coming to understand that the U.S. government may not have complete control over its political subdivisions with respect to foreign policy.⁵² Hence the usage of WWCR in *Barclays* does not meet the requirements of the one voice test under the *Japan Line* criteria, and should have been found to violate the Foreign Commerce Clause.

In *Barclays*, the Court also looked towards the rule of law in *Container Corp. of America v. Franchise Tax Board* (hereinafter "*Container Corp.*").⁵³ Similar to the facts in *Barclays*, Container was a multinational corporation with foreign subsidiaries that did not include any of the subsidiaries' income on its state income taxes because it did not believe that it was part of a unitary business. Container was audited and the state of California determined that under its state tax regime all of the subsidiaries of Container were considered part of the unitary business and thus it owed more state tax.

The Supreme Court upheld California's use of WWCR as it applies to domestic multinationals and as it results in fair apportionment.⁵⁴ Although Container's income tax liability increased by fourteen percent under WWCR, the Court found the increase not to be grossly disproportionate and concluded the difference to be a result of economies of scale.⁵⁵

When analyzing the issues in *Barclays*, the Court held that since Congress had failed to address the concerns surrounding WWCR that were raised in *Japan Line* and *Container Corp.*, the Federal Government had indeed granted its approval of WWCR, and the Foreign Commerce Clause was not violated through a state's usage of WWCR in income taxation. The Court determined that after these cases, silence by Congress – when it could otherwise have prohibited a state's use of taxation under the WWCR taxing scheme – is implicit to inferring congressional permission for the use of this method; and therefore, federal uniformity is not impaired in an area in which such uniformity is essential.⁵⁶

The Court in *Barclays* erred in its analysis of the Foreign Commerce Clause in relation to *Container Corp.*, and should have found a violation under the

⁵⁰ See 26 C.F.R. §1.482-1(b).

⁵¹ Thomas, *supra* note 11, at 103.

⁵² Keith Highet and George Kahale III, *International Trade-Taxation-Multinational Corporations-Extraterritoriality-Federalism*, 88 AM. J. INT'L L. 766, 768 (1994).

⁵³ *Container Corp. of America v. Franchise Tax Bd.*, 463 U.S.159 (1983).

⁵⁴ *Id.* at 185.

⁵⁵ See *id.* at 184.

⁵⁶ *Id.*

Japan Line two-prong test. WWCR does create an aggravated risk of multiple taxation which implicates foreign policy issues and thus violates the Foreign Commerce Clause.⁵⁷

Barclays can be distinguished from *Container Corp.* The main and most important fact is that the Barclays Group was a foreign-owned multinational corporation, while Container was a domestic-owned multinational corporation. The Court should not have made the quick and easy assumption that the results from taxation on domestic-owned multinational companies are always equivalent to effects on a foreign-owned multinational corporation. First, all foreign-owned multinational corporations are regulated under the separate accounting system.

Only domestic-owned multinationals are in the practice of setting all their accounts in the English language and in United States currency. These American-owned multinational corporations do not have to incur the expense of revising their entire accounting records into these formats on an annual basis. The work and skill required to meet these standards can be outrageously expensive and time consuming.

Also, foreign-owned multinational corporations are likely to have more corporate entities located in other non-American countries. All of these non-American nations also impose an income tax, but at a separate accounting rate.

Therefore, a foreign-owned multinational corporation is exposed to greater expense and an increased likelihood of multiple taxation than a domestically-owned corporation. Because these very elements rest at the heart of *Barclays* claims, it was erroneous for the Court to simply assign the identical cause-and-effect terms for the Barclays Group as it had for Container. The Court underestimated the severity of these factors on foreign-owned corporations.

The Court also should have placed more emphasis on the *Japan Line* one voice test. The one distinguishing fact between *Japan Line* and *Barclays* is that the tax in *Japan Line* involved a state issued property tax, while in *Barclays* it was a state income tax. However, the principles of multiple taxation and discrimination against a foreign-owned multinational corporation remain the same. Therefore the *Japan Line* test should have been applied in the *Barclays* analysis.

When examining the *Japan Line* two-prong one voice test, the Court in *Barclays* proclaimed that because Congress had not passed any legislation concerning the legality of WWCR, there was no clear federal policy of state taxation of foreign multinationals.⁵⁸ The Court then reasoned that if there was no stated federal policy, there could be no violation by states' actions. The Court also reasoned that Congress' silence on WWCR had given it approval, and there could not be an impairment of federal uniformity.⁵⁹

The Supreme Court's decision in *Barclays* demonstrates the Court's growing discomfort with foreign affairs and its unwillingness to thoroughly tackle

⁵⁷ See Pelley, *supra* note 17, at 627.

⁵⁸ *Barclays*, 512 U.S. at 322 ("Congress has long debated, but has not enacted, legislation designed to regulate state taxation of income.") (citing *Container Corp. of America v. Franchise Tax Bd.*, 463 U.S. 159, 196-97 (1983)).

⁵⁹ See *id.* at 323.

the complex issues related to international business. Due to its ambivalence, the Court deviated from the appropriate Foreign Commerce Clause analysis and produced a decision that has enraged the global marketplace in which the United States strives to be a key player. Unfortunately, "where the context is international, the Court now predictably assumes a position of least resistance, tending to ratify results brought to it by the political dynamic rather than injecting itself as a significant player in the area."⁶⁰

VI. *The Need For a Uniform United States Position Against WWCR*

In *Barclays*, the Supreme Court ultimately left the decision to legislate WWCR to Congress.⁶¹ The Court found that Congress had implicitly approved the WWCR method by its failure to pass a bill against state use of it.⁶² Therefore, since Congress had spoken on the issue, according to the Court, it was not the place of the Court to question Congress. Congress has failed to pass any legislation or approve any treaty with any relation to restricting or abolishing WWCR.

Although straightforward, WWCR is no longer pronounced by states in the United States. The resistance of the United States to appropriately address and finalize the dilemma continues to hinder international business transactions and leaves the country subject to potential economic harm. California's attempt to silence the issue with its revised water's edge method has not satisfied other nations. The U.K. reluctantly withdrew its immediate threats of retaliatory measures against the United States with the adoption of California's water's edge, and classified it only as "an adequate resolution to the dispute."⁶³

Other key players in the global economy have also voiced their opinions on the issue. The OECD, an international policy-making organization comprised of twenty-five of the world's leading countries including the United States, issued a discussion draft condemning the use of WWCR.⁶⁴ The OECD's report declared that WWCR is "not a realistic approach to the arm's length principle and that any global formulary apportionment should be rejected."⁶⁵ This report was released after the Court reached its decision in *Barclays*.

The entire world has embraced the separate accounting method as the system of choice when regulating taxation of corporate entities. The international consensus on the separate accounting principle is that it has an overwhelming advantage over WWCR. Thus the accepted international framework of corporate income tax on multinationals is the separate accounting method.⁶⁶

⁶⁰ Highet, *supra* note 52, at 768.

⁶¹ *Barclays*, 512 U.S. at 330-31 (where the Court states that the judiciary is not the overseer of the government . . . "we leave it to Congress . . . to evaluate whether the national interest is best served by tax uniformity, or state autonomy.").

⁶² See Pelley, *supra* note 17, at 630; see also *Barclays*, 512 U.S. at 324-25.

⁶³ See Pelley, *supra* note 17, at 625-26.

⁶⁴ See *id.* at 626.

⁶⁵ *Id.*

⁶⁶ *Id.* at 629.

Although some states, such as California, have altered certain tax policies and positions on WWCR, the *Barclays* case and Congress' silence have left the issue unresolved. Under current conditions, WWCR could be re-instituted at any time in the United States. The door remains "open for a cash-strapped state to adopt a unitary system to fill the state's coffers at the expense of foreign multinationals after the international furor [over *Barclays*] dissipates."⁶⁷ Thus as the economy becomes increasingly globalized and companies find themselves expanding into new territories and jurisdictions, the international community is still concerned with WWCR and unhappy with the unwillingness of the United States to take a firm anti-WWCR position.

A plethora of nations threatened to take retaliatory measures against the United States due to California's application of WWCR. These objections were mainly made throughout the 1980s, while the United States enjoyed a position of world dominance and security against most countries. During this time the United States listened to the demands and positions of foreign nations and threats of potential retaliation, but took a relaxed attitude in addressing these nations.

The United States can no longer afford to take an ambivalent approach to threats of retaliation from other countries that could result in serious financial hardships. "Targeted retaliation, nonetheless, is at best an emerging phenomenon, and there will likely always be situations in which other countries will see a strategic advantage to acting against the United States as a whole."⁶⁸ Recent trends in global policy have proven foreign nations, especially in the EU, are not averse to the notion of joining forces and taking economic measures against the United States. For example, member nations of the WTO continue to debate over U.S. policies on trade, especially with respect to food products. The countries of the EU have not only made retaliatory threats, but they have also carried them out despite objections from the WTO. It would be logical to conclude the possibility exists for similar allegiances against the United States when billions of dollars are at stake, such as with the WWCR debate. Retaliatory measures are no longer distant possibilities, but rather have developed into innovative strategies with countries eager and willing to put them into effect.

Due to the exponential growth of the corporate world, international business will continue to be subject to multiple jurisdictions. Since no single court can prevent double taxation in the global sphere, it can only be avoided by following the method chosen by the majority of nations.⁶⁹ The United States is the only nation that permits the use of WWCR; all other nations follow the separate accounting method. It is clear that the separate accounting method is utilized by an overwhelming majority of countries worldwide. Even the federal government endorses it with regards to federal income taxation.

It is hypocritical for the U.S. federal government to continue to resist restricting and abolishing the institution of WWCR in the United States.

⁶⁷ *Id.* at 626.

⁶⁸ Highet, *supra* note 52, at 769.

⁶⁹ Pelley, *supra* note 17, at 629.

Regardless of the sanctity of state sovereignty and governance, the various jurisdictions of the United States have disturbed the working relationship between the United States and its foreign counterparts. State and local governments in the United States have assumed an increasing prominence at the international level, and the federal government is doing very little to control them.⁷⁰ The United States cannot afford to dismiss the declarations of retaliation against it by foreign nations with regards to the WWCR. There is fear and anxiety among nations that unless the United States takes affirmative measures to prohibit the re-institution of WWCR, its resurface in the international business scene can be anticipated.

One major consequence of the unwillingness by the United States to take a solid position on WWCR has been "the reluctance of several countries to establish tax treaties with the United States, because it seemed irrational to make a tax treaty with a nation which will contract to some of its [the treaty's] major taxes but not as to others."⁷¹ Therefore the effects of the United States resistance to meet the demands of the international business community have already hindered international business relations and will continue to do so until the United States takes action.

With new multinational corporations emerging on a daily basis, foreign countries and their corporations cannot afford to wait for another *Barclays* to force the United States to take their objections to international business policies seriously. In order to stay on amicable working terms with the global business environment, the United States must actively address the separate accounting and WWCR issue. Congress should terminate its reluctance to perform its elected duties and lead the United States into a position of cooperative international business law by passing legislation to refute the availability of WWCR to all taxing authorities in the country. Only then will the barriers associated with multiple taxation, as well as the severe monetary burdens on foreign-owned multinationals, be erased and WWCR's obstacles to international business transactions be eliminated.

VII. Conclusion

Although it has been several years since the *Barclays* decision, the implications of this case should not be forgotten or its effects overlooked in today's marketplace. As companies in the United States seek to enter new ventures abroad, the pressure to cooperate with foreign standards will increase. In addition, the United States will become more dependent on amicable working relationships with other nations in order to foster international business and economic growth.

While detailed international accounting methods vary among individual nations, the separate accounting systems are almost universe around the globe for its use to calculate income tax liability. However, the United States still refuses

⁷⁰ Highet, *supra* note 52, at 768.

⁷¹ Thomas, *supra* note 11, at n.51 (quoting Philip T. Kaplan, *Reasons, Old and New, for the Erosion of United States Tax Treaties*, 1986 BRIT. TAX REV. 211, 219).

to take a firm position against the usage of WWCR or to assure that it will not reappear in the future. Although *Barclays* may be over, and even if California has altered its classification of state income taxation system, the world continues to keep a watchful eye on the tax policies of the United States.

By deliberately disturbing the equilibrium established by other countries, the United States jeopardizes the ability of all multinational corporations to enter into international business transactions. The United States should not classify the objections of other countries regarding its position on WWCR as idle threats, and should seriously consider the retaliatory measures recounted by foreign nations as actual, possible future events. There is no reason to believe that these foreign countries will not carry out these retaliations if their demands are not met, and with the growing dependence on a global marketplace the consequences of these measure could be devastating to the United States' ability to conduct international business.

Congress consistently drags its feet with regards to passing any form of legislation terminating the possibility of the re-institution of WWCR and thus alleviating the concerns of and increasing working relationships with foreign countries. It is the duty of Congress to protect the interest of its citizens, one of which is the ability to conduct and exchange business in a free marketplace. Therefore Congress must answer the call of the global market players and support the U.S. position in multinational business by passing legislation in response to *Barclays* which prohibits WWCR as a taxing method and delegate the separate account method as the policy of the United States.