# *BARCLAYS BANK V. FRANCHISE TAX BOARD OF CALIFORNIA*: WORLDWIDE COMBINED REPORTING SURVIVES FOR STATE TAXATION OF MULTINATIONAL ENTERPRISES

The Barclays Group is a multinational banking enterprise[1] that includes more than 220 corporations doing business in some sixty nations.[2] The Barclays Bank PLC (Barclays) is a U.K. corporation within the Barclays Group, and is a successor-in-interest to the tax refund claims of two members of the Barclays corporate family:[3] Barclays Bank International Limited (BBI), and its wholly-owned subsidiary, Barclays Bank of California (Barcal).[4] In 1977, Barcal and BBI conducted business in California, and thus were subject to a California tax called the corporate franchise income tax. This tax determined the taxable state income of a given unitary multinational enterprise which conducts business within the state by means of a worldwide combined reporting formula.[5] This formula calculates the total worldwide income of the enterprise.[6] Part of this worldwide income is then apportioned to the enterprise's California operations,[7]

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1. Barclays Bank v. Franchise Tax Bd., ___ U.S. ___, 114 S. Ct. 2268, 2271 (1994).
2. *Id.* at 2274.
3. *Id.* at 2275, n.5.
4. *Id.* at 2274.
5. *Id.* at 2271. *See* CAL. REV. & TAX. CODE ANN. § 25128 (West 1992). Under the unitary business formula apportionment method, the taxing jurisdiction determines the scope of the enterprise for tax purposes and then apportions the total income of the enterprise between the taxing jurisdiction and the rest of the world. Container Corp. v. Franchise Tax Bd., 463 U.S. 159, 165 (1983). The formula used to make the apportionment takes account of objective measures of the activities of the multinational within and without the taxing jurisdiction, usually the payroll, property, and sales in the respective jurisdictions. *Id.* at 165, 170.

   In applying its apportionment formula prior to the mid-1980s, California utilized worldwide combined reporting, under which a multinational was to determine the total income of the overall enterprise, and then apportion a percentage of that income to its in-state operations. CAL. REV. & TAX. CODE ANN. § 25128. In 1986, California modified the franchise tax by allowing corporations to elect a "water's-edge" approach to combined reporting. *Id.* § 25110. However, the Tax Board was permitted to disregard such an election under certain circumstances and even if the "water's-edge" approach was allowed, a substantial fee had to be paid. *Id.* In 1993, the tax was modified to remove the fee requirement, and to remove the discretion of the Tax Board. *See* CAL. REV. & TAX. CODE ANN. § 25110 (West Supp. 1994).

   This percentage equaled the average of the percentages of the enterprise's payroll, property, and sales which existed in California. *Id.* at § 25128.
6. *See Barclays Bank*, 114 S. Ct. at 2271.
7. *Id.* at 2271-72.

resulting in the amount subject to California taxation. In 1977, Barcal only reported income from its own operation, and BBI reported income from the unitary business composed of only itself and its subsidiaries, failing to include income from its parent corporation and its parent's other subsidiaries.[8] The California Franchise Tax Board (Tax Board) first determined that Barcal and BBI were parts of a worldwide unitary business, and then calculated their taxes using the worldwide combined reporting formula. As a result, both Barcal and BBI were found to have additional tax liabilities.[9] Barcal and BBI paid these taxes, but then filed suit against the Tax Board for a refund.[10] The California Supreme Court ruled that the state's use of worldwide combined reporting did not impair the federal government's ability to uniformly regulate foreign commerce, and remanded the case to the California Court of Appeals to determine whether the tax imposed a compliance burden on foreign-based multinationals, thereby violating the nondiscrimination requirements of the Commerce Clause and the Due Process Clause of the U.S. Constitution.[11] The Court of Appeals ruled against Barclays on this issue and the Supreme Court denied further review.[12]

Worldwide combined reporting was also a contentious issue for the Colgate-Palmolive Company (Colgate), a U.S.-based multinational that conducted business in California and was subject to California's franchise tax.[13] From 1970 to 1973, Colgate reported income on a "water's-edge" basis, asserting that the U.S. Constitution compelled California to limit its unitary business definition to the water's edge of the United States.[14] However, the Tax Board determined that Colgate's taxes should be calculated according to the worldwide combined reporting method, and as a result assessed Colgate with a four-year tax deficiency.[15] Colgate paid the

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8. *Id.* at 2274.
9. *Id.*
10. *Id.*
11. Barclay's Bank Int'l, Ltd. v. Franchise Tax Bd., 829 P.2d 279 (Cal.), *cert. denied,* ___ U.S. ___, 113 S. Ct. 202 (1992).
12. Barclay's Bank Int'l, Ltd. v. Franchise Tax Bd., 14 CAL. RPTR. 2D 537 (Cal. Ct. App. 1992), *review denied.*
13. *Barclays Bank*, 114 S. Ct. at 2271. In addition to its U.S. businesses, Colgate owned approximately 75 corporations that operated entirely outside of the U.S. *Id.* at 2275.
14. *Id.* at 2275. Under this approach, a multinational's reporting group is limited to entities whose individual U.S. presence surpasses a stated threshold. *See id.* at 2273.
15. *Id.*

assessment, but filed suit for a refund. The California Superior Court found for Colgate, holding that the federal government had condemned worldwide combined reporting as impermissibly intrusive on the United States' ability to uniformly regulate foreign commerce.[16] However, the California Court of Appeals reversed, deciding that there was insufficient evidence of federal government opposition to this method.[17] The California Supreme Court vacated and remanded for a refiling of a modified opinion in light of their decision in *Barclay's Bank Int'l*,[18] but the Court of Appeals again ruled against Colgate, and the Supreme Court denied further review.[19] Both Barclays and Colgate then petitioned the U.S. Supreme Court, which granted certiorari in a consolidated action and affirmed the California Court of Appeals, *holding* that neither the Due Process Clause nor the Commerce Clause prohibits the application of worldwide combined reporting in the taxation of foreign or domestic multinational enterprises. *Barclays Bank v. Franchise Tax Bd. of California*, ___ U.S. ___, 114 S. Ct. 2268 (1994).

Under the Commerce Clause, Congress has the express power "[t]o regulate Commerce with foreign Nations, and among the several States."[20] Even when Congress has not legislated to regulate states in a particular field, the negative, or dormant, aspect of the Commerce Clause allows the judiciary to invalidate state legislation "inimical to the national commerce."[21]

In the domestic sphere, the United States Supreme Court held in *Complete Auto Transit*, *Inc. v. Brady*[22] that a state tax on interstate commerce may be upheld under a dormant Commerce Clause analysis "when the tax is applied to an activity with a substantial nexus with the taxing State, is fairly apportioned, does not discriminate against interstate commerce, and is fairly related to the services provided by the State."[23]

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16. *See id.*
17. Colgate-Palmolive Co., Inc. v. Franchise Tax Bd., 284 CAL. RPTR. 780 (Cal. Ct. App. 1991).
18. Colgate-Palmolive Co., Inc. v. Franchise Tax Bd., 831 P.2d 798 (Cal. 1992).
19. Colgate-Palmolive Co., Inc. v. Franchise Tax Bd., 13 CAL. RPTR. 2d 761 (Cal. Ct. App. 1992), *review denied.*
20. U.S. CONST. art. I, § 8, cl. 3.
21. *See* Southern Pac. Co. v. Arizona *ex. rel.* Sullivan, 325 U.S. 761, 769 (1945).
22. 430 U.S. 274 (1977).
23. *Id.* at 279.

In the sphere of foreign commerce, additional considerations apply for Commerce Clause purposes.[24] In *Japan Line, Ltd. v. County of Los Angeles*,[25] the Court held that when a state taxes instrumentalities of foreign commerce, "two additional considerations, beyond those articulated in *Complete Auto*, come into play."[26] The first consideration is the enhanced risk of multiple taxation as a result of differing systems of taxation.[27] Judicial oversight prevents the multiple taxation of domestic instrumentalities, but because instrumentalities of foreign commerce do not enjoy this protection, the Court reasoned that a state tax might be "offensive to the Commerce Clause."[28] The second consideration is uniformity; a state tax "may impair federal uniformity in an area where [such] federal uniformity is essential."[29] The Court, applying what is now referred to as the "one-voice" standard, declared that "'the Federal Government must speak with one voice when regulating commercial relations with foreign governments,'" and a state tax might frustrate the federal government's ability to apply one standard upon particular foreign commerce.[30]

In *Container Corp. v. Franchise Tax Bd.*,[31] the Court held that California's worldwide combined reporting method did not violate the Due Process and Commerce Clauses,[32] even when applied to domestic multinationals. The Court recognized that it is often impossible to reach "precise territorial allocations of 'value'" when dealing with an enterprise operating in more than one state,[33] and that the Constitution does not impose a single apportionment formula on the states.[34] However, the Court did set two requirements for any such state formula.[35] First, the formula must be fair,[36] and second,

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24. Japan Line, Ltd. v. County of Los Angeles, 441 U.S. 434, 451 (1979).
25. *Id.* at 434.
26. *Id.* at 446. California had applied an apportioned *ad valorem* property tax on cargo containers owned and used by six Japanese shipping companies. *Id.* at 436-37.
27. *Id.*
28. *Id.* at 446-48 (citing Evco v. Jones, 409 U.S. 91, 94 (1972)).
29. *Japan Line*, 441 U.S. at 448.
30. *Id.* at 449 (quoting Michelin Tire Corp. v. Wages, 423 U.S. 276, 285 (1976)).
31. 463 U.S. 159 (1983).
32. *Id.* at 162-63.
33. *Id.* at 164 (quoting ASARCO Inc. v. Idaho State Tax Comm'n, 458 U.S. 307, 315 (1982)).
34. *Id.* (citing Wisconsin v. J.C. Penney Co., 311 U.S. 435, 445 (1940)).
35. *Id.* at 169-70.

the formula must not result in discrimination against interstate or foreign commerce.[37] In determining fairness and nondiscrimination, the Court stated that "[t]he Constitution does not 'invalidat[e] an apportionment formula whenever it *may* result in taxation of some income that did not have its source in the taxing State.'"[38] However, a formula would be invalid if "'the income attributed to the State is in fact out of all appropriate proportions to the business transacted . . . in that State.'"[39] In addition, the Court averred that state formulas for income apportionment need not be substantially similar to methods used by other jurisdictions in which the multinational was subject to taxation.[40]

With these general guidelines, the Court applied the *Japan Line* considerations to the worldwide combined reporting method.[41] The Court found that the franchise tax did not unconstitutionally enhance the risk of multiple taxation[42] for three reasons. First, the franchise tax involved a tax on income, not property.[43] Second, the tax did not inevitably result in double taxation.[44] Third, the franchise tax fell not on a foreign owner of an instrumentality of foreign commerce, but rather on a domestic multinational.[45] However, the Court reserved judgment on whether the same result would be reached "with respect to state taxation of domestic corporations with foreign

36. *Container Corp.*, 463 U.S. at 169.

37. *Id.* at 170.

38. *Id.* at 169-70 (quoting Moorman Mfg. Co. v. Bair, 437 U.S. 267, 272 (1978)) (second alteration in original).

39. *Id.* at 170 (quoting *Moorman Mfg. Co.,* 437 U.S. at 274) (internal quotation omitted).

40. *See id.* at 170-71. The federal government and each of the relevant foreign jurisdictions taxing the corporation's foreign subsidiaries used the "arm's-length" (i.e., separate accounting) method. This method treated each individual corporation in the multinational enterprise as if it were an independent entity, and was therefore subject to taxation only by the jurisdiction in which it operates and only for that income which it realized on its own books. *See id.* at 184-85.

41. *Id.* at 187.

42. *Container Corp.*, 463 U.S. at 189.

43. *Id.* at 187-88. According to the Court, "'The reasons for allocation to a single situs that often apply in the case of property taxation carry little force' in the case of income taxation." *Id.* at 188 (quoting Mobil Oil Corp. v. Commissioner of Taxes, 445 U.S. 425, 445 (1980)).

44. *Id.* at 188. The Court noted that it was faced with two different methods of allocation of income and "[w]hether the combination of the two methods results in the same income being taxed twice or in some portion of income not being taxed at all is dependent solely on the facts of the individual case." *Id.* The Court noted that "even though most nations have adopted the 'arm's-length' approach in its general outlines, the precise rules under which they reallocate income among affiliated corporations often differ substantially, and whenever that difference exists, the possibility of double taxation also exists." *Id.* at 191.

45. *Id.*

parents or foreign corporations with either foreign parents or foreign subsidiaries."[46]

The Court then discussed two reasons why the tax did not impair federal uniformity.[47] First, the tax did not encourage economic retaliations, therefore it did not implicate foreign affairs.[48] Although foreign policy might be implicated by other means, the Court noted that this probable lack of retaliation, when combined with the federal government's failure to oppose the tax in an amicus brief, suggested that U.S. foreign policy was "not seriously threatened."[49] Second, the Court found no specific directives of Congress which indicated a federal policy against the use of worldwide combined reporting by the states.[50]

The *Japan Line* "one-voice" standard was developed further in *Wardair Canada, Inc. v. Florida Dep't of Revenue*.[51] The petitioner in *Wardair Canada* argued that numerous agreements and pronouncements by the federal government concerning the elimination of impediments to foreign air travel, including fuel taxation, constituted a federal policy, and that this policy represented the sole voice with which the federal government desired to speak.[52] In rejecting this argument, the Court noted that many international agreements entered into by the federal government maintained allowances for individual states to impose such taxes.[53] In addition, proposals to eliminate such taxes were never actually enacted into law by Congress.[54] Therefore, although a general federal aspiration to remove such fuel taxes may have existed, the Court held that there was no violation of the one-voice standard because "[b]y negative

46. *Id.* at 189 n.26.

47. *Container Corp.*, 463 U.S. at 194-97.

48. *Id.* at 194. The Court's finding here was based on the following considerations: the tax did not create an automatic asymmetry in the international tax structure, the tax was not imposed on a foreign entity, and California had a right to tax the enterprise in some fashion, thereby making the amount eventually paid by the enterprise "more the function of California's tax rate than of its allocation method." *Id.* at 194-95.

49. *Id.* at 195-96.

50. *Id.* at 196-97.

51. 477 U.S. 1 (1986).

52. *Id.* at 9.

53. *See id.* at 10-11.

54. *See id.*

implication . . . the United States has at least acquiesced in state taxation."[55]

In the noted case, the Court first recognized that California's worldwide combined reporting system, as applied to Barclays and Colgate, easily met the *Complete Auto* requirements of substantial nexus, fair apportionment, and relation to state-provided services.[56]

The Court then addressed the final requirement of *Complete Auto*—the Commerce Clause requirement of nondiscrimination. Barclays felt that worldwide combined reporting imposed a discriminatory compliance burden on foreign multinationals,[57] because they were forced to convert diverse worldwide financial and accounting records into the currency, accounting principles, and language of the United States.[58] The Court rejected this argument, noting that the implementing regulations of the tax legislation stated that the Tax Board was to consider the effort and expense required in obtaining information.[59] Since both Barclays and the Tax Board made use of these provisions, the Court could not say that the tax imposed a disproportionate, and thus discriminatory, compliance burden.[60]

In addition, Barclays challenged the use of these "reasonable approximations" by the Tax Board on due process grounds, asserting that such standardless discretion in choosing to accept or reject particular approximations was unconstitutional.[61] The Court rejected this due process challenge,[62] noting that "[r]ules governing

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55. *Id.* at 11-12.

56. *Barclays Bank*, 114 S. Ct. at 2276. The nexus requirement was fulfilled because all three of the taxpayers had done business in California during the years at issue. *Id.* The fair apportionment requirement was fulfilled because neither Barclays nor Colgate demonstrated a lack of a rational relationship between the income attributed to the value of their in-state and out-of-state businesses, nor did they demonstrate that the income attributed to California was completely out of proportion to the business conducted within the state. *Id.* at 2276-77. Finally, the Court stated that California had certainly afforded both petitioners "'protection, opportunities, and benefits'" for which the state could receive a return. *Id.* (quoting *J.C. Penney Co.*, 311 U.S. at 444).

57. *Id.* at 2277.

58. *Id.*

59. *Id.* As Colgate was a domestic multinational, it did not assert this argument for itself. *Id.* In "'appropriate cases, such as when the necessary data cannot be developed from financial records maintained in the regular course of business,'" the Tax Board may accept "'reasonable approximations.'" *Id.* at 2277-78 (quoting CAL. CODE REGS., tit. 18 § 25137-6(e)(1)(1985)).

60. *Id.* at 2278.

61. *Barclays Bank*, 114 S. Ct. at 2278.

62. *Id.* at 2279.

international multijurisdictional income allocation have an inescapable imprecision given the complexity of the subject matter."[63] As a result, "'reasonableness' is a guide admitting effective judicial review in myriad settings."[64] The Court also noted that the California judiciary had interpreted the regulations so as to curtail the discretion of the Tax Board.[65]

Having determined that the tax was nondiscriminatory to foreign multinationals under both the Commerce Clause and the Due Process Clause, the tax was found to have satisfied the *Complete Auto* criteria.[66] The Court then turned to the two additional inquiries required when a state seeks to tax foreign commerce.

The first inquiry that the Court addressed was whether the use of worldwide combined reporting created an enhanced risk of multiple taxation for Barclays.[67] The Court did not dispute that Barclays had a greater share of its operations and entities outside of the United States than a domestic multinational would, and therefore had a higher proportion of its income subject to taxation by foreign nations.[68] The Court also did not dispute that worldwide apportionment enhanced the risk of multiple international taxation for foreign multinationals.[69] However, the Court stated that its validation of the same franchise tax in *Container Corp.* "did not rest on any insufficiency in the evidence that multiple taxation might occur."[70] Rather, the Court declared that the result in *Container Corp.* rested on the considerations that multiple taxation was not the *inevitable* result of the franchise tax.[71] Furthermore, the Court reasoned that the alternative tax method of

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63. *Id.*

64. *Id.* at 2278; *see, e.g.*, United States v. Ragen, 314 U.S. 513, 522 (1942) (determinations by reference to a reasonableness standard are not unusual under federal income tax laws), *cited in Barclays Bank,* 114 S. Ct. at 2278.

65. *Barclays Bank*, 114 S. Ct. at 2278. In determining whether the cost and effort involved in producing information justifies the use of reasonable approximations, the Tax Board must consider normally-maintained or readily-accessible documents. *See Barclay's Bank Int'l,* 14 CAL. RPTR. 2d at 549.

66. *Barclays Bank*, 114 S. Ct. at 2278.

67. *Id.*

68. *Id.* at 2279-80; *see id.* at 2279 n.16.

69. *Id.* It has been asserted that because wages are higher in California than in foreign jurisdictions, but productivity is not higher, the apportionment formula inflates the proportion of income attributed to a corporation's in-state operations. *See Container Corp.*, 463 U.S. at 181-82 (majority opinion); *see also id.* at 187 (Powell, J., dissenting).

70. *Barclays Bank*, 114 S. Ct. at 2280.

71. *Id.* at 2280.

separate accounting would not eliminate the risk of multiple taxation, and in some cases might even enhance the risk.[72]

The Court stated that these considerations were not diminished when the franchise tax was applied to a foreign multinational.[73] For both foreign and domestic multinationals, the existence of multiple taxation was not inevitable, but instead depended on the facts of the individual case.[74] Moreover, if a separate accounting system would not dispositively lessen the risk of multiple taxation for a domestic multinational, the Court saw no reason why such a system would lessen the risk for a foreign multinational.[75] The Court therefore found that even if a corporation or its parent had a foreign domicile, worldwide combined reporting did not unconstitutionally enhance the risk of multiple taxation.[76]

The second question that the Court addressed was whether the franchise tax impaired federal uniformity by preventing the federal government from asserting its sole voice. The Court found no specific indication of Congress' intent to preempt the California tax.[77] In addition, the Court noted that an underlying premise of both *Container Corp.* and *Wardair Canada* was that if a tax met the *Complete Auto* criteria, and did not in some other way discriminate against interstate commerce, Congress could "passively indicate that certain state practices do *not* impair federal uniformity."[78]

In the instant case, the Court noted that if Congress considered the nationally uniform use of separate accounting to be essential, it could have legislated to that effect.[79] Congress has never expressly prohibited worldwide combined reporting, despite three decades of objections by foreign governments, numerous debates and studies, and the introduction of several bills concerning state taxation of multinational corporations.[80] Based upon this history, the Court stated "that Congress implicitly has *permitted* the states to use the

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72. *Id.*
73. *Id.*
74. *Id.*
75. *Barclays Bank*, 114 S. Ct. at 2280.
76. *Id.* at 2281.
77. *Id.*
78. *Id.* at 2282 (internal quote omitted) (emphasis in original).
79. *Id.* at 2283.
80. *Barclays Bank*, 114 S. Ct. at 2283-84.

worldwide combined reporting method."[81] The Court then concluded that U.S. foreign policy was not so seriously threatened by the franchise tax as to warrant judicial interference in an area better left to the political branches of government.[82]

Colgate attempted to distinguish the "one-voice" result of *Container Corp.* by pointing to several executive branch actions, statements, and amicus filings made both before and after *Container Corp.* was decided. Based on these executive actions, Colgate argued that a clear federal policy exists for prohibiting the use of worldwide combined reporting by states.[83] However, the Court rejected Colgate's argument, noting that it is Congress, not the President, that has the exclusive power to regulate foreign commerce.[84] Although the executive branch had proposed legislation to prohibit state use of worldwide combined reporting, Congress was unreceptive to this proposal, and the executive had subsequently yielded to Congress. The Court concluded that these events did "not evidence that the practice interfered with the Nation's ability to speak with one voice."[85]

The Court's affirmation of the constitutional right of states to impose such a tax system[86] adds another facet to the current policy debate over the methods for determining the taxable income of multinational corporations. Although California had already reformed its law to allow avoidance of worldwide combined reporting, the decision caused immediate concern for multinational corporations that states would try to increase tax revenue by adopting such a taxation method.[87] Financial incentives already exist for states to maintain or adopt worldwide combined reporting; by reporting income on a

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81. *Id.* at 2284.
82. *Id.* at 2284-85.
83. *Id.* at 2285.
84. *Id.*
85. *Barclays Bank*, 114 S. Ct. at 2285.
86. *Supreme Court Rules Against Foreign Banks,* 13 BANKING POL'Y REP. 2 (1994).
87. Joan Biskupic, *High Court Hands States Tax Victory; Calif. Levy on Firms' Global Profit Upheld,* WASH. POST, June 21, 1994, at D1. The tax is currently used in some form by six states: Alaska, Idaho, Montana, North Dakota, Tennessee, and Utah. *Id.* As an indication of the greater revenue available to states under this method, it is illuminating to note that had the method been invalidated by the Court, California "would [have been] obliged to refund $2.1 billion already paid by the two multinational corporations and to excuse them from paying another $1.4 billion in back taxes now owed." *Supreme Court Rules Against Foreign Banks, supra* note 86. In addition, one must not forget the other California subsidiaries of foreign corporations subject to taxation. *Id.*

separate accounting basis, multinationals are able to shift profits to out-of-state entities, minimizing tax liability within any particular state.[88]

The U.S. government may also have reason for concern as a result of this Court decision. The states' use of worldwide combined reporting "has severely irritated U.S. trading partners,"[89] increasing the likelihood of retaliation by foreign nations against U.S. companies.[90] For example, after the Court's decision was issued, a British coalition declared that they would exert pressure on the U.K. government to initiate retaliatory measures as a result of state actions imposing worldwide combined reporting on U.K. banks and corporations.[91]

On the other hand, it is quite conceivable that international conflict may be avoided. As previously noted, California had modified its franchise tax system prior to the Court's ruling, probably due to political pressure. This modification "seems to have placated the U.K."[92] Furthermore, other states may also choose to avoid this controversial method if they think its use will drive away multinational corporate business. In addition, if retaliation actually occurs, the American business community might oppose worldwide combined reporting, providing the pressure for Congress to pass legislation favorable to multinationals. In conclusion, it appears that despite a long-fought battle to uphold the constitutionality of

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88. Biskupic, *supra* note 87, at D1.

89. William H. Morris, *U.S. Lags Behind Even Undeveloped Nations in Implementing VAT,* 5 J. INT'L TAX'N 218, 223 (1994).

90. *See Supreme Court Rules Against Foreign Banks, supra* note 86; Biskupic, *supra* note 87, at D1 (stating that some tax experts have expressed concern that foreign nations might institute retaliatory taxes).

91. *Supreme Court Rules Against Foreign Banks, supra* note 86.

92. *Supreme Court Upholds California's World-Wide Combined Reporting System,* 81 J. TAX'N 66 (1994).

worldwide combined reporting, political and economic pressures may nevertheless push states away from the use of such methods.

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