

INCOME TAXATION OF FOREIGN DIRECT INVESTMENT IN ARIZONA BY FOREIGN MANUFACTURING AND MERCHANDISING ENTERPRISES: ANALYSIS OF THE DATA AND THE FEDERAL AND STATE RULES

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INTRODUCTION

The subject of this article is an examination of the federal and the Arizona state income tax rules applicable to foreign-based multinational manufacturing and merchandising enterprises in light of the economic determinants of foreign direct investment.

A multinational enterprise (MNE) is a firm consisting of a group of affiliated branches and subsidiaries, under common management and control and operating in two or more national markets. The business units in a MNE are interrelated through joint costs, managerial control, and control of proprietary information. The essence of being multinational is international production and sale. Otherwise, foreign markets could be serviced by exports.¹

The objective of the MNE is to coordinate the operations of its many units so as to achieve maximum profits for the enterprise as a whole. The objective of the tax authorities is to obtain a measure of real earning capacity attributable to activities carried on in the taxing jurisdiction. In general, this is done by breaking down the business income of a MNE by source so as to capture a part of the surplus generated by coordination of the activities of the separate units. Two methods of tax base division to accomplish this objective are in general use: 1) separate accounting based upon arms length pricing of inter-company transactions; 2) apportionment by formula to a taxing jurisdiction of a percentage of the entire worldwide income of that part of the total activity of the MNE that constitutes a unitary operation. Both of these accounting methods represent compromises with generally accepted tax law definitions of sources of income. The purpose of both methods is to provide relatively simple standards for the definition of the tax base of a MNE and to limit the ability of the MNE to avoid tax by manipulating transfer prices or by transferring title of assets to low tax jurisdictions.

Both the federal and Arizona state tax jurisdiction rules are organized

1. Several terms used in this article should be defined. 1) A foreign-based MNE is a foreign corporation doing business directly in the United States through one or more United States branches or a foreign corporation doing business indirectly in the United States through one or more domestic controlled subsidiaries. 2) A branch is a division; a controlled United States subsidiary is a separate corporation, more than 50 percent of the stock of which is owned by the foreign parent corporation. Both the branch and the controlled subsidiary are affiliates of the foreign corporation making the direct investment in the United States enterprise. 3) Foreign direct investment (FDI) in the United States implies that a single foreign investor has a long-term interest in and control over the management of a United States enterprise. Such interest and control is evidenced by ownership of more than 50 percent of the United States enterprises' voting stock or equivalent interest.

around the successive stages by which a foreign based MNE may enter the United States market: 1) exporting and or licensing to unaffiliated entities; 2) establishment of a branch United States manufacturing and/or selling operation; 3) full scale United States production and marketing through a controlled subsidiary under the direct managerial control of the foreign-based MNE.

The starting point for the computation of the United States taxable income of a foreign based MNE depends on whether the domestic affiliate is a branch or a subsidiary. The computational starting point under federal tax law for a domestic branch of a foreign corporation is the net income of the foreign corporation "effectively connected" with the United States business activities of the branch and the United States source gross investment income of the foreign corporation.² The computational starting point under federal tax law for a domestic subsidiary of a foreign parent is the global income of the subsidiary.³

The starting point for the computation of the Arizona taxable income of both an Arizona branch of a foreign based MNE and of a foreign controlled domestic subsidiary carrying on activities in Arizona is federal net taxable income.⁴ That is, the Arizona corporation income tax structure is "integrated" with the federal income tax system. However, the two systems do not, in all respects, fit smoothly together like the pieces of a puzzle. In the case of a branch operation carrying on activities in Arizona, there is no correspondence between the effective connection concept of the federal system and the state-law combined unitary method of allocation and apportionment. In the case of a foreign-controlled domestic subsidiary carrying on activities in Arizona, federal tax jurisdiction is global in reach; Arizona state tax jurisdiction is essentially territorial.

In 1983 Arizona amended the Income Tax Act of 1978 to adopt the allocation and apportionment rules of the Uniform Division of Income for Tax Purposes Act (UDITPA).⁵ In 1985 Arizona amended these provisions to exclude from the unitary combination method of accounting⁶ for the income of a foreign controlled domestic subsidiary doing business in Arizona the foreign source income of the foreign parent corporation.⁷ This limitation is commonly referred to as the water's edge limitation on the unitary combination method of accounting. In February 1986, Arizona adopted regulations under the UDITPA rules⁸ to repeal the separate accounting rules of

2. Internal Revenue Code §§ 882; 864(c); 881 (1982) [hereinafter I.R.C.].

3. I.R.C. §§ 61(a), 11 (1982).

4. ARIZ. REV. STAT. ANN. § 43-1101(1) (1980 & Supp. 1986). See also ARIZ. COMP. ADMIN. R. & REGS. R15-2-1131 to R15-2-1148 (1986).

5. L. 1983, Ch. 298, § 5; ARIZ. REV. STAT. ANN. §§ 43-1131 to 43-1150 (Supp. 1986).

6. For a definition of the unitary combination method of accounting see text accompanying notes 186-92 *infra*.

7. L. 1985, Ch. 109; ARIZ. REV. STAT. ANN. §§ 43-1132, 43-1140, 43-1143, 43-1145 (Supp. 1986). L. 1985 also excludes from the Arizona tax base foreign source dividends received by a domestic corporation subject to tax in Arizona. This restriction, also a part of the water's edge limitation, ordinarily is not at issue where the taxpayer is a domestic subsidiary of a foreign parent corporation.

8. Letter from J. Elliott Hibbs, Director of Arizona Department of Revenue to Reka P. Hoff (March 12, 1986); see also ARIZ. COMP. ADMIN. R. & REGS. R15-2-1131 to -1148 (1986).

the old regulations, leaving in place the statutory authority to apply the separate accounting method only if the unitary method does not "fairly represent the extent of the taxpayer's business activity" in the state.⁹

With respect to the foreign-based MNE, Arizona taxes the entire income from the use of in-state tangible and intangible property and from in-state sources, whether or not the MNE is doing business in the state. The state taxes, on an apportioned basis, the effectively connected unitary income of a foreign corporation doing business in Arizona through an in-state branch. Arizona taxes, on an apportioned basis, the worldwide unitary income of a foreign controlled domestic corporation doing business within and without Arizona, except that foreign source dividends are excluded from the tax base.¹⁰

This article is divided into four parts. Part I sets forth the annual data on direct investment in Arizona by foreign manufacturing and merchandising corporations, 1977-1984, and compares the rate of growth of Arizona foreign direct investment (FDI) with the rate of growth of FDI for the United States as a whole during this period.

Part II summarizes the literature on the organizational structure of the MNE and the determinants of FDI. It describes the various forms that United States market penetration by a foreign-based MNE can take.

Part III analyzes the federal and Arizona state tax jurisdiction rules applicable to each form of FDI in the context of the controversy over separate accounting versus the worldwide combined unitary method of tax base division.

Part IV concludes that the water's edge limitation adopted by Arizona is a workable solution to the problem of apportioning the international income of a foreign controlled domestic subsidiary carrying on activities in Arizona and creates a favorable tax climate for FDI in Arizona through a foreign-controlled domestic subsidiary. However, the water's edge limitation places FDI in Arizona through a branch operation at a comparative tax disadvantage. With respect to the branch operation, the foreign corporation is the taxpayer, not the branch. Hence, the Arizona state tax base includes both United States source and foreign source effectively connected income reported for federal purposes to the extent such income is a part of the unitary operation carried on in Arizona by the foreign corporation. The Arizona state tax base also would include Arizona source investment income from Arizona assets owned by the foreign corporation and reported for federal tax purposes. Further, the income reallocation rules of Arizona tax law can reallocate income and deductions between the Arizona branch and its affiliated foreign corporation. On the other hand, the income reallocation rules cannot reach foreign source income and deductions of a foreign parent of a domestic subsidiary carrying on activities in Arizona if the foreign parent is not subject to tax in Arizona.

This article recommends that the Arizona Income Tax Act be amended

9. ARIZ. COMP. ADMIN. R. & REGS. R15-2-1148 (1986).

10. See *supra* note 7.

to put Arizona branches of foreign-based MNEs on the same tax footing as foreign-controlled domestic subsidiaries carrying on activities in Arizona.

PART I
ANNUAL DATA ON FOREIGN DIRECT INVESTMENT IN
ARIZONA AND THE UNITED STATES, 1977-1984

The Department of Commerce divides the gross book value of FDI in the United States and within each state into the following industrial categories: mining, petroleum, manufacturing, wholesale trade, retail trade, finance, insurance, real estate, and other industries. This article is concerned only with the tax status of income from FDI by manufacturing and merchandising companies.¹¹

For the country as a whole FDI by manufacturing and merchandising companies has comprised about 50 percent of total FDI in each year between 1977-1984.¹² The principal countries of origin for such investment are Continental Europe and Canada.¹³ The principal form of such investment is equity investment in a United States subsidiary.¹⁴

The FDI picture for Arizona is different than that for the country as a whole. FDI by foreign manufacturing and merchandising companies has comprised a less significant although rapidly increasing percentage of total FDI: 11.3 percent in 1977, 43.5 percent in 1984.¹⁵ The principal countries of origin of such investment in Arizona are Great Britain and Japan.¹⁶ As in the case of the United States as a whole, the principal form of FDI by foreign manufacturing and merchandising companies is equity investment in a United States subsidiary operating in the state and in interstate and foreign

11. The Department of Commerce defines foreign direct investment in the United States as the ownership or control, directly or indirectly, by a single foreign person of 10 percent or more of the voting securities of a United States Corporation or of an equivalent interest in a United States unincorporated business enterprise. The Department of Commerce defines ultimate beneficial owner as "that person, proceeding up a United States affiliated ownership chain, beginning with and including the foreign parent, that is owned more than 50 percent by another person." UNITED STATES DEPARTMENT OF COMMERCE, BUREAU OF ECONOMIC ANALYSIS, FOREIGN DIRECT INVESTMENT IN THE UNITED STATES, OPERATIONS OF UNITED STATES AFFILIATES, 1977-80, at iii, 2 (1985). The value of FDI is the sum of all past capital flows between the foreign parent companies and their United States affiliates plus the foreign parent's share of all past reinvested earnings.

12. See *infra* Table 1-A reproduced at the end of this Article. The statistical material for this article was prepared by the Department of Commerce pursuant to Section 5(8) of the Foreign Investment Study Act of 1974, Pub. L. 93-479, § 5, 88 Stat. 1450-54 (1974). The Act directs the Secretary of Commerce to conduct a comprehensive study of foreign direct and portfolio investments in the United States. In describing the Act, the House Report states: "[t]he purpose of this study is to increase the understanding of the implications of such investments both within the United States Government and among the public at large, and thus to help lay the foundation for a national policy concerning foreign investments in the United States." The impetus for the study was "citizen concern . . . related both to foreign takeovers of American corporations and to rumored large foreign purchases of agricultural lands and natural resources of the United States, such as timberlands and coal mines." H. REP. No. 1183, 93d Cong. 2d Sess. 2, (1974), *reprinted in* 3 1974 U.S. CODE CONG. & AD. NEWS 5957-64.

13. UNITED STATES DEPARTMENT OF COMMERCE, FOREIGN DIRECT INVESTMENT IN THE UNITED STATES Tables D-14 (1977-1984) [hereinafter FDIUS].

14. FDIUS, *supra* note 13, at Tables B-2; Volpe, *Some Preliminary Findings On The Factor Intensity of Foreign Direct Investment in United States Manufacturing*, AM. ECONOMIST, Spring 1975, at 67.

15. See *infra* Table 1-A reproduced at the end of this Article.

16. See *infra* Table 2 reproduced at the end of this Article.

commerce.¹⁷ Typically, the FDI is by takeovers, mergers, or equity acquisitions of existing companies.¹⁸

The FDI picture for Arizona is a rapidly changing one. Based on Department of Commerce data for total assets and thousands of acres of land owned in Arizona and for numbers of persons employed in Arizona, the trend is toward significant increases in petroleum, manufacturing, wholesale and retail trade and real estate investment. The gross book value of total assets of foreign-owned Arizona real estate investment companies shows real estate investment as the predominant activity in all years, comprising about 30 percent of total foreign owned assets in all years.¹⁹ Real estate investment by foreign owned Arizona real estate investment companies accounted for only 8,000 of the total of 143,000 acres in 1977; it accounted for 23,000 of the total of 216,000 acres in 1984, an increase from 5.5 percent to 10.6 percent.²⁰ Total acres of Arizona land owned by foreign owned manufacturing affiliates jumped from one thousand acres, 0.7 percent of the total (1977), to 71,000 acres, 32.9 percent of the total acres of Arizona land owned by Arizona affiliates of foreign investors (1984).²¹

Figures for the total number of employees of Arizona affiliates of foreign investors shows a like increase in the size of the Arizona operations of such affiliates, in particular, affiliates of foreign manufacturing and merchandising companies. Total numbers of employees of Arizona affiliates of all foreign investors more than doubled in 1981 over the 1980 figures: 30,642 (1981); 14,394 (1980). This high level of employment continued in 1983 and 1984: 25,815 (1983); 30,851 (1984). Most of this increase was due to an increase in numbers of persons employed by Arizona affiliates in the chemicals, metals, and machinery manufacturing industries and in retail trade.²² In 1983 employment in the manufacture of primary and fabricated metals jumped from 747 (1982) to 5,233 and remained at 4,944 (1984). It is not possible to determine what part of these increases in employment are due to acquisition of Arizona affiliates by FDI and what part of the increases are attributable to new hiring by new FDI.

In short, while Arizona FDI continues to be dominated by foreign investment in Arizona real property, FDI by foreign-owned manufacturing operations is increasing rapidly and foreign-owned merchandising remains stable. It is likely that, other factors remaining the same, such FDI will take on an increasing importance in the years to come.

17. See *supra* note 14.

18. *The New Wave: Foreign Capital Investment in the United States—A Survey*, THE ECONOMIST, Oct. 25, 1980, at 3 [hereinafter *The New Wave*]; Shea, *United States Business Enterprises Acquired or Established by Foreign Direct Investors in 1985*, SURV. CURRENT BUS., May 1986, at 47.

19. See *infra* Table 3 reproduced at the end of this Article.

20. See *infra* Table 4 reproduced at the end of this Article.

21. *Id.*

22. See *infra* Table 5 reproduced at the end of this Article.

PART II
 ORGANIZATIONAL STRUCTURE OF THE MULTINATIONAL
 ENTERPRISE; DETERMINANTS OF FOREIGN DIRECT
 INVESTMENT AND FORMS OF MARKET
 PENETRATION

A. *Organizational Structure of the MNE*

A MNE is a firm consisting of a group of affiliated branches and subsidiaries, under common management and control, and operating in two or more national markets. FDI by a MNE occurs most prominently in oligopolistic industries.²³ The MNE that produces in the United States the same general line of goods that it produces in the home country or other countries is horizontally integrated. The MNE that manufactures in the home country and invests in its United States suppliers of raw materials or of components is vertically integrated backwards. The MNE that manufactures in the home country and invests in its resale market outlets in the United States is vertically integrated forward.

The main advantage of foreign direct investment in, (that is, acquisition of control of) a competitor consists in increasing profit rates by reducing competition, irrespective of whether the investor is a more efficient producer than the acquired firm. International horizontal integration permits reductions in the unit costs of overhead expenses: financing, marketing, research and development. A further incentive to horizontal expansion into a foreign market is to avoid trade barriers that hamper exports to the foreign country.²⁴ The MNE avoids customs duties by replacing exports with host-country production.²⁵

The main advantage of foreign direct investment in (that is, acquisition of control of) a supplier or in a market outlet consists of reducing the costs and uncertainties that exist when the producer has to handle the different stages of production through market transactions. International vertical integration backwards also may avoid duplicative research and development, plant, and management.²⁶ International vertical integration permits reductions in production and marketing costs through taking advantage of variations in factor prices among markets while achieving economies of scale in production of components and marketing of the final product. The international integration of production and marketing is more difficult through trade because there is no coordination between the different phases of production or in the planning for new investment.²⁷

23. Flowers, *Oligopolistic Reactions in European and Canadian Direct Investment in the United States*, J. INT'L. BUS. STUD., Fall/Winter 1976, at 43.

24. Horst, *The Theory of the Multinational Firm: Optimal Behavior under Different Tariff and Tax Rates*, 79 J. POL. ECON. 1059 (1971).

25. *Id.*

26. Williamson, *The Modern Corporation: Origins, Evolution, Attributes*, 19 J. ECON. LITERATURE 1537 (1981).

27. See generally, J. HENNART, *A THEORY OF MULTINATIONAL ENTERPRISE* (1982). C.P. Kindleberger summarizes the economic reasons for integration:

While internal economies of scale—and monopoly—account for horizontal integration, external economies of scale lead to vertical integration. In a number of lines where production is bulky, inventories are expensive, and coordination of decision is required at several

Further, international integration may reduce the high transaction costs involved in operating across national boundaries; costs attributable to international tax rate differentials, foreign exchange controls, multiple exchange rates, currency manipulation, and governmental regulations that hamper the free flow of investment funds.

In short, the MNE arises because it represents a more efficient method of organizing production across national boundaries than the price mechanism. There is no market between the affiliates of a MNE.²⁸ Purchase and sale transactions (i.e. resource allocation) between affiliates are managed by the economic planning activity of the entrepreneur (parent corporation). That is, the home office replaces the price mechanism in the allocation of resources. As R.H. Coase points out:

Outside the firm, price movements direct production, which is coordinated through a series of exchange transactions in the market. Within a firm, these market transactions are eliminated and in place of the complicated market structure with exchange transactions is substituted the entrepreneur-coordinator, who directs production.²⁹

The major consideration in the determination of the transfer prices for purchases and sales between affiliates in different countries is the overall competitive position of the MNE. The MNE coordinates the operations of its affiliates in different markets with a view to achieving monopoly profits for the entire enterprise. Intercompany prices are not the same as the arm's length prices of the open market unless the costs of organizing the transaction within the firm are equal to costs that would be involved in carrying out this same transaction by an exchange in the open market with an unaffiliated party—in which case, the cost-saving advantage of integration would no longer exist. Horst describes the intercompany pricing practice of a MNE: "One of the truly distinguishing features of multinational corporations is that the intrafirm transactions are not valued in an open market—rather, the firms choose, within certain limits, an optimal transfer price."³⁰

While intrafirm transactions of a MNE would not necessarily be different depending on whether the affiliate is a branch or a controlled subsidiary, a MNE operating in a foreign market through a branch would not necessarily operate in the same way as a MNE operating through a controlled subsidiary. The subsidiary is typically more dependent on the local market for financing, investment opportunities, and information. It is likely to be more sensitive to local market competitive conditions and to compete more vigorously in the local market than would a branch. This may affect the "motiva-

stages of the process, the firm may be a better means of organizing production than the competitive market.

Kindleberger, *The Theory of Direct Investment*, in *INTERNATIONAL FINANCIAL MANAGEMENT: THEORY AND APPLICATION* 19, 25 (D. Lessard ed. 1979).

28. R.H. Coase describes the phenomenon of integration: "There is a combination when transactions which were previously organized by two or more entrepreneurs become organized by one. This becomes integration when it involves the organization of transactions which were previously carried out between the entrepreneurs in a market." Coase, *The Nature of the Firm*, in *AMERICAN ECONOMIC ASSOCIATION READINGS IN PRICE THEORY* 344 (G. Stigler and K. Boulding eds. 1952).

29. *Id.* at 333.

30. Horst, *supra* note 24, at 1061.

tion," "cognition and information," and "opportunity set" of the branch in ways that are difficult to quantify but which may have a bearing on the transfer pricing practices between home office and division.³¹

If the MNE is successful in coordinating the operations of its affiliates in different markets so as to achieve a monopoly profit for the enterprise as a whole, the sum of the profit contributions by each separate affiliate, computed on the basis of arm's length prices, may be less than the total profit of the MNE. That is, a surplus attributable to the cost savings or revenue increases realized through entrepreneurial economic planning activity will have been created. This is the return to what Marshall called the fourth factor of production.³²

B. *Determinants of FDI*

What are the circumstances that cause a firm to acquire control of an existing enterprise in a foreign country or organize a new enterprise in a foreign country? Hymer has a dual explanation for the growth of the MNE. First, FDI "allows business firms to transfer capital, technology, and organizational skill from one country to another. It is also an instrument for restraining competition between firms of different nations."³³ Second, "[s]ome firms have advantages in a particular activity and they may find it profitable to exploit these advantages by establishing foreign operations."³⁴ The mature MNE pools the capital, managerial skill, and technology of the parent and subsidiaries located all over the world to achieve common goals of profit, growth, and product or market diversification.³⁵

In general, the investing firm must be able to realize production economies of scale or gains from the spreading of technological know-how sufficient to offset the locational advantages of local firms and to overcome the disadvantages of operating in an unfamiliar legal environment, the difficulties of controlling operations at long distances and across national boundaries, and the uncertainties of fluctuating exchange rates.³⁶ Once a firm has substantial capital invested in research and development, it is propelled by market forces to exploit this advantage in foreign markets. Caves described the incentive structure, as follows:

The explanation for much foreign investment—certainly that in manufacturing industries—lies in the fact that the successful firm also gains intangible capital in the form of patents, trademarks, or general knowledge about how to produce and distribute its products. Being intangible, these assets can in some measure be moved from one national

31. Caves, *Foreign Direct Investment and Market Performance*, in INTERNATIONAL ECONOMIC POLICIES AND THEIR THEORETICAL FOUNDATIONS 297-300 (J. Letiche ed. 1982).

32. A. MARSHALL, PRINCIPLES OF ECONOMICS 243-61 (8th ed. 1969).

33. Hymer, *The Efficiency (Contradictions) of Multinational Corporations*, 60 AMER. ECON. REV. 443 (1970).

34. S. HYMER, THE INTERNATIONAL OPERATIONS OF NATIONAL FIRMS: A STUDY OF DIRECT FOREIGN INVESTMENT 33 (1976).

35. UNITED NATIONS, TRANSNATIONAL CORPORATIONS IN WORLD DEVELOPMENT, THIRD SURVEY (1983).

36. See generally, Y. AHARONI, THE FOREIGN INVESTMENT DECISION PROCESS (1966); C. KINDLEBERGER, AMERICAN BUSINESS ABROAD: SIX LECTURES ON DIRECT INVESTMENT (1969).

market to another, gaining rents in new locations without impairing the stock left in service at the home base.³⁷

The MNE that invests in the United States makes two location decisions: 1) to choose the United States over any other nation in the world; 2) to choose a state within the United States. The factors taken into consideration are different in each case. In general, the United States offers a favorable climate for FDI. Favorable factors include relative political and economic stability, size and strength of the domestic market, advanced United States technology, and a relatively non-restrictive federal policy toward FDI.³⁸ The basic policy of the United States is to treat FDI on a basis of equality with domestic capital investment.³⁹

While it is not clear that taxes are an important factor in determining location within the United States, the level of taxation can make the crucial difference between two situations otherwise comparable.⁴⁰ A tax on corporate income is equivalent to a tax on the use of capital within the taxing jurisdiction.⁴¹ A tax on the use of capital makes the production of goods and services more expensive in the taxing jurisdiction than elsewhere. This creates an incentive for existing business to move and for new business investment not to enter. Other elements which determine the location of FDI within the United States are cost of factors of production, especially wage rates, transportation costs, fuel prices, level of skill of the local labor force, union strength, level of governmental services, quality of life, including climate, availability of housing, cultural amenities, and proximity to relevant markets.⁴²

The bottom line is that the foreign direct investor must be able to earn more by producing and/or selling in the United States than it could by producing in its home country and exporting goods to the United States market.⁴³ This is true whether the FDI takes the form of the construction of a

37. Caves, *supra* note 31, at 293-99. See also Pugel, *The United States*, in MULTINATIONAL ENTERPRISES, ECONOMIC STRUCTURE AND INTERNATIONAL COMPETITIVENESS (J. Dunning ed. 1985).

38. See *The New Wave*, *supra* note 18; *State Taxation of Foreign Source Income 1980: Hearings on H.R. 5076 Before the Committee on Ways and Means of the House of Representatives*, 96th Cong., 2d Sess. 90 (1980); (statement of C. Fred Bergsten); McLure, *Foreign Direct Investment in the United States: Old Currents, "New Waves," and the Theory of Direct Investment*, in THE MULTINATIONAL CORPORATION IN THE 1980'S 278-333 (C. Kindleberger and D. Andretsch eds. 1983).

39. UNITED STATES DEPARTMENT OF THE TREASURY, FOREIGN INVESTMENT IN THE UNITED STATES: A SUMMARY OF FEDERAL LAWS BEARING ON FOREIGN INVESTMENT IN THE UNITED STATES (1979); Bale, *The United States Policy Toward Inward Foreign Direct Investment*, 18 VAND. J. TRANSNAT'L LAW 199 (1985).

40. Little, *Foreign Direct Investment in the United States: Recent Locational Choices of Foreign Manufacturers*, NEW ENG. ECON. REV. Nov./Dec. 1980, at 5; Luger and Shetty, *Determinants of Foreign Plant Start-Ups in the United States: Lessons for Policymakers in the Southeast*, 18 VAND. J. TRANSNAT'L LAW 223 (1985); Benson and Johnson, *Capital Formation and Interstate Tax Competition*, in TAXATION AND THE DEFICIT ECONOMY, (D. Lee ed. 1986).

41. Harberger, *The Incidence of the Corporate Income Tax*, 70 J. POL. ECON. 215 (1962).

42. Due, *Studies of State-Local Tax Influences on Location of Industry*, 14 NAT'L TAX J. 163 (1961); Little, *Locational Decisions of Foreign Direct Investors in the United States*, NEW ENG. ECON. REV., July/August 1978, at 43, 54-55; Kieschnick, *Taxes and Growth: Business Incentives and Economic Development*, in STATE TAXATION POLICY 155 (M. Barker ed. 1983); COOPERS & LYBRAND, ECONOMIC IMPACTS AND TAX ALTERNATIVES ASSOCIATED WITH WORLDWIDE COMBINED REPORTING FOR THE STATE OF ILLINOIS 16-26 (1982).

43. Vernon, *International Investment and International Trade in the Product Cycle*, in INTER-

new plant or the take-over of an existing firm.

C. *Forms of Market Penetration*

Typically a foreign direct investor enters a new market in a series of evolutionary stages: 1) export through independent commission agents or brokers; 2) license of patents, and production know-how to an unaffiliated enterprise; 3) establishment of a local warehouse or sales office and direct local sales by employees; 4) foreign direct investment, defined as full scale local production and/or marketing by a controlled subsidiary under the direct managerial supervision of the MNE.⁴⁴ The assumption underlying this classification is that the foreign firm goes abroad to expand its market by producing and/or selling goods similar to those it manufactures for its home market. Most FDI in the United States is by a foreign corporation operating either through a United States branch or through a controlled domestic subsidiary.⁴⁵

PART III FEDERAL AND ARIZONA STATE TAX JURISDICTION AND DIVISION OF TAX BASE RULES APPLICABLE TO FOREIGN DIRECT INVESTMENT

A. *Background*

Federal tax law asserts jurisdiction to tax domestic corporations on worldwide net income.⁴⁶ It asserts jurisdiction to tax foreign corporations on investment gross income sourced within the United States⁴⁷ and on business profits effectively connected with a trade or business carried on in the United States.⁴⁸ Arizona claims the right to impose its corporation income tax on income sourced within its borders, either specially allocated (in the case of investment income and capital gains)⁴⁹ or apportioned by formula⁵⁰ (in the case of business income of a domestic corporation, including an Arizona corporation, doing business within and without the state). The United States tax system is based upon both global and source tax jurisdiction prin-

NATIONAL ECONOMIC POLICIES AND THEIR THEORETICAL FOUNDATIONS 307 (J. Letiche ed. 1982).

44. Y. AHARONI, *THE FOREIGN INVESTMENT DECISION PROCESS* (1966).

45. Chung and Fouch, *Foreign Direct Investment in the United States in 1982*, SURV. CURRENT BUS., Aug. 1983, at 31.

46. I.R.C. § 61(a) (1982).

47. I.R.C. § 881 (1982).

48. I.R.C. §§ 864(c), 882 (1982). The Internal Revenue Code does not define what activity constitutes the conduct of a trade or business in the United States. In general, a foreign person is taxable on business income effectively connected with United States business activity if such person "has an office or other fixed place of business within the United States to which such income is attributable" within the meaning of I.R.C. § 864(c)(4)(B) or if the foreign person sells its products in the United States through a dependent agent. See Rev. Rl. 70-424, 1970-2 C.B. 150. The question whether a foreign person is engaged in trade or business in the United States is not an area in which the Internal Revenue Service is not an area in which the Internal Revenue Service will ordinarily issue an advance ruling or determination letter. Rev. Proc. 85-22, 1985-1 C.B. 550.

49. ARIZ. REV. STAT. ANN. §§ 43-1134 to -1138 (Supp. 1986).

50. ARIZ. REV. STAT. ANN. § 43-1139 (Supp. 1986).

ciples. The Arizona state tax system is basically a territorial system.⁵¹

Although the tax jurisdiction rules are different, the objective of both the federal and Arizona state corporation income tax systems is the same: to formulate income computation rules that are a realistic measure of earning capacity within the taxing jurisdiction. Applied to the foreign-based MNE, at the federal level United States "earning capacity" is measured by application of the effective connection concept. At the state level, state "earning capacity" is measured by formula apportionment based on the geographical location of the factors of production creating the total income of the integrated enterprise doing business within and without the state.⁵² The difficulty is, however, that formula apportionment of income derived from business carried on in interstate and foreign commerce is fundamentally inconsistent with a territorial theory of taxation. Formula apportionment attributes the return to investment in the business of a multi-jurisdictional enterprise not by source but by geographic location based upon "corporate presence in the state as compared to corporate presence everywhere."⁵³

B. *Exporting and Licensing*

The first step in the penetration of the United States market by a foreign manufacturing or merchandising company is likely to be sales of foreign manufactured goods by agents who are independent contractors.⁵⁴ This is likely to be followed by the licensing to unrelated entities of patents covering the foreign manufacturing process.⁵⁵

1. *Federal Tax Rules*⁵⁶

Income from the sale by an independent commission agent, to a United

51. A territorial system of taxation, also described as source jurisdiction, asserts jurisdiction to tax persons or entities carrying on activities in the state on income which has its "source" in the taxing state, either directly in the case of investment income and income from intrastate business operations or indirectly by formula apportionment of income from interstate business operations. The underlying theory is that the source state has contributed to the ability of the taxpayer to derive the income in question and thus is entitled to invoke a cost-sharing rule. *Northwestern States Portland Cement Co. v. Minnesota*, 358 U.S. 450 (1959).

52. McLure has shown that state corporation income taxes levied on multistate firms have essentially the same effect as discriminatory state taxes on corporate payrolls, property, or sales (at origin or destination) where the profits of the firm are allocated among the states for tax purposes on the basis of formulas including payrolls, property, and sales. McLure, *Revenue Sharing: Alternative to Rational Fiscal Federalism?* 19 PUB. POL'Y. 472 (1971); McLure, *The State Corporate Income Tax*, in *THE ECONOMICS OF TAXATION* 327 (H. Aaron and M. Boskin eds. 1980). The incidence of the state corporation income tax is on consumers, immobile workers, and owners of immobile capital resident in the taxing state. McLure, *The Elusive Incidence of the Corporate Income Tax: The State Case*, 9 PUB. FIN. Q. 395 (1981).

53. Dexter, *The Attribution of the Net Income of Multi-state-Multinational Corporation for State Taxes on or Measured by Net Income*, 1 MULTISTATE TAX COMMISSION REV. 2 (June 1982).

54. An independent contractor, for purposes of excluding a foreign corporation from the "doing business" category for both federal and state tax purposes, is a commission agent, broker, or other independent agent acting for more than one principal and holding himself out as such in the regular course of business. Rev. Rul. 70-446, 1970-2 C.B. 215; Rev. Rul. 71-274, 1971-1 C.B. 287; 15 U.S.C. § 381 (1982).

55. Aliber, *A Theory of Direct Foreign Investment*, in *THE INTERNATIONAL CORPORATION* 17 (C. Kindleberger ed. 1970).

56. The statutory rules for taxing foreign corporations and nonresident alien individuals, trusts, estates, partnerships and other foreign persons are set forth in Parts I and II of Subchapter N of the

States purchaser of goods manufactured abroad is not United States source income⁵⁷ provided title to the goods passes outside of the United States.⁵⁸ Hence, there is no United States income tax to be paid on the sale. Further, the foreign manufacturer is not regarded as engaged in trade or business in the United States.

The Internal Revenue Code does not define what activities carried on in the United States by a foreign exporter will constitute "doing business" in the United States. The "permanent establishment" articles of the income tax treaties list the kinds of export-related activity that a foreign manufacturer or merchandiser can engage in *without* being subject to United States tax on sales made to domestic purchasers.⁵⁹ The following sales solicitation activities, even when carried on through a United States branch office or warehouse, do not place the foreign company in business:

- (1) the use of facilities solely for the purpose of storage, display, or delivery of goods or merchandise belonging to the foreign company;
- (2) the maintenance of a stock of goods or merchandise belonging to the foreign company solely for the purpose of storage, display, or delivery;
- (3) the maintenance of a stock of goods or merchandise belonging to the foreign company solely for the purpose of processing by a United States company;
- (4) the maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise, or of collecting information, for the foreign company;
- (5) the maintenance of a fixed place of business solely for the purpose of carrying on, for the foreign company, any other activity of a preparatory or auxiliary character;
- (6) the maintenance of a fixed place of business solely for any combination of these five activities.⁶⁰

All of these export-related activities have one factor in common. No sale is made in the United States. Delivery may be made from a United States warehouse; customers may be identified through market surveys and solicited directly. But the sale is made abroad where the sales offer is accepted and title passes. Also, any or all of these activities "of a preparatory

Internal Revenue Code (I.R.C. §§ 861-892 (1982)). These statutory rules apply alike whether the ultimate beneficial owner of a foreign corporation is a foreign corporation, nonresident alien, or United States parent company of a foreign first tier subsidiary corporation having a second tier United States subsidiary or a United States branch.

57. I.R.C. §§ 864(b), 861(a)(6) (1982); Rev. Rul. 67-194, 1967-1 C.B. 183.

58. Barry v. Scofield, 53-1 U.S. Tax Cas. (CCH) ¶ 9403 (W.D. Tex. 1953); Cadwallader Estate, 13 T.C. 214 (1949); Rev. Rul. 76-161, 1976-1 C.B. 193.

59. The United States has entered into income tax treaties with over 30 foreign countries. For purposes of applying the treaty provisions to FDI activities in the United States, reference will be made only to the provisions of the Treasury Department Model Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital, June 16, 1981 [hereinafter Model Treaty]. Generally the treaties in force follow the Model Treaty definition. Model Treaty, art. 5, Permanent Establishment, *reprinted in* 1 Tax Treaties (CCH) ¶ 158.

60. Model Treaty, *supra* note 59, art. 5, Permanent Establishment.

or auxilliary character"⁶¹ can be carried on by employees of the foreign company physically present in the United States. There is no requirement that the exporter deal with United States independent commission agents or brokers.

Federal case law and administrative practice follow the permanent establishment concept defined in United States income tax treaties. A foreign corporation, resident in a nontreaty country, is not regarded as doing business in the United States if the activity carried on is "of an isolated and noncontinuous nature."⁶² The fact that the corporation may have qualified to do business under state law is irrelevant for federal tax purposes.⁶³

If goods manufactured abroad are sold in the United States, with title passing in the United States, the net sales income is allocated between the home country of manufacture and the United States place of sale.⁶⁴ If there is an established factory price, the taxable income is allocated between the foreign country of manufacture and the United States place of sale on that basis. If there is no established factory price, one half of the taxable income is apportioned on the basis of the value of the property used in the business within and without the United States; the other half is attributed to the country where the sale is consummated—where the rights, title, and interests of the seller are transferred to the buyer.⁶⁵ The foreign manufacturer who makes direct export sales in the United States is engaged in trade or business in the United States whether these direct sales are made through independent commission agents or employees. The sales income is not United States source "fixed or determinable annual or periodical gains, profits [or] income" taxable on a gross basis at the 30 percent statutory rate.⁶⁶ Therefore, it must be income effectively connected with the conduct of a trade or business in the United States by the foreign exporter,⁶⁷ taxable on a net basis at graduated rates.⁶⁸ There are only these two categories of United States source income for foreign persons. If the foreign manufacturer or merchandiser is a resident of a treaty country, United States source sales income is exempt from tax if the company is not engaged in trade or business in the United States through a permanent establishment.⁶⁹ A literal reading of Article 5 of the Model Treaty suggests that if the United States sales are made through a "dependent agent" and the agent "has and habitually exercises" in the United States "an authority to conclude contracts in the name of the enterprise," the foreign manufacturer would be regarded as having a permanent establishment in the United States.⁷⁰ On the other hand, if the

61. *Id.*

62. *Continental Trading, Inc. v. Commissioner*, 265 F.2d 40, 45 (9th Cir. 1959).

63. *Id.* at 41.

64. I.R.C. § 863(b)(2) (1986); *Treas. Reg. § 1.863-3* (as amended in 1977).

65. *Treas. Reg. § 1.861-7(c)* (1960).

66. I.R.C. § 881(a) (1982).

67. I.R.C. § 882 (1982).

68. I.R.C. §§ 882(a), 11 (1982); *See Rev. Rul. 70-424*, 1970-2 C.B. 150, superceding G.C.M. 21219, 1939-1 C.B. 201.

69. The foreign corporation in this circumstance would not be a "corporation" within the meaning of I.R.C. § 11 (1982).

70. *Model Treaty, supra* note 59, art. 5, *Permanent Establishment*, ¶ 5; *Rev. rul. 81-78*, 1981-1 C.B. 604.

United States sales are made through a "general commission agent, or any other agent of an independent status . . . acting in the ordinary course of their business,"⁷¹ the foreign company would not have a permanent establishment in the United States and hence the sales income would be exempt United States source business profits.⁷²

Income from the licensing of a foreign patent or secret process for use in the United States, including income from the sale of such patent or secret process, is United States source income.⁷³ Such income is subject to tax withheld at source at the 30 percent statutory rate applicable to foreign corporations not engaged in trade or business in the United States.⁷⁴ If the foreign corporation licensor is resident in a treaty country, the royalty income is exempt from tax in the United States and fully taxable in the home country of the licensor as long as it does not come within the treaty category of doing business through a permanent establishment in the United States.⁷⁵

2. Arizona State Tax Rules

Sales of tangible personal property made to the Arizona market by a foreign-based exporter through an independent commission agent or broker give rise to Arizona source taxable income "regardless of the F.O.B. point or other conditions of the sale."⁷⁶ In the case of a domestic exporter to the Arizona market, Public Law No. 86-272⁷⁷ ensures that income from sales to Arizona purchasers is not taxed to the out-of-state seller under the Arizona corporation net income tax if the seller has no office, warehouse, or other fixed facility in the state from which delivery is made and confines his in-state activities solely to solicitation, whether through an employee or an independent commission agent.⁷⁸

Public Law No. 86-272 does not apply to sales in foreign commerce.⁷⁹ Arizona has not voluntarily applied the jurisdictional restrictions of Public

71. Model Treaty, *supra* note 59, art. 5, ¶ 6.

72. *Id.*

73. I.R.C. § 861(a)(4) (1986); Treas. Reg. § 1.861-5 (as amended in 1975).

74. I.R.C. § 881(a) (1982); Rev. Rul. 55-17, 1955-1 C.B. 388.

75. Model Treaty, *supra* note 59, art. 12, Royalties.

76. ARIZ. REV. STAT. ANN. § 43-1146(1) (Supp. 1986).

77. 15 U.S.C. § 381 (1982).

78. *Id.* This rule is more restrictive than the permanent establishment article of the Model Treaty (*supra* note 59, art. 5). It exempts from state income tax state-source solicitation sales income received by a corporation not incorporated within the state only if the in-state orders are approved and shipped or delivered from a source outside of the state *and* the exporter to Arizona does not maintain within the state a local warehouse or office from which deliveries are made. The Act restricts the in-state activity of the out-of-state exporter to any combination of:

- (1) Solicitation, by the person or his representative, of orders sent outside the taxing state for approval or rejection and filled by shipment or delivery from outside the taxing state; or
- (2) Solicitation in similar fashion (see preceding paragraph) but in the name of or for the benefit of a prospective customer; or
- (3) Selling or soliciting sales through one or more independent contractors, whether or not the latter have an office in the taxing state.

15 U.S.C. § 381 (1982). See generally, J. HELLERSTEIN, STATE TAXATION, CORPORATE INCOME AND FRANCHISE TAXES §§ 6.8-6.17 (1983).

79. 15 U.S.C. § 381(a)(1) (1982).

Law 86-272 to foreign corporations.⁸⁰ This means that a foreign manufacturing or merchandising company is taxable on sales made to Arizona purchasers even though the sales are made through independent commission agents, acceptance and title passage occurs in a foreign country, and delivery is made from a storage or other physical facility located in a foreign country. This is true whether the sale is "solicited" either directly through employees or indirectly through independent commission agents located in Arizona.

Further, Arizona does apply the throwback rule to foreign as well as domestic companies making sales to purchasers located outside of Arizona (whether in the United States or a foreign country) if the property is shipped from an office, warehouse, or other physical storage facility located in Arizona and the seller is not taxable in the country (state) of residence.⁸¹ This means that a foreign manufacturing or merchandising company owning a storage facility in Arizona or using a storage facility owned by an unrelated, independent contractor, for the storage of goods manufactured abroad, sold abroad, and delivered to purchasers located outside of Arizona is taxable on the foreign source sales income if not taxable on such income by the foreign country of residence and source.

This is a startling result. A foreign manufacturer or merchandiser, not engaged in trade or business in the United States for federal tax purposes, not having a permanent establishment in the United States for treaty purposes, not carrying on sales solicitation activity in Arizona for state purposes, would nonetheless be taxable by Arizona on foreign source sales income derived from sales to non-Arizona purchasers if the goods sold are delivered out of a physical storage facility located in Arizona and the foreign source sales income is not taxable in the foreign country of source.

In this situation the foreign exporter would be required to file an Arizona tax return because it is "subject" to the Arizona corporation income tax.⁸² However, as a practical matter, how can foreign source export sales income in fact be taxed in Arizona if federal net taxable income is the starting point for the computation of Arizona gross income and the foreign source sales income is not taxable at the federal level? There is no provision in the Arizona Income Tax Act for the add-back of Arizona source export sales income excluded from the federal tax base but included in the Arizona income tax base under the throwback rule or because the solicitation rules of Public Law 86-272 do not apply to sales in foreign commerce.

Arizona asserts jurisdiction to tax income from the use of instate property whether or not the owner of the property is doing business in the state.⁸³ Royalty income received by a foreign corporation from the license for use in Arizona of patents or know-how is Arizona source income taxable at the corporate rate.⁸⁴ A foreign corporation not doing business⁸⁴ in Arizona but subject to tax in Arizona on Arizona source royalty income must file the

80. Tatarowicz, *State Judicial and Administrative Interpretations of U.S. Public Law 86-272*, 38 THE TAX LAWYER 293, 331 (1985).

81. ARIZ. REV. STAT. ANN. § 43-1146(2) (Supp. 1986).

82. ARIZ. REV. STAT. ANN. § 43-307(A) (Supp. 1986).

83. ARIZ. REV. STAT. ANN. § 43-104(10) (1980 & Supp. 1986).

84. ARIZ. REV. STAT. ANN. §§ 43-1138(A)(1), 43-1131(1) (Supp. 1986).

same corporation income tax return as a foreign corporation doing business in Arizona.⁸⁵ This requirement would appear to apply even though the corporation may not have any federal taxable income for the year. This would be the case if the Arizona-United States source royalty income is exempt from federal tax under an applicable treaty because the foreign corporation does not have a permanent establishment in the United States.

The Arizona tax law rules give rise to several uncertainties when combined with the federal tax law rules:

- 1) If a foreign corporation, not engaged in trade or business in the United States, and not resident in a treaty country, receives United States (i.e., Arizona) source royalty income, such income is taxed for federal purposes on a gross basis at the rate of 30 percent.⁸⁶ Is it also taxed on a gross basis by Arizona given the fact that federal net taxable income is the starting point for the computation of Arizona taxable income?⁸⁷
- 2) If a foreign corporation is engaged in trade or business in the United States (i.e., in Arizona), and the royalty income is effectively connected income, it is taxed for federal purposes on a net basis at graduated rates.⁸⁸ Is it therefore also taxed on a net basis by Arizona?
- 3) If a foreign corporation, not engaged in trade or business in the United States, is resident in a treaty country, the United States source royalty income is taxable only in the foreign country of residence. How can it be taxable in Arizona, as a practical matter, if the foreign corporation does not file a federal return, which it is not required to do since it would have no effectively connected income and the United States payor is not required to file either a federal or a state information return with respect to exempt United States source income?

These questions arise because, although Arizona asserts jurisdiction to tax Arizona source income of nondomiciliary corporations not doing business in Arizona, the Income Tax Act makes federal net taxable income the basis for the computation of Arizona gross income without making provision for adding back Arizona (i.e., United States) source income not taxable at the federal level.⁸⁹

85. ARIZ. REV. STAT. ANN. § 43-307 (Supp. 1986).

86. I.R.C. § 881(a) (1982).

87. ARIZ. REV. STAT. ANN. § 43-1101(a) (1980 & Supp. 1986).

88. I.R.C. § 882 (1982).

89. In *American Refrigerator Transit Co. v. State Tax Commission*, 238 Or. 340, 395 P.2d 127 (1964), the Oregon Supreme Court upheld the validity of an Oregon net income tax on rental income received by an out-of-state lessor, not doing business in the state. Taxpayer had challenged the constitutionality of the tax under the Due Process Clause on the ground that the requisite jurisdictional nexus was lacking. The Court stated:

We cannot accept the lower court's concept of nexus necessary to sustain the constitutionality of the tax imposed upon plaintiff. We do not regard it as essential to the existence of a nexus that the taxpayer, through its agents, *directly* engage in some form of physical activity within the state in furtherance of a business purpose. The connection between the taxing state and the out-of-state taxpayer necessary to establish nexus is essentially an economic rather than a physical relationship. . . .

The nexus exists whenever the corporation takes advantage of the economic milieu within the state to realize a profit. The state is entitled to tax if the benefits it provides are a

C. Branch Operation

1. Federal Tax Rules

A foreign corporation, not resident in a treaty country, engaged in trade or business in the United States through a branch office (factory, warehouse, sales office or other fixed facility), is taxed on income effectively connected with the carrying on of this trade or business on a net basis at the regular corporate rate.⁹⁰ All United States source branch profits are deemed to be effectively connected income if the foreign corporation's activities amount to the carrying on of a trade or business in the United States.⁹¹ If the foreign corporation is from a non-treaty state and is engaged in trade or business in the United States through a branch office, effectively connected income could also include foreign source business income.⁹² To rephrase the effective connection concept in terms of state tax-law concepts: the United States source sales income of a non-treaty-state foreign corporation doing business through a branch office and exporting two or more unrelated products to the domestic market is, by definition, income derived from a single unitary operation. Example (3) of Reg. § 1.864-4(b) illustrates this point:

Example (3). Foreign corporation S, which uses the calendar year as the taxable year, is engaged in the business of purchasing and selling electronic equipment. The home office of such corporation is also engaged in the business of purchasing and selling vintage wines. During 1968, S establishes a branch office in the United States to sell electronic equipment to customers, some of whom are located in the United States and the balance, in foreign countries. This branch office is not equipped to sell, and does not participate in sale of, wine purchased by the home office. Negotiations for the sales of the electronic equipment take place in the United States. By reason of the activity of its branch office in the United States, S is engaged in business in the United States during 1968. As a result of advertisements which the home office of S places in periodicals sold in the United States, customers in the United

substantial economic factor in the production of the taxpayer's income. These benefits are found in the maintenance of conditions essential to the production or marketing of goods. They may be realized simply in the protection of the taxpayer's property used in the production of income.

. . . Nexus may be found even where neither property nor personnel of the taxpayer is employed within the taxing state if it can be said that the state substantially contributes to the production of the taxpayer's income.

Id. at 346-47, 395 P.2d at 130-31. See generally, J. HELLERSTEIN, *supra* note 78, § 6.6.

90. I.R.C. §§ 882, 864(c), 11 (1982).

91. Treas. Reg. § 1.864-4(b) (as amended in 1984). This is a remnant of the "force of attraction" principle found in the older treaties, namely, that if a foreign corporation is doing business in the United States, all of the United States source income is "attracted" to the business and hence taxed on a net basis. See, e.g., Article III(1), Income Tax Treaty Between Italy and the United States (1956) reprinted in 2 Tax Treaties (CCH) ¶ 4305. The 1956 treaty has been superceded by a new treaty effective beginning in 1986. Article III(1) of the 1956 treaty provided:

(1) An enterprise of one of the contracting States shall not be subject to tax by the other contracting State in respect of its industrial and commercial profits unless it is engaged in trade or business in such other State through a permanent establishment situated therein. If it is so engaged such other State may impose its tax upon the entire income of such enterprise from sources within such other State.

92. I.R.C. § 864(c)(4)(B) (1982). Dispositions of United States real property interests after June 18, 1980 also are treated as "effectively connected" income. I.R.C. § 897 (1982).

States frequently place orders for the purchase of wines with the home office in the foreign country, and the home office makes sales of wine in 1968 directly to such customers without routing the transactions through its branch office in the United States. The income or loss from sources within the United States for 1968 from sales of electronic equipment by the branch office, together with the income or loss from sources within the United States for that year from sales of wine by the home office, is treated as effectively connected for that year with the conduct of a business in the United States by S.⁹³

Two factors to be taken into account to determine whether investment income (i.e., fixed or determinable income) or capital gain income is effectively connected are: the income derived from assets used in, or held for use in the United States business; are the activities of the United States operation a "material factor" in the realization of the income.⁹⁴ In applying these two factors the treatment of the asset on the books of the branch operation is significant but not controlling.⁹⁵ The Internal Revenue Service will not rule under section 864 on whether income is effectively connected.⁹⁶

The treaty permanent establishment concept is more restrictive than the effective connection concept. Under the treaties, no host country-source business income is taxable by the host country unless "attributable" to the specific permanent establishment whose activities give rise to the host country-source income.⁹⁷ A foreign corporation carrying on two or more unrelated businesses in the United States is regarded, for treaty purposes, as having a separate permanent establishment for each business.⁹⁸ This is not significant for federal tax purposes since the income and losses of all of the separate permanent establishments would be combined on the single corporation return filed by the foreign corporation. This could be significant for state tax purposes, however, in application of the combined unitary method for defining the state taxable income base.

If the foreign source effectively connected income is also taxed by the country of residence of the foreign corporation doing business in the United States, double taxation is avoided through allowance of a foreign tax credit,⁹⁹ subject to the overall limitation.¹⁰⁰ United States source investment income unrelated to the business carried on in the United States by the foreign corporation is taxed on a gross basis at the 30 percent statutory rate or lower treaty rate.¹⁰¹ The foreign tax credit is not allowable against the 30 percent tax.¹⁰²

The policy underlying these rules is twofold: to encourage FDI in the United States but at the same time to make this country unavailable as a tax

93. Treas. Reg. § 1.864-4(b) (as amended 1984).

94. I.R.C. § 864(c) (1982).

95. *Id.*

96. Rev. Proc. 85-22 I.R.B. 1985-12, 13, superceding Rev. Rul. 84-22, 1984-1 C.B. 449.

97. Rev. Rul. 81-78, 1981-1 C.B. 604.

98. *Id.*

99. I.R.C. §§ 906(a), 901 (1982); Rev. Rul. 76-190, 1976-1 C.B. 196.

100. I.R.C. § 904 (1982).

101. I.R.C. § 881 (1982).

102. I.R.C. § 906(b)(3) (1982).

haven.¹⁰³

If a foreign corporation is carrying on business in the United States through a permanent establishment, the reduced treaty rates or exemptions do not apply to United States source nonbusiness income. The strict attribution rules of the treaty apply to United States source business income; the statutory rate of 30 percent applies to investment income and capital gain.¹⁰⁴ In cases where both the treaty permanent establishment rule and the effective connection rule apply, the foreign corporation can elect between the treaty and the statutory rule, whichever results in the more favorable tax treatment.¹⁰⁵

A United States branch of a vertically integrated foreign manufacturer or merchandiser is subject to the transfer pricing rules of section 482.¹⁰⁶ It may also be subject to the transfer pricing rules of the United States double taxation treaties.¹⁰⁷ Basically, a transfer pricing rule is a technique for arriving at a reasonable division of income between the buying and selling units of a MNE as well as for apportioning the MNE monopoly profit or surplus among taxing jurisdictions. The arms length¹⁰⁸ requirement attempts to ascertain the true income (tax base) of each related entity by requiring the affiliates to deal with each other as strangers even though a MNE operates as a single monolithic structure and hence a market does not exist between the different units of the MNE. The underlying assumption is that intra-firm prices that do not conform to open-market or arms length prices are being used to transmit profits from one tax jurisdiction to another (from a high to a low tax jurisdiction).¹⁰⁹ In fact, "today's world of imperfect competition

103. Testifying on what was to become Public Law 89-809, then Secretary of the Treasury Henry Fowler stated:

The purpose of this bill is to remove tax barriers which have served to discourage foreigners from making investments in the United States, in comparison with other competing areas. At the same time we recognize that no purpose will be served if the bill violates international tax standards, thereby setting off a struggle among the developed nations of the world to attract foreign investors through tax devices. To attract foreign investors, the United States must not offer "tax breaks" or "tax gimmicks"—it must offer a growing and dynamic economy.

Removal of Tax Barriers to Foreign Investment in the United States: Hearings on H.R. 13103 Before the House Comm. on Ways and Means, 89th Cong., 2d Sess. 26 (1966) (statement of Henry Fowler, Secretary of the Treasury).

104. Rev. Rul. 55-282, 1955-1 C.B. 634.

105. Rev. Rul. 80-147, 1980-1 C.B. 168.

106. I.R.C. § 482 (1982) applies to "organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated)" if such organizations, etc. are "owned or controlled directly or indirectly by the same interests." *Id.* Transfer pricing only occurs in the case of a vertically integrated MNE where the separate stages of production and sale occur within different countries within the same company.

107. Model Treaty, *supra* note 59, Art. 3(1)(C), defines a permanent establishment as an enterprise, and the treaty transfer pricing rules, Art. 9, apply to "associated enterprises."

108. The term "arms length" means that an intercompany price will be a "market price," assuming a willing buyer and a willing seller acting without compulsion even though as a matter of economic reality no market in fact exists for the intercompany transaction. The basic principle underlying the concept is that related companies are required to deal with each other on the same basis as unrelated persons under the same or similar circumstances. Treas. Reg. § 1.482-1(b) (1960). See McLure, *Defining a Unitary Business: An Economist's View*, in THE STATE CORPORATION INCOME TAX, 89 (1984). For a history of the derivation of the arms length pricing concept, see Langbein, *The Unitary Method and the Myth of Arm's Length*, 30 TAX. NOTES 625 (1986).

109. See Gordon, *Tax Havens And Their Use By United States Taxpayers—An Overview*, A REPORT TO THE COMMISSIONER OF INTERNAL REVENUE, THE ASSISTANT ATTORNEY GENERAL

and knowledge gives ample opportunity and incentive for multinational firms *not* to price uniformly."¹¹⁰

The arms length standard is the standard used by the major trading partners of the United States to determine which country has the primary right to tax the business income of a MNE.¹¹¹ It also is the standard used originally by the separate states to tax the interstate business income of a corporation operating in several states through separately incorporated affiliates.¹¹² In practice, the "arms length" criterion is satisfied if there are no profit-shifting, fictional transactions between the foreign company and its United States branch, with the result that United States source business profits reported by the branch accurately reflect the profits which the branch would have made had it been organized as a separate entity dealing with the foreign company through market transactions.¹¹³ Again, in practice, if the Internal Revenue Service challenges the amount of United States source business profits reported by the branch for tax purposes, the best defense under both section 482 and the associated enterprises articles of the income tax treaties is for the taxpayer to show that the transfer prices on intermediate sales transactions (product transfers) correspond to "comparable uncontrolled prices" as defined by the section 482 regulations and the income tax treaties.¹¹⁴ If such comparable prices are not available, formulary determination to compute the income of the branch is permissible.¹¹⁵

If, as a result of a section 482 adjustment the United States branch distributor for a foreign manufacturing or merchandising company, is required to increase its United States taxable income and this same income is taxed by the country of residence of the foreign company, double taxation results unless the residence country gives the foreign company a credit against its taxes for the United States tax paid on the allocated income or unless it makes a "correlative adjustment." An increase in United States taxable income could result either from an increase in United States source sales income, reported by the branch as noneffectively connected foreign source sales income, or from a decrease in a deduction, as for cost of goods sold, claimed by the branch. If the foreign company is a resident of a treaty country, a

(TAX DIVISION), AND THE ASSISTANT SECRETARY OF THE TREASURY (TAX POLICY) (Jan. 12, 1981).

110. J. ARPAN & L. RADEBAUGH, INTERNATIONAL ACCOUNTING AND MULTINATIONAL ENTERPRISES 235 (1981).

111. REPORT OF THE OECD COMMITTEE ON FISCAL AFFAIRS, TRANSFER PRICING AND MULTINATIONAL ENTERPRISES (1979); REPORT OF THE OECD COMMITTEE ON FISCAL AFFAIRS, TRANSFER PRICING AND MULTINATIONAL ENTERPRISES: THREE TAXATION ISSUES (1984); Note, *Multinational Corporations and Income Allocation Under Section 482 of the Internal Revenue Code*, 89 HARV. L. REV. 1202, 1216 (1976). Langbein, *supra* note 108, at 641, challenges the view that the arms length or separate accounting method is widely used by other countries for allocating the income of a MNE. See also Boren, *Separate Accounting in California and Uniformity in Apportioning Corporate Income*, 18 UCLA L. REV. 478 (1971).

112. J. HELLERSTEIN, *supra* note 77, at ¶ 8.3.

113. Donnelly, *Eliminating Uncertainty in Dealing With Section 482*, 12 INT'L TAX. J. 213 (1986). Separate accounting, which reflects the contribution to total MNE profits made by each branch in each taxing jurisdiction in effect allocates all of the monopoly profit to the home country of the MNE. The host tax jurisdictions capture none of the surplus.

114. Treas. Reg. § 1.482-2(e) (as amended in 1983).

115. Treas. Reg. § 1.482-2(e)(2) (as amended in 1983). Model Treaty, *supra* note 79, art. 9(2), Associated Enterprises.

correlative adjustment or foreign tax credit would be available automatically.¹¹⁶

2. *Arizona State Tax Rules*

A nondomiciliary corporation (including a foreign corporation) is taxable on Arizona source investment income and on business income attributable by formula apportionment to a branch operation carried on within Arizona if the nondomiciliary corporation is "doing business" within and without the state, including abroad.¹¹⁷ That is, a foreign-based MNE doing business in Arizona through a branch is the taxpayer, not the branch. Arizona, like most states, does not define "doing business" by statute or regulation. Clearly, a branch factory from which foreign manufactured goods are shipped for sale in interstate or foreign commerce, or a branch sales office to which are attached employees who solicit orders for goods manufactured abroad, would constitute doing business sufficient to satisfy the due process¹¹⁸ and commerce clauses.¹¹⁹ Business income apportionable to Arizona would include not only sales and service income from activities carried on within and without the state but also income from investment in both foreign and domestic subsidiaries where the investment is made to expand the integrated unitary business activities of the MNE carried on in Arizona or to assure a source of inputs for the Arizona operation.¹²⁰

Arizona asserts jurisdiction to tax a nondomiciliary domestic corporation doing business in Arizona by carrying on one or more of the following activities:

1. a research facility for company use only;
2. ownership of Arizona real estate producing investment income;
3. a stock of goods in the state consigned to customers;
4. displaying goods at space leased occasionally and for short term;

116. Model Treaty, *supra* note 79, Art. 9(2), Associated Enterprises.

117. ARIZ. REV. STAT. ANN. §§ 43-1131(1), 43-1132, 43-1134 (Supp. 1986). State tax jurisdiction over a corporation doing business in the state but not incorporated in the state is limited to income earned within the state. *Hans Rees' Sons, Inc. v. North Carolina ex. rel. Maxwell*, 283 U.S. 123 (1931). The distinction made between specially allocated nonbusiness (i.e., investment) income and apportionable business income follows the Uniform Division of Income for Tax Purposes Act (UDITPA) promulgated by the Conference of Commissioners of Uniform State Laws in 1957 and incorporated into Article IV of the Multistate Tax compact. It is basically consistent with the distinction between effectively connected and non-effectively connected income for federal purposes. However, nonbusiness income, for state tax purposes, is not necessarily the same as investment income for federal purposes. "Income is classified as business income under UDITPA because it has no recognized situs or source apart from where the UDITPA apportionment formula attributes such income on an approximate basis," Dexter, *The Business Versus Nonbusiness Distinction Under the Uniform Division of Income for Tax Purposes Act*, 10 URB. LAW. 246 (1978). Dexter forcefully argues that all corporate income is business income because "corporations engage in business transactions for the purpose of producing income." *Id.* at 265. Therefore, "the distinction between business and nonbusiness income has little or no economic pertinence." *Id.*

118. U.S. CONST. amend. XIV, § 1; *Northwestern States Portland Cement Co. v. Minnesota*, 358 U.S. 450 (1959). The limitations of Public Law 86-272 do not apply to a foreign corporation engaged in business in foreign commerce. See *Tatarowicz, supra* note 80.

119. U.S. CONST. art. I, § 8; *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274 (1977).

120. This is the asset use test of Treas. Reg. § 1.864-4(c) (2)(ii) (a) (as amended in 1984); see also ARIZ. REV. STAT. ANN. § 43-1131(1) (Supp. 1986).

5. stock of goods in the state from which goods are delivered in the state by common carrier;
6. sales office in the state, with orders accepted in the state;
7. C.O.D. shipments into the state;
8. security interest retained in goods sold;
9. credit investigations and collections made by salesmen on a regular basis;
10. cars in the state owned by the corporation and used by salesmen on a regular basis;
11. delivery of goods into the state in company-operated vehicles;
12. installation or assembly of corporation's products by salesmen;
13. acceptance of orders in the state by salesmen;
14. servicing or repairing of corporation's products by its employees at no additional charge.¹²¹

Most of the different activities listed give rise to Arizona source sales or service income and to apportionable net income from the domestic company's unitary operation carried on within the state through a branch and without the state.¹²² However, several of the activities would not constitute doing business for federal income tax purposes or qualify as a permanent establishment were the nondomiciliary corporation a foreign corporation: a research facility, displaying goods, security interest retained in goods sold, credit investigations and collections, maintaining a stock of goods from which delivery is made.

A foreign corporation doing business in Arizona through a branch office is an Arizona taxpayer if: 1) the foreign corporation has United States source effectively connected income, or 2) the Arizona branch is a permanent establishment and the foreign corporation is resident in a treaty country, or 3) the foreign corporation has a branch office or permanent establishment in one or more other states and these operations are a part of the unitary business of the Arizona branch operation. Although any corporation, including a foreign corporation, is technically an Arizona taxpayer if it derives income from property located in Arizona or from business activity carried on within the state,¹²³ it is federal tax law which determines whether the Arizona source income is taxable.¹²⁴

Combination of the federal and Arizona tax rules creates an anomalous situation: a foreign corporation may be doing business in Arizona under Arizona jurisdictional rules and earning Arizona source income and yet not be doing business in Arizona under the effective connection or permanent establishment rules as an Arizona taxpayer. In this circumstance, the foreign corporation is required to file an Arizona return¹²⁵ even though it is not subject to tax in Arizona because it has no "Arizona gross income." With

121. See Tatarowicz, *supra* note 80.

122. Chromalloy Pharmaceuticals, Inc. v. Arizona Department of Revenue, Arizona State Tax Reporter (CCH) ¶ 200-592 (1983).

123. ARIZ. REV. STAT. ANN. §§ 43-104(25), 43-1111, 43-1132B (Supp. 1986).

124. ARIZ. REV. STAT. ANN. § 43-1101(1) (Supp. 1986).

125. ARIZ. REV. STAT. ANN. § 43-307 (Supp. 1986).

respect to Arizona source sales income,¹²⁶ the foreign corporation would also be subject to the Arizona Sales, Receipts or Use Tax on goods manufactured abroad if sold through a branch retail outlet in the state.¹²⁷

If a foreign corporation is an Arizona taxpayer doing business abroad and in Arizona and also in one or more other states through branches, and it derives income from the foreign operation and from one or more of the other states, but not from the Arizona operation, in principle it is subject to tax in Arizona on the foreign and out-of-state branch profits if the foreign and out-of-state branch operations are part of the unitary business carried on within and without Arizona.¹²⁸

A foreign corporation doing business in Arizona through a branch is taxable in Arizona on its effectively connected income, including foreign source effectively connected income, reported for federal purposes. If from a treaty country, the foreign corporation is taxable on income "attributable" to the Arizona permanent establishment—a narrower test than the effective connection test.¹²⁹ The income reported for federal purposes is apportioned to the state by the 3-factor formula of property, payroll, and sales; or by separate accounting if formula apportionment does not accurately reflect the income generated by the Arizona activity.¹³⁰ The 3-factor apportionment formula of property, payroll and sales would include in the denominator of each fraction foreign property, payroll and sales values if the tax base includes foreign source unitary income:¹³¹

$$\text{Unitary apportionable income} = \frac{\text{Property}_{AZ}}{\text{Property total}} + \frac{\text{Payroll}_{AZ}}{\text{Payroll total}} + \frac{\text{Sales}_{AZ}}{\text{Sales Total}}$$

3

126. ARIZ. REV. STAT. ANN. § 43-1146 (Supp. 1986). The statutory rules for Arizona source sales income place the income within the state if

1. the property is delivered or shipped to an Arizona purchaser,
2. the property is shipped from an Arizona warehouse, office, store, factory and either the purchaser is the United States Government or the sale is not taxed in any other state.

127. ARIZ. REV. STAT. ANN. § 42-1301 (Supp. 1986).

128. ARIZ. COMP. ADMIN. R. & REGS. R15-2-1091D(3)(a) (1986), applicable to "nonresidents," reads:

The gross income from the entire business, trade, or profession must be reported if a business, trade, or profession carried on within this state is an integral part of the unitary business carried on both within and without the state, or if the part within the state is so connected with the part without the state that the net income from the part within the state cannot be accurately determined independently of the part without the state. Thus, if a nonresident engaged in the business of manufacturing and selling goods for example maintains a factory outside this state and sales offices in this state or vice versa, he must report the gross income from the entire business.

129. See text accompanying notes 97-98.

130. ARIZ. REV. STAT. ANN. §§ 43-1139, 43-1148 (Supp. 1986). ARIZ. COMP. ADMIN. R. & REGS. R15-2-1141A(3) (1986) reads:

If a corporation is engaged in carrying on business between this state and other states or countries, a portion of the income derived from the business is attributable to this state and as such constitutes income from sources within this state even though the corporation may have no offices or established place of business in this state.

This rule is broader than the provision of I.R.C. § 864(c)(1) (1982) which reaches only United States source business income if the corporation does not have an office or other fixed place of business in the United States.

131. ARIZ. REV. STAT. ANN. § 43-1132 (Supp. 1986).

The United States source investment income (not sourced in Arizona) would not be subject to Arizona tax, being specially allocated to the foreign country of residence of the company.¹³²

A foreign corporation doing business in Arizona through a branch also would be subject to the allocation of income and deduction provisions of the statute which apply "in any case of two or more persons, organizations, trades or businesses, whether or not organized in the United States. . . ."¹³³ "In the case of a corporation doing business within the meaning of this title, . . . by rendering services of any nature whatsoever or acquiring or disposing of its products or the goods or commodities in which it deals, at less than a fair price therefore . . ." the Department of Revenue has authority to adjust the terms of the transaction so as to prevent the avoidance of Arizona tax.¹³⁴ Again, there is no provision in either the statute or the regulations restricting the "fair price" adjustment to United States source income and expenses. Thus, technically the Department of Revenue can reach a foreign corporation in a low tax country that "sells" tangible personal property to its Arizona branch at an artificially high price, placing the sales profit in the low tax country and giving the branch a high cost of goods sold with concomitantly reduced Arizona sales income.

The significance of the arms length standard in the context of calculating apportionable income of a unitary business carried on abroad and in Arizona through a branch may be illustrated by the *X* and *Y* company intercompany sales transaction. Assume a manufacturer in country *X* produces product *D* for distribution and sale in the United States. *X* has an Arizona branch office, *Y*, engaged in the business of soliciting sales at wholesale, filling orders and making deliveries from a warehouse located in Arizona. Assume further that *X* and *Y* have the following balance sheets:

Item	<i>X</i> (foreign) (\$ millions)	<i>Y</i> (Az) (\$ millions)
(1) Gross sales	\$50.	\$100.
(2) Total expenses [(3)+(4)+(5)]	30.	55.
(3) Raw material	10.	0
(4) Cost of goods sold	0	50.
(5) Compensation	20.	5.
(6) Net income [(1)-(2)]	20.	45.
(7) Property	200.	15.

If *X* increases the transfer price to *Y* from \$50 to \$75, the result is to reduce the United States source *Y* income from \$45 million to \$20 million and to increase the foreign source gross sales income of *X* from \$20 million to \$45 million. If the foreign tax rate is lower than the United States tax rate, it may be to the overall tax advantage of the foreign parent to increase

132. ARIZ. REV. STAT. ANN. § 43-1134 (Supp. 1986).

133. ARIZ. REV. STAT. ANN. § 43-941 (Supp. 1986).

134. ARIZ. REV. STAT. ANN. § 43-946 (1980).

the transfer price to Y .¹³⁵ However, for Arizona state tax purposes, where the foreign source sales income of X is included as part of the combined unitary income of Y , the state tax savings of transfer pricing for state tax purposes may not be significant because the unitary income of the foreign company and the combined Arizona branch remains the same, namely \$65 million. The principal advantage of transfer pricing for state tax purposes would most likely be to decrease the relative value of the numerator of the Arizona gross sales factor.

Arizona apportionable income of X would be \$20.29 million if the transfer price were \$50:

$$\$65 \times \frac{15}{215} + \frac{5}{25} + \frac{100}{150} = \$20.29$$

$$\frac{\quad\quad\quad}{3}$$

Arizona apportionable income of X would be \$18.23 million if the transfer price were \$75:

$$\$65 \times \frac{15}{215} + \frac{5}{25} + \frac{100}{175} = \$18.23$$

$$\frac{\quad\quad\quad}{3}$$

In conclusion, a foreign corporation doing business in Arizona through a branch is taxed on its worldwide effectively connected income or, if resident in a treaty country, on its United States source business income attributable to the permanent establishment maintained in the United States. The business income reported for federal purposes is apportioned to Arizona by a 3-factor formula which includes the foreign value of property, payroll, and sales in the denominators of the apportionment ratios. This is a broader assertion of tax jurisdiction than obtains in the case of a foreign corporation operating in Arizona through a domestic subsidiary, as shown in the next section.

D. *Domestic Controlled Subsidiary*

1. *Federal Tax Rules*

Most FDI in the United States is in the form of equity control of a subsidiary corporation, incorporated in one of the states and doing business in foreign and interstate commerce.¹³⁶ A foreign-controlled United States subsidiary corporation is taxed on its worldwide net income.¹³⁷ In the usual

135. Even if the federal income tax includes the increased reallocated foreign source income in the tax base as foreign source effectively connected income, the taxpayer will have reduced his Arizona state tax bill because he has decreased the limitation on the foreign tax credit by increasing the numerator of the fraction which limits the amount of the foreign tax credit. I.R.C. § 904 (1982). The increased foreign tax credit on the reallocated foreign source income is subtracted from federal net taxable income to reach Arizona taxable income. ARIZ. REV. STAT. ANN. § 43-1122(4) (1980).

136. See *supra* note 14.

137. I.R.C. §§ 61(a), 11 (1982).

case the United States earnings of the United States subsidiary corporation are taxed to the foreign parent company as investment income when distributed in the form of dividends.¹³⁸ United States source earnings repatriated in the form of dividends are subject to United States tax withheld at source at the rate of 30 percent,¹³⁹ or lower treaty rate. Most tax treaties provide for a reduced rate of 5 percent if the foreign parent company owns at least 10 percent of the voting stock of the payor subsidiary company.¹⁴⁰ The foreign parent company is not treated as engaged in a United States trade or business by virtue of such stock ownership. Capital gains upon sale or other disposition of the stock interest by the parent are exempt from tax.¹⁴¹

Earnings may also be repatriated from the subsidiary to the foreign parent in the form of interest, royalties, rents or other charges which reduce the profits of the United States subsidiary. Such payments also are subject to the 30 percent tax withheld at source.¹⁴² Most tax treaties exempt from United States tax United States source interest,¹⁴³ and royalties.¹⁴⁴ Rents are fully taxable by the United States as the source state, but the foreign parent can elect to be taxed on a net basis.¹⁴⁵

In addition, the transactions between parent and subsidiary giving rise to these payments are subject to the arm's length pricing rule.¹⁴⁶ There is no fundamental difference in the tax consequences of an arm's length reallocation between a United States branch and the foreign company and a United States subsidiary and the foreign parent or between two United States subsidiaries of the foreign parent.¹⁴⁷ As in the case of an allocation between a foreign corporation and its United States branch, an arm's length allocation between a foreign parent and a United States controlled subsidiary may determine both the amount and the source of the world-wide net business income reported by the subsidiary. The difficulties and deficiencies of the arms-length pricing rule applied to a MNE and its branch operations obtain with equal force where the MNE operates through controlled subsidiaries.¹⁴⁸

All tax treaties provide that each contracting state will provide relief from double taxation by a foreign tax credit, exemption, or reduced rate.¹⁴⁹ The United States, as the state of residence of the domestic subsidiary, unilaterally grants a foreign tax credit with respect to foreign source income of the subsidiary taxed in the source state and in the United States.¹⁵⁰ Tax

138. I.R.C. § 861(a)(2) (1982).

139. *Id.* See also I.R.C. §§ 881(a), 1441 (1982).

140. Model Treaty, *supra* note 79, art. 10(2)(a), Dividends.

141. Capital gain income is not fixed or determinable periodical income with the meaning of I.R.C. § 881 (1982).

142. I.R.C. § 881(a)(1982), Treas. Reg. § 1.881-2(b) (as amended in 1973).

143. Model Treaty, *supra* note 79, art. 11, Interest.

144. Model Treaty, *supra* note 79, art. 12, Royalties.

145. Model Treaty, *supra* note 79, art. 6, Income from Real Property.

146. I.R.C. § 482 (1982); Model treaty, *supra* note 79, art. 7, Business Profits. See *supra* text accompanying notes 133-35.

147. Treas. Reg. § 1.482-1(b)(2) (as amended in 1968).

148. See *supra* text accompanying notes 133-35.

149. Model Treaty, *supra* note 79, art. 23, Relief from Double Taxation.

150. I.R.C. §§ 901, 902, 904, 960 (1982).

treaties do not modify this rule.

2. Arizona State Tax Rules

The Arizona corporation income tax applies to the adjusted worldwide net income¹⁵¹ of a foreign-controlled domestic subsidiary¹⁵² allocable by formula to Arizona,¹⁵³ if the subsidiary is doing business in Arizona;¹⁵⁴ it applies also to Arizona source investment income specially allocated to Arizona.¹⁵⁵ The Arizona corporation income tax does not apply to a domestic corporation that has derived less than 20 percent of its federal gross income from United States sources for the three-year period preceding the taxable year or to a domestic corporation that derives more than 65 percent of its federal gross income from the active conduct of a trade or business in a United States possession (except for the Virgin Islands).¹⁵⁶ With respect to the foreign parent of the domestic subsidiary doing business in Arizona, no amount of the foreign source income of the foreign parent company, not doing business in Arizona, can be apportioned to Arizona by formula or by arm's length pricing adjustment.¹⁵⁷ This is the water's edge rule adopted by Arizona in 1985.¹⁵⁸

This subsection will describe the structure of the Arizona corporation income tax as it applies to a domestic subsidiary of a foreign parent. The following subsection will explain the significance of the Arizona approach in the context of the controversy over separate accounting versus worldwide unitary combination or water's edge unitary combination.

(a) Taxable income base

The Arizona taxable income base of a domestic subsidiary of a foreign parent includes foreign source business income if the subsidiary is carrying on a unitary business both in Arizona and abroad; it also includes foreign source investment income (rents, royalties, interest), other than foreign source dividends, if included in the federal net income tax base.¹⁵⁹ If foreign source income is included in the Arizona tax base of the subsidiary, the denominators of the three-factor apportionment formula (property, payroll, and sales) also would include the foreign values.¹⁶⁰ Foreign income tax paid

151. ARIZ. REV. STAT. ANN. § 43-1101(1) (Supp. 1986).

152. A domestic corporation is any corporation organized in the United States or under the laws of the United States or of any state of the United States or the District of Columbia. ARIZ. REV. STAT. ANN. § 43-1101(3) (Supp. 1986).

153. ARIZ. REV. STAT. ANN. § 43-1132 (Supp. 1986).

154. ARIZ. COMP. ADMIN. R. & REGS. R15-2-1141(3) (1986) does not define what constitutes "doing business" in Arizona except to make it clear that an out-of-state corporation may be doing business in the state notwithstanding the fact that "the corporation may have no offices or established place of business in this state."

155. ARIZ. REV. STAT. ANN. § 43-1134 (Supp. 1986).

156. ARIZ. REV. STAT. ANN. § 43-1101(5) (Supp. 1986).

157. ARIZ. REV. STAT. ANN. § 43-1132 (Supp. 1986).

158. See *supra* note 7.

159. ARIZ. REV. STAT. ANN. § 43-1122(3) (Supp. 1986).

160. There is a trade-off under the unitary combination method which includes out-of-state (foreign) income in the state tax base. As the state tax base is increased by the addition of out-of-state income, the denominators of the three apportionment ratios are increased with the result that the apportionment fraction declines as the tax base increases: that is, the state takes a smaller percent-

on foreign source income included in the Arizona tax base and for which a deduction is claimed for federal purposes is added back to the federal tax base to reach the Arizona tax base.¹⁶¹ The foreign tax credit claimed with respect to the foreign tax paid on foreign source income apportionable or allocable to Arizona is subtracted from the federal tax base.¹⁶² Foreign source dividends, including the gross-up of such dividends are subtracted from the federal tax base to reach Arizona taxable income.¹⁶³

A foreign corporation owning 50 percent or more of the stock of an Arizona subsidiary or of a domestic subsidiary doing business in Arizona is not, by virtue of such stock ownership, doing business in Arizona and no part of the income of the parent can be regarded as part of the unitary operation of the subsidiary.¹⁶⁴ Unlike the branch operation, separate incorporation of the Arizona operation completely insulates the foreign parent from the Arizona corporate income tax. This is an advantage tax-wise if the foreign activities are profitable. It also could be an advantage if the foreign property, payroll and sales values are higher than the Arizona values. It would be a disadvantage tax-wise if the foreign business operates at a loss.

Arizona, like many states, makes a distinction between corporations deriving business income from Arizona sources and corporations deriving passive income from sources within Arizona. Business income is defined to mean:

Income arising from transactions and activity in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations.¹⁶⁵

"Nonbusiness income" is all other income.¹⁶⁶

Nonbusiness income is taxable at the same rate as business income but the allocation rules differ. Net rents and royalties from real property located in Arizona are allocated to Arizona.¹⁶⁷ Net rents and royalties from real and tangible personal property (wherever located) are allocable to Arizona:

age of a larger base. Whether this trade-off works to the advantage of the taxpayer or the revenue depends on the value of the out-of-state property, payroll, and sales in comparison to the in-state values, not on the size of the tax base.

161. ARIZ. REV. STAT. ANN. § 43-1121(3)(Supp. 1986).

162. ARIZ. REV. STAT. ANN. § 43-1122(4)(Supp. 1986).

163. ARIZ. REV. STAT. ANN. § 43-1122(8)(Supp. 1986). Under I.R.C. § 902 (1982), a domestic corporation receiving dividends from a foreign corporation can elect the foreign tax credit for a proportionate part of the foreign taxes paid by the foreign payor corporation with respect to the foreign earnings out of which the dividends are paid. If the election is made, the domestic corporation must include in gross income both the actual dividends received and the foreign taxes paid on the earnings out of which the dividends were paid. These foreign taxes "deemed paid" by the domestic corporation are the "gross up." I.R.C. § 78 (1982).

164. ARIZ. REV. STAT. ANN. § 43-1132 (Supp. 1986).

165. ARIZ. REV. STAT. ANN. § 43-1131(1) (Supp. 1986). ARIZ. COMP. ADMIN. R. & REGS. 15-1131(A) (1986) states, "In essence, all income from the conduct of trade or business operations of a taxpayer is business income . . . unless clearly classified as nonbusiness income."

166. ARIZ. REV. STAT. ANN. § 43-1131(4)(Supp. 1986). The rules of ARIZ. COMP. ADMIN. R. & REGS. R15-2-1131(B) (1986) for determining whether rents, gains, losses, interest, dividends, royalties are business or investment income are similar to the activities and assets use tests of I.R.C. § 864(c) (1982).

167. ARIZ. REV. STAT. ANN. § 43-1135(A) (Supp. 1986).

1) if and to the extent, used within the state; or 2) if taxpayers' commercial domicile is in Arizona and the state where the property is used does not tax such rents and royalties; or 3) if the rents and royalties are "used in the taxpayer's trade or business."¹⁶⁸ Arizona defines the term "commercial domicile" as "the principal place from which the trade or business of the taxpayer is directed or managed."¹⁶⁹ Capital gains and losses from the sale of real property are allocable to the state if: 1) located in Arizona; or 2) "used in the taxpayer's trade or business."¹⁷⁰

Capital gains and losses from the sale of tangible personal property are allocable to Arizona if: 1) the property has a situs in Arizona at the time of the sale; or 2) taxpayer's commercial domicile is in Arizona and the company is not taxable in the state of situs; or 3) the gains are "used in the taxpayer's trade or business."¹⁷¹ Capital gains and losses from the sale of intangible personalty are allocable to Arizona if: 1) the taxpayer's commercial domicile is in Arizona; or 2) "used in the taxpayer's trade or business."¹⁷² Interest and dividends are allocable to Arizona if taxpayer's commercial domicile is in the state "unless the interest or dividend constitutes business income."¹⁷³ Foreign source dividends can never be classified as business income for Arizona tax purposes.¹⁷⁴

Business income of a domestic subsidiary is apportioned to Arizona on the basis of the average of property, payroll and sales ratios if the subsidiary is carrying on a unitary business in Arizona and in one or more other states.¹⁷⁵ If the subsidiary is engaged in two or more trades or businesses in Arizona, the business income attributable to each trade or business is determined separately. The property, payroll and sales ratios are also determined separately for each business and the apportionment for each business is made separately. The sum of the apportioned taxable incomes is the Arizona tax base.¹⁷⁶

The property ratio is based on the rate of the "average value" of real and tangible personal property owned or rented and used in the state to the entire value of property so held.¹⁷⁷ The payroll ratio is based on the ratio of salaries, wages, commissions and other personal service compensation paid by the taxpayer in connection with the business of taxpayer in the state to

168. ARIZ. REV. STAT. ANN. § 43-1135(B) (Supp. 1986). ARIZ. COMP. ADMIN. R. & REGS. R15-2-1131(B)(1)(a) uses the phrase "if the property with respect to which the rental income was received is used in the taxpayer's trade or business or is attendant thereto. . . ." This is the unitary business income test. *Id.* at R15-2-1131(A). Similar language is used *id.* at R15-2-1131(B)(1)(b).

169. ARIZ. REV. STAT. ANN. § 43-1131(2) (Supp. 1986).

170. ARIZ. REV. STAT. ANN. § 43-1136(A) (Supp. 1986); ARIZ. COMP. ADMIN. R. & REGS. R15-2-1131(B)(1)(b) (1986).

171. ARIZ. REV. STAT. ANN. § 43-1136(B) (Supp. 1986); ARIZ. COMP. ADMIN. R. & REGS. R15-2-1131(B)(1)(b) (1986).

172. ARIZ. REV. STAT. ANN. § 43-1136(C) (Supp. 1986); ARIZ. COMP. ADMIN. R. & REGS. R15-2-1131(B)(1)(b) (1986).

173. ARIZ. REV. STAT. ANN. § 43-1137 (Supp. 1986); ARIZ. COMP. ADMIN. R. & REGS. R15-2-1131(B)(1)(c),(d) (1986). Dividends and interest are business income if the debt or security "arises out of," or is "created in the course of" taxpayer's business or where the purpose for acquiring and holding the instrument "is related" to taxpayer's business. *Id.*

174. ARIZ. REV. STAT. ANN. § 43-1122(8) (Supp. 1986).

175. ARIZ. REV. STAT. ANN. § 43-1139 (Supp. 1986).

176. ARIZ. COMP. ADMIN. R. & REGS. R15-2-1131(D) (1986).

177. ARIZ. REV. STAT. ANN. § 43-1140 (Supp. 1986).

total payroll.¹⁷⁸ The sales ratio is the ratio of all gross receipts not previously allocated attributable to the state to total sales.¹⁷⁹

Sales are attributable to Arizona if the goods are delivered to a purchaser, other than the United States Government, located in Arizona or shipped from Arizona to a United States Government purchaser or to a purchaser in a state where the taxpayer is not subject to tax.¹⁸⁰ In the case of a controlled subsidiary of a foreign parent not doing business in Arizona, neither the apportionable taxable income base of the subsidiary nor the denominators of the three ratios can include any foreign values attributable to the foreign parent.¹⁸¹

In practice, Arizona uses the separate accounting method to determine the apportionable net income of a domestic subsidiary of a foreign parent.¹⁸² All income and expense transactions between parent and subsidiary are taken as reported for federal income tax purposes. The Arizona tax authorities can reallocate income and deductions between an Arizona subsidiary of a foreign parent and a domestic subsidiary or branch of the same foreign parent doing business outside of Arizona in order "to prevent evasion of taxes or clearly to reflect the income of any such taxpayers."¹⁸³ The reallocation can reach both United States and foreign source income of the subsidiaries since the subsidiaries would not be foreign corporations not subject to tax in Arizona.¹⁸⁴ The requirement is that purchases and sales between the domestic affiliates of the Arizona subsidiary be made at a "fair price."¹⁸⁵ It is not certain whether a fair price is a market price sufficiently high to capture for Arizona a portion of the monopoly profit of the entire MNE. There is no provision for subsequent adjustment for Arizona state tax purposes in the event the Commissioner of Internal Revenue reallocates income and deductions of the foreign parent and Arizona subsidiary.

The Arizona tax authorities can require an Arizona subsidiary of a foreign parent to file a combined report with an out-of-state domestic subsidiary of the same foreign parent if necessary to reflect accurately the Arizona income of any member of the group.¹⁸⁶ The companies included in the combined return would be those owned more than 50 percent by the common parent that are interconnected operationally.¹⁸⁷ The Arizona tax authorities cannot require an Arizona subsidiary of a foreign parent to file a combined

178. ARIZ. REV. STAT. ANN. § 43-1143 (Supp. 1986).

179. ARIZ. REV. STAT. ANN. § 43-1145 (Supp. 1986).

180. ARIZ. REV. STAT. ANN. § 43-1146 (Supp. 1986).

181. ARIZ. REV. STAT. ANN. §§ 43-1140, 43-1143, 43-1145 (Supp. 1986).

182. ARIZ. COMP. ADMIN. R. & REGS. R15-2-1141(A)(9) (1986) provides: "When the operation of the business within Arizona is independent and distinct enough to determine the gross income and expenses in Arizona the separate accounting method should be used." Of necessity this is the method that would have to be used in the case of an Arizona subsidiary of a foreign parent where under the Arizona statute no part of the foreign parent's income can be allocated or apportioned to Arizona.

183. ARIZ. REV. STAT. ANN. §§ 43-941, 43-942 (Supp. 1986).

184. ARIZ. REV. STAT. ANN. § 43-1132 (Supp. 1986).

185. ARIZ. REV. STAT. ANN. § 43-946 (Supp. 1986).

186. ARIZ. REV. STAT. ANN. §§ 43-941, 43-942, 43-1132 (Supp. 1986).

187. ARIZ. REV. STAT. ANN. § 43-947(A) (Supp. 1986); ARIZ. COMP. ADMIN. R. & REGS. R15-2-1131(D)(2) (1986).

report with the foreign parent.¹⁸⁸

The 1986 regulations under A.R.S. § 43-1131 contain an elaborate definition of the elements of a unitary group for purposes of requiring the filing of a combined report. The "basic operations of the components . . . are integrated and interdependent."¹⁸⁹ There must be "common management."¹⁹⁰ "At least some part of the unitary business must be conducted in Arizona."¹⁹¹ The members of the unitary group doing business in Arizona and in other states "are so tied together at the basic *operational level* that it is truly difficult to determine the state in which profits are actually earned."¹⁹² "In the manufacturing, producing or mercantile type of business, a substantial transfer of material, products, goods, technological data, processes, machinery, and equipment between the branches, divisions, subsidiaries of affiliates is required for an entity or group of entities to be defined as a unitary business."¹⁹³

The regulations list the following factors as indicating the existence of a unitary business:

1. the same or similar business conducted by components;
2. vertical development of a product by components, i.e., manufacturing, distribution and sales;
3. horizontal development of a product by components, i.e., sales, service, and repair financing;
4. transfer of materials, goods, products, and technological data and processes, between components;
5. sharing of assets by components;
6. sharing or exchanging of operational employees by components;
7. centralized training of employees;
8. centralized, mass purchasing of inventory, materials equipment, technology, etc.;
9. centralized development and distribution of technology relating to the on-going day to day operations of the components;
10. use of common trademark or logo at basic operational level, centralized advertising with impact at basic operational level;
11. exclusive sales-purchase agreements between components;
12. price differentials between components as compared to unrelated businesses;
13. sales or leases between components;
14. other contributions between components at the basic operational level.¹⁹⁴

188. ARIZ. REV. STAT. ANN. § 43-1132 (Supp. 1986).

189. ARIZ. COMP. ADMIN. R. & REGS. R15-2-1131(E)(1) (1986).

190. *Id.*

191. *Id.*

192. *Id.* (emphasis added).

193. *Id.* The flow of goods and services test would apply only to the vertically integrated MNE with two or more domestic subsidiaries, also vertically integrated. It would be more likely that the common management test would apply to two or more horizontally integrated domestic subsidiaries of a foreign parent whether the MNE as a whole was vertically or horizontally integrated. It is difficult to know to what extent, if at all, the flow of goods test differs from the three unities of *Butler Bros. v. McCollgan*, 315 U.S. 501, 508 (1942): unity of ownership, management, and use.

194. ARIZ. COMP. ADMIN. R. & REGS. R15-2-1131(D)(2) (1986).

On a combined report, intercompany transactions among members of the unitary group are eliminated to the extent paid from the unitary income subject to apportionment. No consideration is given to minority interests in computing the tax base. The combined report is not a tax return. In the case of a combined report filed by two or more Arizona affiliates of a foreign parent, each member of the unitary group of affiliated corporations would file its own Arizona state income tax return, reporting its share of the apportioned, unitary income. If a corporation member of the unitary group in addition has state income and activities separate from its unitary business, it would separately account for such income and activities on the same Arizona corporation income tax return on which it reports its apportioned combined income and the formula factors by which the combined income is apportioned. Depending on the circumstances, the total tax payable to Arizona by the taxpayer member of the affiliated group could be based on separate (nonbusiness) income, separate (business) income and unitary (business) income. In no event could it be based on income not reported for federal tax purposes by one or more members of the unitary group.¹⁹⁵

(b) Worldwide versus Water's Edge Unitary Combination

The formula apportionment method used by Arizona to apportion to the state the combined income of a unitary group of affiliated entities is the water's edge unitary combination method. This is to be distinguished from the worldwide unitary combination method used by California, Montana, Alaska and North Dakota.¹⁹⁶ Worldwide combination covers two different kinds of combined reporting: "downstream" and "upstream." Downstream worldwide combination includes in the apportionable tax base foreign source unitary income of a foreign subsidiary of a United States parent even though the foreign company is not directly engaged in business in the United States. Downstream worldwide combination also may treat as business profits, includible in the apportionable tax base, foreign source dividends paid out of foreign source earnings of a foreign subsidiary not engaged in business in the United States. Upstream and downstream worldwide combination include in the apportionable tax base the unitary income of a foreign parent of a domestic subsidiary as well as the unitary income of foreign subsidiaries of the foreign parent even though the foreign parent and its foreign subsidiaries are not engaged in business in the United States nor subject to federal income tax. As of this date only California and Montana apply both upstream

195. ARIZ. COMP. ADMIN. R. & REGS. R15-2-1132(E) (1986) states: "The extent of the unitary business or group is limited to that business which is subject to the tax imposed by and computed pursuant to the Internal Revenue Code. . . ."

196. Daily Tax Rep. (BNA) No. 168, at G-3. (August 29, 1986). See also Tannenwald, *The Pros and Cons of Worldwide Unitary Taxation* 27 TAX NOTES 649 (1985); 20 STATE BUDGET AND TAX LAWS 10 (October 21, 1986). On September 5, 1986, Governor Deukmejian signed legislation (SB 85) giving a qualified foreign corporation doing business in California the option, beginning in 1988, of continuing to be taxed on a portion of its worldwide unitary income or electing, for at least a ten-year period, to use the water's edge method of apportioning its United States source income based on a percentage of the corporation's California property, payroll and sales. Corporations that make the water's edge election must pay an annual fee of 0.03 percent of the sum of its California property, payroll and sales. 47 STATE TAX REVIEW 1 (1986); Daily Tax Rep. (BNA) No. 173 (September 8, 1986).

and downstream worldwide combination.¹⁹⁷

Whether the combined unitary method of accounting for the state tax base of a multijurisdictional corporation is worldwide or water's edge, the accounting procedure is a difficult one to apply in concrete situations. The combined report takes into account the assets and activities of affiliated entities which are not subject to tax in the state of the taxpayer but which participate with the taxpayer in conducting a single unitary business within and without the taxing state. The combined report is based on the assumption that the profit-to-factor ratios used to apportion profits are comparable across different economic environments. Two different kinds of operations must be performed by the tax auditor in order to identify the enterprise whose income is to be apportioned: he must segregate multiple businesses within a single corporation;¹⁹⁸ he must integrate a single business conducted by multiple affiliated corporations and divisions (branches).¹⁹⁹

The essential ingredient of a unitary business is interdependence of "operating functions" of a vertically integrated enterprise under centralized management.²⁰⁰ The problem of defining the boundaries of a unitary business for state tax purposes is similar to the federal tax problem of determining whether a corporation is operating one or more than one trade or business under the divisive reorganization provisions of the Internal Revenue Code.²⁰¹ There are no generally accepted, objective criteria for making these determinations and practice varies substantially among the states.²⁰²

A combined return or report filed by a taxpayer, member of a unitary group of affiliated entities, is not a tax return. It is not a consolidated return for federal income tax purposes although it is a form of consolidation. Factors which characterize combination are:

1. Combination of only those affiliated corporations that have a unitary relationship.
2. Minority interests are not separately stated in the combined income and apportionment data computations.
3. The corporation, member of the group, doing business in the taxing jurisdiction is the taxpayer, not the combined group.

197. See the sources cited *supra* note 196. Most of the litigation defining the scope of the worldwide unitary concept has concerned the state tax base of a United States parent company doing business outside of the United States through a foreign subsidiary. The approach developed in the domestic based MNE cases, however, has direct application to the tax status of the foreign based MNE. The issue in both situations is: To what extent can a state include in the apportionable net income of a United States corporation carrying on economic activity within the state foreign source income of a foreign affiliate with no economic ties to the taxing state? See, e.g., *Container Corp. of Am. v. Franchise Tax Bd.*, 463 U.S. 159 (1983); *F.W. Woolworth Co. v. Taxation & Revenue Dept. of N.M.*, 458 U.S. 354 (1982); *ASARCO, Inc. v. Idaho State Tax Commission*, 458 U.S. 307 (1982); *Mobil Oil Corp. v. Commissioner of Taxes of Vt.*, 445 U.S. 425 (1980); *Exxon Corp. v. Department of Revenue of Wisc.*, 447 U.S. 207 (1980).

198. Multistate Tax Commission Apportionment Regulations Adopted Under Article IV of the Multistate Tax Compact. Reg. IV.1(b) [hereinafter MTC Reg.], reprinted in ALL STATES TAX GUIDE (PH) ¶ 632 (1977).

199. MTC Reg. IV.1(b), reprinted in ALL STATES TAX GUIDE (PH) ¶ 632.10-632.25 (1977).

200. *Id.*

201. I.R.C. § 382 (1982). See Treas. Reg. §§ 1.382-1(a)(h)(7)(as amended in 1968), 1.355-1 (1960).

202. Miller, *State Income Taxation of Multiple Corporations and Multiple Businesses*, 49 TAXES 102 (1971).

4. Each member of the group doing business in the taxing state files a return and is separately liable for its pro-rata share of the combined tax liability.
5. Only unity and control is required. Control is more than 50 percent whereas consolidation requires at least 80 percent ownership.
6. Intercompany dividends are eliminated to the extent that they are paid out of unitary business income realized by the declaring company while engaged in a unitary business and filing a combined report with the recipient company.²⁰³

The Multistate Tax Commission, through the Uniform Division of Income for Tax Purpose Act (UDITPA),²⁰⁴ has been in the forefront of the move to reach foreign source income of foreign-based MNEs not engaged in business in the United States and has been opposed to federal legislation that would restrict the jurisdiction of the states to tax apportioned net income of a multijurisdictional corporation. In particular, it has opposed federal legislation that would prohibit states from using the worldwide combined unitary business method to apportion multijurisdictional corporate earnings to the different states.²⁰⁵ Arizona, by amending its Income Tax Act to exclude from the unitary income of an Arizona subsidiary foreign source income of the foreign parent not doing business in the state, has explicitly rejected the UDITPA position.

By this action Arizona has settled for Arizona foreign direct investors the issue left unresolved by the United States Supreme Court in *Container Corporation of America v. Franchise Tax Board*.²⁰⁶ Can worldwide unitary combination be applied to a foreign parent not doing business within the taxing state and not subject to tax in the United States?²⁰⁷

To have an appreciation of the significance for FDI in Arizona of the legislative decision to limit the state's tax jurisdiction to water's edge, a brief history of the litigation efforts of foreign based MNEs and of the impasse reached by The Working Group appointed by President Reagan to study the "unitary problem" would be helpful.

As early as 1924 the Supreme Court in *Bass, Ratcliff & Gretton, Ltd. v. State Tax Commission*²⁰⁸ upheld a New York State franchise tax, measured by the preceding year's apportioned world-wide income of a British company that manufactured ale in Great Britain and sold it in the United States through branch offices located in New York City and Chicago.

The apportionment formula consisted of the single factor of real and tangible personal property. The British company was not subject to federal income tax, possibly because its United States' operations, considered sepa-

203. See *supra* note 5.

204. See L. HALE & R. KRAMER, STATE TAX LIABILITY AND COMPLIANCE MANUAL, 60-105 (1981).

205. See generally, MULTISTATE TAX COMMISSION, 1983-84 HANDBOOK OF UNITARY BUSINESS INCOME TAX MATERIALS (1983).

206. 463 U.S. 159 (1983).

207. The Court stated: "We have no need to address in this opinion the constitutionality of combined apportionment with respect to state taxation of domestic corporations with foreign parents or foreign corporations with either foreign parents or foreign subsidiaries." 463 U.S. at 189, n. 26.

208. 266 U.S. 271 (1924).

rately, did not return a net profit. The Court dismissed this fact as irrelevant. "The fact that the Company may not have had any net income upon which it was subject to payment of income tax to the Federal Government, obviously does not show that it received no net income from the business which it carried on in New York."²⁰⁹ The tax was imposed for the "carrying on" of business in New York, not *on* income sourced in New York.

There is no sufficient reason why a foreign corporation desiring to continue the carrying on of business in the State for another year—from which it expects to derive a benefit—should be relieved of a privilege tax because it did not happen to have made any profit during the preceding year.²¹⁰

Over fifty years intervened between *Bass* and the next case involving a foreign corporation to reach the Supreme Court. *Japan Line, Ltd. v. County of Los Angeles*,²¹¹ concerned the imposition of a California *ad valorem* property tax on cargo containers of a Japanese shipping corporation. The containers happened to be located in Los Angeles, for repair or awaiting the loading and unloading of cargo, on the lien date under California law. All of the containers were subject to a property tax in Japan and were used exclusively in foreign commerce. The California Supreme Court upheld the tax. The United States Supreme Court reversed on the ground that the tax, as applied, created a "substantial risk of international multiple taxation" and prevented the Federal Government from "speaking" with one voice when regulating commercial relations with foreign governments."²¹² While *Japan Line, Ltd.* concerned an apportioned state property tax, not an apportioned state income tax, the opinion contains language which indicates that the court would apply a stricter jurisdictional standard under the foreign commerce clause than under the interstate commerce clause.

We may assume that, if the containers at issue here were instrumentalities of purely interstate commerce, *Complete Auto*²¹³ would apply and be satisfied, and our Commerce Clause inquiry would be at an end. Appellants' containers, however, are instrumentalities of foreign commerce. . . . When construing Congress' power to "regulate Commerce with foreign Nations," a more extensive constitutional inquiry is required.²¹⁴

Specifically, a state-apportioned property tax, when applied to the property of an out-of-state domestic taxpayer, cannot result in double taxation because all other states which may have jurisdiction to tax this same property can tax it on an apportioned basis only. However, a state apportioned property tax applied to the property of a foreign taxpayer does result in

209. *Id.* at 283.

210. *Id.* at 284.

211. 441 U.S. 434 (1979).

212. *Id.*

213. *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274 (1977). *Complete Auto Transit* set forth four requirements which an apportioned state income tax must satisfy in order to pass the burden-on-interstate commerce test. The activities of the taxpayer must be sufficient to establish a "substantial nexus" with the taxing state; the tax must be "fairly apportioned"; the tax must not "discriminate against interstate commerce"; the tax must be "fairly related to the services provided by" the taxing state. *Id.* at 279.

214. *Japan Line*, 441 U.S. at 445-46.

double taxation if the foreign country taxes this same property on an unapportioned basis. This was the situation in *Japan Line*. Japan imposed an unapportioned property tax on the full value of the same containers taxed on an apportioned basis by California. If other states were to follow the California practice the result would be to subject foreign-owned containers "to various degrees of multiple taxation, depending on which American ports they enter."²¹⁵ The Court stated:

This result, obviously, would make "speaking with one voice" impossible. California, by its unilateral act, cannot be permitted to place these impediments before this Nation's conduct of its foreign relations and its foreign trade.

* * * *

This case concerns foreign commerce. Even a slight overlapping of tax—a problem that might be *de minimis* in a domestic context—assumes importance when sensitive matters of foreign relations and national sovereignty are concerned.²¹⁶

It is instructive to point out here that the "double taxation" argument is a specious one when applied to the formula apportionment of combined unitary business income of a multijurisdictional enterprise. As a matter of arithmetic, double taxation of multijurisdictional business income can occur any time the sum of the apportionment factors of all states imposing an income tax on apportioned net income exceeds 100 percent. This can occur under one of two circumstances. First, it is possible that, because the taxing jurisdictions use different apportionment formulas, the taxpayer-corporation has no factor (i.e., no property or no sales or no payroll) in one or more of the jurisdictions. Conversely, it is equally possible for undertaxation to occur where the sum of the states' outside apportionment formulae is less than 100 percent.²¹⁷

Japan Line was followed by *Container Corporation of America v. Franchise Tax Board*,²¹⁸ the first case in which the United States Supreme Court addressed the issue of the validity of worldwide combined reporting. The case involved a United States parent company engaged in the business of manufacturing paperboard packaging in California directly and abroad through 20 controlled subsidiaries located in Europe and Latin America. California took the position that the taxpayer and its foreign subsidiaries constituted a unitary business and apportioned to the California tax base a percentage of the foreign source earnings of the foreign subsidiaries. The percentage was determined by a three-factor formula which included in the denominator of each factor foreign source property, sales, and payroll of the foreign subsidiaries.²¹⁹ The Supreme Court declined to follow *Japan Line* on the ground that the difference between an apportioned property tax and an apportioned income tax was a "constitutionally significant difference"

215. *Id.* at 453.

216. *Id.* at 453, 456.

217. There is a further problem with formula apportionment: The method assumes that all capital and payroll expenditures are equally productive of profits regardless of the type of business involved or its geographic location.

218. 463 U.S. 159 (1983).

219. *Id.* at 170. For a discussion of this formula, see *supra* text accompanying notes 129-34.

and upheld the validity of worldwide combined reporting as applied to a domestic based MNE.²²⁰ It reserved decision, however, with respect to the validity of worldwide combined reporting as applied to a foreign based MNE. Without further elaboration the Court noted that "the legal incidence of a tax" imposed on a United States corporation owned by foreign interests" might be "less significant" than the legal incidence of a tax imposed on a United States corporation owned by domestic interests.²²¹

Taken in the context of a discussion of possible foreign retaliation against United States companies doing business abroad in response to state inclusion of foreign source income in the taxable income base of domestic affiliates of foreign corporations, the inference is that foreign retaliation is more likely in the case of worldwide unitary combination applied to a foreign based MNE than in the case of a domestic based MNE.

The dissent regarded the distinction made by the majority between worldwide unitary combination as applied to a domestic based MNE and as applied to a foreign based MNE as creating a dilemma:

If California attempts to tax the American subsidiary of an overseas company on the basis of the parent's worldwide income, with the result that double taxation occurs, I see no acceptable solution to the problem created. Most of the Court's analysis is inapplicable to such a case. There can be little doubt that the parent's government would be offended by the State's action and that international disputes, or even retaliation against American corporations, might be expected. It thus seems inevitable that the tax would have to be found unconstitutional—at least to the extent it is applied to foreign companies. But in my view, invalidating the tax only to this limited extent also would be unacceptable. It would leave California free to discriminate against a Delaware corporation in favor of an overseas corporation. I would not permit such discrimination without explicit congressional authorization.²²²

The action of California in aggressively applying worldwide combination to multinational groups headed by foreign parents signaled the beginning of a major effort by foreign parent companies to enjoin the state action as a violation of United States Treaties of Friendship, Commerce and Navigation (FCN)²²³ with the foreign country of domicile of the parent company.²²⁴ All FCN treaties contain provisions that limit taxes to income "reasonably allocable or apportionable" to the taxing jurisdiction.²²⁵

Plaintiff foreign parent companies have not succeeded in enjoining assessment or collection of state taxes calculated on the basis of worldwide combinations. Plaintiff in *Japan Line* argued that Art. XXII, section 2 of

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

221. 463 U.S. at 195 n. 32.

222. *Id.* at 202-03 (Powell, J., dissenting).

223. The United States has entered into treaties of Friendship, Commerce, and Navigation with 50 separate countries. Basically, these treaties ensure that the two contracting states will not discriminate against traders from the other contracting state.

224. See Note, *Standing Under Commercial Treaties: Foreign Holding Companies and the Unitary Tax*, 97 HARV. L. REV. 1894 (1984).

225. See, e.g., Treaty of Friendship, Commerce, and Navigation, Jan. 21, 1950, United States-Ireland, art. IX, ¶ 2, T.I.A.S. No. 2155, at 785.

the Treaty of Commerce, Navigation and Friendship between the United States and Japan, the nondiscrimination clause, prohibited assessment of the California apportioned property tax against their containers. The Supreme Court rejected the argument: "The provisions appellants cite interdict *discrimination* against Japanese nationals; there is no evidence that California has treated Japanese containers differently from domestic containers for purposes of applying its property tax."²²⁶

In *Shell Petroleum, N.V. v. Graves*,²²⁷ and *EMI Ltd. v. Bennett*,²²⁸ plaintiffs, foreign parent corporations, argued that the Treaty of Friendship, Commerce and Navigation between the United States and the foreign country of domicile of the parent company gave it standing to sue. These arguments were not successful. In *EMI*, for example, the court rejected plaintiff's interpretation: "[t]he treaty relied upon by EMI does not specifically, or even implicitly, grant special status to stockholders in respect to the corporations in which they have ownership. . . . Moreover, the treaty by its explicit terms does not even cover taxes imposed by a state."²²⁹

Not having standing to sue under an FCN treaty, foreign parent companies contended in the alternative that they had standing to sue to enjoin assessment and collection of a tax calculated on the basis of treating as one business the unitary activities of the foreign parent and its United States subsidiary, notwithstanding the Tax Anti-Injunction Statute.²³⁰ On this ground, also, the companies have lost. The United States subsidiary has a remedy and standing to sue but not the foreign parent. The fact that imposition of the state tax on the United States subsidiary may reduce the value of the foreign parent's investment does not suffice to give the parent an independent cause of action.²³¹

Having lost on the foreign commerce issue and having no standing to sue, the foreign countries of domicile of corporations doing business in the United States through domestic subsidiaries protested directly to the federal government. The Senate debate on the United States-United Kingdom treaty during 1977-79 put in issue Article 9(4) of the proposed amended treaty which would have prohibited states from including within the state income tax base foreign source earnings derived by United Kingdom parent corporations. The Treasury Department took the position that this prohibition of state taxation practice was required to conform state law to the internationally accepted separate accounting method of computing the tax base of multijurisdictional firms. Although the restriction on state taxation was deleted in the final version of the United States-United Kingdom Treaty, the

226. *Japan Line, Ltd. v. County of Los Angeles*, 441 U.S. 434, 439 n.3 (1979).

227. 709 F.2d 593 (9th Cir. 1983).

228. 738 F.2d 994 (9th Cir. 1984).

229. *Id.* at 998.

230. 28 U.S.C. § 1341 (1982) provides that "[t]he district courts shall not enjoin, suspend, or restrain the assessment, levy or collection of any tax under State law where a plain, speedy and efficient remedy may be had in the courts of such State."

231. *Alcan Aluminum Ltd. v. Franchise Tax Board of California*, 558 F. Supp. 624 (S.D.N.Y. 1983); *Shell Petroleum N.V. v. Graves*, 709 F.2d 593 (9th Cir. 1983); *EMI Ltd. v. Bennett*, 560 F. Supp. 134 (N.D. Cal. 1982); 681 F.2d 1107 (9th Cir. 1982), *cert. denied*, 459 U.S. 1203 (1983), *on remand* 738 F.2d 994 (9th Cir. 1984).

matter was not laid to rest. The countries of the Organization for Economic Cooperation and Development continued to press for Congressional action to legislate a uniform set of rules that would limit state tax jurisdiction to the water's edge.²³² In particular Belgium, Canada, France, Italy, the United Kingdom, and the nine countries of the European Economic Community filed statements of protest with the Treasury Department. Their principal objection was to the practice of California of including within the worldwide unitary enterprise foreign parent corporations not engaged in business in the United States nor receiving United States source income.²³³

The need for uniform state rules had been recognized as early as 1965 when the Willis Report of the Subcommittee of the House Judiciary Committee 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.²³⁴

In 1976 the House Ways and Means Committee appointed a special task force to study the question of state taxation of foreign source income. Headed by Congressman Rostenkowski the committee recommended that federal income tax rules apply to state taxation of foreign source income.²³⁵ Legislation has been introduced annually to conform state practice to the federal rules but no bill has yet made it through both houses of Congress.

Also in the background of the controversy over the worldwide unitary method is the fact that the United States is party to some 30 independently negotiated income tax treaties designed to bring about international tax harmonization and to promote the free flow of international trade and investment. Treaties accomplish this harmonization by reducing the opportunities for double taxation and eliminating where possible tax rules which discriminate between foreign and domestic investment. All of these treaties allocate the business income of foreign MNEs by the separate accounting method and not by formula apportionment. Each affiliate of an integrated unitary MNE is treated as a separate enterprise and business income is attributed to geographical source by constructing mythical arms length prices on fictitious transactions between the hypothetically independent enterprises.

There is increasing evidence that domestic affiliates of foreign parents are avoiding those states, such as California, that aggressively apply the unitary system on a worldwide basis. In addition, there exists the ever present

232. Congressional authority to legislate uniform state tax laws that affect foreign commerce is based on U.S. CONST. art. I, § 8, cl. 3 and § 10, cl. 1.

233. The Organization for Economic Cooperation and Development (OECD) Treaty, revised in 1977, and the United States Model Treaty of 1981 both reflect a water's edge rule.

234. H.R. REP. No. 952, 89th Cong., 1st Sess., 1155 (1965).

235. House Committee on Ways and Means, Recommendations of the Task Force on Foreign Source Income, 30 (1977).

likelihood of national harm if foreign governments impose retaliatory taxation on United States' corporations doing business abroad, or refuse to enter into tax treaties with the United States Government.²³⁶

Secretary of the Treasury James A. Baker III in a Treasury Department press release, December 18, 1985 stated:

The continued imposition of State corporate income tax on a worldwide unitary basis has a serious adverse impact on the conduct of the foreign economic policy of the United States. Limiting the States' use of the unitary method will provide a more consistent national policy with respect to the taxation, both State and Federal, of multinational enterprises.²³⁷

The Federal government, in response to pressure from foreign governments to require states to limit state taxation of MNEs to income earned in the United States, took several actions. In 1983 President Reagan established a Worldwide Unitary Taxation Working Group to study the problem with a view towards reaching an acceptable compromise between the states and the multinational enterprises. In 1985 the Administration introduced a bill in the House (H.R. 3980) and Senate (S. 1974) that would limit state tax jurisdiction to the water's edge.²³⁸ The Administration proposal counterbalances the restriction on state taxing jurisdiction by increasing substantially the amount of financial information required by multinationals to be filed with the Internal Revenue Service and by providing that the IRS will share the information through a domestic disclosure spreadsheet with those states which use the water's edge approach.²³⁹

The proposed legislation would prohibit states from requiring the inclusion in unitary combinations of those corporations which have less than \$10 million in business activity or conduct less than 20 percent of their business within the United States. The effect of this limitation would be to exclude most foreign corporations and domestic "80/20" corporations from state taxation unless affiliated with corporations within the water's edge and not subject to substantial foreign tax on their income. The water's edge method would not be mandatory, however. The states may offer the taxpayer an unconditional election to be taxed on a worldwide basis.

236. See Perris, *A Suggested American Response to U.K. Retaliation Against Worldwide Unitary Taxation: Awakening Section 891 of the Code*, 29 TAX NOTES 1071 (1985). In September 1985, Ian Gow, Minister of State of Britain's Treasury, stated that Britain would retaliate against United States companies operating in the United Kingdom. Sheppard, *Unitary Method: Domestic Multinationals Win Another Round*, 28 TAX NOTES 1424 (1985). On January 30, 1986, sixteen foreign governments filed *amicus curiae* briefs in *Imperial Chemical Industries and Alcan Aluminum Limited v. California Franchise Tax Board*. Uhlfelder, *Sixteen Countries File Amicus Briefs Against Unitary Method; California Unitary Legislation Introduced*, 30 TAX NOTES 498 (1986). The case is being heard in the U.S. District Court for the Northern District of Illinois.

237. Department of the Treasury, Treasury News, Dec. 18, 1985.

238. Sheppard & Uhlfelder, *President Asks for Federal Restriction on Unitary Method*, 29 TAX NOTES 670 (1985).

239. *Unitary Taxes: President to Seek Legislation Banning Use of Unitary Method of Taxation*, [Oct.-Dec.] Daily Tax Rep. (BNA), No. 218, at G-5 (Nov. 12, 1985); *Unitary Taxes: Treasury Expected soon to Propose Legislation Outlawing Unitary Taxation*, Daily Tax Rep. (BNA) No. 238, at G-1 (Nov. 11, 1985); Krevitsky, *United States Treasury Proposes Domestic Disclosure Spreadsheet*, 5 INTERSTATE TAX REP. No. 5, at 1 (Aug. 1985). See Report of the Committee on Interstate Commerce of the New York State Bar Association Tax Section, *Report on Legislation Prohibiting State Taxation on a Worldwide Unitary Basis*, 32 TAX NOTES 817 (Aug. 25, 1986).

The Administration proposal is highly controversial, which is not surprising given that the Working Group could not agree on a set of policy recommendations.²⁴⁰ In the main, the range of reactions to the proposed legislation mirrors the differing views of the members of the Group. Business representatives contended that the administration proposal "would give states too much new power and would snarl many firms in a web of new paperwork."²⁴¹ The Multistate Tax Commission, speaking through Eugene Corrigan, on the other hand, has suggested a tightening of the penalty provision and of the reporting requirements for offshore financing branches of United States firms.²⁴²

In general, the Multistate Tax Commission has been sharply critical of the Working Group and of the final report. As an example, William Dexter, characterized the work of the group and the decision as follows:

At the inception of the deliberations of the Working Group, all members agreed that, unless an agreement was reached on all issues, the Group would have reached no agreement on anything, notwithstanding interim concessions for negotiation purposes. As a consequence, the Working Group did not reach agreement on anything. Notwithstanding this fact, the Chairman's Report was so worded and structured that it has been useful to opponents of worldwide combined reporting.²⁴³

At the heart of the problem of dissension among members of the working group was a disagreement about the extent to which the water's edge limitation should apply to the domestic MNE. It was agreed that the foreign MNE should not be included as a unitary enterprise with its domestic subsidiary. However, the Working Group could not agree that the foreign source earnings and activities of a foreign subsidiary of a domestic parent should be excluded if the foreign activity constituted a unitary enterprise with the United States parent. The issue of state taxation of foreign source dividends paid to a domestic parent is not properly related to the foreign parent issue. It is unfortunate that the Working Group defined the water's edge limitation as applying alike to the foreign and the domestic MNE.

IV CONCLUSION

The corporation income tax as applied to the unitary income of an integrated MNE is an unsatisfactory source of revenue for state governments.²⁴⁴ The profit-to-factor ratios used to apportion profits among competing tax jurisdictions are not comparable across different economic environments.

240. *Chairman's Report on the Worldwide Unitary Taxation Working Group Transmitted to the President*. Treasury News, July 31, 1984.

241. *Business Hits Treasury's Unitary Tax Plan as Too Harsh; State Audit Program Leaves Key Issues Unresolved*, Daily Tax Rep. (BNA) No. 166, at K-1 (Aug. 27, 1985).

242. *Id.* at K-3.

243. Dexter, *A Comment On the Unitary Working Groups Deliberations and Product*, 29 TAX. NOTES 419, 420 (Oct. 28, 1985).

244. Many economists take the position that the corporation income tax is an unsatisfactory source of state revenue for both domestic and foreign based multijurisdictional corporations. See e.g., R. MUSGRAVE & P. MUSGRAVE, *PUBLIC FINANCE IN THEORY AND PRACTICE* 311-13 (1976).

The apportionable income tax base is different depending on whether the parent corporation operates through operating divisions or separately incorporated subsidiaries. There is no economic theoretic basis for making a distinction between specially allocable nonbusiness income and apportionable business income. It is impossible to accurately attribute multijurisdictional unitary business income to a particular geographical source or precisely to capture for the host taxing jurisdiction its proportionate share of the monopoly profit of the entire MNE. For those states that base apportionable income on net taxable income reported for federal purposes, the state tax reflects changes in the total federal income tax base whether or not the profits reported for federal purposes are attributable to changes in state-source profits. Finally, it has been forcefully pointed out that the state corporation income tax based on formula apportionment is not really an income tax at all. It is a discriminatory tax on property, payroll, and sales and might as well be replaced by a direct tax on these factors.²⁴⁵ A direct tax on the factors of production combined with an excise tax on gross sales would uncouple the effective state tax rate from the corporation's national profit level.

The Arizona state tax rules which limit the combined unitary method of dividing the profits of a foreign-based MNE to the water's edge represent an arbitrary attempt to solve the definition of tax base problems on a territorial basis, leaving intact unitary formula apportionment for the integrated domestic multijurisdictional enterprise and for the foreign-based multinational doing business in Arizona through a branch. The difficulty is that this approach not only does not reflect the economic interdependence of the separately incorporated members of MNEs generally, it discriminates against the foreign-based MNE that operates directly through an unincorporated division.²⁴⁶

There is also a practical justification for applying the water's edge limitation to branches as well as subsidiaries of foreign-based MNEs. The worldwide unitary method imposes a significant administrative burden on the foreign-based MNE. This method requires the annual translation of the books of the foreign corporation into United States accounting concepts and currency. In the case of the branch operation, the worldwide unitary method may include within the state apportionable business income tax base of the foreign corporation foreign source income of the foreign corporation taxable for federal purposes but never received in the United States by the branch.

The economic effect of Arizona's water's edge limitation is to create an incentive to FDI by the acquisition of existing domestic corporations and by separate incorporation. It is a disincentive to penetration of the Arizona market by operating branches. This is unfortunate for two reasons: 1) Most new foreign capital flows follow the evolutionary stages of exporting, licensing, branch operation and, only when the United States market is assured, separate incorporation; 2) The water's edge limitation as applied only to sep-

245. See *supra* note 52.

246. Although not an issue covered by this Article, it should be pointed out that the water's edge limitations also discriminate against United States companies.

arately incorporated affiliates perpetuates the cumbersome and unrealistic arms length pricing rules of the separate accounting method in the case of foreign-based MNEs doing business in Arizona through branch operations. The Arizona Income Tax Act should be amended to put Arizona branches of foreign-based MNEs on the same tax footing as foreign controlled domestic subsidiaries doing business in Arizona.²⁴⁷

247. This result can be accomplished to considerable extent if Arizona follows § 1241 of the Tax Reform Act of 1986, Public Law 99-514, and adopts a branch-level tax on profits of foreign corporations doing business in Arizona. *But see* New York State Bar Association Tax Section, *The Proposed Foreign Corporation Branch Level Tax*, 32 TAX NOTES 247 (July 21, 1986).

TABLE 1-A(a)

Gross Book Value of Property, Plant, and Equipment of United States Affiliates of Foreign Manufacturing and Merchandising Companies as a Percentage of Total Foreign Direct Investment, All Industries.
(\$ in Millions)

	<u>Arizona</u>							
	<u>1977</u>	<u>1978</u>	<u>1979</u>	<u>1980</u>	<u>1981</u>	<u>1982</u>	<u>1983</u>	<u>1984</u>
Table D-14 Total FDI	\$548	\$709	\$1,017	\$1,314	\$2,949	\$3,206	\$3,459	\$3,700
From Table 1(a) Manufacturing & Merchandising	62	115	148	191	650	754	1,498	1,609
<u>Manu & Merch = %</u> Total Percentage	11.3	16.2	14.6	14.5	22.0	23.5	43.3	43.5
	<u>United States</u>							
From Table 5, D-13 Total FDI	143,488	181,187	228,556	291,339	406,985	472,989	244,013	268,214
From Table 1(C) Manufacturing & Merchandising	75,302	94,344	120,357	141,716	211,734	237,623	115,071	126,355
<u>Manu & Merch = %</u> Total Percentage	52.4	53.0	52.7	48.6	52.0	50.2	47.2	47.1

^{a)} Source: U.S. Department of Commerce. FOREIGN DIRECT INVESTMENT IN THE UNITED STATES: ANNUAL SURVEY RESULTS. Tables 1-B and 1-C, at 15, 16.

TABLE 1-B^(a)

Gross Book Value of Property, Plant, and Equipment of Arizona Affiliates of Foreign
Manufacturing and Merchandising Companies by Industry of Affiliate.
(\$ in Millions)

	<u>1977</u>	<u>1978</u>	<u>1979</u>	<u>1980</u>	<u>1981</u>	<u>1982</u>	<u>1983</u>	<u>1984</u>
Total	\$ 62	\$ 115	\$ 148	\$ 191	\$ 650	\$ 754	\$1,498	\$1,609
<u>By Industry</u>								
Manufacturing	59	88	145	185	526	592	1,359	1,425
Wholesale Trade	3	3	3	6	—	30	—	29
Retail Trade	—	24	—	—	124	132	139	155

^{a)} Source: U.S. Department of Commerce. FOREIGN DIRECT INVESTMENT IN THE UNITED STATES: ANNUAL SURVEY RESULTS. Tables D-13. A cell left blank indicates that the data was suppressed for that particular year to avoid disclosure of data of individual companies. The data for 1977-79 are on a calendar-year basis; data for 1980-84 are on a fiscal year basis.

TABLE 1-C^(a)

Gross Book Value of Property, Plant, and Equipment of United States Affiliates of Foreign
Manufacturing and Merchandising Companies by Industry of Affiliate.
(\$ in Millions)

	1977	1978	1979	1980	1981	1982	1983	1984
Total	\$75,302	\$94,344	\$120,357	\$141,716	\$211,734	\$237,623	\$115,071	\$126,355
By Industry								
Manufacturing	41,759	52,198	67,960	81,963	122,959	129,505	92,445	101,229
Wholesale Trade	29,744	36,655	45,237	50,114	77,424	93,324	14,036	15,656
Retail Trade	3,799	5,491	7,160	9,639	11,351	14,794	8,590	9,470

^{a)} Source: FDIUS, Tables 5, D-13.

TABLE 2(a)

FOREIGN OWNED MANUFACTURERS IN ARIZONA

	AUSTRALIA	BELGIUM	CANADA	FRANCE	GREAT BRITAIN	GERMANY	JAPAN	MEXICO	NETHERLANDS	SO. AFRICA	SWITZERLAND	TOTALS
FOOD				1								1
CHEMICALS				1		3		1				5
METALS				1		3				1		7
MACHINERY						1	2				1	3
OTHER	1	1	1	4	2	2	2	1	1			12
ELECTRONICS						2			1			3
TOTALS:	1	1	1	3	11	3	6	1	2	1	1	31

SOURCE:

AUSTRALIA Moniger Roof Tile, Phoenix. Concrete roofing tile.
BELEMUM Continental Material Corp., Tucson. Mining exploration.
CANADA Jalart House, Scottsdale. Periodical printing & publishing.
FRANCE Casino USA Inc., Phoenix. Canned specialties.
 Dye Oxygen Co., Yuma. Welding apparatus; electric metalworking machines.
GREAT BRITAIN M & T Chemicals, Chandler. Industrial inorganic chemicals.
 Arco, Nogales. Industrial gasses.
 Arco, Phoenix. Industrial gasses.
 Ceneration Co. of America Inc., Tucson. Mining development.
 DEA Equipment, Tempe. Printed circuit boards, microelectronic circuits, on chemically milled parts.
 Evans Rotork Inc., Glendale. Woodworking machines, wood moldings & screws.
GERMANY General Cable Corp., Kingman. Motors & generators. Rolling, drawing & extruding cotton. Aluminum rolling & drawing.
 Hydro Conduit Corp., Phoenix. Concrete products.
 Phillip A. Hunt Chemical Corp., Tempe. Chemicals & chemical preparations.
MEXICO Southwest Pipe & Supply Inc., Glendale. Manufacturing, mining, lumber & transportation.
NETHERLANDS Thermotank Div., Tucson. Miscellaneous plastics & fabricated structural metal products.
 Triumph Corp., Tempe. Small arms.
GERMANY American German Industries Inc., Scottsdale.
JAPAN American Hoechst Corp., Nogales. Plastics.
 Foton Production, Chandler. Semiconductor equipment.
 Alumax Building Products, Casa Grande. Aluminum fabrication for recreational vehicles & mobile homes.
 Alumax Mill Products, Casa Grande. Aluminum sheet, plate & foil.
 CMC Shimazake Corp., Tempe. Computer controls.
MEXICO G-C Infil. Corp., Scottsdale. Dental materials.
 IMC Magnetics Corp., Tempe. Aeronautic components.
NETHERLANDS NKK Switches of America, Inc., Scottsdale. Electro-mechanical switches.
 Polymer Optics, Phoenix. Industrial organic chemicals.
 Advance Semi-Conductor, Phoenix. Semiconductors; related devices.
SOUTH AFRICA Lever Brothers Co., Phoenix. Consumer products.
SWITZERLAND Inspiration Consolidated Copper Co., Phoenix. Metal mining/copper ores.
 ESEC (USA) Inc., Tempe. Vire benders, die attachers, water saw.

a) Source: Jeffrey Arpan and David Ricks, DIRECTORY OF FOREIGN MANUFACTURERS IN THE UNITED STATES (1985).

TABLE 3(a)

Gross Book Value of Property, Plant, and Equipment of Arizona Affiliates of Foreign Investors
by Industry of Affiliate.

(\$ in Millions)

	<u>1977</u>	<u>1978</u>	<u>1979</u>	<u>1980</u>	<u>1981</u>	<u>1982</u>	<u>1983</u>	<u>1984</u>
Total, all industries	\$ 548	\$ 709	\$1,017	\$1,314	\$2,949	\$3,206	\$3,459	\$3,700
<u>By Industry</u>								
Petroleum	17	20	20	37	—	370	398	—
Manufacturing	59	88	145	185	526	592	1,359	1,425
Wholesale Trade	3	3	3	6	—	30	—	29
Retail Trade	—	24	—	—	124	132	139	155
Finance (except banking)	—	3	3	9	—	—	13	19
Insurance	2	2	2	2	11	14	14	18
Real Estate	196	290	518	660	851	962	1,026	1,170
Other Industries	—	—	53	106	116	—	144	156

^{a)} Source: FDIUS, Tables D-13.

TABLE 4(a)

Acres of Arizona Land Owned by Arizona Affiliates of Foreign Investors by Industry of Affiliate.
(Thousands of Acres)

	<u>1977</u>	<u>1978</u>	<u>1979</u>	<u>1980</u>	<u>1981</u>	<u>1982</u>	<u>1983</u>	<u>1984</u>
Total, all industries	143	102	105	111	221	278	197	216
<u>By Industry</u>								
Agriculture	—	68	68	—	—	—	45	70
Manufacturing	1	(D)	(D)	5	(D)	42	75	71
Wholesale Trade	(*)	(*)	(*)	(*)	(*)	(*)	(*)	(*)
Real Estate	8	15	18	22	20	20	25	23
Other Industries	—	—	—	—	—	—	51	52

^{a)} Source: FDIUS, Table D-36. An asterisk "*" indicates a value between \$500,000 and + \$500,000 or less than 500 acres.

TABLE 5(a)

Number of Employees in Arizona of Arizona Affiliates
of Foreign Investors by Industry of Affiliate

	1977	1978	1979	1980	1981	1982	1983	1984
All industries, all countries	6,885	8,388	12,147	14,394	30,642	27,197	28,815	30,851
<u>By Industry</u>								
Mining	—	—	—	—	—	—	—	—
Petroleum	—	—	—	—	—	622	1,173	1,080
Manufacturing (total)	2,664	2,847	3,902	5,698	8,106	7,303	10,932	11,946
Food, kindred products	144	187	239	318	480	510	472	505
Chemicals, allied products	1,347	1,442	2,091	2,969	3,069	3,205	3,486	3,762
Primary & fabricate metals	—	28	172	453	841	747	5,233	4,944
Machinery	892	906	985	1,317	3,121	2,024	813	1,346
Other manufacturing	—	284	415	641	595	817	928	1,389
Wholesale trade	208	260	368	463	569	949	1,196	1,039
Retail trade	—	1,048	2,078	1,905	5,905	8,085	6,668	9,956
Finance, except banking	—	—	—	333	—	—	86	170
Insurance	152	171	139	202	246	247	251	326
Real estate	622	927	1,251	1,464	1,574	1,815	—	—
Other industries	650	1,254	2,028	1,806	2,693	2,449	2,609	3,883

^{a)} Source: Table F-7, FDIUS.

