

**FROM JAPAN LINE TO BARCLAYS:
THE RISE AND FALL OF THE FOREIGN COMMERCE CLAUSE**

By Charles Rothfeld^{*/}

The Supreme Court's recent decision in Barclays Bank PLC v. Franchise Tax Board,^{1/} which upheld the constitutionality of California's worldwide combined reporting method of apportionment,^{2/} had some unusual features for a case involving the arcana of state taxation. The enormous amount of money involved -- estimates of California's potential refund liability ran (somewhat improbably) as high as \$4 billion -- guaranteed wide attention for the case in the press. And the Clinton administration's Rube Goldberg attempts to honor one of the President's campaign promises by defending the constitutionality of California's tax, which took on some of the character of a Keystone Kops episode, provided comic relief.

These aspects of the case, however, and the focus of most commentary on California's good fortune in dodging a billion-dollar bullet, threaten to obscure the more fundamental importance of the Court's holding. The Barclays decision is not just an endorsement of a particular (and since-repealed) form of taxation; instead, it marks a major departure from the Court's prior rulings under the Foreign Commerce Clause, significantly weakening the constitutional protections for

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^{1/} 62 U.S.L.W. 4552 (June 20, 1994).

^{2/} California applied this method of apportionment to an income-based corporate franchise tax. The California scheme required the taxpayer to aggregate the income of all corporate entities constituting the unitary corporate enterprise, including affiliates operating abroad as well as those operating within the United States. Having thus broadly defined the unitary business, California used the familiar three-factor formula -- based on the enterprises's payroll, property, and sales -- to determine the percentage of its income taxable in the state. In contrast, the United States, virtually all foreign nations, and most other American states use the so-called "water's edge" method of separate accounting, in which the taxpayer combines only income earned in the United States in determining its tax liability. See Barclays, 62 U.S.L.W. at 4553.

multinational businesses. It therefore signals the end of an experiment that the Court began 15 years ago, when it forcefully held that state taxation of foreign business warranted special scrutiny.

1. Japan Line

When state taxation of domestic interstate commerce is challenged, the Court applies what has become the familiar four-part test of Complete Auto Transit, Inc. v. Brady: the tax will be upheld if it is "applied to an activity with a substantial nexus with the taxing state, is fairly apportioned, does not discriminate against interstate commerce, and is fairly related to the services provided by the state."^{3/} In the landmark case of Japan Line, Ltd. v. County of Los Angeles,^{4/} however, the Court held that the Complete Auto test provides inadequate protection to foreign commerce. The Court cited two considerations in support of this conclusion. "The first is the enhanced risk of multiple taxation" when foreign commerce is involved.^{5/} As the Court explained, "neither this Court nor this Nation can ensure full apportionment when one of the taxing entities is a foreign sovereign,"^{6/} and "[e]ven a slight overlapping of tax -- a problem that might be deemed de minimis in a domestic context -- assumes importance when sensitive matters of foreign relations and national sovereignty are concerned."^{7/} The second factor cited by the Japan Line Court was the danger that "a state tax on instrumentalities of foreign commerce may impair federal uniformity in an area where federal uniformity is essential"^{8/}; in particular, the Court noted the possibility that

^{3/} 430 U.S. 274, 277-278, 287 (1977).

^{4/} 441 U.S. 434 (1979).

^{5/} Id. at 446.

^{6/} Id. at 447.

^{7/} Id. at 456 (footnote omitted).

^{8/} Id. at 448.

"foreign nations disadvantaged by the levy may retaliate against American-owned instrumentalities present in their jurisdictions."^{9/}

The Court in Japan Line therefore stated a new test to govern state taxation falling upon foreign commerce:

In addition to answering the nexus, apportionment, and nondiscrimination questions posed in Complete Auto, a court must also inquire, first, whether the tax, notwithstanding apportionment, creates a substantial risk of international multiple taxation, and, second, whether the tax prevents the Federal Government from "speaking with one voice when regulating commercial relations with foreign governments." If the tax contravenes either of these precepts, it is unconstitutional under the Commerce Clause.^{10/}

The Court went on to hold that the tax at issue in Japan Line was invalid under both prongs of its new test. The case involved an apportioned California property tax imposed on foreign-owned cargo containers that were subject to a similar (though unapportioned) tax in Japan. Because the containers were taxed on their full value in Japan, the California tax inevitably resulted in duplicative taxation and therefore was unconstitutional.^{11/} In finding that the tax also failed the "one voice" test, the Court cited to the Customs Convention on Containers,^{12/} an international agreement that did not preempt the tax^{13/} but that the Court read to "reflect a national policy to remove

^{9/} Id. at 450.

^{10/} Id. at 451.

^{11/} Id. at 451-452.

^{12/} Japan Line considered the 1956 Customs Convention on Containers, [1969] 20 U.S.T. 301. The United States has also since acceded to the 1972 Customs Convention on Containers, [1985] 988 U.N.T.S. 43.

^{13/} The Court made clear that it did not believe California's tax actually to be preempted by the Customs Convention, rejecting California's argument that "a State is free to impose demonstrable burdens on commerce, so long as Congress has not pre-empted the field by affirmative regulation." 441 U.S. at 454.

impediments to the use of containers."^{14/} And because Japan did not tax American containers, the Court found that California's tax created "an asymmetry in international maritime taxation" that could lead to Japanese retaliation against American container owners.^{15/} The Court went on to reject California's argument that the tax should be upheld on the ground that "any multiple taxation * * * can be cured by congressional action," explaining that "California may not tell this Nation or Japan how to run their foreign policies."^{16/}

Despite the seeming precision of its multi-part test, there was a certain lack of clarity in the rule of Japan Line. The Court left open the question whether the risk of multiple taxation was enough to invalidate a tax,^{17/} and whether duplicative taxation that was not the inevitable product of incommensurate taxing systems was unconstitutional. As for the one voice test, the Court simply offered a pair of factors (the existence of the Container Convention and the possibility of foreign retaliation) that evidenced the need for uniformity; the Court did not offer a general formula for determining when a state tax prevents the United States "from 'speaking with one voice' in regulating foreign trade."^{18/} But the broad and forceful language of the opinion -- as well as the fact that only a single Justice (Rehnquist) dissented from the holding of unconstitutionality -- seemed to promise that Japan Line's gaps would be filled in a manner that provided substantial protection for foreign commerce.

2. The Erosion of Japan Line

^{14/} 441 U.S. at 453.

^{15/} Ibid.

^{16/} Id. at 454, 455.

^{17/} Id. at 452 & n.17.

^{18/} Id. at 452.

That promise, however, was not fulfilled in the Court's subsequent Foreign Commerce Clause opinions. Rather surprisingly, given the uncompromising tenor of Japan Line, the Court instead began a slow but steady retreat from the broader pronouncements of that decision. By a 6-3 vote, the Court thus rejected the constitutional challenge in Container Corp. v. Franchise Tax Board,^{19/} which involved application of California's worldwide combined reporting method (the tax at issue in Barclays) to a domestic multinational firm. Although the Court in Container Corp. acknowledged that there was actual multiple taxation^{20/} and that Japan Line had hinted that even a slight overlapping of tax would be unconstitutional, it concluded that "absolute consistency" in the allocation of income between jurisdictions "may be just too much to ask."^{21/} The Court added that a method of apportionment that "inevitably" led to duplicative taxation might be suspect, but found that not to be the case in Container Corp.

Addressing the one voice test, the Court went on to explain that "a state tax at variance with federal policy will violate the 'one voice' standard if it either implicates foreign policy issues which must be left to the Federal Government or violates a clear federal directive. The second of these considerations is, of course, essentially a species of pre-emption analysis."^{22/} Applying the first prong of this test, the Court recognized, as it had in Japan Line, that "[t]he most obvious foreign

^{19/} 463 U.S. 159 (1983).

^{20/} The Container Corp. Court recognized that "the tax imposed here, like the tax imposed in Japan Line, has resulted in actual double taxation, in the sense that some of the income taxed without apportionment by foreign nations as attributable to appellant's foreign subsidiaries was also taxed by California as attributable to the State's share of the total income of the unitary business of which those subsidiaries are a part." 463 U.S. at 187 (footnote omitted).

^{21/} Id. at 192.

^{22/} Id. at 194 (emphasis in original).

policy implication of a state tax is the threat it might pose of offending our foreign trading partners and leading them to retaliate against the Nation as a whole."^{23/} The Court therefore offered several "objective standards" that bear on the likelihood of retaliation: whether the tax creates an "automatic 'asymmetry'" in international taxation, whether the tax is imposed on a foreign or a domestic entity, and whether the taxpayer is "without a doubt amenable to be taxed in [the taxing jurisdiction] in one way or another" (since the amount due is more a function of the rate than of the allocation method).^{24/} The Court concluded that all of these factors weighed "against the conclusion that the tax imposed by California might justifiably lead to significant foreign retaliation."^{25/} Going on to the second prong of the one voice test, the Court found that Congress had not preempted California's system.

In the Court's next encounter with the Foreign Commerce Clause, Wardair Canada, Inc. v. Florida Dept of Revenue,^{26/} it gave the states an additional tool with which to satisfy the one voice test. There, the taxpayer, joined by the United States, argued that a state tax on the purchase of airplane fuel was unconstitutional because it was inconsistent with a federal policy favoring tax exemptions for instrumentalities of international air traffic. Rejecting this contention, the Court found it dispositive that the United States had entered into a variety of agreements with other nations that prevented national governments, but not states or other political subdivisions, from taxing aviation fuel. Looking to these agreements, the Court held that "[b]y negative implication * * * the

^{23/} Id. at 194.

^{24/} Id. at 195.

^{25/} Id. at 194.

^{26/} 477 U.S. 1 (1986).

United States has at least acquiesced in state taxation"^{27/} -- even though none of these agreements in terms authorized the imposition of such taxes.

Most recently, the retreat from Japan Line continued in Itel Containers International Corp. v. Huddleston.^{28/} The case involved a challenge to the imposition of a state sales tax on the transfer of cargo containers used in international commerce. As in Japan Line, the taxpayer argued both that the Customs Convention on Containers evidenced a national policy in favor of treating containers uniformly and that foreign nations had threatened retaliation in response to the state tax. But the Court, by an 8-1 vote (with only Justice Blackmun, author of the Court's opinion in Japan Line, dissenting), upheld the tax. Noting that the Customs Convention preempted certain taxes but did not specifically displace the particular levy challenged by Itel, the Court concluded that "the most rational inference to be drawn is that this tax, one quite distinct from [those specifically preempted], is permitted."^{29/} The Court made no attempt to explain away Japan Line's conclusion, in virtually identical circumstances, that the Customs Convention militated in favor of a finding of unconstitutionality by establishing a national policy of limiting the taxation of containers. Instead, the Court distinguished Japan Line on the ground that the Executive Branch filed a brief in Itel indicating that the state tax would not cause foreign policy problems for the United States^{30/} -- although on this point, the Court did not attempt to reconcile its holding with Wardair's conclusion that the views of the Executive Branch are not dispositive.

^{27/} Id. at 12.

^{28/} 113 S. Ct. 1095 (1993).

^{29/} Id. at 1105.

^{30/} Id. at 1105.

The law thus stood in a state of considerable uncertainty when the Court granted review in Barclays. The Court had held that "inevitable" duplicative taxation would be struck down, but it had not made clear whether the inevitability had to be the product of two wholly incommensurate systems of taxation. And while the Court had stated and restated the one voice test on several occasions, its holdings left in doubt how that test was to be applied. It was not enough to invalidate a tax, Wardair made clear, that the Executive Branch believed that uniformity was essential – although Itel held that the Executive Branch's endorsement of a tax provided strong support for its constitutionality. And although both Japan Line and Container Corp. indicated that the possibility of retaliation by trading partners was the touchstone of the inquiry, an actual threat of retaliation was held insufficient to render the tax unconstitutional in Itel. In fact, the Court's somewhat impressionistic reliance in these cases on a number of disconnected factors supporting its decisions seems a telltale sign that the Justices did not have a terribly clear idea of what they were doing.

3. The Barclays Decision

Against this background, the Court's grant of review in Barclays raised the possibility that the Court would bring needed clarification to the Foreign Commerce Clause. And the circumstances of that grant seemed to suggest that the Court would strengthen the protections provided by the Clause. California, after all, had won in the state supreme court, and the challenged portions of the tax had been repealed prior to the Court's grant of certiorari -- a point emphasized by the Solicitor General when he urged the Court to deny review. The likeliest explanation for the Court's decision nevertheless to hear the case appeared to be that the Justices were troubled by the state-court decisions upholding the tax. And that impression was strengthened by the Court's decision also to review Colgate-Palmolive Co. v. Franchise Tax Board, Barclays' companion case, which, like Container Corp., involved application of the worldwide combined reporting method to a domestic

multinational. That the Court was willing to reconsider Container Corp. seemed to presage a return to the strict approach of Japan Line.

In the event, the Court in Barclays clarified the law -- but it did so by dramatically restricting the scope of the Foreign Commerce Clause. On the issue of duplicative taxation, the Court acknowledged that "multinational enterprises with a high proportion of income taxed by jurisdictions with wage rates, property values, and sales prices lower than California's face a correspondingly high risk of multiple international taxation."^{31/} But the Court nevertheless held that this risk did not invalidate the tax, explaining that "[m]ultiple taxation of such entities because of California's scheme is not 'inevitable'; the existence vel non of actual multiple taxation remains, as in Container Corp., dependent 'on the facts of the individual case.'"^{32/} In any event, the Court continued, use of a separate accounting system would not wholly eliminate the possibility of duplicative taxation. This conclusion finally inters Japan Line's suggestion that even de minimis duplicative taxation is constitutionally suspect.

It was in its application of the one voice test, however, that Barclays' departure from Japan Line was most profound. The Court began with the observation that Congress may "passively indicate that certain state practices do not 'impair federal uniformity in an area where federal uniformity is essential.'"^{33/} With that understanding in mind, the Court indicated that it "discern[ed]

^{31/} 62 U.S.L.W. at 4558. Dissenting in Container Corp., Justice Powell explained why this is so. Under the three-factor apportionment formula, a state attributes to itself the percentage of the taxpayer's income that corresponds to the percentage of the taxpayer's payroll, property, and sales in the state. This means that a state with high wage rates and property values will assign itself a high proportion of the income. See 463 U.S. at 199-201 (Powell, J., dissenting).

^{32/} Id. at 20, quoting Container Corp., 463 U.S. at 188.

^{33/} Id. at 25, quoting Japan Line, 441 U.S. at 448.

no 'specific indications of congressional intent' to bar the state action here challenged." As the Court explained, Congress "could have enacted legislation prohibiting the States from taxing corporate income based on the world-wide combined reporting method. In the 11 years that have elapsed since our decision in Container Corp., Congress has failed to enact such legislation."^{34/} And Congress's failure to pass bills that would have prohibited use of worldwide combined reporting, as well as the Senate's rejection of a bilateral treaty with the United Kingdom that would have prevented use of the method, "reinforced [the Court's] conclusion that Congress has implicitly permitted the States to use the worldwide combined reporting method."^{35/}

The Court's identification of "these indicia of Congress' willingness to tolerate States' worldwide combined reporting mandates" was the beginning and end of its one voice analysis.^{36/} Indeed, without acknowledging that its conclusion was inconsistent with its past decisions, the Court rejected the holding of Japan Line (and the dictum of Container Corp.) that the possibility of foreign retaliation and the need for uniformity could render a tax unconstitutional. The Court held that the judiciary

has no constitutional authority to make the policy judgments essential to regulating foreign commerce and conducting foreign affairs. * * * For this reason, Barclays' and its amici's argument that California's worldwide combined reporting requirement is unconstitutional because it is likely to provoke retaliatory action by foreign governments is directed to the wrong forum. The judiciary is not vested with power to decide "how to balance a particular risk of retaliation against the sovereign right of the United States as a whole to let the States tax as they please."^{37/}

^{34/} Id. at 4559-4560.

^{35/} Id. at 4560 (emphasis in original).

^{36/} Id. at 29.

^{37/} Id. at 4560-4561, quoting Container Corp., 463 U.S. at 194. Although the Court purported to follow Container Corp. in this holding, Barclays actually was a significant departure from the prior

The Court also rejected its prior suggestions that the position of the Executive Branch is relevant to this inquiry, holding that "[e]xecutive branch communications that express federal policy but lack the force of law cannot render unconstitutional California's otherwise valid, congressionally condoned, use of worldwide combined reporting."^{38/}

In one respect, this language is imprecise -- perhaps intentionally so: the Court in Barclays did not make entirely clear whether it was essential to the holding that there were affirmative "indicia of Congress' willingness to tolerate States' worldwide combined reporting mandates," or whether a constitutional challenge must be rejected even when Congress is entirely silent. The logic of the Court's opinion, however, suggests that congressional silence is enough to validate a state tax -- which means, in effect, that the "one voice" principle simply does not establish an inherent constitutional limit on the state taxing power. After all, the conclusion that the Court lacks the power and institutional competence "to make the policy judgments essential to regulating foreign commerce"^{39/} applies whether or not Congress has "passively indicate[d]" that the challenged state tax is acceptable, and may apply with special force when Congress has not spoken at all. Two concurring Justices (Blackmun and Scalia) thus indicated in separate opinions that the Court had permitted congressional "inaction" to support state restrictions on foreign commerce.^{40/} And the

decision. While the Court in Container Corp. did express concern about its ability to make judgments about fine points of foreign affairs, its response was to develop objective criteria to guide future decisions. See 463 U.S. at 194-195. Barclays, in contrast, held that the judiciary is "not vested with power to decide" such matters.

^{38/} Id. at 4561 (footnote omitted).

^{39/} Ibid.

^{40/} Id. at 1 (Blackmun, J. concurring); id. at 2 (Scalia, J., concurring in part and concurring in the judgment).

conclusion that Congress may "passively" endorse (and thus establish the constitutionality of) a state tax by doing nothing means, as a practical matter, that a tax is constitutional unless Congress affirmatively preempts it.

In this light, the amount of space that the Court devoted to seeking evidence of congressional acquiescence in California's taxing practice allowed the majority to purport to engage in "the 'additional scrutiny' required when a state seeks to tax foreign commerce"^{41/} -- and therefore served to obscure the extent of the Court's departure from Japan Line. But it is telling that the Court summarized its conclusion as follows:

Having determined that the taxpayers before us had an adequate nexus with the State, that worldwide combined reporting led to taxation which was fairly apportioned, nondiscriminatory, fairly related to the services provided by the State, and that its imposition did not result inevitably in multiple taxation, we leave it to Congress -- whose voice, in this area, is the Nation's -- to evaluate whether the national interest is best served by tax uniformity, or state autonomy.^{42/}

This restatement of the Foreign Commerce Clause test reduced the multiple taxation inquiry to a search for actual, inevitable duplicative taxation -- and eliminated the one voice test altogether.

The contrast here with Japan Line is striking -- as is the Barclays Court's failure to discuss Japan Line at all. (Japan Line is cited by the Barclays majority three times in passing.) In Japan Line (and for that matter, in Container Corp.) the Court examined in detail the possibility of foreign retaliation; in Barclays, the Court declared that inquiry irrelevant. And the Court's basic mode of analysis has changed. In Japan Line, the Customs Convention's preclusion of certain taxes at the federal level was seen as establishing a federal policy favoring uniform treatment by the states; in Barclays (following the lead of Wardair and Itel), the Court concluded that any congressional

^{41/} Id. at 4557.

^{42/} Id. at 33.

enactment that did not preempt state action should be read to authorize state taxation. Thus in Japan Line, the Court rejected the contention that the challenged tax was constitutional because any problems it caused could "be cured by congressional action"; in Barclays, the Court came full circle when it upheld the tax because Congress "could have enacted legislation prohibiting the States from taxing corporate income based on the worldwide combined reporting method."

What is left of the Foreign Commerce Clause after Barclays? Not much. The preemption prong of the one voice test recognized in Container Corp. remains in effect -- but the Court hardly needs the Commerce Clause to set aside state enactments that have been preempted by Congress. And while inevitable multiple taxation will be invalidated under Barclays, that also is true under the four-part Complete Auto test used to evaluate restrictions on the taxation of interstate commerce. The rule applicable to foreign commerce appears to differ in only one respect: while an apportioned tax (like the one at issue in Japan Line) will be upheld under Complete Auto, such a tax will be invalidated if a foreign sovereign insists upon unapportioned taxation -- at least if the unapportioned tax is consistent with the "custom of nations," a caveat that the Court announced in Japan Line but has not had occasion to elaborate.^{43/} It appears that this mouse of a doctrine is all that remains of the Japan Line whale.

What explains this reversal in approach? It has no parallel under the Interstate Commerce Clause, where the Court, despite constant nagging by Justice Scalia (who would be happy to do away with dormant Commerce Clause analysis altogether), continues happily to apply the Complete Auto test. It may be that while Japan Line seemed a sensible reaction to a state enactment that threatened to create serious foreign policy problems, the Court ultimately was brought up short by

^{43/} 441 U.S. at 545.

the difficulty of deciding whether a state tax was likely to prompt foreign retaliation -- an inquiry that in any event seemingly hinged the constitutionality of state law on the opinions either of foreign nations or of the Executive Branch. And it would not be surprising had the Court become increasingly skeptical about the seriousness of the Japan Line problem as threats of massive foreign retaliation in Wardair and Itel did not materialize after the rejection of the constitutional challenges in those cases. But whatever the Court's motivation, one point is clear: most complaints about the dire international consequences of state taxation now must be directed to Congress rather than the courts.