

S B

119

FISCAL NOTE

REQUEST:

Revision Date: _____
Title: Unitary Tax
Sponsor: Rules Committee
Requestor: Governor

Agency Affected: Commerce & Econ. Dev.
BRU: Division of Banking, Securities
and Corporations
Components: _____

EXPENDITURES/REVENUES: (Thousands of Dollars)

OPERATING	FY 89	FY 90	FY 91	FY 92	FY 93	FY 94
PERSONAL SERVICES						
TRAVEL						
CONTRACTUAL						
SUPPLIES						
EQUIPMENT						
LAND & STRUCTURES						
GRANTS, CLAIMS						
MISCELLANEOUS						
TOTAL OPERATING	-0-	-0-	-0-	-0-	-0-	-0-

CAPITAL	-0-	-0-	-0-	-0-	-0-	-0-
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REVENUE	-0-	-0-	-0-	-0-	-0-	-0-
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FUNDING: (Thousands of Dollars)

GENERAL FUND						
FEDERAL FUNDS						
OTHER						
TOTAL	-0-	-0-	-0-	-0-	-0-	-0-

POSITIONS:

FULL-TIME						
PART-TIME						
TEMPORARY						

ANALYSIS : (Attach a separate page if necessary)

Prepared by: Willis F. Kirkpatrick, Director Phone: 465-2521
Division: Banking, Securities and Corporations Date: 01/09/1989

Approved by Commissioner: Larry Mercurieff Date: 01/09/1989
Agency: Dept. of Commerce & Economic Development

Distribution (by preparer):
Legislative Finance
Legislative Sponsor
Requestor
Office of Management and Budget
Impacted Agency(ies)

Changes in CSSB 119 (Fin)
have no fiscal impact.
This fiscal note is
appropriate. 3/23/90

No fiscal impact is
expected through 1996.

STEVE COWPER
GOVERNOR



STATE OF ALASKA
OFFICE OF THE GOVERNOR
JUNEAU

January 17, 1989

The Honorable Tim Kelly
President of the Senate
Alaska State Legislature
P.O. Box V
Juneau, AK 99811

Dear Senator Kelly:

Under the authority of art. III, sec. 18, of the Alaska Constitution, I am transmitting a bill relating to the methods of corporate income tax reporting for certain taxpayers. This bill requires that corporations that are members of affiliated groups owned by foreign corporate parents file returns based on the "water's edge" method, instead of the "worldwide" method of tax accounting. The "water's edge" method is a taxing method that takes into consideration only the domestic activities of foreign corporations and does not consider income from their non-American operations.

The "worldwide" method of tax accounting has many virtues, but it is intensely disliked by most potential investors overseas. Virtually every other state that used the "worldwide" method has repealed it in recent years in order to increase investment and trade opportunities. There is simply no reason why Alaska should keep this barrier to investment on the books when other states have repealed it.

The next century, it is said, will be the era of the Pacific Rim. Alaska is strategically placed to participate fully in the booming economies of the region. I believe that we must take every step possible to encourage trade and investment in Alaska. This bill will remove a major psychological barrier to investment in the state while having only a minimal fiscal impact. I urge your prompt and favorable consideration of this bill.

Sincerely,

A handwritten signature in dark ink, appearing to read "Steve Cowper".

Steve Cowper
Governor

Transmittal Letter

Alaska State Legislature

Senate Resources Committee

Senator Bettye Fahrenkamp, Chairman

Senator Jay Kentula, Vice Chairman
Senator Dick Eliason
Senator Steve Frank
Senator Rick Hallford
Senator Arliss Sturqulewski
Senator Fred Zhamif



P.O. Box V
Juneau, Alaska 99811
(907) 465-4907

SENATE RESOURCES COMMITTEE LETTER OF INTENT FOR SB 119

This bill will require multinational firms with foreign parents to file Alaska corporate tax returns using the water's edge method. The ability to use the water's edge method has been sought by foreign firms contemplating investments in Alaska, and by Keidanren, the umbrella organization of Japanese business and economic interests. The committee believes the change proposed in this bill will remove a barrier to greater foreign investment in Alaska.

Under SB 119 (and under current law), firms with domestic (U.S.) parents are not permitted to use the water's edge filing method. The committee considered arguments for extending the water's edge method to domestic firms, but rejected such an extension. Water's edge accounting entails very little state revenue loss when applied only to firms with foreign parents, but would cause a loss of \$3-6 million annually if applied to all multinational firms doing business in Alaska. Testimony before the Senate Resources Committee failed to demonstrate that additional investment would flow to Alaska from domestic firms as a consequence of allowing them water's edge filing, or that such additional investment would justify the revenue loss.

It is the intent of the committee that the administration continue to monitor the potential impacts of extending the water's edge method to all multinational corporations. Further, it is the intent of the committee that the administration notify the appropriate legislative committees if it appears that significant new domestic investment would occur as a result of the change.

Letter of Intent S (Res)

STATE OF ALASKA
1989 LEGISLATIVE SESSION

BILL VERSION: SB 119 (a)
PUBLISH DATE: 1/17/89

FISCAL NOTE

REQUEST: _____

Revision Date: January 9, 1989
Title: Alaskan Corporate Taxpayers with Foreign Parent Corporations
Sponsor: Rules Committee
Requestor: Governor

Agency Affected: Revenue
BRU: Income and Excise Audit
Components: _____

EXPENDITURES/REVENUES: (Thousands of Dollars)

	FY 89	FY 90	FY 91	FY 92	FY 93	FY 94
OPERATING						
PERSONAL SERVICES	-	-	-	-	-	-
TRAVEL	-	-	-	-	-	-
CONTRACTUAL	-	-	-	-	-	-
SUPPLIES	-	-	-	-	-	-
EQUIPMENT	-	-	-	-	-	-
LANDS & STRUCTURES	-	-	-	-	-	-
GRANTS, CLAIMS	-	-	-	-	-	-
MISCELLANEOUS	-	-	-	-	-	-
TOTAL OPERATING	-	-	-	-	-	-
CAPITAL	-	-	-	-	-	-
REVENUE	0	(60.0)	(60.0)	(60.0)	(60.0)	(60.0)

FUNDING: (Thousands of Dollars)

GENERAL FUND	-	-	-	-	-	-
FEDERAL FUNDS	-	-	-	-	-	-
OTHER	-	-	-	-	-	-
TOTAL	-	-	-	-	-	-

POSITIONS:

FULL-TIME	-	-	-	-	-	-
PART-TIME	-	-	-	-	-	-
TEMPORARY	-	-	-	-	-	-

ANALYSIS: See attached analysis.

Prepared By: Steven E. Kettel
Division: Income and Excise Audit

Carl Hoyer for

Phone: (907) 465-2320
Date: January 9, 1989

Approved by Commissioner: Hugh Malone
Agency: Department of Revenue

H Malone

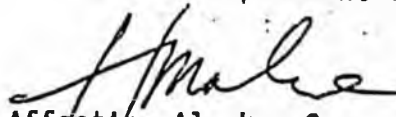
Date: January 9, 1989

Distribution (by preparer):

- Legislative Finance
- Legislative Sponsor
- Requestor
- Office of Management and Budget
- Impacted Agency(ies)

SB 119 (a)
1/17/89

Prepared by: John Larson and
Steve Kettel
Alaska Department of Revenue



Fiscal Note Analysis: Legislation Affecting Alaskan Corporate Taxpayers
with Foreign Parent Corporations

The proposed legislation would require corporate income taxpayers with foreign parents to file on a water's edge combined basis beginning in calendar year 1989. The legislation would not affect taxpayers who currently file under AS 43.20.072 (Oil and Gas Producers and Pipelines). Nor would it affect Alaska corporations which do not have foreign operations. The total number of taxpayers affected and the total tax liability of these taxpayers are small.

In order to derive an estimate of the possible revenue impact of this proposed legislation the Department analyzed tax returns filed for the most recent tax year available - 1986. For tax year 1986 staff identified the tax returns of taxpayers with foreign parents. This methodology was designed to determine the potential revenue impact from only those taxpayers currently operating in Alaska. The Department did not estimate the potential revenue impact of incremental business activity in Alaska by corporations with foreign parents which may be induced by this proposed legislation.

Based on an analysis of the taxpayers which were identified as possibly being affected by the proposed legislation, the maximum tax liability decrease for tax year 1986 would have been no greater than \$60,000.

SB 119
Modifying the Unitary Tax

Briefing materials
provided to the:

Alaska State Senate
Resources Committee
Senator Bettye Fahrenkamp, Chairman

Office of the Governor
Division of Policy
February 23, 1989

Annotated Table of Contents

Basic source materials

- Tab 1. SB 119, "An Act relating to required reporting methods for corporate income taxes...", with a summary and sectional analysis.
- Tab 2. Governors transmittal letter on SB 119.
- Tab 3. Fiscal note on SB 119.
- Tab 4. Excerpt from the Governor's State of the State address, January 20, 1987, relating to the unitary tax issue.

Materials advocating elimination of the worldwide unitary tax system.

- Tab 5. "A Japanese Perspective--Is Worldwide Unitary Fair?" by Mitsuru Misawa, Industrial Bank of Japan, from *Sloan Management Review*, Winter 1985.
- Tab 6. "Walk Softly or Carry a Big Carrot," by Paul Laird, *Alaska Business Monthly*, February 1987.

Briefing materials provided by the Department of Revenue.

- Tab 7. "Water's Edge Combination--Opportunity for Uniformity?" published by the Multistate Tax Commission, no date.
- Tab 8. "Economic Development and Alaska's Corporate Income Tax: Reviewing the Options," a briefing paper prepared for Governor Cowper by the Department of Revenue, September 4, 1987.

Recent Japanese contacts and comments on Alaska's unitary tax.

- Tab 9. "Investment From Japan Essential to Diversification of [Alaska and Hawaii] State Economies," by Hideo Ishihara, Managing Director, Industrial Bank of Japan, and leader of the Keidanren mission to Alaska and Hawaii, from *Keidanren Review*, October 1988.
- Tab. 10. Keidanren Investment Mission to the United States of America, Alaska and Hawaii, September 1988, list of participants.

Annotated Table of Contents, *page 2*

Tab 11. Testimony of Sadami (Chris) Wada, Senior Vice President, Sony Corporation of America, in support of SB-119.

Materials prepared by the Staff Working Group on Unitary Taxation.

Tab 12. Attachments A-E to memo notifying members of Sept 15 working group meeting, September 10, 1987. Includes the working group's initial list of unitary options and other background data.

1 IN THE SENATE

BY THE RULES COMMITTEE BY
REQUEST OF THE GOVERNOR

2

SENATE BILL NO. 119

3

IN THE LEGISLATURE OF THE STATE OF ALASKA

4

SIXTEENTH LEGISLATURE - FIRST SESSION

5

A BILL

6 For an Act entitled: "An Act relating to required reporting methods for
7 corporate income taxes owed by members of an affili-
8 ated group whose common parent is a corporation
9 incorporated outside the United States; and providing
10 for an effective date."

11 BE IT ENACTED BY THE LEGISLATURE OF THE STATE OF ALASKA:

12 * Section 1. It is the purpose of this Act to promote investment and
13 trade opportunities in the state.

14 * Sec. 2. AS 43.20 is amended by adding a new section to read:

15 Sec. 43.20.073. AFFILIATED GROUPS. (a) A corporation that is a
16 member of an affiliated group whose common parent is a corporation
17 incorporated outside the United States shall file a return using the
18 water's edge combined reporting method. A return under this section
19 shall include the following corporations if they are a part of a
20 unitary business:

21 (1) corporations included or includable in a consolidated
22 return for federal corporate income tax purposes;

23 (2) corporations incorporated in or doing business in any
24 state or United States possession or territory;

25 (3) domestic international sales corporations and foreign
26 sales corporations; and

27 (4) tax haven corporations.

28 (b) The department may require a corporation filing under this
29 section to file a worldwide combined report if

1 (1) the corporation or any affiliate fails to comply with
2 regulations adopted under this chapter, including domestic disclosure
3 spreadsheet filing requirements; or

4 (2) the corporation does not provide information requested
5 by the department on the operations of a foreign parent necessary for
6 the department to audit the taxpayers corporation return within a
7 reasonable period of time.

8 (c) This section does not apply to taxpayers subject to AS
9 43.20.072 engaged in the production of oil or gas from a lease or
10 property in the state or engaged in the transportation of oil or gas
11 by regulated pipeline in the state.

12 (d) As used in this section:

13 (1) an "affiliated group" is a group of two or more corpo-
14 rations, in which 50 percent or more of the voting stock of each
15 member is directly or indirectly owned by a common owner or by common
16 owners, either corporate or non-corporate, or by one or more of the
17 member corporations of the group;

18 (2) a "tax haven corporation" means a corporation that is
19 incorporated in or does business in a country that does not impose an
20 income tax, or that imposes an income tax at a rate lower than 90
21 percent of the federal tax rate on the federally defined income tax
22 base, and 50 percent or more of sales, purchases, or payments of
23 income or expenses, exclusive of payments for intangible property, of
24 the corporation are made directly or indirectly to one or more members
25 of a waters' edge group and which conducts no significant economic
26 activity.

27 * Sec. 3. This Act is retroactive to tax years beginning after Decem-
28 ber 31, 1988.

29 * Sec. 4. This Act takes effect immediately under AS 01.10.070(c).

*Office of the Governor
Division of Policy
7 February 1989*

Summary & Sectional Analysis

**SB 119
Legislation to Modify
Unitary Tax Provisions in Alaska Law**

This bill is designed to resolve objections by foreign business interests to Alaska's unitary corporate income tax. The bill disturbs the state's existing taxing arrangements as little as possible, consistent with the goal of removing the objectionable unitary provisions. Oil and gas taxpayers are not affected.

The legislation establishes a water's edge taxing regime for an affiliated corporate group, but if and only if the group is headed by a foreign parent corporation. The foreign parent corporation is not required to report, only the subsidiaries doing business in the U.S. Water's edge filing is not extended to foreign corporations that directly do business in Alaska.

Firms filing a water's edge report must provide a domestic disclosure spreadsheet verifying consistency among returns filed in different U.S. states. Income earned within the U.S. would still be subject to apportionment among the states. Firms using the water's edge reporting method may be required to provide data needed to audit their Alaska returns.

The fiscal note estimates that an annual revenue loss of \$60,000 would result from this legislation.

**Section 1* states that the purpose of the bill is to promote trade and investment opportunities.

**Section 2* amends the the Alaska [corporate] net income tax, AS 43.20, to require water's edge combined reporting for taxpayer corporations with foreign parents. The return is required to combine all elements and subsidiaries of the unitary business incorporated or doing business in the U.S., as well as certain special kinds of international corporations formed to reduce tax liability.

**Section 3* gives the bill retroactive application to tax years beginning after the last day of 1988.

**Section 4* provides for an immediate effective date.

January 17, 1989

INTRODUCTION AND REFERENCE OF SENATE BILLS

SB 119

SENATE BILL NO. 119 by the Rules Committee by request of the Governor, entitled:

"An Act relating to required reporting methods for corporate income taxes owed by members of an affiliated group whose common parent is a corporation incorporated outside the United States; and providing for an effective date."

was read the first time and referred to the Senate Special Committee on International Trade and Tourism, the Judiciary Committee, the Resources Committee and the Finance Committee.

Fiscal note published today from Department of Revenue.
Zero fiscal note published today from Department of Commerce and Economic Development.

Governor's transmittal letter dated January 16:

Dear Senator Kelly:

Under the authority of art. III, sec. 18, of the Alaska Constitution, I am transmitting a bill relating to the methods of corporate income tax reporting for certain taxpayers. This bill requires that corporations that are members of affiliated groups owned by foreign corporate parents file returns based on the "water's edge" method, instead of the "worldwide" method of tax accounting. The "water's edge" method is a taxing method that takes into consideration only the domestic activities of foreign corporations and does not consider income from their non-American operations.

The "worldwide" method of tax accounting has many virtues, but it is intensely disliked by most potential investors overseas. Virtually every other state that used the "worldwide" method has repealed it in recent years in order to increase investment and trade opportunities. There is simply no reason why Alaska should keep this barrier to investment on the books when other states have repealed it.

The next century, it is said, will be the era of the Pacific Rim. Alaska is strategically placed to participate fully in the booming economies of the region. I believe that we must

January 17, 1989

SB 119 cont'd

take every step possible to encourage trade and investment in Alaska. This bill will remove a major psychological barrier to investment in the state while having only a minimal fiscal impact. I urge your prompt and favorable consideration of this bill.

Sincerely,

/s/
Steve Cowper
Governor

SB 120

SENATE BILL NO. 120 by the Labor and Commerce Committee, entitled:

"An Act extending the termination date of the Alaska Public Utilities Commission; and providing for an effective date."

was read the first time and referred to the Labor and Commerce Committee and the Finance Committee.

SB 121

SENATE BILL NO. 121 by Senator Karttula, entitled:

"An Act relating to conditions of scholarship loans; and providing for an effective date."

was read the first time and referred to the Health, Education and Social Services Committee and the Finance Committee.

SB 122

SENATE BILL NO. 122 by Senators Sturgulewski, Roday and Zharoff, entitled:

"An Act authorizing treatment of a minor who misuses hazardous volatile materials or substances as a child in need of aid."

was read the first time and referred to the Health, Education and Social Services Committee.

FISCAL NOTE

REQUEST:

Revision Date: November 18, 1988
 Title: Alaskan Corporate Taxpayers with Foreign Parent Corporations
 Sponsor: Governor
 Requestor: _____

Agency Affected: Revenue
 BRU: Income and Excise Audit
 Components: _____

EXPENDITURES/REVENUES: (Thousands of Dollars)

	FY 89	FY 90	FY 91	FY 92	FY 93	FY 94
OPERATING						
PERSONAL SERVICES	-	-	-	-	-	-
TRAVEL	-	-	-	-	-	-
CONTRACTUAL	-	-	-	-	-	-
SUPPLIES	-	-	-	-	-	-
EQUIPMENT	-	-	-	-	-	-
LANDS & STRUCTURES	-	-	-	-	-	-
GRANTS, CLAIMS	-	-	-	-	-	-
MISCELLANEOUS	-	-	-	-	-	-
TOTAL OPERATING	-	-	-	-	-	-
CAPITAL	-	-	-	-	-	-
REVENUE	0	(60.0)	(60.0)	(60.0)	(60.0)	(60.0)

FUNDING: (Thousands of Dollars)

GENERAL FUND	-	-	-	-	-	-
FEDERAL FUNDS	-	-	-	-	-	-
OTHER	-	-	-	-	-	-
TOTAL	-	-	-	-	-	-

POSITIONS:

FULL-TIME	-	-	-	-	-	-
PART-TIME	-	-	-	-	-	-
TEMPORARY	-	-	-	-	-	-

ANALYSIS: See attached analysis

Prepared By: Steven E. Kettel *Steven E. Kettel*
 Division: Income and Excise Audit

Phone: (907) 465-2000
 Date: November 18, 1988

Approved by Commissioner: Hugh Malone *H.M.*
 Agency: Department of Revenue

Date: November 18, 1988

Distribution (by preparer):

- Legislative Finance
- Legislative Sponsor
- Requestor
- Office of Management and Budget
- Impacted Agency(ies)

Prepared by: John Larson and
Steve Kettel
Alaska Department of Revenue
November 18, 1988

Fiscal Note Analysis: Legislation Affecting Alaskan Corporate Taxpayers
with Foreign Parent Corporations

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In order to derive an estimate of the possible revenue impact of this proposed legislation the Department analyzed tax returns filed for the most recent tax year available - 1986. For tax year 1986 staff identified the tax returns of taxpayers with foreign parents. This methodology was designed to determine the potential revenue impact from only those taxpayers currently operating in Alaska. The Department did not estimate the potential revenue impact of incremental business activity in Alaska by corporations with foreign parents which may be induced by this proposed legislation.

Based on an analysis of the taxpayers which were identified as possibly being affected by the proposed legislation, the maximum tax liability decrease for tax year 1986 would have been no greater than \$60,000.

Excerpt from Governor Cowper's State of the State address,
January 20, 1987:

...The key to the new Alaska economy is marketing for our commodities,
for our products, for our services....

With that overall goal in mind, my administration will ask you to adopt
the following proposals for the permanent recovery of the Alaskan
economy...

5. Repeal the unitary tax on multinational corporations, replacing
the lost revenue through other means. The unitary tax was adopted as
a means of making sure that expenses connected with drilling in
Indonesia weren't deducted from Alaska tax returns. Its benefits are
now outweighed by its disadvantages. Foreign investors are reluctant
to locate in states which have a unitary tax because of the fear that
those states might tax income earned elsewhere. A less threatening
tax structure will make Alaska more attractive to those investors.

SMR Forum: A Japanese Perspective — Is Worldwide Unitary Taxation Fair?

Mitsuru Misawa

Industrial Bank of Japan, Ltd.

Under a system of unitary taxation, a state government bases a corporation's income tax liability not on the earnings of the corporation's local subsidiaries but on earnings worldwide. Even if the subsidiary is losing money, it may be allocated some tax, based on the profitable performance of the corporation elsewhere. The author attacks this system as unfair and ineffective, causing double taxation, misallocation of resources, and various procedural difficulties. He also offers an alternative, the "water's-edge" approach, which would exclude income outside the U.S. from taxation by a state. Although not a perfect solution, the author advocates this as a means of eliminating the worst problems of unitary taxation. Ed.

Japan's direct investment in the United States is increasing steadily, having reached a balance of \$3 billion at the end of 1982 (which is equal to 36 percent of Japan's total investment worldwide). However, the future of this trend is now clouded by the system of a worldwide unitary taxation adopted by California and twelve other states.¹ Under unitary taxation, a state government determines a corporation's consolidated income worldwide and allocates its local subsidiary a pro rata income assessed on the evaluation of labor compensation, local assets, and sales proceeds. The validity of this method is open to question.

During his November 1983 visit to Japan, President Reagan was reminded of this problem by Prime Minister Nakazone.² Although the U.S. government is now looking into the matter, Japan's leading businesses are very much concerned about the outcome.

This past June, Keidanren (The Japanese Federation of Economic Organizations) dispatched a high-level unitary tax survey mission to the United States. Representatives from some twenty leading businesses³ visited a total of twenty-four states, including several where unitary taxation is applied.⁴ The purpose of this mission was to meet with government authorities (including governors) and encourage them to either abolish or not adopt unitary taxation. In this paper, I will attempt to summarize the problems that unitary taxation has created for Japanese corporations and then explore possible solutions.⁵

The Consequences of Unitary Taxation on Japanese Corporations

Several Japanese corporations with subsidiaries in California have encountered large state tax liabilities despite their lim-

ited sales within the state. This situation prevails even when a subsidiary is performing poorly in California.⁶ A newly established subsidiary is rarely profitable as depreciation and amortization costs are particularly heavy in the initial years. Yet, even new firms are liable to taxation because of the performance of already well-established parent companies.

For example, Kyocera Corporation, a representative Japanese high-technology firm paid a total of \$18 million in corporate income tax to the Internal Revenue Service over twelve years from 1972 through 1983. In this period, the corporation paid \$3.5 million to the state of California on a net income of \$22 million. However, with the imposition of unitary taxation, tax liabilities were recalculated to include corporate income earned throughout the world. Thus the state levied an additional amount of \$1 million inclusive of interest accrued during an alleged delay in payment. Altogether, the state tax paid exceeded net income. In this case, the grievance against unitary taxation on the part of Kyocera Corporation appears to be justified.⁶

Given these circumstances, Kyocera has suspended its plan to enlarge its plant in San Diego, California. Instead, the firm may consider relocating to the state of Washington which does not impose unitary taxation.

Another well-known electronics firm NEC,⁹ has also suspended additional investment in California and is tentatively planning to invest in an optical fiber telecommunications plant in Oregon, where unitary taxation is expected to be abolished shortly.¹⁰

The Background of Unitary Taxation The system of worldwide unitary taxat

Mitsuru Misawa is Deputy General Manager, International Investment Services Department, of the Industrial Bank of Japan, Tokyo. Dr. Misawa holds the L.L.B. degree from Tokyo University, the L.L.M. degree from Harvard University, the M.B.A. degree from the University of Hawaii, and the Ph.D. degree in business administration from the University of Michigan. He was an official member of the Keidanren Investment Study Mission to the U.S. sent by Keidanren (Japan Federation of Economic Organizations) to investigate the general investment climate in various states for future Japanese investments. Dr. Misawa is the author of articles that have appeared in the *Vanderbilt Journal of Transnational Law*.

represents an attempt to replenish treasuries in several states that are troubled with revenue shortfalls. In southern states such as Georgia and Kentucky, where a balanced budget is a mandatory constitutional requirement, unitary taxation has never been proposed, and their governors have disclaimed any intention to introduce it in the future.¹¹

A number of consumer groups, on the other hand, are adamantly demanding enforcement of unitary taxation to prevent big business from getting away with paying little taxes. Thus, state governments might experience considerable opposition if they withdraw their commitment to unitary taxation.¹² For instance, a government would first have to secure an alternative source of revenues and then convince consumer groups that the tax burden would be equitably shared.

In a recent ruling, the U.S. Supreme Court upheld the constitutionality of unitary taxation.¹³ In this particular case, the corporation, which is incorporated in Delaware and doing business in California, and its overseas subsidiaries constituted a "unitary business." The "formula apportionment" method used by California did not violate the requirement of fair apportionment imposed by the due process clause of the U.S. Constitution.¹⁴ Application of the unitary business and formula apportionment method to overseas subsidiaries did not violate the Foreign Commerce Clause of the U.S. Constitution.

The Arm's-Length Approach

The litigant corporation had undertaken an alternative approach called the "arm's-length" approach, obeying the laws and relevant tax treaties of the U.S. federal government and other national governments under whose jurisdiction the corporation operates subsidiaries. By employing the arm's-length approach, a government imposes taxes only on incomes earned within its jurisdiction — provided that within a group of affiliated firms, each firm is legally treated as an independent entity and that the firms transact

with one another on an arm's-length basis. This ruling, however, leaves the question of foreign parent companies that are operated in the U.S. through U.S. subsidiaries unresolved. It seems worthwhile, therefore, for a Japanese firm like Kyocera to contest its point in court.

Problems for Japanese Corporations

The problems that Japanese corporations counter with unitary taxation are listed below.

1. Tax Jurisdiction. Tax jurisdiction is considered to be counterbalanced by the benefits and protection provided by the authorities to the taxpayers also under their jurisdiction. Logically, therefore, tax jurisdictions can impound incomes accruing to the party outside the tax jurisdiction of the taxing authority. This is widely accepted as an international practice based on justice and equity; it is probably right to infer, therefore, that several states in the United States may not fully impose a tax on the foreign-based incomes of foreign corporations.

Although it is true that a group of affiliated firms is interdependent, and the total income of the group represents the fruit of its global activities straddling jurisdictional borders, the method of aggregating worldwide income and then apportioning the total to geographical jurisdictions in accordance with mere business indices is too mechanical to do justice to the complexities of actual business. This point is plain enough in the case of a Japanese corporation, with a U.S. subsidiary, that is gaining profits from the operations of its Southeast Asian and West European subsidiaries. Here, there is not only a remote possibility for the U.S. subsidiary to contribute anything to the overall profits derived from the Asian or the West European operation. The system of unitary taxation requires, even in this case, the allotment of state tax based on the Asian or West European operation.

2. Conflicting Taxation Principles. Both the United States and Japan use the arm's-length

approach in taxation, and thus it may be considered the internationally accepted approach. However, the action of some U.S. states in pursuing unitary taxation creates a complex situation for multinational corporations that have to deal with two differing taxation principles.

The arm's-length approach cannot cope with tax evasion effected through transfer pricing within a group of affiliates. In such cases, the tax revenue of the taxing authorities would perhaps suffer a decrease. However, the U.S. and Japan have no appreciable differences in the rates of corporate income taxes, and no merits exist in manipulative transfer pricing.¹³

3. Conceptual and Procedural Ambiguities. Conceptually and procedurally, the system of worldwide unitary taxation involves ambiguities, and there is no assurance that the relevant taxing authorities will not adopt an arbitrary stand. To assess the global aggregate income of an affiliate group, the three indices — assets, labor compensation, and sales proceeds — are considered of equal weight. This erroneous assumption is too simplistic to do justice to the complex management of a multinational corporation.

When a Japanese subsidiary constructs a new factory in the U.S., the required site must be purchased at the current price, which is entered on the subsidiary's books as the book value. The parent firm's land holdings in Japan, on the other hand, are recorded at their historical value. This use of asset values inflates the amount of tax liabilities in the United States.

4. Double Taxation. The corporate income of a multinational group is now subject to taxation in either the country of operation or residence. Worldwide unitary taxation — imposing tax liabilities on the foreign income of foreign corporations taxed already under arm's-length taxation — thus entails double taxation.

For example, a Japanese subsidiary in the United States owes tax liabilities to the state government, although, from the viewpoint of

the Japanese parent, tax is being levied part of the parent's income. The parent cannot claim a tax deduction under Japanese law because the amount in question is levied on its U.S. subsidiary, not on the parent itself. State and local taxes are not covered by the Japan-U.S. tax treaty because the federal government has no power over them. For this reason, Japanese corporations cannot expect relief from the ad hoc consultation procedure set forth in the treaty.

An Alternative: The Water's-Edge Approach. The water's-edge approach to resolving the issue of unitary taxation, which has been advocated by a competent task force in the Treasury Department, appears to be a constructive proposal.¹⁴ This approach recommends that income earned outside the U.S. by a multinational group should be included in the income aggregation only if a number of conditions, which are described below, exist. Thus, the unitary taxation of income from interstate business activities would remain a problem, but its international application would be theoretically eliminated in many cases.

Even so, there is a catch to this proposal. A wide range of corporations based outside the U.S. would continue to be subject to worldwide aggregation of income. This would include all corporations by which the average of the three indices for a foreign-based corporation amounted to more than 10 percent of the corporate activities (in terms of wages/salaries paid, assets held, and sales registered) to have originated in the United States. Global income assessment would be applied if either wages/salaries paid in the U.S., or assets held in the U.S., or sales in the U.S. exceeded \$10 million. These provisions would effectively make most Japanese corporations subject to unitary taxation. Further, the same report demands wide-ranging financial disclosure by foreign-based corporations, which might conceivably involve inordinately large costs.

The range of disclosure includes: (1) submission to the state tax authorities of related information concerning the p

The Keidanren Group (Japanese Federation of Economic Organizations) is composed of the leading business executives in Japan, and operates much like The Business Roundtable in the United States. Maintaining close contact with various economic sectors in Japan and abroad, Keidanren endeavors not only to find practical solutions to economic problems but also contributes to the sound development of the economies of Japan and other countries.

firm; (2) the summarized listing of the amount of taxes paid to each state; and (3) oral explanation in response to a summons from the state tax authorities. To reinforce the legal obligation to respond to summonses, foreign-based firms must deposit a certain amount of money with the authorities. Accordingly, the firms that fail to meet fully these conditions of disclosure would be subject to worldwide unitary taxation.

This sort of disclosure requirement is not unjustifiable because the assessment of tax on multinational business activities presupposes a knowledge of intragroup dealings. In practice, however, several problems could arise. As a separate legal entity, the foreign parent firm of a U.S. subsidiary is not entirely free to furnish the kind of information required by this proposed approach. It should also be remembered that different states employ different taxation principles and procedures. The synopsis listing of tax payments to each and every state is, there-

fore, easier said than done. Furthermore, selective obligation to respond to the summons could constitute a discrimination against foreign-based firms.

The water's-edge approach as proposed by the Treasury Department task force is also problematical. It is hoped that with further refinement, this approach will take a form that will be considered reasonable by most multinational corporations.

Conclusion

The initiative for satisfactory settlement of this issue rests with each of the state governments and legislatures concerned. Having fully appraised the adverse effects of unitary taxation on direct investment in the United States, I would like to see the bodies take the constructive steps necessary to create more jobs and encourage economic prosperity within their states. This is the scenario most Japanese corporations strongly hope to see.

References

- 1 The other states include Massachusetts, Florida, Oregon, and Indiana.
- 2 Secretary of the Treasury Regan, who accompanied the president to Japan, stated that in considering unitary taxation, the apprehensions on the part of the Japanese government would be duly considered.
- 3 The membership included representatives of Nissan Motor Co., Toyota Motor Co., several other manufacturers, the Mitsubishi Corporation, several other trading houses, the Industrial Bank of Japan, and several other banks. The Federation of Economic Organizations is a voluntary association of some 1,000 businesses. It has a considerable influence on public policies and private managerial decision making.
- 4 California is of strategic importance to most Japanese corporations because approximately 1,000 out of the

3,000 Japanese corporations investing in the U.S. are based in California. This state raises an annual revenue of about \$400 million by — and appears firmly committed to — unitary taxation, according to the Nihon Keizai Shimbun (3 July 1984, p. 4).

5 I am solely responsible for the views herein expressed which do not necessarily agree with the official standpoints of either the Federation of Economic Organizations or the Industrial Bank of Japan.

6 Apart from a few exceptions, most Japanese subsidiaries in California do not in fact perform better than their parents.

7 Kyocera is a pioneer in ceramic IC packages. It controls 70 percent of the world market for these products. Sales in 1983 was ¥133,230 million.

8 In June 1984, Kyocera deposited \$21 million request with the judicial authorities and embarked on litigation.

against the state government. See the Nihon Keizai Shimbun, 28 June 1984, p. 8.

9
NEC is a major maker of telecommunications equipment, electronic computers, and semiconductors. In the production of semiconductors, NEC is number 2 in the world. Its total sales in 1983 were ¥1,253,588 million.

10
In June 1984, the Keidanren mission met the governor of Oregon, who confirmed his commitment to the abolition of unitary taxation. This commitment has been put in writing by the governor and also by several leading members of the state legislature.

11
On this point, the Keidanren mission was very much concerned, and, in its meetings with Governors Harris of Georgia and Collins of Kentucky in June 1984, the mission sounded out their intentions. The governors disclaimed any intention to impose unitary taxation.

12
Following the visit of the Keidanren mission, it seems that some efforts have been made in the direction of the abolition of unitary taxation in California. On the other hand, it is widely acknowledged that its total abolition

cannot readily be attained. Sentiments in the state legislature seem to oppose any concessions to big business at a time when the state is unable to increase the salaries of underpaid schoolteachers. See Nihon Keizai Shimbun, 3 July 1984, p. 6.

13
See *Container Corporation of America v. Franchise Tax Board* (June 27, 1983).

14
See the Constitution of the United States, Article I, Section 8.

15
According to the Ministry of Finance of Japan, the effective rate of corporate taxation is 51.18 percent in the U.S. and 51.55 percent in Japan. If anything, exclusive submission to U.S. jurisdiction would be slightly advantageous for a multinational enterprise.

16
A task force of the Department of the Treasury submitted its report on May 1, 1984, to a working group chaired by the Secretary of the Treasury. The second and third proposals contained in this report advocate the water's-edge approach. Unitary taxation is a prerogative of the various states and the federal government; has, therefore, no veto power in this matter.

Walk Softly or Carry a Big Carrot



Alaska's one of only three states that still tax corporations on the basis of worldwide earnings. If the state doesn't want its resources to walk softly in world markets forever, the worldwide reporting requirement may be one of the first big sticks it must drop to attract foreign investment in resource development.

BY PAUL LAIRD

LISTEN. Hear it? No? It's the thundering silence of Alaska's enormous resource and development potential walking softly and carrying a big stick in the international marketplace. So softly, in fact, that many foreign investors haven't been paying much attention.

Truth is, it never seemed to matter much what foreign investors thought about the big stick routine—you know, limited infrastructure and access to remote areas; high labor, construction and real estate costs, and an inhospitable climate. Weather-wise and tax-wise: Love us or leave us alone. Until recently, anyhow. With the steady stream of billions of dollars flowing into an Alaskan economy we all knew had outlived the days of boom and bust (say hallelujah!), who had time to listen to those nattering nabobs of negativism preaching diversification or doom?

"The oil boom made us fat, dumb and happy," says Anchorage attorney Robert Breeze, who's been active in international affairs and is a director of the Alaska-Korea Business Council. "Now that it's over, we're starved, more astute and unhappy."

Cheer up, Alaska may have to carry a big carrot instead of a stick if it doesn't want to walk softly in the international arena forever, but the first step toward creating a more favorable foreign investment climate could turn out to be relatively painless yet symbolically significant: repealing the worldwide combined reporting requirement in the state's unitary tax and replacing it with a water's edge approach.

"Going to a water's edge approach alone won't bring more foreign capital into the state," says one foreign trade expert. "Taxes are just part of the package of what goes into a decision to invest in a project. But the worldwide reporting requirement is a major stumbling block. The Japanese and Koreans have as much as told other states that if they have a worldwide unitary tax, they won't invest there unless it's absolutely necessary."

Adds Dan Dixon, director of international affairs in the Alaska Department of Commerce & Economic Development, "The tax structure alone generally doesn't inhibit investment, because a fair and consistent system can be worked into profit-and-loss projections. But the tax system in Alaska is confusing and inherently unfair.

"It sends out a signal of greed, and most of the United States has realized worldwide combined reporting is stupid. It puts us in a rather lonely position when it comes to attracting foreign

investment, and when we're already not competitive in a lot of ways, why add in an onerous tax that doesn't do us any good? We can no longer presume that foreign investors will come here to develop our resources just because we have them. We have to realize we're competing on a global basis with other countries that have the same things."

Unitary taxation is based on the premise that various parts of a corporation engaged in related business activities—divisions, subsidiaries, plants, etc.—contribute equally to produce a single profit or loss. Its goal: to assure that each jurisdiction gets its "fair share" of corporate income when levying taxes.

Unitary tax is determined by calculating the percentage of a company's total business conducted in a given taxing jurisdiction and multiplying its total earnings by that percentage. Assets, sales and payroll commonly are used to determine that percentage. Advantage: The company can't structure its accounting so losses will be weighted toward activities in high-tax jurisdictions while profits are shifted to operations in low-tax states or countries.

If a widget company earns \$100,000 by extracting raw materials in Alaska, manufacturing them in Taiwan and operating its sales division out of Washington, and if 25 percent of the compa-

ny's sales, assets and payroll are in Alaska, Alaska corporate tax would be based on a \$25,000 profit.

Objections to the worldwide reporting method:

- It results in double taxation of profits from foreign operations.

- It adds an immense administrative burden by requiring multinational corporations to keep multiple sets of books and to translate all activities into English and U.S. dollars.

- At least in Alaska, enforcement is said to be inconsistent.

- It dilutes early-year tax losses for investments in capital-intensive projects and slows returns.

- The constitutionality of taxing overseas earnings of foreign-based multinationals has never been upheld by the U.S. Supreme Court.

- It's perceived by many foreign corporations and governments to be an invasion of privacy.

Concludes a January 1985 study of Korean interests in Alaska for then-House Speaker Joe Hayes, "The assumption underlying unitary tax—that a dollar of property, payroll and sales yields the same income wherever it may be—is patently false with respect to multinational corporations. The result is tremendous distortion and regular overallocation of the U.S. income of

multinationals to Alaska. . . . the bastion of worldwide reporting. Beginning Jan. 1, 1985, a company operating in California will have the option of sticking with the existing system of worldwide reporting or paying an annual fee based on California payroll, property and income to switch to a water's edge approach.

"California was literally losing foreign business investment to states without worldwide reporting," says Ken Hansen, a partner in the Sacramento office of Peat Marwick Mitchell & Co. "The Japanese were saying they wouldn't invest any more in California if the worldwide requirement weren't changed, and right after the voters change the system, Sony announced it would substantially increase its investment in the state."

According to one report, Sony expects its California tax bill to drop by a third when the new system takes effect next year. One Japanese firm relocated to Washington when its California corporate tax actually exceeded its net income from operations in the state. While there's still resistance to some provisions of California's tax bill, foreign investors and governments for the most part seem to feel appeased.

Even with worldwide reporting, the state has captured more than 40 percent of all Japanese investment in the United

Worldwide Combined Reporting Method

$$\frac{\text{Alaska Sales}}{\text{Worldwide Sales}} + \frac{\text{Alaska Assets}}{\text{Worldwide Assets}} + \frac{\text{Alaska Payroll}}{\text{Worldwide Payroll}} \times \text{Worldwide Earnings} = \text{Income subject to Alaska corporate tax}$$

3

Water's Edge Reporting Method

$$\frac{\text{Alaska Sales}}{\text{U.S. Sales}} + \frac{\text{Alaska Assets}}{\text{U.S. Assets}} + \frac{\text{Alaska Payroll}}{\text{U.S. Payroll}} \times \text{U.S. Earnings} = \text{Income subject to Alaska corporate tax}$$

3

Separate Accounting

$$\text{Alaska Sales} - \text{Alaska Expenses} = \text{Income subject to Alaska corporation tax}$$

ny's sales, assets and payroll are in Alaska, its corporate tax liability in Alaska is based on a \$25,000 profit. That's *worldwide combined reporting*.

With a *water's edge* approach, only U.S. widget activities would be used in calculating state tax liability. Fair market value would be used to determine the value of raw materials extracted in Alaska and "sold" to the manufacturing division in Taiwan and the value of finished widgets shipped from Taiwan to be sold out of Washington. If the corporation earns \$30,000 from U.S.

multinational corporations.

"Because non-U.S.-based companies likely carry on a greater proportion of their business outside the U.S. than U.S.-based companies, the systematic overtaxation they suffer is correspondingly greater. These burdens may seriously discourage Korean investment in unitary states, i.e., Alaska . . ."

As recently as two years ago, 23 states had unitary tax systems with worldwide reporting requirements. Now: three. The other two: North Dakota and Montana. The most recent

States. Donald Fitzgerald, partner in charge of tax work in the Los Angeles law firm Manatt, Phelps, Robertson, Tunney & Phillips, notes foreign investors are reluctant to blackball states as lucrative as California's on the basis of tax structure. That's why California has been able to impose an election to switch to water's edge reporting while other states have dropped worldwide reporting with few or no costs attached.

California figures it will receive more than \$100 million in state

Water's edge and the foreign dividend dilemma

SEPARATE ACCOUNTING? Unitary taxation with combined worldwide reporting? Unitary tax with the water's edge approach?

Did you *really* think any issue having to do with taxes was going to be as simple as choosing (a), (b) or (c)? Think again.

Once a state's chosen the water's edge approach, the fun has just begun. One of the thorniest issues for states that have made the switch is how or whether to tax dividends paid to U.S.-based multinationals by foreign subsidiaries.

The dilemma:

Do you exclude foreign dividends from water's edge taxes and give multinational corporations—U.S.- and foreign-based—a competitive edge over purely domestic corporations engaged in the same business? And conceivably encourage U.S. multinationals to invest outside the United States? (Illinois did.)

Do you include foreign dividends paid to U.S. multinationals and give foreign-based multinationals a competitive edge over both U.S. multinationals and purely domestic corporations? (California.)

Do you straddle the fence and tax only a portion of foreign dividends? What portion? (Oregon chose 15 percent.)

The issue may have little significance in Alaska. However, a 1984 study on unitary taxation in Alaska for then-House Speaker Joe Hayes suggested the competitive balance among Sohio Alaska Petroleum Co. (now Standard Alaska Production), ARCO Alaska and Exxon—the three dominant players in North Slope production—could be influenced. The report characterized Sohio as a foreign-based multinational, ARCO as "a mostly domestic corporation" and Exxon as a U.S.-based multinational.

of its subsidiaries. The company declined to be named in the study because of its income and sales in the state. Investment in the change—

Nonetheless, the tax issue remained after intense lobbying and arguing within the state and across the board. The Reagan Administration, after a year of not-so-gentle nudges from California, worldwide reporting-free negotiations with the north, Oregon and Washington.

Oregon lawmakers in June of 1984 adopted a water's edge approach that was implemented in 1986. Results were swift and impressive. Just prior to the repeal of worldwide reporting—but after it was apparent the measure would pass—Japan's Nikon Camera Corp. (NEC) announced it would build a laser optics plant in the Siskiyou County area just outside Portland. Within weeks of the repeal, Fujitsu America announced plans for a disk drive plant in the same area. Epson announced it would build a plant to make printers. Fuji Microelectronics unveiled plans to build a facility to manufacture semiconductors and computer chips, but Fuji's project reportedly since has been put on hold.

Says Glen Ulmer, tax partner in the Portland office of Arthur Andersen & Co. and member of a Portland Development Commission task force that went on several trade missions to the Far East



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...to the repeal. Some Japanese companies are tax-sensitive and others aren't. But no matter who we talked to, we had a difficult time explaining the worldwide reporting unitary issue.

I think the repeal was critical in attracting new Japanese investment. It was a major statement that Oregon was open for business. You can't underestimate the importance of intangibles, and a state's attitude toward business is one of the most important factors.

Andis Lee-Fahley, tax partner in the Portland office of Peat Marwick Mitchell & Co., "California has a marketplace that's more lucrative than Oregon's; if California would have acted earlier, it probably would have gotten some of the investment that came here."

While the constitutionality of the use of worldwide reporting to determine state corporate taxes for foreign multinationals hasn't been tested, the U.S. Supreme Court has upheld its use in calculating taxes of U.S.-based multinationals. Pressure from the federal level to scrap worldwide reporting came at the prompting of foreign- and U.S.-based multinationals and other governments: Britain threatened to retaliate by imposing penalties on U.S. firms doing business there.

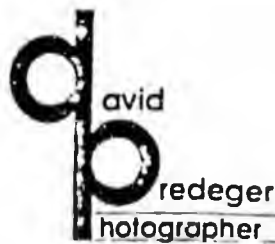
President Reagan resisted pressure to endorse a federal law against the worldwide reporting requirement on the basis that such a law would violate states' rights, but he did appoint a task force headed by then-Treasury Secretary Donald Regan to study the issue. Its recommendations:

- That states still using worldwide reporting should abandon it in favor of a water's edge approach;
- That the federal government should assist states in monitoring compliance with water's edge reporting;
- That a competitive balance be maintained among U.S.-based multinationals, foreign-based multinationals and purely domestic corporations.

"IT'S BEEN an emotional issue not just for the Japanese, but for Britain and West Germany, too," says Jim Thayer, manager of international investments in the State of Oregon's Economic Development Department. "Now that the pressure's off California, one of two things will happen: they'll either write off the others (Alaska, North Dakota and Montana) or they'll start putting more pressure on them. Alaska certainly is of the most interest of what's left."

Alaska's Dixon suggests Alaska should be positioning its ports as a cargo staging and assembly areas for European goods destined for Pacific Rim markets, and repeal of worldwide reporting is vital to that effort.

Alaska has had a unitary tax since before statehood. In recent years it's accounted for a fraction of state govern-



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ent's total revenues, and like state revenues in general, it's come almost exclusively from the oil industry.

Worldwide reporting isn't significant at this moment in terms of attracting foreign investment into Alaska," maintains Michael Gay, executive director of corporate development for Calista Corp. and author of the study for former House Speaker Hays on Korean busi-

ness activities in the state. "But in the long term, it's very significant.

"Korea and Japan are natural markets for Alaska's resources. The Koreans and the Japanese aren't going to make the major commitments we need in Alaska to develop resources as long as the worldwide reporting requirement is in place. Feasibility studies, pre-feasibility studies, sure, but not major invest-

ment-in-development." From a handful of major resource development projects in Alaska, none of the negotiations with potential foreign investors haven't reached the point where state tax policy has been a significant issue.

Benefits to Alaska from foreign investment in resource development: shared risk, reliable markets, abundant capital. The state's Dixon maintains

Why oil curdles at the thought of (another) tax change

IN THE MIDST OF LAST YEAR'S MINI-DEBATE OVER whether to reimpose separate accounting on Alaska's oil industry, one long-time state legislator dismissed industry arguments that another change in the tax structure would reinforce business's perception that the state has an unstable tax climate and discourage investment in Alaska. "We've changed taxes nine times on the industry since statehood," he declared.

Is it any wonder the oil industry reaches for its Roloids whenever someone brings up the issue of changing the tax structure?

"Whenever you make a change in taxes, there's an expense involved in complying with it," assesses one business analyst.

Adds a state official, "Historically, any time there's been talk of changing taxes, it means some group of legislators has found a better way to gouge the oil companies."

The state first imposed separate accounting in 1978. Intent: to maximize state government's take from Prudhoe Bay production. Lawmakers returned to worldwide unitary taxation in 1981 when it appeared separate accounting could be unconstitutional and the state eventually could face a multibillion-dollar judgment against it. The system now in use has been in effect since 1981.

For most multinationals, state corporate tax is based on sales, assets and payroll. Exceptions: airlines, construction companies, companies involved in land transportation. And companies that produce oil or are involved in pipeline transportation.

Companies producing oil are taxed on the basis of assets and extraction.

Companies providing pipeline transportation are taxed on assets and sales.

Companies producing oil and providing pipeline transportation are taxed on extraction, assets and sales.

While corporate taxes account for a relatively minor portion of Alaska's total state revenues, the oil industry picks up about 90 percent of the corporate tax tab. (Surprise!)

It's unclear what impact a switch to water's edge unitary taxation from the current system of worldwide reporting would have on the state's biggest tax benefactor, largely because of the number of potential variations on the water's edge theme. Possibly little.

What is clear is that the oil industry is in no mood to talk change in the current climate of uncertainty. Says a tax attorney for one multinational, "You only have to look at what's happened to the industry in the last couple years to understand why we need some tax stability. Any kind of change would be perceived as Alaska not having a stable tax climate, and we need a bit of predictability in this kind of economy."

Not ironically, the oil industry is said to have been one of the biggest proponents of switching from worldwide

reporting to water's edge when the issue came up in California. Reason: Marketing and refining, the mainstays of oil's activities in California, historically haven't been as profitable as production overseas.

That's also been the reason for some Alaskan legislators' apparent penchant for separate accounting—a method in which sales and expenses are calculated on a state-by-state basis so corporate taxes can be levied on earnings attributable to operations within each state. Until the oil price collapse in 1986, North Slope production was more profitable than the average of earnings from all operations.

Vince Wright, chief of research for the Alaska Department of Revenue, says separate accounting is more oil price-sensitive than unitary taxation, and in the prevailing climate of \$14-per-barrel oil, separate accounting actually would yield less state revenue than worldwide unitary. The department is conducting a study to pinpoint the breakeven point for state revenues under various tax structures.

Must the oil industry—which loathes separate accounting in Alaska and longs for stability—and potential foreign investors—who loathe worldwide reporting, prefer separate accounting, but will settle for a change to water's edge reporting—forever be locked in an Alaskan standoff?

When California implements water's edge taxation next January, multinational corporations will have the option of staying with the current system of worldwide reporting or paying an annual fee based on California payroll, property and income to switch to water's edge reporting for a 10-year period. The annual water's edge election fee has been set at a maximum of 0.03 of a percent of the sum of those three factors, and the fee can be reduced to as little as 0.01 of a percent through new investment in the state.

The oil industry tax attorney, however, maintains it's unlikely initiatives for any change in Alaska's tax structure—even one that gives the industry the option of sticking with the status quo—will be supported by the oil industry. "We just don't feel an impetus for any kind of change right now."

Suggests one international trade expert, "The oil industry is just gun-shy. They're afraid that once the issue of taxes is on the table for review, anything can happen. And most of it's bad. They fear wolves in sheep's clothing."

Frank Danner, chairman of the Alaska-Korea Business Council and managing partner of the Anchorage office of Peat Marwick Mitchell & Co., maintains the oil industry could be one of the biggest long-range beneficiaries of a change to water's edge reporting.

Says he, "If the change brings more investment into Alaska and assists in diversifying our economy, there will be other industries to share the tax burden with the oil companies."

there's no shortage of debt capital in Alaska, but rather a shortage of venture capital. "Any time you have equity involvement, you don't want a project to fail. That's why the Japanese haven't pulled out of Sitka (Alaska Pulp Co.), and it's why the Beluga coal project and the gas line will go."

The controller for one foreign multinational operating within the state characterizes Alaska's attitude toward taxation as "cavalier" and maintains that image is a turnoff to potential investors. Adds Albert Kawabe, an Alaskan fish exporter operating out of Seward, "Enforcement is done on a project-by-project basis; there's no consistency. It's made me hesitant to try to convince my contacts they should invest in projects like shore-based processing facilities."

Shore-based bottomfish processing could represent one of the brightest short- to medium-term prospects for foreign investment in Alaska's resources. Instead of encouraging foreign investments in fishing ventures that will provide jobs for Alaskans, however, state policy has had the opposite effect.

Attorney Breeze says on-shore processing isn't competitive with high seas processing in Alaska because of labor costs, real estate and construction costs and taxes. Taxes often account for more than a third of a processor's operating costs, he says, and they represent a powerful tool for reducing the state's uncompetitiveness. Instead, the state has supported reduced allocations to foreign fleets and forced them into joint ventures with U.S. fishermen—often from Seattle.

Joint ventures assure foreign fleets supplies within the 200-mile U.S. limit, and by fishing and processing outside the three-mile state limit, they can avoid state corporate taxes. Breeze maintains that the proper package of incentives—repeal of the worldwide reporting requirement being one of them—Alaska could land 10 new on-shore processing plants costing \$10-\$20 million and having 100 to 200 employees each.

"IT SEEMS LIKE we often forget who our friends really are," he says. "The state has seemed to treat foreigners like they're on the other side of a competitive game. The Japanese, Koreans and Taiwanese have more of a holistic view of things. They figure they need help with fishing and they need help with some of our other resources; they can't figure out why we want to cut off one hand while we're massaging the other. They see us as quite schizophrenic."

There's debate over why foreign investors find worldwide reporting so onerous. One school of thought: The approach may have limited long-term impact on their bottom lines, but the primary objection is philosophical.



PHOTO COURTESY OF THE ALASKA-KOREA BUSINESS COUNCIL

Frank Danner, chairman of the Alaska-Korea Business Council and managing partner of the Peat Marwick Mitchell office in Anchorage, says Orientals are "very close with their financial information. They view it as an invasion of privacy, and they don't want to invest where they're not wanted."

He adds foreign investors have "no love for the water's edge approach either" and would prefer separate accounting in which tax liability is calculated by subtracting expenses from sales on a state-by-state basis, "but they accept water's edge."

The other school: The bottom line is still the bottom line, and the goal of any business venture is to recapture initial investment as soon as possible. Any significant investment in developing Alaska's resources almost inevitably will result in substantial losses in the early years. By taxing profits on a worldwide basis, a multinational could find itself losing millions of dollars in Alaska yet paying the state corporate income tax on earnings elsewhere.

Says Calista's Gay, "Business is still business, no matter who's doing it. The investor isn't going to get any return at all until the project is developed and operating, and with some of the projects being looked at in Alaska, that could be as much as 10 years. The most important issue is economics, and investors have to have a way to get over that initial hurdle."

In other states, one of the primary concerns has been the impact of water's edge reporting on state government revenues. According to one study, the average corporate tax setback has been 15 to 25 percent. Oregon projected losing only \$18 million from its 1986-87 biennial budget, though, and there have been no studies of the impact of new investment on water's edge states' economies.

Peat Marwick's Danner: Alaska's investment environment is being eroded by water's edge approach to taxation. Taxation should be a net benefit to Alaska's industry in the long term.

Alaska's Department of Revenue late in 1986 was studying how various tax systems would affect the state budget. Vince Wright, chief of the department's Research Section in Juneau, says an examination several years ago indicated water's edge reporting would have "no material impact."

Unlike other states, Alaska currently has no vehicle to benefit directly from increased investment stemming from a tax change. No state property tax. No personal income tax. No sales tax. While adopting a water's edge approach may not materially reduce state revenues, additional foreign investment may not materially increase them, either.

Nonetheless, worldwide reporting may be one of the big sticks the state will have to be willing to lay down if it's serious about attracting foreign capital to diversify its economy and it doesn't want to walk forever softly in world markets.

Says Peat Marwick's Danner, "I don't know that we get all that much (tax revenue) from foreign corporations anyhow, but with the intense competition for foreign investment, the benefits to the economy outweigh the revenue state government gets from worldwide reporting."

Adds Gay, major foreign investment in Alaska's development will mean "billions of dollars turning over in our economy for years to come. Our future is resource development, and in the longer term, foreign investment will be critical. But we need to send a message now that we want to make Alaska competitive and make it attractive to foreign investors."

Repeal of worldwide reporting may be the loudest and clearest message Alaska can send in the near term: show that it's ready to lay down the big stick and replace it with a carrot.

Water's Edge Combination — Opportunity for Uniformity?

Richard Pinger

Richard Pinger, Senior Manager of Price Waterhouse in Houston, said that an opportunity to achieve uniformity has already been lost because nine states now apply water's edge combination but no two are alike. He said that water's edge is a fairness concept, but that it involves costs. For the taxpayer, the costs are those of return preparation and payment and the costs of compliance.

He said that dividends constitute the most important aspect of water's edge combination, but only for U.S. companies. He said that water's edge plus the inclusion of dividends without including factor relief is worse than worldwide combination.

He said that another problem is that of determining which corporations are includable in the combination. Seven of the nine states, he said, include all that are more than 50% commonly owned, one includes only 80% commonly owned corporations and one includes "unitary corporations." Four states include 936 corporations and five include them only partly. He noted other disparities.

Pinger said that eight of the states include at least a part of foreign dividends in the income base; that three provide some form of factor relief; that four states provide for water's edge to be allowed at the taxpayer's election but five require filing on the water's edge basis; that three make an election binding for three or more years; that two impose a fee for electing water's edge; and that only five have regulations.

All of those areas address the tax costs, he said, but the spreadsheet costs, which are provided for in the statutes of four of the nine states, will likely be a major compliance cost. He urged that those states be careful to see to it that any information required will be useful and that taxpayer compliance costs be considered. He expressed the hope that the four states would at least be uniform in establishing spreadsheet requirements. He said that this is the area that provides the best opportunity to attain some uniformity.

John James

John James, Director of the Department of Revenue in Idaho, reviewed the history of his state's use of the unitary method. The state first adopted domestic, but not water's edge, combination as of July 1, 1981. It included U.S. Possession corporations and 931 and 936 corporations and did not recognize the 80/20 concept. Historically, both foreign and domestic dividends were 80% excluded, which continued to be the case under domestic combination. Royalties from foreign subsidiaries were not excluded; nor was there ever any factor relief for intangible or foreign income.

In 1985, the legislature enacted two changes, excluding from the base: 1) 100% of foreign dividends; and 2) 100% of foreign royalties received by 80/20 corporations.

1986 legislation cut the foreign dividend exclusion back to 80% and cut the foreign royalty exclusion for 80/20s to 35%.

1988 legislation phases in various changes which will ultimately result in the following: retention of the 80% exclusion for foreign dividends (70% if the receiving company owns more than 80% of the paying company) with no factor relief; exclusion of royalties received from a foreign subsidiary if part of the receiving corporation's unitary business (no factor relief); foreign operating corporations, unitary 936s 80/20s, are effectively treated as foreign corporations so 80% of their income is excluded and the remaining 20% treated as a fully taxed deemed dividend to the parent corporation (no factor relief). U.S. Possessions corporations are essentially treated as foreign corporations. Intangible operating business income other than that which qualifies for the exclusion is fully included in income subject to factor relief which involves including such income in the sales factor.

James said that worldwide unitary combination is the appropriate approach conceptually, but that Minnesota adopted what amounts to water's edge combination. In doing so, it seeks to provide comparable tax treatment for foreign operations regardless of how organized.

Phil Aldape

Phil Aldape, Idaho's Income Tax Bureau Chief, who has also served as Chair of the MITC's Uniformity Committee for the past several years, said that water's edge combination is not what people had expected. He said that there had been great hope for uniformity under the movement toward worldwide combination; that the business community had driven the movement toward water's edge and that, in doing so, it should have expected diverse results.

Aldape said that water's edge produces substantial increases in tax burdens; that the purpose of the water's edge movement, at least in the minds of legislators, was to produce an economic boom but that it is too early to determine its effects. He said that uniformity of administration were not foremost in the minds of legislators as they adopted water's edge. He said that uniformity is desirable but that it should not become a means by which to restrict the tax base.

Aldape hoped that the spreadsheet would help the states to administer their taxes effectively. He expressed the belief that some multinationals prefer non-uniformity even though other businesses sincerely yearn for uniformity and consistency among the states; that most multinationals do not want uniformity on the condition of having to comply with spreadsheet requirements. He said that state administrative needs need to be taken into account and that increased uniformity can be helpful to them as well as to many taxpayers.

Aldape said that those states which have excluded 80/20s are particularly vulnerable to tax avoidance attacks; that Section 482 adjustments are a practical answer; and that non-combination states are in the mercy of the taxpayer because the states do not have the resources to deal with Section 482 problems.

Nevertheless, he does think that the states should continue to work for uniformity, that it is possible in the water's edge area, and that it is desirable for both the states and

taxpayers. He said that the four states that have been working on the spreadsheet have been trying to limit the requirements to information that would be necessary, important, and useful and would promote uniformity.

He suggested that current water's edge legislation should remain unchanged for a couple of years. That, he said, would give states and taxpayers alike a chance to evaluate it from state to state; and would increase the chances that any changes to be made in the future would be constructive ones which would enhance uniformity.

Aldape concluded with the comment that uniformity, if it is ever to be achieved, will require a substantial amount of unselfish cooperation between the states and the business community, and that the MTC is uniquely qualified to coordinate that effort.

John LaFaver

Montana's Director of Revenue, who moderated this session, said that, as he listened to the presentations, "it struck me that the changes in the tax laws that we've seen now in the last two or three years in a number of states, moving away from worldwide to water's edge, have served to substantially increase the cost of compliance for both taxpayers and tax agencies. ~~When we moved from worldwide to water's edge, we found that the cost of compliance for both taxpayers and tax agencies increased substantially. Therefore, he said, "I have to wonder whether, somewhere down the road, we are not going to have to re-invent worldwide unitary" combination.~~

Sales Taxation of Services

Ron Shreiner, Wade Anderson, Steve Keene

Ron Shreiner, the South Dakota Revenue Secretary, Wade Anderson, Executive Counsel for the Texas Comptroller, and Steven N. Keene, Director of the New Mexico's Audit and Compliance Division, described the manner in which their states had approached the taxation of services. All agreed upon the importance of taxing this fastest growing segment of the nation's economy. Shreiner and Anderson emphasized the importance of bringing the business community into the legislative process early, implying that Florida's troubles traced to a failure to do so; and Keene thought that Florida had taken the wrong approach in specifying services to be taxed rather than enacting a broad tax on services subject to exemptions.

Walter Hellerstein

Walter Hellerstein, the U. of Georgia law professor who had participated in the drafting of the Florida law, responded that Florida had in fact brought the business community into the process early and that legislative staff members had met endlessly with industry; that the apportionment that had been applied to interstate service transactions had been requested by the business community, which had then turned around and attacked it; that the real reason for the subsequent repeal was that the advertising industry simply did not want to be taxed, and that that would have been true regardless of the approach

taken. He said that most other industries seemed to be willing to accept the tax as one that was needed to solve the state fiscal problems. He predicted that most of the services which the legislation had addressed would end up being subject to the tax anyway; but that the process would take longer and would be accomplished incrementally by expanding the base of the present sales/use tax in Florida.

Hellerstein said that some 50% of the GNP now consists of services and that the percentage is increasing. The states, he said, will have to take that into account in shaping their tax systems and will have to broaden their sales and use tax base.

There is no economic distinction, he said, between consumption of tangible personal property and the consumption of services. Eliminating the distinction between the two for tax purposes would greatly facilitate administration, would bring an end to the extensive litigation which has been addressed to the distinction. He said that it would also increase tax neutrality between sales of services and sales of tangible personal property, that it would increase the responsiveness of the sales/use tax to changing economic conditions, and that it might be claimed to reduce regressivity though he expressed doubt as to the validity of that claim.

Like the other speakers, he referred to special difficulties that are involved in the taxation of services, particularly sales for resale and sales across state lines. But he noted that the sale of services to business, even though the cost is included in the sales price of business products, does not necessarily conflict with current practices in many states with respect to sales of tangible personal property to business. He said that if sales to business were exempted, the base would be so narrow that much higher rates would be required. Thus, he said, it is not possible to eliminate all pyramiding without making the base too narrow, whether talking about sales of tangible personal property or sales of services.

He noted that Florida had sought to tax consumption rather than performance, that that was consistent with the basic philosophy of treating a sales tax as a consumption tax, that, in that context, the place where the service is performed is not relevant. This then raises the question as to what one must apply apportionment with respect to a service that is used simultaneously in many jurisdictions. He thinks that, as a constitutional matter, apportionment is required. Florida's credit is considered an adequate response to any multiple taxation complaint. Hellerstein said that debate will now center on the question of whether this is true.

He said that the U.S. Supreme Court would address the question in the pending cases of *G.T.E. Sprint v. Sweet* and *Goldberg v. Sweet*, Nos. 87-826 and 86-1101. There, Illinois imposes its tax on all receipts from telecommunication services originating in or terminating in Illinois and billed to an Illinois service member, subject to a credit for tax paid on the same transaction and base to another state. He said that, while he believes that the credit deals effectively with the apportionment requirement, there remains the possibility that it will not satisfy Due Process requirements in all circumstances.

*Economic Development and Alaska's
Corporate Income Tax:*

REVIEWING THE OPTIONS

Briefing for Governor Steve Cowper
and senior state officials

prepared by

**The Alaska Department of Revenue
Hugh Malone, Commissioner**

A. SUMMARY OF THE ISSUE

In his state of the state message Governor Cowper outlined a 16-point program for permanent recovery of the Alaska economy, including a proposal to "repeal the unitary tax on multinational corporations, replacing lost revenue by other means. "Two weeks later the governor directed the Department of Revenue and the Division of Policy to "review Alaska's tax structure with an eye toward removing potential barriers to international trade. " The Governor specified that he had no preconceived notions about what the review might suggest. He noted, however, that that "the current unitary system appears to scare off potential investors in Alaska."

The Department of Revenue's preliminary review of the corporate income tax structure suggests that the economic development effects of changing the present structure may not be as anticipated. Of special concern to the Department is the additional uncertainty that changing the current structure will introduce into the state's revenues, and its unpredictable effects on the prospects for achieving the balance of the administration's legislative program.

B. NEED FOR BRIEFING AT THIS TIME

Completion of the Department of Revenue's preliminary analysis is an appropriate point for further consideration of the complex ramifications of any change in the corporate tax structure, and to bring diverse expert opinion to bear on the subject.

C. AGENCY INVOLVEMENT

The Department of Revenue administers the tax laws of the state. It has aggressively applied the worldwide combined reporting method to unitary businesses for approximately the last 15 years. The agency has developed expertise with the unitary concept at the audit and administrative level as well as for revenue forecasting purposes.

The Department of Commerce and Economic Development and the Office of International Trade also have an indirect interest in the unitary concept. The focus of the interest is upon promoting investment in Alaska and expanding the state markets. A number of foreign interests, most

notably the Japanese, have argued to these agencies that the unitary concept applied on a worldwide basis inhibits new investment in Alaska.

D. THE STATE POLICY CONSIDERATIONS

An extremely important function of state government is the establishment of fiscal policy. Included within this area is the setting of state tax policy. The state has the unilateral right and responsibility to determine and implement a taxing system that is in the best interest of the people of the state.

Tax policy can be weighed with actual increased foreign investment bringing into the state new jobs for Alaska residents and a broader tax base. The increased foreign investment must be real, not hypothetical or based upon empty promises, to counter any reductions in tax revenues that may result; if not, small domestic corporate taxpayers could be required to pay increased levels of taxes to offset the shortfalls.

E. THE APPROACH TO THE ISSUES

The first step in the weighing of the state tax policy considerations is the identification of the alternative methods of corporate income taxation. The experience of other states in moving to a different method of taxation is also important as an indicator of what the state might expect. The historical results of using tax policy to attract investment is a further consideration.

SECTION ONE

Summary

In the past few years eleven of twelve states have repealed their worldwide combined apportionment statutes. In its place they have adopted either a water's edge or domestic combination method for calculating the corporate net income tax. Alaska remains as the only state applying combination and apportionment on a worldwide basis.

Alaska's policymakers are facing increased pressure to change its tax law. This pressure comes from such diverse entities as the United States Treasury Department, Pacific rim and European governments and foreign based businesses. Before offering legislation to effect such a change, this administration must carefully consider the ramifications such a change may have on its economy and on the ability of the state to generate revenues to fund public services.

This briefing paper analyzes our current income tax structure, providing both the proponent and opponent viewpoint on it and several alternatives. The Department of Revenue has recently begun a study to determine the potential effects of changing our worldwide unitary tax structure to a water's edge or domestic apportionment, or to a separate accounting type of tax. Until that study is completed, it is not possible to accurately predict the revenue impact a law change would create.

Finally, the Department of Revenue recommends that a comprehensive analysis of the intended and predictable economic impacts on the state be conducted. A change in tax structure in exchange for or in expectation of an increase in private sector economic development must be weighed against the increased difficulty state and local governments are having in providing necessary services to its citizens, as well as any impact it may have on small Alaska businesses.

DEFINITION OF TERMS

1. *Unitary Business*

If the operation of the portion of the business done within the state is dependent upon or contributes to the operations of the business outside the state, the operations are unitary. The business is characterized through functional integration, centralization of management and economics of scale.

2. *Combination (or combined report)*

When an operation is unitary, the separate corporate members' incomes are combined, before applying the apportionment formula (three factor formula).

3. *Worldwide Combination*

When members of a unitary group of corporations include subsidiaries incorporated in a foreign country, or where the parent company is a foreign corporation, and the incomes of the foreign companies are combined before applying the apportionment formula. Alaska is the only remaining state utilizing full worldwide combination.

4. *Domestic Combination*

An apportionment method which includes in apportionable income the profits of U.S. affiliates no matter where earned. Foreign affiliates income is not included.

5. *Water's Edge Apportionment*

An apportionment method which limits the scope of the unitary business to the domestic operations of U.S. affiliates. Income from foreign operation, branches or affiliates is not considered, though some states may tax the dividends paid by a foreign affiliate to a domestic parent company.

6. *Separate Accounting Method*

Each corporate taxpayer computes its income *only* on the basis of receipts and costs related to its in-state activities, without reference to their out-of-state branches, subsidiaries and affiliates. This method needs no apportionment formula.

7. Apportionment Factor

A formula used to determine a state's share of a multijurisdictional business' taxable income. The formula is usually based upon factors of property, payroll and sales in the state, because of their close link with income producing activities.

EXAMPLES

To illustrate the various methods of apportionment, the following example is offered. Assume Company ABC is an integrated steel company with three affiliated companies, A, B and C.

Facts

Company A: Coal mining operation in Alaska.

Company B: Steel Company in Pittsburgh, 100% subsidiary of A.

Company C: Sales company in Canada, 100% subsidiary of A.

Branch A-1: Coal mining operation in Australia, branch of company A.

Separate Accounting

Company A would file its tax return in Alaska and report only those receipts and costs related to its in-state business. Sales between A and B must be determined on an arms length basis for tax purposes even though the companies books and records may report them differently.

Water's Edge Apportionment

Company A and B if unitary, will combine and their combined incomes will be apportioned using the three factor formula. Because Branch A-1 and Company C are not domestic, they cannot combine with the foreign coal mining and sales operations. Some water's edge methods tax the dividends Company C would pay to Company A.

Domestic Combination

Company A and B will combine, including Company A's Australian branch. In some cases, dividends from C may be included in apportionable income.

Worldwide Combination

Companies A, B, and C, including A's Branch, will combine and apportion their entire income. This is the current tax method used by Alaska for both petroleum and non-petroleum taxpayers.

WHAT IS THE UNITARY BUSINESS PRINCIPAL?

More than two dozen states use the unitary method of determining how some corporations figure their income tax, but what exactly is the unitary method? Sometimes it is referred to as a "unitary tax" or a "new tax" on income earned outside the taxing state. It is not a new tax or even a separate tax but a theory or accounting method which some corporations subject to Alaska tax must use to figure out what portion of their income is attributable to Alaska. This method is called the combined income approach. If a unitary group exists, all of the group's income is subject to apportionment based on their use of the state market place. That means that the taxpayer must determine what portion of its income is attributable to Alaska. The amount of tax any company pays to Alaska is determined on the basis of the ratio of its activities in Alaska to its activities everywhere else. The formula method measures the level of business activity conducted in the state. The more or less business in Alaska, as measured by property, payroll and sales factors results in a corresponding reduction or rise in the amount of income subject to tax. The unitary method of taxation is designed to tax corporations based on their actual business relationships rather than the mere form of their relationships.

SECTION TWO

WHAT IS A UNITARY BUSINESS?

AS 43.19 provides how unitary business are taxed. The law applies to two or more corporations conducting a single or unitary business. These corporations must have over 50% common ownership and the business activities must be of mutual benefit, dependent upon or contributory to the activities of one or more of the other corporations in the unitary group.

Whether or not a business is unitary is decided by looking at all phases of the business' operation, its overall management and the relationships between its operating branches or departments.

Whether there is a unity of ownership (over 50% common ownership), operation and use are the three factors which are considered in determining if a business is unitary. Unity of operation is present if there is centralized advertising, accounting, financing, management, and group or committee purchasing. Unity of use occurs when the same group of people (the executive force) perform managerial functions for the group. Courts have recognized these characteristics as proof that a corporation is a member of a unitary business.

HOW DOES ALASKA'S LAW WORK?

Once it is determined that there is a unitary group, each member of the group which does business in Alaska must file a tax return which reflects the income of the entire group. Corporations which do not do any business in Alaska need not file a return in Alaska. Each corporation filing an Alaska return must compute their taxable income using the standard three factor formula, or in the case of oil and gas production and pipeline companies, a modified formula. These formulas may be stated as follows:

STANDARD 3 FACTOR APPORTIONMENT FORMULA

Alaska Taxable Income = Total Apportionable Income X

$$\frac{\text{property, payroll and sales in-state}}{\text{total property, payroll and sales everywhere}}$$

**MODIFIED APPORTIONMENT FORMULA FOR OIL AND GAS
PRODUCERS**

Total Apportionable Income X

$$\frac{\text{Property in this State} + \text{AK Barrels or MCF extracted}}{\text{Total Property Everywhere} + \text{Total Barrels or MCF extracted}} \times 2$$

**MODIFIED APPORTIONMENT FORMULA FOR PIPELINE
COMPANIES**

Total Apportionment Income X

$$\frac{\text{Property in this State} + \text{Sales in this State}}{\text{Total Property Everywhere} + \text{Total Sales Everywhere}} \times 2$$

**MODIFIED APPORTIONMENT FORMULA FOR COMPANIES IN OIL
AND GAS PRODUCTION & TRANSPORTATION**

Total Apportionment Income X

$$\frac{\text{Property, Extraction and Sales In-State}}{\text{Total Property, Extraction and Sales Everywhere}}$$

**ANSWERS TO SOME COMMON QUESTIONS ABOUT THE UNITARY
THEORY**

1. *Q. If each state taxes a portion of a unitary group's income, isn't it likely that double taxation will occur?*

A. The issue of double taxation has been raised many times before the courts, but no case has ever shown an instance where the combined income approach inevitable resulted in double taxation.

Two or more states which use the separate accounting method may also arrive at conflicting conclusions as to how income is taxed. A recent Supreme Court decision (Container Corporation of America vs. Franchise Tax Board 103 S. ct. 2933, 2954, (1983)), recognized this possibility when it stated "it would be perverse, simply for the sake of avoiding double taxation, to require California to give up one allocation method that sometimes results in double taxation in favor of another allocation method that also sometimes results in double taxation."

The fact that many states use the three-factor formula minimizes the possibility of double taxation.

2. Q. The unitary theory is unfair because it gives a break to companies with out-of-state losses and penalizes companies with profitable business operations. Shouldn't profitable businesses be encouraged?

A. Corporations with out-of-state losses and in-state gains appear to getting a tax break because they pay tax based only on their profitable Alaska business but on the whole their business is less profitable. Their fair share of tax to Alaska may actually be less than what they would pay under separate accounting.

Corporations which pay more tax to Alaska, based on their overall profitable business operations are just paying their fair share of tax to Alaska. The fact that corporations which earn more income pay more taxes is not a penalty. When corporations are so unfortunate as to suffer losses, it really would penalize them if they were required to pay higher taxes. Corporations plan to make profits. They rarely go into business to lose money.

3. Q. Does the use of the unitary method tax Alaska corporations on the income of separate businesses which have no connection with Alaska?

A. It is a well established legal principle that states may tax income arising out of activities conducted in different states if there is a connection between the out-of-state activities and the taxing state. There must be a rational relationship between the out-of-state activities and the in-state activities and the taxing state. There must be a rational relationship between the out-of-state activities and the in-state activities. If there is a unitary group

as defined above, the members of the group are operating as a single business. That business' out-of-state activities are related to its in-state activities. In other words the so-called "separate" businesses do have a connection to Alaska. If some part of that single business is conducted with Alaska, Alaska may tax that business. Because that business does not operate entirely in Alaska, Alaska can only tax the fraction of income which is related to Alaska. As explained above, the three factor formula is used to determine what this percentage is.

If a business which does not operate in Alaska is truly separate, in the sense that it is not part of the unitary group which has operations in Alaska, it is not included on the combined report and its income is not taxed by Alaska. Only the income of businesses which do have a connection to Alaska are included on the combined report.

4. *Q. How does Alaska's law differ from unitary laws of other states?*

A. Alaska's unitary law is similar to unitary laws in several other states but there are a few significant differences. Alaska's statute applies to corporations which are created or organized in any country in the world. (Other states' statutes may apply only to corporations organized in the United States.)

Alaska allows corporations to use an equally weighted arithmetic formula or formula which weighs sales, property and payroll the same. A few states use a formula which weighs one or more of the factors to a greater degree or eliminates one or more of the factors.

Some states, including Alaska, include sales in the part of the sales factor attributable to that state if they are not taxable to any other state. This is called a "throwback" rule because sales not taxable elsewhere are thrown back and treated as a sale which occurred in that state.

5. *Q. How does Alaska's unitary statute affect the business community?*

A. There has been a lot of discussion about Alaska's "business climate." Because Alaska's unitary statute is over 20 years old general observations can be made concerning its overall impact. Although Alaska's economy is dominated by domestic oil production, foreign investment has been heavy over the years in the fisheries, timber and tourist industry. Alaska's unitary concept applied to all corporations (except big oil from 1978 through 1981)

has been one of the most stable aspects of a state's business climate. Its corporate taxation method, while important to many businesses, is only one factor to consider. California has used the unitary method since the late 1930's and its economic growth has been ranked at or near the top in comparison to other states.

Small businesses and companies which conduct their entire business within Alaska may benefit from Alaska's unitary statute because they are able to take losses currently. Several studies indicate that small businesses create more new jobs than larger businesses. Higher employment rates contribute to a stronger state economy. A healthy economy is always good for business.

Some segments of the business community object to combined reporting, but other segments of the business community support it. For example, the National Federation of Independent Business has testified before Congress in support of combined reporting.

6. *Q. What are the arguments against the worldwide combined reporting method of unitary taxation as compared to those against separate accounting or an arm's length method?*

A. The opponents of the worldwide method make various claims in support of the arguments to abandon the method. These include the following:

- - it may result in double taxation of the same income unless all countries adopt the method.
- - it may interfere with international trade and impede new investment in the United States.
- - foreign based corporations may have a greater income distortion since they have a greater proportion of foreign to U.S. activities.
- - it departs from the international norm of arm's length or separate accounting.
- - it gives rise to foreign threats of retaliation against U.S. based companies.
- - it is administratively burdensome for corporations and companies may not have access to the information concerning a parent or other subsidiaries.
- - it is difficult to define the parameters of a unitary business which gives rise to taxpayer uncertainty.
- - states apply the concept nonuniformly.

The proponents of the method voice the following concerns on the use of separate accounting or the arm's length method:

- - it fails to accurately measure income and may lead to undertaxation in organizations that are functionally integrated, have centralized management, and share economies of scale.

- - it is administratively burdensome for states and taxpayers because of the millions of transactions that must be reviewed in order to source income among the various jurisdictions and the lack of free access to foreign information.

- - states lack the resources to administer it effectively which can result in the tax burden being shifted away from multinational corporations to smaller domestic companies.

- - the allocation of indirect expenses and the determination of value in intracompany transfers is extremely difficult, can be based on arbitrary criteria, can vary from one company to another, and is nearly impossible to audit in large multinational companies.

- - the rules and level of implementation at the international level are not uniform and it departs from the accepted method of state taxation based on apportionment.

- - it has been criticized by the General Accounting Office for failing to provide consistent, equitable measurement of income.

SECTION THREE

FACTORS AGAINST WORLDWIDE APPORTIONMENT

1. Taxpayers believe it exposes them to double taxation;
2. Taxpayers believe it burdens them with excessive bookkeeping requirements;
3. Distorts international flows of trade and investment;
4. Upsets longstanding agreements among the nations to achieve tax harmony;
5. Limits federal government's ability to conduct consistent international economic policy;
6. Invites retaliation by nation's trading partners;
7. Violates the Constitution.

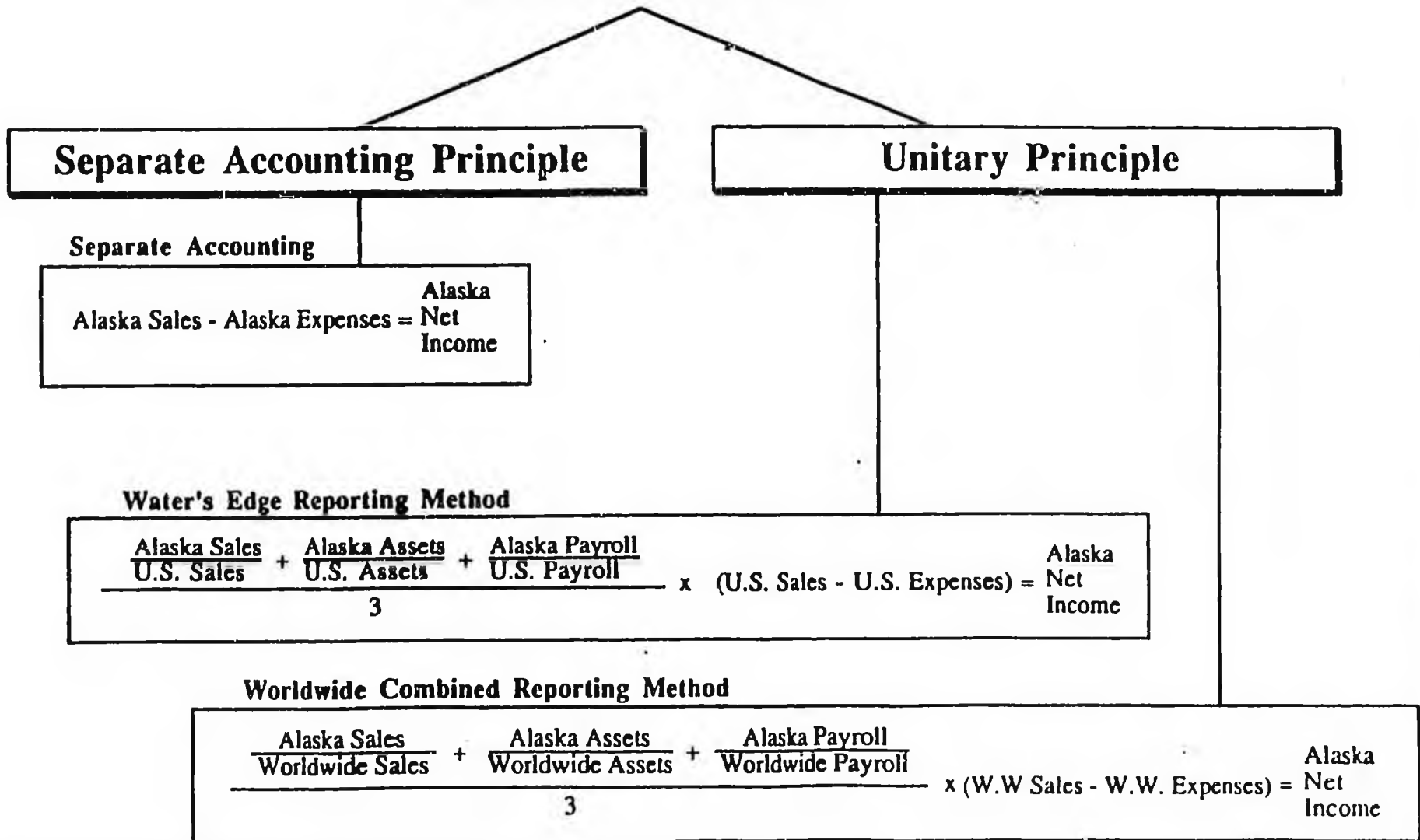
FACTORS FAVORING WORLDWIDE APPORTIONMENT

1. Prevents corporations from evading taxes by misrepresenting the geographical allocation of their income;
2. Easier to administer than various separate accounting methods;
3. Generally, worldwide apportionment increases a state's corporate income tax revenue.
4. On a domestic basis, apportionment has been court approved.

Figure 1

How Much Income Did A Corporation Earn In Alaska?

Alternative Methods:



No. 113/October 1988

— BIMONTHLY —

KEIDANREN

on Japanese
Economy **REVIEW**

In This Issue:

Strengthening the Multilateral Free Trade System

A Keidanren proposal to the government calls for steps to reduce Japan's trade surplus, improve the quality of life, promote free trade and prevent investment friction.

Japanese Direct Investment In U.S. Gains Momentum

The Council for Better Investment in the U.S. report discusses trends in Japanese direct investment in the U.S. and related problems.

Investment from Japan Essential to Diversification of State Economies

Hideo Ishihara, leader of Keidanren investment mission to the U.S., reports on the investment climates and prospects in Alaska and Hawaii.



Published by Public Affairs Department,
KEIDANREN
(Japan Federation of Economic Organizations)

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KEIDANREN is a private and non-profit economic organization which represents virtually all branches of economic activities in Japan. Keidanren, maintaining close contact with both public and private sectors at home and abroad, endeavors not only to find practical solutions to economic problems but also to contribute to the sound development of the economies of Japan and other countries around the world. Its membership counts 119 association members and 913 corporations as of October 1988. The association members include trade associations and regional economic organizations. The corporate members are leading Japanese enterprises and foreign companies operating in Japan.

Investment From Japan Essential to Diversification of State Economies

—A Report on Keidanren Investment Mission to the U.S. (Alaska, Hawaii)—

By Hideo Ishihara

Leader of Keidanren Investment Mission to the U.S.
Managing Director, Industrial Bank of Japan

1. Background and Purpose

Japanese direct investment in the United States has increased sharply in the past few years against a background of the rapid and steep appreciation of the yen. In fiscal 1987, such investment reached \$14.7 billion, accounting for 44 percent of Japan's total overseas direct investment, according to the statistics compiled on the basis of reports submitted by investing entities, although the rate of growth fell to 45 percent from 88 percent in fiscal 1986.

Keidanren has been making efforts over the years to promote overseas direct investment, in the belief that such investment will help to correct trade imbalances in the long run and mitigate trade frictions with the U.S. and other countries. As part of these efforts, this organization sent investment missions to 23 states of America in 1984, to 16 states in 1986 and to five in 1987. In addition, we have made consistent efforts to seek abolition of the worldwide unitary tax, a major impediment to direct investment in the U.S. Substantial progress was made toward the resolution of this problem in 1986 when the state legislature of California passed an amendment bill.

The rapid rise in investment in the U.S., however, is causing concern about possible frictions related to investment, such as lack of harmony between investing corporations and

local communities. In these circumstances, the Council for Better Investment in the U.S. was created in April this year by succeeding to the Worldwide Unitary Tax Council. The new council aims to deal with the remaining problems related to the unitary tax and to identify problems related to U.S. investment and study ways to cope with such problems.

The latest mission visited Alaska and Hawaii from September 4 to September 13 to obtain firsthand information on the investment climate in the two states and on problems related to investment in these states. Another purpose of the mission was to find out how these states perceived the growing concerns of Japanese investment in the U.S. generally — a sentiment that had intensified since the year before.

2. Impressions of the States Visited

(1) General Impressions

The states of Alaska and Hawaii are very different, when compared in terms of the level of Japanese direct investment. In Alaska, only a small number of investments have been made in the field of natural resources. In Hawaii, by contrast, a considerable number of investments have been made, particularly in the area of tourism.

We were impressed during the visits, however, by the fact that the two states have a number of ex-



tremely important things in common. First, both states are geographically separated from the other 48 states. Second, both are the newest states of America, Alaska being the 49th state and Hawaii the 50th. People in Alaska call the 48 states the "lower (southern) 48 states." In Hawaii, these states are collectively called the "mainland." These characteristics of Alaska and Hawaii have had significant effects on economic activities in these states. In particular, they have a strong desire to expand economic exchanges not only with the other 48 states but also with countries in the Pacific economic region, especially Japan. The warm welcome we received in the two states was an expression of this desire. We believe that now is the time for Japan to strengthen its economic relations with both states.

Industrial development needs to be promoted both in Alaska and Hawaii by taking advantage of their geographical characteristics. Alaska is situated at an almost equal

distance from Tokyo, New York and major cities in Europe, while Hawaii is located in the center of the Pacific. To cite a specific example, Federal Express has decided to use Anchorage as the hub of its international parcel delivery services. In addition, a plan to open a securities market in Hawaii is being studied since such trading can be conducted on the basis of time differences between Tokyo and New York. Hawaii also has the potential to develop an education industry since it can serve as the cultural bridge between East and West.

Both states are aiming to "diversify" their economies — an important fact which should be taken into account when Japan's economic relations with them are considered. Alaska, whose economic structure is traditionally oriented toward oil and other natural resources, has been hit hard by the fall in crude oil prices. Consequently, a major challenge for that state is to correct the excessive dependence on oil and other natural resources. Alaska's efforts toward economic diversification are evident in, for example, the fact that the governor of the state is taking the initiative to review the worldwide unitary tax and thereby facilitate foreign direct investment in the state.

In Hawaii, although the importance of promoting the tourism industry is recognized, efforts are being made to strengthen the economic structure through diversification of the economy, specifically through development of high-technologies such as oceanic technologies, in light of the state's geographical and other advantages. Although investment in real estate has elicited some criticism, we obtained the impression that the state government believes that investment from Japan has a large role to play in the development of the Hawaiian economy, and that continued expansion of such investment is to be

welcomed.

(2) Impressions in Each State

Some of the impressions we gained during our visits to the two states will be described in more detail on a state-by-state basis:

1) Alaska

The purpose of our visit to Alaska was to conduct a survey on the investment climate there, including the worldwide unitary tax problem.

Regarding the worldwide unitary tax, we were encouraged by the fact that the state government, from the governor on down, is very positive about reviewing it. In fact, the government is already drafting an amendment bill. At a luncheon he hosted, Governor Cowper stated that Alaska has made efforts to expand trade and investment relations with Japan ever since it became the first state of America to open a representative office in Japan in 1964. As for the worldwide unitary tax, he expressed an intention to review it by taking into account the views of Japanese business leaders including Mr. Akio Morita, Vice Chairman of Keidanren and Chairman of the Council for Better Investment in the U.S.

However, the situation surrounding this tax problem does not warrant optimism since some members of the state legislature are said to be reluctant to change the current system. In the background of such negative attitudes is the fact that the current unitary tax system makes it possible for oil companies making large profits in the state to reduce their tax burden. The state government wants to lure more investment from abroad by introducing the water's edge method. At the same time, however, it is concerned about the possible impact of a tax change on the oil industry, which is playing a key role in the state economy. Under the present circumstances, the government is studying a revision on the condition that the tax would apply to the oil industry as an

exception to the rule. Since the amendment bill now in the works is likely to come up for debate in the state legislature opening in January next year, we need to keep a close watch over future developments concerning the bill.

During the discussions on the unitary tax, the following question was often asked: Will Japanese investment in Alaska increase if the tax is changed? Our answer to the question was that not only the tax system but also various other factors are taken into account in the making of investment decisions. We believe that the Alaskan side understood our position, at least to some extent. However, since a change in the unitary tax would cause a drop in tax revenue, it is necessary for us to work out a more convincing answer to this question, which is expected to be asked time and again in future discussions on this problem.

In the past, economic relations between Japan and Alaska have centered on trade in mineral and fishery resources, forestry products, paper and pulp. The only notable case of Japanese direct investment is Alaska Pulp. Currently, there are several Japanese investment projects in the fields of coal exploration and resort development, and there are great expectations for these projects.

However, close attention must be paid to the question of environmental regulation in the implementation of these projects since local residents have a keen interest in the protection of the natural environment, one of the great physical assets of the state. On this point, Ms. Brady, the commissioner for natural resources, stated that no development project can be initiated without the consent of local residents. In order to obtain such consent, the state government hold public hearings. Only after the understanding of residents is obtain-

ed, can the legislature proceed to take action. This process of building a consensus naturally takes time.

During the visit to Alaska the mission conducted a tour of the Alaska Pulp plant in Sitka, a small coastal city. The plant, a pioneering example of Japanese direct investment in the U.S., has been in operation since 1959. The company has as many as 360 local people on its payroll and thus maintains close relations with the local community. However, it experienced a labor dispute and learned valuable lessons in the process. We also had much to learn from its experience regarding labor problems, relations with the local community and other relevant matters. The knowledge we obtained during the tour will help greatly, we believe, to promote activities of the Council For Better Investment in the U.S.

2) Hawaii

Hawaii has deep historical relations with Japan, as shown by the factor that about one-fourth of the state's population (about 1 million) are of Japanese descent. Also, one in five tourists from outside Hawaii is Japanese, and Japanese visitors account for one-third of the total revenue from tourism.

Thus Japan maintains a conspicuous presence in Hawaii, as compared with other states of America. Regarding Japanese investment in the state, the reaction was generally favorable except in a few cases, and most people we met expressed hope that investment would be expanded. Governor Waihee, stated during a meeting with us that Hawaii always welcomes foreign investment and that investment from Japan is making a material contribution to economic development in the state. Concerning real estate investment aimed at speculation, the governor stated that it is a matter of concern, as in Japan, and expressed hope that investment would increase in ways

that would promote the development of the state economy.

Japanese enterprises, including their affiliates, already occupy an important position in the Hawaiian economy, and they have paid close attention to relations with the local community since they expanded into the state. We were informed that the Japan Club was making greater contributions to the local community, including a \$500,000 donation made last year to the Aloha United Way, the Hawaiian branch of the United Way, a nonprofit organization whose business it is to collect donations from across the U.S. The visit to Hawaii was of great significance to the activities of the Council For Better Investment in the U.S. since maintaining harmonious relations with local communities is one of the key objectives of the council.

The state of Hawaii welcomes foreign direct investment in a range of fields from the point of view of promoting the diversification of the local economy. For example, Hawaii is promoting projects to build communications facilities taking advantage of its geographical position as the state situated in the center of the Pacific, to construct a base for space facilities on Hawaii Island and to develop oceanic technologies on Oahu and Maui islands.

In addition, a waterfront redevelopment project is under way in Honolulu Bay and adjacent areas. Members of the mission had the opportunity to observe some of the redevelopment work in progress on a boat tour of the bay. The project is designed to develop a bay area of 1,550 acres stretching along a 6-mile coastline by 1989 with the state government taking the initiative.

It needs to be noted, however, that development projects in Hawaii are subject to various restrictions as in Alaska. To take the waterfront development project as an example, efforts are being made to obtain the

understanding of the local community. We learned that because of stringent restrictions, new development projects are avoided and acquisitions of existing areas and facilities are preferred in many cases.

The education industry is another area that seems to hold out much promise. In this connection, the mission visited the Japan America Institute of Management Science (JAIMS), which is managed with the support of Fujitsu Ltd. The institute is conducting a Japanese language program for Americans and scholarship students from Southeast Asia, in addition to a reorientation program for employees taking up overseas assignments. Considering that Hawaii is a cross-cultural center where people from the East and West mingle, it is expected that such global educational activities will produce highly satisfactory results.

3. Future Prospects

The growth of Japanese direct investment in the U.S. has elicited criticism from some Americans since late last year. At the level of individual states, however, such investment is generally welcomed. In Alaska, as described above, foreign investment, particularly from Japan, is being encouraged as an essential means of achieving economic diversification. In Hawaii, too, Japanese investment is appreciated generally from the same standpoint, although there have been some undesirable cases of speculative real estate investment. In the case of Alaska, however, information on the state as host to foreign investors is not yet sufficiently available since it is relatively recently that the state showed a positive attitude toward foreign investment. The move to revise the unitary tax is a manifestation of the positive attitude which the state government takes toward Japanese

corporations. We believe that Alaska will be cited more often as a candidate for Japanese investment if a tax change leads to a better understanding of the investment climate on the part of Japanese corporations.

One thing notable about Alaska is that the state is rich in undeveloped tourism resources as well as in natural resources. With the Japanese people becoming increasingly aware of the need to improve the quality of life, the natural environment in Alaska is a great attraction. A plan to hold various international conferences in the state is worth considering, since it is located at an almost equal distance from Japan, the continental U.S. and Europe. Through such moves the Japanese will have a deeper understanding of and a greater sense of affinity toward Alaska and, as a result, possibilities for investment in a variety of fields will likely increase.

As for Hawaii, possibilities for investment in areas other than tourism have tended to be overlooked because the image of the state as a tourist resort is too strong. One interesting possibility is the establishment of a securities market in Hawaii, which is situated between Tokyo and New York. Given such prospects, it is important, we believe, for the state to select certain priority areas and publicize their strong points to would-be foreign investors.

There is also a growing need to maintain harmonious relations with local communities, at a time when Japanese direct investment in the U.S. is expanding rapidly. Hawaii has an important role to play in this. If Japanese businesses learn from their experience in this friendly state and apply the lessons they have learned to their activities in other parts of the U.S., then such efforts will produce useful and beneficial results. In this sense, the JAIMS we

visited is a good example of global educational institutions where people from various parts of the world can learn about the economies and cultures of the U.S. and Japan.

4. Acknowledgements

In sending the mission to Alaska and Hawaii we received generous cooperation and support from the governors of the two states, other officials of the state and municipal governments, private economic organizations, the Japanese Consulate General, Japanese corporations in the two states and their representative offices in Japan. We also obtained the cooperation of representatives from member companies who participated actively and enthusiastically in the mission throughout the tightly scheduled trip. I would like to express my deep gratitude for the cooperation and support extended to us and look forward to continued guidance and support.

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Japan National Tourist Organization

Keidanren Investment Mission to U.S.A. Purpose and Back Ground

Japan's direct investment in the United States has been rapidly expanding since the early 1980s, far outpacing the high growth of its global overseas investment. The United States has always been ranked as the number one host of Japan's direct investment. According to the figures released annually by the Ministry of Finance, 1,816 cases of direct investment, amounting to \$14.7 billion (44.1% of Japan's global investment of the year), in the United States were made by Japanese companies in fiscal year 1987. This registered a vigorous 44.7% increase over 4.5 billion of the previous fiscal year. The cumulative (FY1951-87) total of Japan's direct investment in the U.S. now amounts to 50.2 billion dollars.

Keidanren believes Japanese direct investments into the U.S. will contribute to the economic development of both the U.S. and Japan, and has helped its member companies explore investment opportunities.

In this context, Keidanren sent three investment study missions covering 23 states in order to obtain firsthand information on economic and social environment of the respective state in June 1984. For the same purpose Keidanren sent similar missions to 16 states in 1986, and to 5 states in 1987. These missions exchanged views with the Governors, members of the state legislature, Mayors, leaders of the state and municipal governments, business community, as well as Japanese companies who already operate locally and visited major industrial sites as well.

With the fast increasing direct investment, Japanese companies are bound to face various new problems caused by their direct investment in the U.S., including such issues as fostering better community relations and avoiding movements towards greater investment restriction. In order to cope with these problems, a new council named "Council for Better Investment in the U.S." (CBIUS) was established on April 6, 1988.

Following these activities, another investment expansion mission was organized to visit the State of Alaska and the State of Hawaii from September 4 to 13.

The Mission will report its findings to the member companies of Keidanren and CBIUS and other Japanese corporations for reference in their future investment plans.

Though this mission will not engage in immediate business talks on investment, we are convinced that the visits by the mission, composed of representative corporations of major industrial sectors in Japan, will lead to a smooth expansion of Japan's direct investment, taking into account various social and economic concerns in the United States.

Keidanren Investment Mission to The United States of America Alaska, Hawaii

September 1988

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Keidanren (Japan Federation of Economic Organizations) is a private, non-profit economic organization representing virtually all branches of economic activities in Japan. Keidanren, maintaining close contact with both public and private sectors at home and abroad, endeavors not only to find practical solutions to economic problems but also to contribute to the sound development of the economies of Japan and countries around the world.

Through the merger of several economic and industrial organizations active since prewar days, Keidanren was established in August 1946.

Since then Keidanren has grown into a nationwide body with 120 associations and 915 corporate members as of August 1988.

Headed by internationally acknowledged leaders of the Japanese business community, Keidanren plays an active and influential role in the achievement of harmonious economic prosperity for all mankind.

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Sadami (Chris) Wada
Senior Vice President
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February 22, 1989

Testimony in support of
SB-119
Of Alaska State Senate
To modify
The Worldwide Unitary Tax
To Water's Edge Method

By

Sadami (Chris) Wada
Senior Vice President
Sony Corporation of America

U.S. Advisor to
The Council for Better
Investment in the U.S.
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My name is Sadami (Chris) Wada, Senior Vice President of Sony Corporation of America and I am also U.S. Advisor to the Council for Better Investment in the U.S. of KEIDANREN.

KEIDANREN is a Japanese name for Japan Federation of Economic Organizations. It is a private, non-profit economic organization representing virtually all branches of economic activities in Japan. It is certainly a nation-wide body with 120 association members and 921 corporate members as of September 1988.

KEIDANREN has sent a series of investment-related missions to various states since 1984, covering 23 states in the first year, 16 states in 1986, 5 states in 1987 and Alaska and Hawaii in September 1988.

Last September the 21-member KEIDANREN investment study mission to Alaska visited a number of places and had a number of important meetings in the state. The meetings included the state legislature leaderships, business leaderships, the Administration leaderships and reporters from media world.

We were very much impressed by the beauty of Alaska and its short distance from Japan. Its abundant natural resources also impressed us. Even though the state lost competition for 1994 winter Olympic site, the state is rich in sites for skiing and other winter sports.

However, we were very much disappointed to learn that this rich and beautiful state has the notorious worldwide unitary tax system. The British, Dutch and other European nations united their efforts to appeal to the United States with their strong opposition against this unfair, unreasonable and internationally-rejected tax system. Prime Minister Margaret Thatcher repeatedly urged then president Ronald Reagan of the U.S. to stop the practice of the unitary tax on a worldwide basis.

We also found out the unfortunate nature of this worldwide unitary tax system, that results in unfair double taxation and in most onerous administrative burden that in most cases do not give any justice in the final tax assessment. We thought this is very ironic for Alaska, because this beautiful state was the first state to open its office in Tokyo, Japan in order to invite our investments in the state, but now it is the last state to eliminate it if it wants to see its Tokyo office succeed in inviting Japanese investments into the state.

In 1984 the following 12 states had the worldwide unitary tax system. They were Alaska, California, Colorado, Florida, Idaho, Indiana, Massachusetts, Montana, New Hampshire, North Dakota, Oregon and Utah. All except Alaska changed their tax system. The most important worldwide unitary tax state, California with its largest tax exposure among the 12 states, provided the water's edge choice by its state legislature and the governor's signature in 1986. The governor of California did support their water's edge and signed it into the law for their economic growth through greater international investment particularly in manufacturing. All of those states that modified their tax system did so in the same thought as California.

KEIDANREN, Sony and others from Japan, for greater investments in Alaska are all pleased to see SB-119 before the state legislature, and wish very much to support the passage of the bill. We are very happy to know that Governor Cowper took the initiative in this effort with the wide support from the Alaska state legislature. The worldwide unitary tax system penalizes investment. When one makes an investment in manufacturing, it takes time in purchasing land, building plant structures, machines, training workers, organizing plant operations to be efficient, debugging machine operations and also in securing and training material and parts suppliers. It takes easily a few years before you can have real profit on which you may pay income tax. Until you make profit, you have nothing to pay tax out of. The notorious worldwide unitary tax demands state tax payment out of global income from other countries, through what they call worldwide combination of income. Income made in other countries is of course taxed in each country. Why such income should be subjected to another tax. We oppose such double taxation. After invited to invest and to contribute to the economic activities and to the economic base, why one should be penalized by such double taxation.

Further, the worldwide unitary tax system requires combining of properties, sales and payroll of the whole world, in order to find out what percentage of the global income should be attributed to a certain state. Prices of one acre in the U.S. and Japan are very different, particularly when the one acre in Japan was bought three hundred years ago while the one in the U.S. was bought 1989. Those original book values of the each acre, make no basis for apportioning global income. It creates nothing but distortion. Sales in large and traditionally established market and in unstable and risky market would of course have different profit margin, therefore, such providing no rational basis to allocate global income. Wage levels are clearly known to be different country to country, once again, providing no reasonable basis for allocating global income. In Japan, no-lay off means very much beyond some wage differences and it can have important value. Country to country, fringe

benefits are different, that include housing in some countries where it could mean very much in value. Therefore, contribution to income creation cannot be direct translation of wages or salaries. There are in some cases, very important elements that enables contribution by employees to the corporate income, outside wages and salaries.

I am sure that state tax authorities are responsible to tax corporations without allowing them to hide income and evade due taxes. The Federal Government is very much responsible for making sure that they tax right and not allow international corporations to evade taxes. Their responsibilities may be even far greater, the stake being much larger compared to state level. The Federal tax authorities use "arm's length" method to test any suspicious transactions. IRS Code 482 gives the Secretary of Treasury such an authority to carry out their responsibility to tax. Why cannot a state use the same test, rather than rely upon the impossible worldwide unitary tax system.

Exchange rates among nations that have been changing so much not only over years but even within a year of twelve months. What exchange rate to use? What justification is there for choosing any exchange rate? What could have been the exchange rate of the Japanese currency of three hundred years ago to the U.S. dollar? Should we combine the result, whatever it may be, with the value of any U.S. property bought this year?

Japan has made about \$50 billion direct investment in the United States so far. As we make trade surplus with the U.S. we must get the money back to U.S. Unless we do so, the shortage of money in U.S. will drive the interest rate higher and economic activities lower. Japan should invest such U.S. money in manufacturing industries, rather than national bonds, considering productive and job-creating impact. Greater manufacturing has tremendous ripple effects in economic activities.

I am sure all the people in the world find Alaska beautiful and exciting with her natural beauty. She is rich in resources and attractive for recreational sports of different kinds. The KEIDANREN mission came and found this state very attractive but when we learned that unfortunately this state still keeps what we thought was something of the past, we were surprised and disappointed, because the worldwide unitary tax means a red flag for investment.

SB-119 eliminates the worldwide unitary tax from Alaska and removes fear of unfair double taxation from investing in Alaska. It ends the most cumbersome and onerous tax system.

Once the notorious worldwide unitary tax is removed from Alaska and the internationally accepted system is applied to investors from U.K., Holland, Germany or any other country certainly including Japan, I am sure Alaska is really ready for any international investments. KEIDANREN will remove the red flag from Alaska on the investment map.

I would like to express here my sincere appreciation for the opportunity to communicate our opposition against the worldwide unitary tax and our support to the Senate Bill SB-119.

I would also like to express here my appreciation for the January 25, 1989 opportunity to testify via telephone in support of the same SB-119 before the Senates's Committee on International Trade and Tourism under the chairmanship of Senator Szymanski.

***** end *****

ATTACHMENT A

Draft List of Possible Options

1. **Separate accounting for all corporate taxpayers.** This is nominally what the Japanese are asking for, and would remove the psychological barrier said to deter foreign investment. It could lose us up to \$2 million annually (depending on how implemented) in non-petroleum corporate tax revenue, but at current oil prices would increase petroleum tax revenue by at least \$150 million. Under separate accounting, production and pipeline profits earned in Alaska would be taxed at the full 9.4 percent nominal rate. See the table below for the effective rates under current law.

Net Income, Tax Paid, and Average Effective Rates
Petroleum Corporate Income Tax

-----millions-----

	Alaska Net Income	Tax Paid	Tax Rate
1983	\$5,771	\$236	4.1%
1984	\$6,639	\$265	4.0%
1985	\$5,083	\$169	3.3%
1986	\$3,452	\$134	3.9%

Net income calculated from data in Sohio annual reports and FERC filings.

2. **Water's edge for all corporate taxpayers.** Would also remove the psychological barrier said to deter foreign investment. Likely to have little impact on current non-petroleum corporate tax revenue (i.e. ± <\$1 million annually). The effect on petroleum revenue could be much larger, though difficult to predict. EXXON and Standard would probably pay more tax, and that ARCO would pay less, resulting in a net increase of \$10-40 million in annual corporate petroleum income tax revenue.

3. **Status quo for oil companies, separate accounting for everyone else.**

4. **Status quo for oil companies, water's edge for everyone else.**

5. **Status quo for oil companies, separate accounting or water's edge for everyone else, with a compensating rate change to make result "revenue neutral."** But has anyone figured out what we mean by "revenue neutral?"

6. **Separate accounting or water's edge for everyone, with a compensating rate change to make result "revenue neutral."** Theoretically, this could get the state the same

amount of money as it is currently getting, while cutting the nominal tax rate roughly in half. The oil companies would pay a tiny bit more than at present. Everyone else (at least everyone currently paying 9.4 percent) would have their corporate tax reduced by half. This would unequivocally have a positive economic diversification effect, a statement that can't be made about any of the options describe above. The problem, of course, is that the rate adjustment required for revenue neutrality this year (assuming we could figure that out in advance) would almost certainly not be revenue neutral in the following year.

7. **Abolish the non-petroleum tax, go to separate accounting for oil companies and adjust the rate to achieve "revenue neutrality."** We could probably reduce our nominal 9.4 percent rate (now paid only by ^{NON-}oil companies) to 5.5 percent and expect the result to approximate the revenue from our current corporate tax structure. Like option 6, this would produce an unequivocal economic diversification impact.

8. **Abolish the non-petroleum tax, go to separate accounting for oil companies.** Like option 1, above, this would raise oil company taxes and state revenue. Unlike option 1, this would be certain to have a positive impact on economic diversification.

9. **Give corporations an option, a la California.** Any time we give the oil companies (or any other profit maximizers) an option, they will use it to lower their costs. Where the amounts at stake are large, as they are with in the case of Alaska oil, there is the risk of losing big bucks.

10. **Give non-petroleum corporations an option, a la California, but retain (and require) worldwide unitary for oil companies.** But some authorities have suggested that once you establish an option, it must be made available to all.

11. **Do nothing.** "Sorry, governor. It seemed like a good idea at the time, but further study suggests that it doesn't make sense. The reason it doesn't make sense is...."

12. **Study the question until it goes away.** A variation on the "do nothing" option, above. An easy option to justify because no matter how much analysis we devote to any proposed change, we will still face considerable uncertainty on the revenue effects of the change. And while it may not always be true, it can always be asserted that additional analysis will reduce the residual uncertainty.

TABLE D-6
CORPORATE INCOME TAX
AS PERCENT OF STATE TAX COLLECTIONS
1985

RANK	STATE	PERCENT
1	NEW HAMPSHIRE	22.0
2	MICHIGAN	16.0
3	CONNECTICUT	14.0
4	MASSACHUSETTS	12.9
5	CALIFORNIA	12.6
6	NORTH DAKOTA	12.2
7	NEW JERSEY	12.0
8	ALASKA	10.8
9	MONTANA	9.8
10	DELAWARE	9.4
11	NORTH CAROLINA	9.4
12	PENNSYLVANIA	9.3
13	GEORGIA	9.2
14	NEW YORK	9.0
15	TENNESSEE	8.6
16	KANSAS	8.3
17	RHODE ISLAND	8.2
18	WISCONSIN	8.2
19	OREGON	7.8
20	ILLINOIS	7.7
21	VERMONT	7.6
22	LOUISIANA	7.6
23	ARKANSAS	7.5
24	MINNESOTA	7.3
25	SOUTH CAROLINA	7.3
26	ALABAMA	7.3
27	KENTUCKY	7.0
28	ARIZONA	6.9
29	IOWA	6.7
30	VIRGINIA	6.4
31	MISSISSIPPI	5.9
32	IDAHO	5.8
33	MARYLAND	5.7
34	FLORIDA	5.5
35	MAINE	5.3
36	WEST VIRGINIA	5.3
37	OHIO	5.1
38	MISSOURI	4.8
39	SOUTH DAKOTA	4.8
40	NEBRASKA	4.7
41	NEW MEXICO	4.5
42	COLORADO	4.4
43	INDIANA	4.1
44	UTAH	3.9
45	HAWAII	3.6
46	OKLAHOMA	3.5
47	NEVADA	0.0
48	TEXAS	0.0
49	WASHINGTON	0.0
50	WYOMING	0.0
	50 STATE AVG.	8.2

ATTACHMENT B

The corporate tax is plays a bigger role in Alaska than in most states, though a smaller role than it did before the 1981 tax amendments (see Attachment D). Alaska would rank a little lower if the comparison were made against "all general revenues," which would then include our royalty income in the denominator. This is U.S. Census data.

TABLE D-32
CORPORATE PROFITS TAX
ON ADDED DOLLAR OF PROFIT
(\$1,000,000 TO \$1,000,001)

1986

RAI/RK	STATE	PERCENT
1	MINNESOTA	12.00
2	CONNECTICUT	11.50
3	NEW YORK	10.00
4	OHIO	9.70
5	CALIFORNIA	9.60
6	MASSACHUSETTS	9.50
7	PENNSYLVANIA	9.50
8	ALASKA	9.40
9	NEW JERSEY	9.00
10	VERMONT	9.00
11	MAINE	8.93
12	DELAWARE	8.70
13	NEW HAMPSHIRE	8.25
14	RHODE ISLAND	8.00
15	WISCONSIN	7.90
16	IDAHO	7.70
17	OREGON	7.50
18	KENTUCKY	7.25
19	MARYLAND	7.00
20	WEST VIRGINIA	7.00
21	KANSAS	6.75
22	MONTANA	6.75
23	NEBRASKA	6.65
24	ILLINOIS	6.50
25	IOWA	6.48
26	HAWAII	6.44
27	ARKANSAS	6.00
28	GEORGIA	6.00
29	NEW MEXICO	6.00
30	NORTH CAROLINA	6.00
31	SOUTH CAROLINA	6.00
32	TENNESSEE	6.00
33	VIRGINIA	6.00
34	ARIZONA	5.67
35	NORTH DAKOTA	5.67
36	FLORIDA	5.50
37	COLORADO	5.00
38	MISSISSIPPI	5.00
39	OKLAHOMA	5.00
40	UTAH	5.00
41	LOUISIANA	4.32
42	INDIANA	3.00
43	ALABAMA	2.70
44	MISSOURI	2.70
45	MICHIGAN	0.00
46	NEVADA	0.00
47	SOUTH DAKOTA	0.00
48	TEXAS	0.00
49	WASHINGTON	0.00
50	WYOMING	0.00

ATTACHMENT C

As this ranking shows, Alaska has a fairly high corporate tax rate. Large mining companies and others which historically pay virtually no income tax may not care. For small to medium corporations (annual sales less than \$50 million) studies suggest that the rate may be a significant factor in both location decisions and business success. The desire to reduce the nominal rate has been an element in tax "reform," both federally and in states like Minnesota and New York. For many, a quick and quantitative measure of income tax "reform" is the increase in collections per percentage point of rate:

ATTACHMENT D

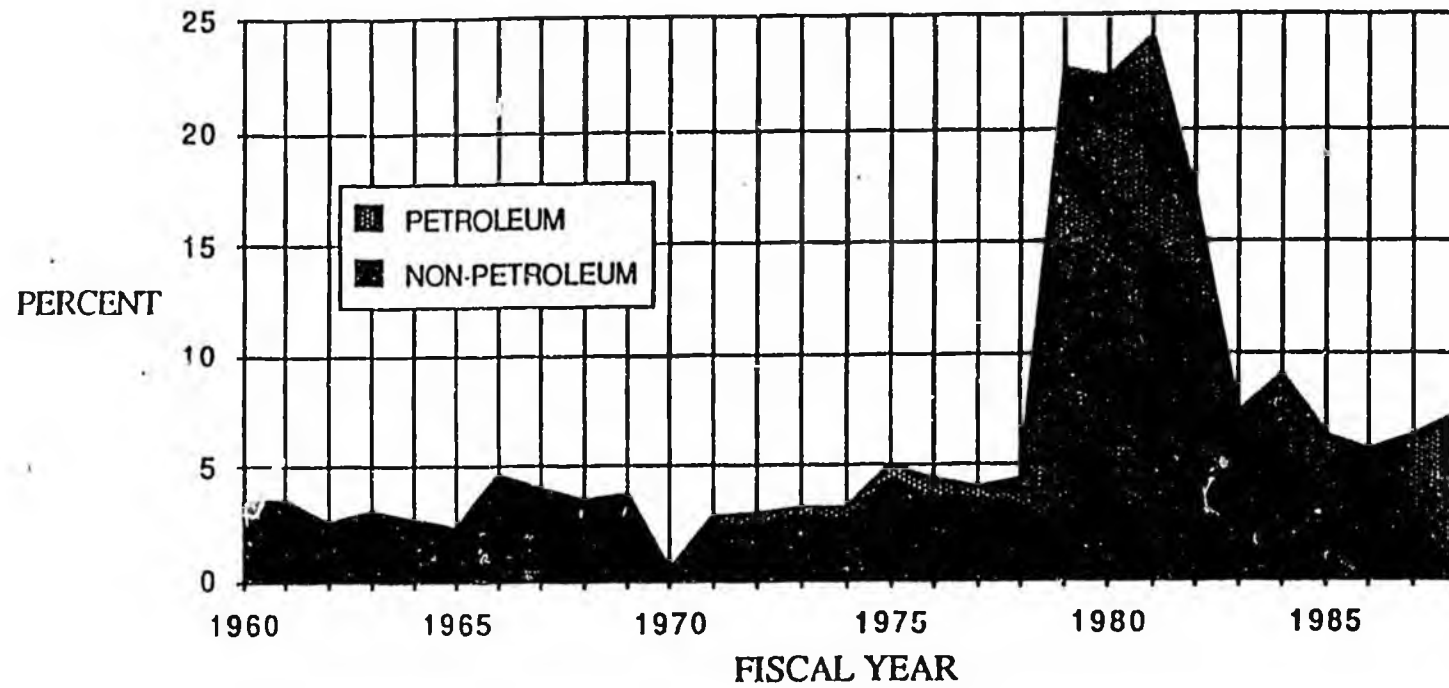
CORPORATE TAX AND TOTAL UNRESTRICTED REVENUE, FY 1959-88
(\$ Millions)

FY	UNRESTRICTED GENERAL FUND REVENUE	CORPORATE INCOME TAX REVENUE	
		Petroleum	Non-petroleum
59	25.4		1.4
60	48.0		1.7
61	40.5		1.4
62	68.9		1.8
63	71.6		2.2
64	67.0		1.8
65	83.0		1.9
66	86.5		4.1
67	86.6		3.5
68	112.7	0.1	3.8
69	112.4	0.1	4.2
70	1067.3	0.4	4.9
71	220.4	0.9	5.2
72	219.2	1.2	5.3
73	208.2	0.9	5.9
74	254.9	1.2	7.0
75	333.4	2.5	14.8
76	709.8	4.9	26.2
77	874.3	5.0	30.8
78	764.9	8.4	25.1
79	1133.0	232.6	24.8
80	2501.2	547.5	17.9
81	3718.2	860.1	34.8
82	4108.4	668.9	34.8
83	3631.0	236.0	30.1
84	3390.1	265.1	39.5
85	3260.0	168.6	36.0
86	2679.4	135.0	15.0
87	1741.3	95.0	14.0
88*	1716.1	110	15

*Forecast.

ATTACHMENT E

**CORPORATE INCOME TAX REVENUES
AS A SHARE OF TOTAL U.G.F. REVENUE**





FLUOR DANIEL

Fluor Daniel Alaska, Inc.
900 West 5th Avenue, Suite 300, P.O. Box 196680
Anchorage, Alaska 99519-6680
(907) 276-2636

April 24, 1989

Senate Finance Committee
Pouch V
Juneau, Ak 99811

Attention: Senator Rick Uehling, Co-Chairman
Senator John Binkley, Co-Chairman

Gentlemen:

PROPOSED SENATE BILL 119
An Act Relating to Corporate Income Taxes

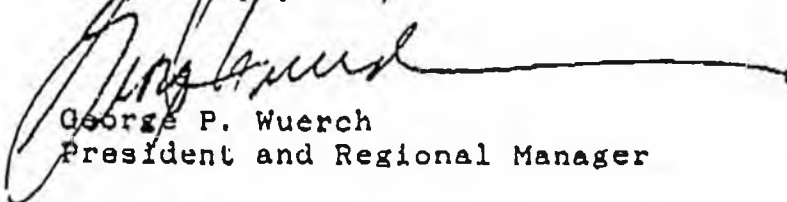
Fluor Daniel Alaska, Inc. is Alaska's largest engineering and construction company. It is a wholly owned subsidiary of the world wide Fluor Corporation which has a long history of work in Alaska.

Senate bill 119 proposes to change the basis of income taxes for foreign companies from worldwide unitary taxation to water's edge taxation. This action would discriminate against domestic corporations in competing both in Alaska and overseas.

In your deliberation of tax legislation, we strongly urge you to maintain a level hand in regards to treating foreign and domestic companies equally. If water's edge taxation is to be used for foreign companies, it should, at a minimum, be available for domestic companies as a discretionary option to worldwide unitary taxation in a manner such as that used by the State of California.

Fluor Daniel Alaska is proud to be Alaskan but should not be forced to pay a premium over our foreign competitors.

Very truly yours,



George P. Wuerch
President and Regional Manager

GPW:jnr

9114A.115



SYNOPSIS OF CSSB 119 (Finance)

Senate Bill 119, as originally introduced, provided for water's edge reporting for only for corporations having foreign parents. That bill contained no definition of a water's edge reporting method, however, and left it largely to the discretion of the Department of Revenue to prescribe the method that taxpayers would be required to use. The proposed CS does two things. First, it expands the coverage of the bill to include domestic multinational corporations; second, it sets out in some detail the provisions that will govern tax returns under a water's edge combined reporting method.

The proposed CS contains only one substantive provision, contained in sec. 2 of the bill. */ Section 2 adds a new section to AS 43.20 -- AS 43.20.073. That provision is divided into seven subsections. Subsection (a) sets out the kinds of affiliated corporations that are to be included in the taxpayer's water's edge combined tax return. These consist only of (1) corporations that do substantial business within the United States (regardless of whether

*/ Section 1 of the proposed CS sets out the purpose of the Act -- to promote investment and trade opportunities in the state. Sections 3 and 4 are effective date sections, providing that the water's edge method will apply to tax years beginning after December 31, 1989.

they are incorporated in the United States or elsewhere), **/
(2) domestic and foreign sales corporations (which are essentially paper corporations formed for the purpose of obtaining special federal tax treatment under the Internal Revenue Code), and (3) so-called "tax haven" corporations (which have been formed for the purpose of avoiding taxes in the United States).

Subsection (b) provides that certain income received from foreign corporations will be excluded from the taxpayer's total taxable income -- specifically, 80 percent of dividends and royalties as well as all amounts that are treated as dividends under Sec. 78 of the Internal Revenue Code. ***/ Foreign dividends and royalties are in actuality nothing more than income earned outside the United States that happens to be returned to

**/ Specifically, a corporation is considered to be part of the taxpayer's water's edge "family" (and its income taxable in Alaska) if 20 percent or more of its average property, payroll and sales factors are within the United States. An affiliated corporation with less than 20 percent of its property, payroll and sales factors within the United States will also be considered part of the water's edge group if that corporation does not meet the requirements of sec. 861(c) of the Internal Revenue Code; that is, if 20 percent or more of the corporation's gross receipts are from sources within the United States.

***/ Under the Internal Revenue Code, a corporation is permitted to take a tax credit for income taxes paid by certain affiliated foreign corporations. Section 78 provides that if a corporation does take a foreign tax credit, an amount equal to the tax credit will be "deemed" to have been received as taxable income by the taxpayer corporation as a dividend from the foreign corporation. Alaska does not allow corporations to take a foreign tax credit. Thus in Alaska there is no justification for including any amount of these "deemed" dividends in the corporation's taxable income.

the domestic parent in the form of dividends or royalties. Since the purpose of a water's edge method is to tax a corporation based only on income derived from its United States operations, foreign income in the form of dividends and royalties must be excluded. At the same time, a certain amount of the total expenses that a domestic parent incurs inevitably go towards supporting the income producing activities of its foreign subsidiaries. The expenses attributable to foreign operations should not be deductible from income that is earned within the United States. For that reason, the proposed CS provides that 20 percent of dividend and royalty income received from a foreign corporation will remain taxable. The actual expenses of a particular corporation in a given year may, of course, be greater or less than 20 percent of its foreign dividend and royalty income. However, it would be extremely difficult for the Department of Revenue to determine precisely which expenses of a corporation are actually attributable to foreign operations. The simplest way to deal with the concern that expenses related to foreign operations will be deductible from domestic income is simply to require corporations to include each year a fixed percentage of their foreign dividends and royalties as taxable income.

Subsection (c) is borrowed from Minnesota's water's edge statutes, and addresses a concern that the Minnesota tax administrators had that a taxpayer might attempt to claim the 80 percent exclusion for dividends or royalties received from a

foreign corporation that is not part of the taxpayer's unitary business -- in other words, purely passive investment income. This provision ensures that corporations will not be able to exclude any portion of passive investment income received from foreign corporations.

Subsection (d) simply recognizes that the 20 percent of foreign dividends and royalties that are included in taxable income are included for the purpose of offsetting the expenses of the parent corporation attributable to its foreign operations.

Subsection (e) provides that if taxpayers do not provide the Department of Revenue with the information it needs to properly audit a water's edge return, then the department may require the taxpayer to file a worldwide combined return instead.

Subsection (f) makes it clear that the water's edge reporting method is not applicable to taxpayers subject to AS 43.20.072, who are engaged in the production or transportation of oil or gas.

Subsection (g) contains definitions of the terms "affiliated corporation," "affiliated group," "foreign corporation," and "water's edge combined reporting method."

STATE OF ALASKA
1990 LEGISLATIVE SESSION

BILL VERSION: CS SB 119
PUBLISH DATE: _____

FISCAL NOTE

REQUEST:

Revision Date: February 27, 1990 Amended
Title: Corporate Taxpayers with Foreign Parent Corporations
Sponsor: Rules Committee
Requestor: On Draft CS

Agency Affected: Revenue
BRU: Income & Excise Audit
Components: Operating

EXPENDITURES/REVENUES: (Thousands of Dollars)

	FY 91	FY 92	FY 93	FY 94	FY 95	FY 96
OPERATING						
PERSONAL SERVICES	335.0	335.0	335.0	335.0	335.0	335.0
TRAVEL	31.4	31.4	31.4	31.4	31.4	31.4
CONTRACTUAL	65.0	65.0	65.0	65.0	65.0	65.0
SUPPLIES	10.0	10.0	10.0	10.0	10.0	10.0
EQUIPMENT	43.0	0	0	0	0	0
LANDS & STRUCTURES	0	0	0	0	0	0
GRANTS, CLAIMS	0	0	0	0	0	0
MISCELLANEOUS	0	0	0	0	0	0
TOTAL OPERATING	484.4	441.4	441.4	441.4	441.4	441.4
CAPITAL	0	0	0	0	0	0
REVENUE	<1-3mil>	<1-3mil>	<1-3mil>	<1-3mil>	<1-3mil>	<1-3mil>

FUNDING: (Thousands of Dollars)

GENERAL FUND	484.4	441.4	441.4	441.4	441.4	441.4
FEDERAL FUNDS	0	0	0	0	0	0
OTHER	0	0	0	0	0	0
TOTAL	0	0	0	0	0	0

POSITIONS:

FULL-TIME	6	6	6	6	6	6
PART-TIME	0	0	0	0	0	0
TEMPORARY	0	0	0	0	0	0

ANALYSIS: (Attach a separate page if necessary)

Prepared By: Steven E. Kettel *Steven E. Kettel* Phone: (907) 465-2320
Division: Income and Excise Audit Date: March 1, 1990

Approved by Commissioner: Hugh Malone *Hugh Malone for* Date: March 1, 1990
Agency: Department of Revenue

Distribution (by preparer):

- Legislative Finance
- Legislative Sponsor
- Requestor
- Office of Management and Budget
- Impacted Agency(ies)

Prepared by:
Steven E. Kettel
Alaska Department of Revenue

Fiscal Note Analysis

This legislation affects all Non-Petroleum Multinational Alaskan Corporate Taxpayers, both those with U.S. Domestic parent Corporations and those with Foreign Parent Corporations.

The proposed legislation would provide an election for Alaska corporate income taxpayers with activities in and outside the United States to file on a water's edge combined basis beginning in calendar year 1991. The legislation would affect multinational corporations which are required to file on a worldwide unitary basis under current law. The legislation would not affect taxpayers who currently file under AS 43.20.072 (Oil and Gas Producers and Pipelines). Nor would it affect Alaska corporate taxpayers with operations only with Alaska or only within the United States.

The Department estimates the annual revenue loss due to this proposed legislation from taxpayers currently filing in Alaska to be in the range of \$1-3 million.

<u>Personal Services</u>	<u>FY 91</u>	
<u>Staffing includes:</u>		
2 Appeals Officers - Juneau	\$115.0	
2 Revenue Auditor IV - Seattle	105.0	
2 Revenue Auditor IV - Anchorage	<u>115.0</u>	
Total Personal Services Costs		\$335.0
<u>Travel</u>		
12 Audits conducted by 4 auditors @1.2	\$ 14.4	
6 Appeals conducted in Anchorage @1.0	6.0	
IRS Training - 6 @ \$1.5	9.0	
Management Review - 4 @ \$.5	<u>2.0</u>	
Total Review		31.4
<u>Contractual</u>		
Forms Development and publication	\$13.0	
Telecommunications, Centrex	4.0	
New leased space - Seattle*	48.0	
Total Contractual		65.0
* The Seattle office will need to be relocated due to a lack of available space for new staff.		
<u>Supplies</u>		
Office Supplies, Audit Manuals & References	10.0	
Total Supplies		10.0
<u>Equipment</u>		
Office Furniture	21.0	
6 Wang PC Computers, Cable Hookup	15.0	
2 Laptop Computers	<u>7.0</u>	
Total Equipment		<u>43.0</u>
Total Costs		<u>\$484.4</u>

Alaska State Legislature



Legislative Research Agency

P.O. Box Y
Juneau, AK 99811-3100
Phone: (907) 163-3891
Fax: (907) 163-3351

March 1, 1990

MEMORANDUM

TO: Senator Rick Uehling

ATTN: Carol Horos

FROM: Gordon S. Harrison, Director *(gsh)*

RE: Administrative Burden of Implementing Unitary Tax Change from Worldwide to Water's Edge Method in Colorado and Oregon

At your request, I queried revenue officials in the states of Colorado and Oregon about the administrative impact of implementing a change in the unitary income tax law from the so-called worldwide to water's edge method. Oregon made such a change in 1984 (effective 1986), and Colorado in 1986. My conversations were brief and did not deal at length with the technical details of the laws of these states. Nor did I discuss the revenue impact of the law changes.

Colorado

I spoke with Ted Middle, chief auditor of the Colorado Department of Revenue (303-294-5100). Mr. Middle said that the Colorado law incorporates many innovative provisions; that it is not a conventional formulation of the water's edge approach. Consequently, he foresees a degree of difficulty in implementing the law that would not otherwise exist under a standard approach to the water's edge rule. Specifically, he foresees difficulty with auditing returns because of the peculiarities of the law. The department is only now beginning to audit 1986 returns, so it has not fully assessed the problems it may have. However, the department has not been given more staff to deal with the new law (and this seems unlikely anytime soon), so the outcome of the situation will be fewer audits and less effective enforcement.

The department had to print new forms and instructions; and it has had to promulgate new regulations. The first task was not significant; the second has been. Mr. Middle estimates that he has approximately one full-time equivalent employee working full time on the regulations. Mr. Middle believes that the writing and adoption of regulations would have been a shorter and less complicated process with a more conventional law (for example, model regulations would have been available).

Senator Uehling
March 1, 1990
Page 2

Oregon

I spoke with Richard A. Munn, director of the Oregon Department of Revenue (503-378-3363). He said that the change to the water's edge approach did not have a significant fiscal impact on the department. The department had to print new forms and instructions and adopt regulations, but he characterized these expenses as minor. He also described the Oregon law as unconventional, although it sounded less so than the Colorado law. He said that the law resulted in lower revenues to the state, but did not lower or increase the administrative costs of the department. Like the Colorado department, the Oregon department is just beginning to audit 1986 returns.

Oregon's law applies to all foreign and domestic businesses with interstate activity. It is Mr. Munn's opinion that a law targeting only "foreign parents" would be unconstitutional by the Oregon and U.S. constitutions. Mr. Munn said that the Oregon Department of Revenue has offices in several major U.S. cities. The existence of these offices predates the change from worldwide to water's edge taxation.

I hope this information is sufficient for your needs. If you have any questions, or would like additional information, please call.



FEB 28 1990

ASSOCIATED GENERAL CONTRACTORS of ALASKA

4041 B STREET • ANCHORAGE, ALASKA 99503
P.O. BOX 240609 • ANCHORAGE, ALASKA 99524-0609
TELEPHONE (907) 561-5354 • FAX (907) 562-6118

February 22, 1990

The Honorable Rick Uehling
Co-Chairman
Senate Finance Committee
P.O. Box V
Juneau, AK 99811

Dear Senator Uehling:

We understand that the unitary tax issue, Senate Bill 119, has been raised in the current legislative session.

The Associated General Contractors of Alaska membership is composed of construction and construction-related businesses. A number of our members are headquartered in the lower 48 and have income produced from foreign operations.

The proposed legislation benefits only foreign corporations and puts our domestic corporation members at a tax and competitive disadvantage.

We agree with the need to repeal worldwide unitary tax but the legislation must include U.S. domestic corporations.

Sincerely

ASSOCIATED GENERAL CONTRACTORS
OF ALASKA

F. Michael Swalling
President



JAN 29 1990

Anchorage • Star of the North
Chamber of Commerce

January 23, 1990

The Honorable Rick Uehling
Co Chairman
Senate Finance Committee
P.O.Box V
Juneau, AK. 99811

Reference: Senate Bill 119

Dear Rick:

We understand that the unitary tax issue will likely be raised again in the 1990 session of the Legislature.

Last year the Anchorage Chamber of Commerce presented testimony on Senate Bill 119 concerning corporate income tax reporting methods. Our testimony recommended repealing unitary worldwide tax for both foreign and domestic multinational corporations in a way which encourages domestic and foreign corporations to locate in Alaska and help diversify our economic base, while not adversely affecting the tax burden of Alaska's oil industry.

The Anchorage Chamber recommends that multinational corporate tax policy be modified in accordance with the philosophy expressed above, and that domestic and foreign companies be treated equally.

Sincerely,
ANCHORAGE CHAMBER OF COMMERCE

Dave Harbour
Chairman

Xerox Corporation
4341 B Street
Anchorage, Alaska 99503
(907) 561-8200

JAN 7 1990

XEROX

December 28, 1989

Senator Rick Uehling
Co-Chairman
Senate Finance Committee
P.O. Box V
Juneau, Alaska 99811

RE: Senate Bill 119

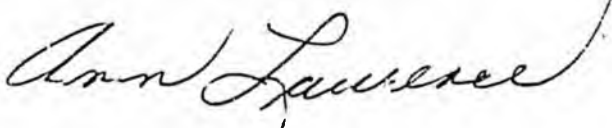
Dear Senator Uehling:

It is our understanding that Senate Bill 119 proposes to repeal the worldwide unitary tax for foreign-based corporations. As such, the proposed legislation would benefit only foreign corporations and would put domestic corporations such as Xerox at a tax and competitive disadvantage.

We agree with the need to repeal worldwide unitary tax but the legislation must include U.S. domestic corporations. Please consider our position as you deliberate on this important issue.

Sincerely,

XEROX CORPORATION



Ann Laurence
Alaska Manager

AL:eg



ALASKA MINERS ASSOCIATION, INC.

501 W Northern Lights Blvd., Suite 203, Anchorage, AK 99503 (907) 276-0347

October 10, 1989

Steve Cowper, Governor
State of Alaska
P.O. Box A
Juneau, AK 99811-0101

Dear Governor Cowper:

We understand that the Unitary Tax issue will be raised in the 1990 session of the Legislature.

Last year the Alaska Miners Association presented testimony on Senate Bill No. 119 concerning reporting methods for corporate income tax. We supported the bill, but with an amendment which puts our domestic multi-national corporations on the same tax footing as foreign corporations.

Currently much of the mineral development in Alaska is by foreign corporations and we encourage the continuation of their interest and expertise, but not at the expense of our own domestic mining companies. We need to encourage both; we need to look at incentives which can diversify Alaska's economic base. We need to think long term. Granted there may be a small immediate loss of revenue but those who take the high risks in developing mining properties must look 10 to 20 years ahead. It is incumbent on Government to also look to the future not just satisfy an immediate shortfall.

I don't know if there has been any economic analysis conducted on the decrease of investments by U.S.-based companies but suggest if not, this might be in order. It is indeed logical to assume U.S.-based companies would prefer to invest in the U.S. where they know the system. This should not be discouraged. Dollars retained in the U.S. mean jobs.

SB 119 as proposed in the 1989 Legislature will further constrain U.S.-based companies. We recommend that it be amended and passed, thus providing an incentive bringing investments from both domestic multi-national and foreign sources.

Sincerely,

Curtis McVee
Executive Director



Brown & Root U.S.A., Inc.

5900 Arctic Blvd.
Anchorage, Alaska 99515

April 28, 1989

Senator Rick Uehling
Pouch V
Juneau, Alaska 99811

Re: Senate Bill 119

Dear Senator Uehling:

It is our understanding that SB119 proposes to change the basis of income tax calculation from a worldwide unitary basis to a water's edge basis for foreign companies. We feel this would unfairly discriminate against domestic companies, such as Brown & Root, that seek to compete both in Alaska and overseas.

Our position is one for equal treatment for domestic companies. Please consider our position on this matter as you deliberate on this important issue.

Truly yours,

H. C. Hunt
Brown & Root U.S.A., Inc.

HCH:lp
R4:89



APR 27 1989

FLUOR DANIEL

Fluor Daniel Alaska, Inc.
900 West 5th Avenue, Suite 300 P O Box 196680
Anchorage, Alaska 99519 6680
907 276-2636

April 24, 1989

Senate Finance Committee
Pouch V
Juneau, Ak 99811

Attention: Senator Rick Uehling, Co-Chairman
Senator John Binkley, Co-Chairman

Gentlemen:

PROPOSED SENATE BILL 119
An Act Relating to Corporate Income Taxes

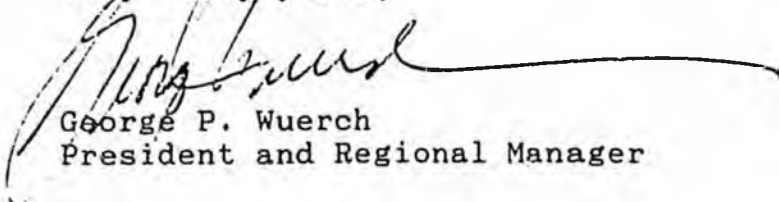
Fluor Daniel Alaska, Inc. is Alaska's largest engineering and construction company. It is a wholly owned subsidiary of the world wide Fluor Corporation which has a long history of work in Alaska.

Senate bill 119 proposes to change the basis of income taxes for foreign companies from worldwide unitary taxation to water's edge taxation. This action would discriminate against domestic corporations in competing both in Alaska and overseas.

In your deliberation of tax legislation, we strongly urge you to maintain a level hand in regards to treating foreign and domestic companies equally. If water's edge taxation is to be used for foreign companies, it should, at a minimum, be available for domestic companies as a discretionary option to worldwide unitary taxation in a manner such as that used by the State of California.

Fluor Daniel Alaska is proud to be Alaskan but should not be forced to pay a premium over our foreign competitors.

Very truly yours,



George P. Wuerch
President and Regional Manager

GPW:jnr

9114A.115

STATE OF ALASKA

DEPARTMENT OF REVENUE

OFFICE OF THE COMMISSIONER

STEVE COWPER, GOVERNOR

P.O. BOX 5
JUNEAU, ALASKA 99811-0400
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February 28, 1990

Denby Lloyd
Special Staff Assistant
to the Governor
Governor's Office
P.O. Box A
Juneau, AK 99811

Dear Mr. Lloyd:

I believe that it is time for the people inside the administration to sit down and review the status of the work on the administration efforts on the changes to the unitary (worldwide) corporate income tax reporting.

The Department of Revenue has been working with the office of international trade (Bob Poe) and various representatives of the interested corporations in an attempt to arrive at a change that would meet the interests of those corporations restricting the reporting requirements that now existing under the worldwide combination method that has been the states policy so far.

The purpose in modifying the worldwide combination approach is to send out a signal that provides assurance that companies doing business here will not be discriminated against, and that we want to encourage people to come. The purpose has not been to tap the general fund to provide a subsidy to very large international business concerns.

The Department of Revenue has been working to arrive at change that would be "revenue neutral"; that is, not result in any significant change in the amount of revenue received by the state. It appears that there is no agreement possible that would allow this. There are ways, but various companies disagree with the particular effects of the reporting methods on their operations.

The latest proposal by IBM forms the basis of a Senate Committee substitute on SB 119. It will cost the general fund perhaps upwards of three million dollars a year, money redirected from the state treasury into the international corporate treasuries. It increases our reliance on petroleum revenue. The IBM bill reduces the diversification in our already narrow tax base. It is a substantial change from the purpose of the original bill introduced by the governor.

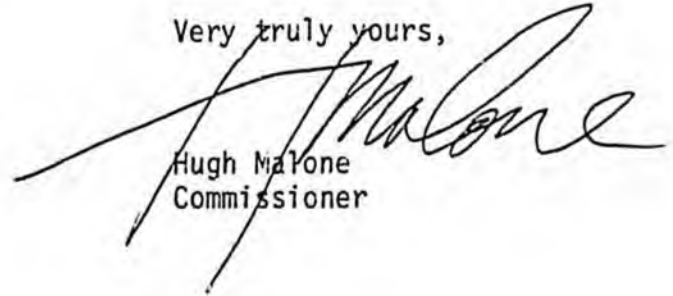
Because of these reasons, I think it is necessary for an administration review to take place. Perhaps it would be preferable for separate legislation to be introduced by the Senate if the IBM approach is to be followed. Perhaps the modifications in the approach that the

Denby Lloyd
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Department has discussed with IBM could be incorporated in the bill (although I really believe that is not something that is likely, since I discussed these issues with the company representative). Or perhaps the IBM proposal is one that, after considering all the alternatives, is somehow seen as being in the interests of Alaskans.

I recommend that we discuss this as soon as reasonably possible. Since the legislation is under active consideration in the Senate, I am as a courtesy, informing the Chairman and members of the Senate Finance committee of my recommendation for the administration review via a copy of this letter.

Very truly yours,

A handwritten signature in dark ink, appearing to read "Hugh Malone", written in a cursive style. The signature is positioned above the printed name and title.

Hugh Malone
Commissioner

cc: Mary Halloran
Bob Evans
Bob Poe
Chairman and Members/Senate Finance Committee

SECTION

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Sunday
February 25, 1990

P-I Focus

A HEARST NEWSPAPER

Foreign firms taking massive U.S. tax cheat?

NEW YORK — A report this week that foreign companies doing business in the United States allegedly have cheated on their taxes on a large scale strikes me as a major scandal with far-reaching implications for American business.

As the investigation of the charges by the Internal Revenue Service proceeds, I hope the media will give the story the attention it clearly deserves.

I've always been in favor of unrestricted foreign investment in the United States, as long as American investors abroad received reciprocal treatment and there was fair play all around. The alarm expressed in recent years that foreigners are "buying up" our country's assets struck me as exaggerated and somewhat hysterical in tone. It still does, although I fully agree that far too little has been done to make the Japanese open up to U.S. investment in the same way that we're open to investment by them.

Throughout our history, ours has been the nation where other people have been able to invest, not only their capital, but also their ideas and technology, with the greatest freedom and the fewest political or bureaucratic obstacles. It's a policy that has paid off handsomely for us — helping to make America the world's most flourishing economy for a century or more — and it shouldn't be changed.



W.R. Hearst Jr.

Editor's Report

\$544 billion in tax deductions against total income of \$543 billion . . . That looks pretty fishy to me.

But the disclosure that foreign corporations seem to have engaged in a tax fraud of huge proportions indicates that our hospitality has been badly abused. The Japanese make good cars, but Americans don't want to be taken for a ride by their tax accountants.

According to the IRS, more than half of 86,800 foreign-owned companies filing tax returns in 1986 reported no taxable income. All told, foreign-owned firms that year — the last for which the complete figures are available — took \$544 billion in tax deductions against total income of \$543 billion.

That looks pretty fishy to me.

IRS officials were quoted by the New York Times last week as estimating that, in the past 10 years, the U.S. subsidiaries of foreign companies may have underpaid their taxes by \$12 billion.

The Search for the Beginning of TIME

Hubble space telescope promises astronomers revolutionary findings

By John Noble Wilford

Any spacecraft that inspires allusions to Alice of Wonderland cannot be meant for some ordinary excursion through the heavens.

The Hubble Space Telescope is, indeed, not just any spacecraft. Scheduled for launching this spring, after five years of delays, the spacecraft and its exquisitely polished 94 1/2-inch-wide telescopic mirror should enable astronomers to see farther and 10 times more clearly than they have before, out tantalizingly close to the edge of the universe and toward the very beginning of time.

Excited astronomers can hardly believe their good fortune to be living at a moment so rich in the promise of revolutionary discovery. One of them likens the anticipated adventures in astronomy to Alice stepping into Wonderland.

Analysis

Malcolm Longair, the Astronomer Royal of Scotland, has written, with respectful apologies to Lewis Carroll, a whimsical (though highly technical) book about the "world's most extraordinary looking glass" and titled it "Alice and the Space Telescope." His Alice encounters Humpy Dumpty, who has been put together again by the people at the National Aeronautics and Space Administration. She asks him why the telescope will revolutionize mankind's understanding of the universe. "The answer is



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The principal method of evading taxes apparently has been for U.S. branch companies to pay artificially inflated "book" prices for products and services they buy from their parent companies to sell here. In that way, of course, they are able to reduce the amount of their taxable income. One such case, involving the U.S. affiliate of Yamaha, the Japanese motorcycle manufacturer, is already pending in the United States Tax Court.

But indications that underpayments over many years have been widespread and systematic suggests to me that what is involved isn't simply a matter of individual companies trying to put one over on the tax collector.

Scams like this normally require the participation of a lot of people in order to be carried off successfully over a long period. Approval, almost certainly, has to come from a very high corporate level.

The fact that many companies seem to have adopted the same illicit strategy more or less simultaneously raises additional questions which, I hope, the IRS investigation and one announced last week by a subcommittee of the House Ways and Means Committee will find the answers to.

What's at stake here is far more than making sure that a number of foreign-controlled companies cough up what they owe to the U.S.

Of course, the IRS isn't everyone's most beloved government agency. Already, cries of "Witch hunt" have gone up from companies that expect to come under scrutiny. But before the IRS probe came to light, Congress's Joint Committee on Taxation was on record as deploring the fact that "the level of tax payments of foreign-owned businesses in the United States is unusually low." So it doesn't look like a question of over-zealousness by the IRS, a tendency of which it is frequently accused.

What's at stake here is far more than making sure that a number of foreign-controlled companies cough up what they owe to the U.S. government.

Tax evasion on the scale that's being talked about distorts the whole competitive system and, consequently, the workings of the free market.

It appears to have given offending firms a big advantage over their American-owned rivals.

James Wheeler, a professor of accountancy at the University of Michigan, told the Times that the low level of profits habitually reported by many foreign-owned companies is "unbelievable."

As a result of this state of affairs, he noted, "on the average, foreign-owned U.S. corporations pay substantially less tax . . . than the American firms with which they compete."

If that's true, it is an intolerable situation. Something should be done about it forthwith.

William Randolph Hearst Jr. is editor in chief of The Hearst Newspapers.

Focus

The Seattle Post-Intelligencer Focus section presents a perspective on the news and the newsmakers. It offers analysis and background, debate and opinion, and is written and edited by the P-I staff. For views of the P-I Editorial Board, see the next page.

again by the people at the National Aeronautics and Space Administration. She asks him why the telescope will revolutionize mankind's understanding of the universe. "The answer is very short," Humpty Dumpty replies. "Space Telescope will revolutionize mankind's understanding of the Universe because it cost a billion dollars."

Actually, since construction began in 1977 \$1.5 billion have been spent on the space telescope, mostly by the United States, but with some critical help from the 13-nation European Space Agency. Hubble's costs escalated, in large part, because of early development difficulties and the four-year launching delay necessitated by the explosion of the space shuttle Challenger in January 1986. Just operating the Hubble, once it gets into space, will run \$200 million more a year.

But astronomers reckon the value of their expensive eye in the sky not by cost, the cynical Humpty Dumpty notwithstanding, but by their own vision of impending discovery. Over the next 15 years or more, the Hubble's designed lifetime, the breadth and depth of view from the telescope's 380-mile-high orbit should open their minds to realms of knowledge once denied mere mortals. With it they expect to learn the age and size of the universe and to probe its origin, evolution and ultimate fate.

The telescope will search for planets around other stars, a key to the quest for extraterrestrial life, and examine interstellar dust and gases out of which stars are born. It will contribute to the heated dispute over the rate of the universe's expansion — and thus over its age — one of the most important measurements to be undertaken by astronomers operating the telescope. "In Wonderland, you get prizes for asking the questions, not for giving the answers," says Longair's Mad Hatter. "It's just like extragalactic astronomy."

With the spirit of Alice leading the way I set out on my own wide-eyed adventure, which landed me in Baltimore. Now, astrophysicists applying Einstein's general theory of relativity to three-dimensional space believe that the universe is curved and has no center. But try telling that to the engineers and scientists established in a beige brick building on a wooded hillside on the campus of Johns Hopkins University. This is the Space Telescope Science Institute, financed by NASA and operated by the Association of Universities for Research in Astronomy, a consortium of 20 institutions that also runs major observatories at Kitt Peak in Arizona and Cerro Tololo in Chile. Here astronomers are putting the finishing touches on mission plans and will be directing, by remote control, what the telescope looks at.

OVERSEEING THIS AMBITIOUS

undertaking is Riccardo Giacconi, an Italian-born astronomer and the institute's director. He was a professor of astronomy at Harvard and led the international scientific teams that developed and successfully operated the Uhuru and Einstein X-ray astronomy satellites in the 1970s. For the last eight years he has been planning how to make the most of the Hubble telescope's abilities.

"We are in a period of revolution in astronomy," Giacconi says with a heavy Italian accent. "Anything you really want to know about the universe we've found out in the last 50 or so years. If you want to know how stars form, produce their energy and then die — that was unknown until the theory of general relativity and the discovery of nuclear fusion in this century. If you want to know how big the universe is and how old — we started learning that in 1930."

It was the American astronomer Edwin P. Hubble who laid the groundwork for studying the age of the universe. In the 1920s he made two startling discoveries — that the universe is organized

John Noble Wilford writes about science and space for The New York Times. His latest book, "Mars Beckons," will be published in May by Alfred A. Knopf, Inc. Excerpted from The New York Times Magazine.



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