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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 Virtually every other state that used the "worldwide" method has repealed it in recent years in order to increase investment and trade opportunities. There is simply no reason why Alaska should keep this barrier to investment on the books when other states have repealed it.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,

Steve Cowper
Governor

No. 18

119

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 Carl Meyer for
Division: Income and Excise Audit
Phone: (907) 465-2320
Date: January 9, 1989

Approved by Commissioner: Hugh Malone H Malone
Agency: Department of Revenue
Date: January 9, 1989

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

No. 18

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.

No. 18 STATE OF ALASKA
1989 LEGISLATIVE SESSION

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

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-
REVENUE	-0-	-0-	-0-	-0-	-0-	-0-

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
Division: Banking, Securities and Corporations
Phone: 465-2521
Date: 01/09/1989

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

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

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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 extremely 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, Japanse 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

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 Nakasone.[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 businesses[3] 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 limited 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 debt service 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.[7] 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 $21 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.[8]

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 taxation

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 operating in the U.S. through U.S. subsidiaries unresolved. It seems worthwhile, therefore, for a Japanese firm like Kyocera to contest this point in court.

Problems for Japanese Corporations

The problems that Japanese corporations encounter 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 cannot 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 lawfully impose a tax on the foreign-based incomes of foreign corporations.

Although it is true that a group of affiliate 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 normally 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 the 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.[15]

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 on 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 U.S. 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.[16] 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 incomes from interstate business activities would still 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. These would include all corporations by which the average of the three indices for a foreign-based corporation amounted to more than 20 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 also 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 provisos 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 tax-related information concerning the parent

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, therefore, 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 those 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 requested 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 reconfirmed 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.

Secretariat:

Atsushi YAMAKOSHI
Staff Economist
International Economic Affairs Dept.
Keidanren
山越 厚志
経団連国際経済部

Yukito NAGATANI
International Travel Div.
Tokyo Air Service Branch
Nippon Express Co., Ltd.
永谷 幸人
日本通運東京航空支店国際旅行部

Interpreter:

Yaejoong KIM
金 礼 中(通訳)
サイマル・インターナショナル通訳

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 association 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.

KEIDANREN
Japan Federation of Economic Organizations

9-4, Ohtemachi 1-chome,
Chiyoda-ku, Tokyo 100, Japan
Tel. (03) 279-1411
Telex: 222-3188 KDRTOKJ
Facs. (03) 246-0574

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

Leader:

Hideo ISHIHARA
Managing Director
The Industrial Bank of Japan, Ltd.
石原 秀夫
日本興業銀行業務取締役

3-3, Marunouchi 1-chome, Chiyoda-ku, Tokyo 100, Japan

Members:

Yoshimi MIZUKAMI (Alaska only)
Chairman of the Board
Hasegawa Komuten Co., Ltd.
水上 芳美 (アラスカのみ参加)
長谷川工務店代表取締役会長

32-1, Shiba 2-chome, Minato-ku, Tokyo 105, Japan

Jiro HAYASHI (Alaska only)
Director
General Manager, Energy Development Dept.
Idemitsu Kosan Co., Ltd.
林 二郎 (アラスカのみ参加)
出光興産取締役新燃料部長

1-1, Marunouchi 1-chome, Chiyoda-ku, Tokyo 100, Japan

Katsuzo FURUDATE
Director-Accounting, Finance and Information & Communication Systems Dept.
Taiyo Fishery Co., Ltd.
古舘 一造
太洋漁業株式会社経理・財務・情報通信システム部担当

1-2, Otemachi 1-chome, Chiyoda-ku, Tokyo 100, Japan

Kunio UCHINO
General Manager
Business Development Dept.
Building Construction Div.
Kajima Corporation
内野 紀夫
鹿島建設建築本部営業部長

2-7, Moto-Akasaka 1-chome, Minato-ku, Tokyo 107, Japan

Members:

Satoshi OGIHARA
Manager, Business Planning Dept.
International Operations
Fujitsu Limited
荻原 諭
富士通海外事業本部営業推進統括部業務部長

6-1, Marunouchi 1-chome, Chiyoda-ku, Tokyo 100, Japan

Takehiko SUZUKI
General Manager (Planning)
General Planning Dept.
The Tokyo Electric Power Co., Inc.
鈴木 健彦
東京電力企画部部長

1-3, Uchisaiwaicho 1-chome, Chiyoda-ku, Tokyo 100, Japan

Hiroyuki HOTTA
Vice President
Associated Business Administration and Development.
Japan Air Lines Co., Ltd.
堀田 寛行
日本航空関連事業本部付部長

7-3, Marunouchi 2-chome, Chiyoda-ku Tokyo 100, Japan

Mitsuru MISAWA, Ph. D.
General Manager
International Headquarters
General Manager
International Investment Services Div.
The Industrial Bank of Japan, Ltd.
三沢 満
日本興業銀行海外本部海外事業部国際投資情報室室長

3-3, Marunouchi 1-chome, Chiyoda-ku, Tokyo 100, Japan

Yoshihiko SHOYAMA
Manager
Project Dept.
Systems Engineering Div.
Hitachi, Ltd.
庄山 佳彦
日立製作所システム事業部プロジェクト室室長

6, Kanda-Surugadai 4-chome, Chiyoda-ku, Tokyo 101, Japan

Members:

Shozo MIYAKAWA (Alaska only)
General Manager
Energy Group Administration Office
Nissho Iwai Corporation
宮川 尚三 (アラスカのみ参加)
日商岩井エネルギー部門総括室室長

4-5, Akasaka 2-chome, Minato-ku, Tokyo 107, Japan

Heiji UEDA
General Manager
International Finance
Shimizu Corporation
上田 平治
清水建設財務担当部長

16-1, Kyobashi 2-chome, Chuo-ku, Tokyo 104, Japan

Shinichiro FUKUDA
Deputy General Manager
Business Development Division I
Chiyoda Corporation
福田 信一郎
千代田化工建設第1本部副部長

31-19, Shiba 2-chome, Minato-ku, Tokyo 105, Japan

Hirohisa MITSUCHI
Deputy General Manager
Overseas Dept.
Sumitomo Corporation
三土 裕久
住友商事海外業務部次長

2-2, Hitotsubashi 1-chome, Chiyoda-ku, Tokyo 100, Japan

Katsuaki TATOBE
General Manager
International Dept.
Kowa Real Estate Investment Co., Ltd.
田土部 勝昭
興和不動産海外事業部部長代

12-24, Nishi-Azabu 4-chome, Minato-ku, Tokyo 106, Japan

Members:

Hajime MORI (Alaska only)
President
Nippon Express Travel USA, Inc.
森 (アラスカのみ参加)
米国日通旅行社長

49 Geary St., San Francisco, CA 94132, U.S.A.

Sadami (Chiris) WADA (Alaska only)
Senior Vice President
Sony Corporation of America
和田 貞実 (アラスカのみ参加)
米国ソニー副社長

9 West 57th Street, 43rd Fl., New York, N.Y. 10019, U.S.A.

Yoshimichi OHARA
Executive Vice President
Nippon Steel U.S.A., Inc.
尾原 嘉道
米国新日鐵副社長

611 West 6th Street, Suite 2900, Los Angeles CA 90017, U.S.A.

Makoto SUNAGAWA (Alaska only)
Chief Representative
Representative Office in Washington
The Export-Import Bank of Japan
砂川 誠 (アラスカのみ参加)
日本輸出入銀行ワシントン駐在員事務所

1707 H St., N.W., #801, Washington, D.C., U.S.A.

Yoshio NAKAMURA (Coordinator)
Senior Assistant Director
International Economic Affairs Dept.
Keidanren
中村 芳夫 (幹事)
経団連国際経済部調査役

9-4, Otemachi 1-chome, Chiyoda-ku, Tokyo 100, Japan

ALASKA UNITARY TAX

The Alaska Unitary Tax Bill was adopted in 1970. The Alaska Unitary Tax uses the unitary method of accounting to determine the amount of income of a multi-state or multi-national corporation that is subject to the state's corporate net income tax. In calculating the unitary tax, the net income of a unitary business is combined, and a percentage of that income is apportioned to the state on the basis of the ratio of property, payroll and sales in the state to all property, payroll and sales of the unitary business.

A unitary business is a business enterprise with in-state activities contributing or dependant upon out-of-state activities. A unitary business can be a single corporation, a vertically integrated business with different aspects of its operation in different states or countries, or a group of commonly owned businesses where the parent and subsidiaries form an integrated operation. The rationale for the unitary method of accounting for tax purposes is that in many cases it provides a more accurate reflection of the benefits an integrated business derives from operating in a state than does separate accounting, which allocates to a state only the income and expenses that arise within its geographical boundaries.

The unitary tax/worldwide combination has been scrutinized in recent years by both foreign and domestic multinational corporations and by several foreign governments including Japan, Great Britain, and the European Economic Community. Complaints of the unitary tax range from companies' concerns that income from activities with minimal connection to a state or even the United States is being included in the tax base, to foreign government concerns about double taxation and violation of tax treaties.

At one point, Great Britain enacted retaliatory legislation that would have penalized U.S. owned companies operating in Great Britain. This has brought about changes in many states methods of assessing taxes from separate accounting, waters edge methods or other forms of domestic combination. Currently, Alaska has not adopted a new method of calculating the tax base.

Major oil producers in the state (ie. Arco, Exxon, and Sohio) do not promote changes in the unitary tax method in because they fear that changes in the law may, in the long run, increases taxes imposed on the oil companies.

Governor Cowper has directed the Office of Management and Budget - Division of Policy to prepare legislation to resolve current Japanese objections to Alaska's corporate income tax. The proposed legislation will not change existing oil and gas corporate tax. The draft legislation establishes a water's edge taxing regime for affiliated corporate groups with foreign parent

Alaska Unitary Statement

My name is Susan Burke and I am here today representing the IBM Company and their interest in corporate tax reform.

IBM has a long business history in Alaska. They currently employ 170 people in our State. Their annual payroll exceeds $10 million. The company is an active corporate citizen contributing more than $125,000 to charities and community projects in the last year.

IBM is most interested in the Governor's proposal to reform our State's worldwide unitary method of taxation. However, they are disappointed and concerned that the proposed legislation is limited to only foreign corporations. The proposed legislation benefits only corporations who are non U.S. companies and thus would discriminate against U.S. domestic corporations and put them at even more of a tax disadvantage than today. IBM agrees with the fundamental need to repeal Alaska's world wide unitary taxation; however, the legislation must be expanded to include domestic corporations or it will only exacerbate tax inequities for U.S. companies.

While one issue is competitive fairness between foreign and domestic companies, an equally important issue is good tax policy. Repeal of worldwide unitary taxation has been a priority of IBM and the business community for years.

Alaska is the only state currently requiring worldwide unitary taxation. In the past four years, 11 states have revised their tax laws to no longer require this form of state taxation. In addition, no country in the world uses this method of taxation. In fact, many countries have petitioned the U.S. government protesting the fact that states use worldwide combination.

Why does IBM oppose worldwide unitary taxation? IBM operates in more than 130 countries around the world. When an IBM overseas affiliate earns income, it pays taxes to the country in which the income was earned. In most cases, the foreign tax is at a higher rate than in the United States. A fundamental tenet of international tax law and practice is that foreign source income is not taxed by the home country until it is repatriated and then only to the extent that it is not offset by foreign tax credits. Clearly, the intent of this policy is to avoid double taxation of foreign source income.

A state, like Alaska, that uses worldwide unitary taxation, taxes foreign source income when it is earned even if it is never brought back to the U.S. Furthermore, using foreign income in calculating state tax liability may result in over apportionment of income to a state, taxation of income already taxed by a foreign government (and not taxed by the U.S. government), and potentially disruptive effects on international trade. Thus, use of the worldwide unitary method of taxation can distort a

company's taxation relationship to a state and mean double taxation of income earned in another governmental jurisdiction.

Corporate taxes are a basic and significant cost of doing business and no company can withstand a tax disadvantage without suffering an important economic impact. Therefore, IBM strongly recommends repeal of Alaska's worldwide unitary tax system for all corporations.

Reform of the worldwide unitary system will make Alaska a more attractive place to invest if it is applied equally to domestic U.S. corporations and foreign corporations. If worldwide unitary reform applies only to foreign corporations, they would no longer be taxed on their foreign income, while U.S. corporations will continue to be taxed of foreign income. This is not only a disincentive to investment in Alaska by U.S. corporations, but penalizes them compared to their foreign competitors.

IBM would be pleased to work with the Legislature in an effort to draft legislation that provides meaningful and comprehensive reform of the worldwide unitary tax system.

DRAFT #2 (I.B.M.)
11/22/88

_____ BILL NO.

IN THE LEGISLATURE OF THE STATE OF ALASKA

SIXTEENTH LEGISLATURE - FIRST SESSION

A BILL

For an Act entitled: "An Act relating to corporate income taxes; and providing for an effective date."

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

* Section 1. It is the purpose of this Act to promote investment in the state.

* Sec. 2. AS 43.20.031 is repealed and re-enacted to read:

Sec. 43.20.031. TAXABLE INCOME OF CORPORATIONS; DEDUCTIONS; EXCLUSIONS; EXEMPTIONS. (a) Taxable income shall be determined in accordance with Section 63 of the Internal Revenue Code, except as otherwise provided.

(b) In computing Alaska taxable income for a corporation, the following amounts shall be excluded:

(1) 80 percent of dividend income from foreign corporations;

(2) any amount treated as a Section 78 dividend under Section 78 of the Internal Revenue Code; and

(3) 80 percent of royalties accrued or received from a foreign corporation.

GRUENS & BIRCH
A PROFESSIONAL CORPORATION
424 NORTH FRANKLIN STREET
JUNEAU, ALASKA 99801
(907) 586-2777

For this purpose, the payment is deemed to be received from a corporation that is part of the unitary business if the payments are received by a member of an affiliated group included in a combined Alaska report from a corporation in which the recipient owns 50 percent or more of the stock of such corporation.

(c) Dividends and royalties taxable under (b) of this section are in lieu of any expense attribution for income excluded under (b) of this section.

(d) In computing the tax under this chapter, the taxpayer is not entitled to deduct any taxes based on or measured by net income.

(e) An affiliated group of corporations may make or the commissioner may require them to make a consolidated return for the taxable year in place of separate returns. For purposes of calculating the amount of tax payable by the group under a consolidated filing, 26 U.S.C. 1501 - 1552 (Internal Revenue Code), as amended, apply.

(f) A corporation that is a member of a group of unitary corporations that collectively has income from business activity taxable both inside and outside the state, or income from other sources both inside and outside the state, shall determine its income from sources in this state by use of the combined method of accounting provided under AS 43.20.073.

424 NORTH FRANKLIN STREET
JUNEAU, ALASKA 99801
(907) 586 2777

* Sec. 3. AS 43.20 is amended by adding a new section to read:

Sec. 43.20.073. CORPORATIONS. (a) A corporation that is a member of an affiliated group shall file a return using the water's edge combined reporting method. A return under this section shall include the following corporations if they are a part of a unitary business:

(1) affiliated corporations that are eligible to be included in a federal consolidated return as described in Sections 1501 to 1505, inclusive, of the Internal Revenue Code, the average of whose property, payroll and sales factors within the United States is 20 percent or more;

(2) affiliated corporations that are eligible to be included in a federal consolidated return as described in Sections 1501 to 1505, inclusive, of the Internal Revenue Code, the average of whose property, payroll and sales factors within the United States is less than 20 percent, and that do not meet the requirements of Section 861(c) of the Internal Revenue Code;

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

(4) any corporation, regardless of the place where it is incorporated if the average of its property, payroll and sales factors within the United States is 20 percent or more; and

(5) tax haven corporations.

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

(1) the corporation or any affiliate fails to comply with the domestic disclosure spreadsheet filing requirements as required by the department in regulations;

(2) the corporation does not provide information requested by the department on the operations of a foreign parent necessary for the department to audit the taxpayer's corporation return within a reasonable period of time.

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

(d) As used in this section:

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

(2) A "tax haven corporation" means a corporation that is incorporated in or does business in a country that does not impose an income tax, or that

imposes an income tax at a rate lower than 90 percent of the federal tax rate on the federally defined income tax base, and 50 percent or more of sales, purchases, or payments of income or expenses, exclusive of payments for intangible property, of the corporation are made directly or indirectly to one or more members of a water's edge group and that conducts no significant economic activity.

* Sec. 4. AS 43.20 is amended by adding a new section to read:

Sec. 43.20.051. DEFINITIONS. "Foreign corporation" means a corporation created or organized outside of the United States, the District of Columbia, the commonwealth of Puerto Rico or any possession of the United States.

* Sec. 5. This Act is retroactive to tax years beginning after December 31, 1988.

SB 119
Modifying the Unitary Tax

Briefing materials provided to the:

Alaska State Senate
Judiciary Committee
Senator Jan Faiks, Chairman

Office of the Governor
Division of Policy
February 7, 1989

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Basic source materials.

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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.

Materials prepared by the Staff Working Group on Unitary Taxation.
Tab 11. 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.

Introduced: 1/17/89
Referred: Special Committee on International Trade and Tourism, Judiciary, Resources and Finance

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.

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

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.

Sincere y,

/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 Kerttula, 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, Rodey 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.

③

STATE OF ALASKA
1989 LEGISLATIVE SESSION

BILL VERSION: _____
PUBLISH DATE: _____

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
Division: Income and Excise Audit
Phone: (907) 465-2320
Date: November 18, 1988

Approved by Commissioner: Hugh Malone RW FOR
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

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.

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 Nakasone.[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 businesses[3] 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 limited 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 debt service 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.[7] 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 $21 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.[8]

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 taxation

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 operating in the U.S. through U.S. subsidiaries unresolved. It seems worthwhile, therefore, for a Japanese firm like Kyocera to contest this point in court.

Problems for Japanese Corporations

The problems that Japanese corporations encounter 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 cannot 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 lawfully impose a tax on the foreign-based incomes of foreign corporations.

Although it is true that a group of affiliate 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 normally 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 the 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.[15]

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 on 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 U.S. 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.[16] 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 incomes from interstate business activities would still 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. These would include all corporations by which the average of the three indices for a foreign-based corporation amounted to more than 20 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 also 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 provisos 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 tax-related information concerning the parent

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, therefore, 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 those 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 requested 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 ¥1,253,568 million.

10
In June 1984, the Keidanren mission met the governor of Oregon, who reconfirmed 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 oil 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 company'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 $50,000 from U.S. activities only, and if 60 percent of the company's U.S. assets, sales and payroll are in Alaska, Alaska corporate tax would be based on a $30,000 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 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 domino to tumble was California, once the bastion of worldwide unitary taxation. Beginning Jan. 1, multinationals 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 vote to 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 States. Donald Fitzgerald, partner in charge of tax work in the Los Angeles law firm Manatt, Phelps, Rothenberg, Tunney & Phillips, notes foreign investors are reluctant to blackball a market as lucrative as California's on the basis of tax structure. That's why California has been able to impose an election fee to switch to water's edge reporting, while other states have dropped worldwide reporting with few or no strings attached.

California figures it will lose less than $100 million in state revenues

Worldwide Combined Reporting Method

$$\frac{\frac{\text{Alaska Sales}}{\text{Worldwide Sales}} + \frac{\text{Alaska Assets}}{\text{Worldwide Assets}} + \frac{\text{Alaska Payroll}}{\text{Worldwide Payroll}}}{3} \times \text{Worldwide Earnings} = \text{Income subject to Alaska corporate tax}$$

Water's Edge Reporting Method

$$\frac{\frac{\text{Alaska Sales}}{\text{U.S. Sales}} + \frac{\text{Alaska Assets}}{\text{U.S. Assets}} + \frac{\text{Alaska Payroll}}{\text{U.S. Payroll}}}{3} \times \text{U.S. Earnings} = \text{Income subject to Alaska corporate tax}$$

Separate Accounting

Alaska Sales – Alaska Expenses = Income subject to Alaska corporation tax

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.

annually due to the revision – a fraction of its estimated $4.4 billion annual corporate tax take. Further, it expects that decline to be more than offset by property, income and sales taxes from new investment the change should spawn.

Nonetheless, the revision came only after intense lobbying and teeth gnashing within the state and pressure from the Reagan Administration. And a pair of not-so-gentle nudges from California's worldwide reporting-free neighbors to 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 Nippon Electric Corp. (NEC) announced it would build a fiber optics plant in the "Silicon Forest" area just outside Portland. Within weeks of the repeal, Fujitsu America finalized 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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prior 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."

Adds Les Fahey, 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.

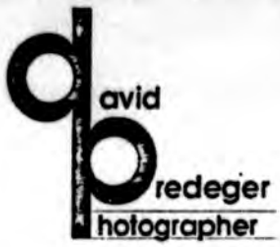
President Reagan resisted pressure to endorse a federal law against the worldwide reporting requirement on the basis that such a law would violate states' rights, but he did appoint a task force headed by then-Treasury Secretary Donald Regan to study the issue. Its recommendations:

- 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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ment'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 business 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 investments in development." Promoters of a handful of major resource development projects in Alaska note their 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 Rolaids 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 holistic view of things. They figure they need help with fishing and we 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.

Peat Marwick's Danner: Economic diversification encouraged by a water's edge approach to corporate taxation should benefit Alaska's oil industry in the long term.

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.

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 revenues state government gets from worldwide reporting."

Adds Gay, major foreign investments 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 to 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 spreadsheets, which are provided for in the statutes of four of the nine states, will trigger tremendous compliance costs. 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

Minnesota's Commissioner of Revenue 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 less than 80% of the paying company) with no factor relief; 80% exclusion of royalties received from a foreign subsidiary that is part of the receiving corporation's unitary business (no factor relief); foreign operating corporations, unitary 936s and 80/20s, are effectively treated as foreign corporations so that 80% of their income is excluded and the remaining 20% is 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 80% 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 has adopted what amounts to water's edge combination. In doing so, it seeks to provide comparable tax treatment for major foreign operations regardless of how organized.

Phil Aldape

Idaho's Income Tax Bureau Chief, who has also served as Chair of the MTC's Uniformity Committee for the past several years, said that water's edge combination is not what many people had expected. He said that there had been growing 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 reductions in the tax base as well as shifts 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 and ease 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 administer their taxes effectively. He expressed the belief that some multinationals prefer non-uniformity even though many 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 costs need to be taken into account and that increased uniformity can be helpful to them as well as to many taxpayers.

He said that those states which have excluded 80/20s from their water's edge base are particularly vulnerable to taxpayer tax avoidance tactics; that Section 482 adjustments are not a practical answer; and that non-combination states are at 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 many

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. We have reduced the tax base in a number of states, we have moved the states away from uniformity, have shifted the tax burden, and we have looked for an economic boom that has not happened." 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's fiscal problems. He predicted that most of the services which the legislation had addressed would end up being subjected 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 bases.

There is no economic distinction, he said, between the consumption of tangible personal property and the consumption of services. Eliminating the distinction between the two for tax purposes would greatly facilitate administration, and 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, although 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, and that, in that context, the place where the service is performed is not relevant. This then raises the question as to whether 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 considers a credit to be 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 that 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 telecommunications 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.

8

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 instate 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 instate 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 same 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

$$\text{Alaska Taxable Income} = \text{Total Apportionable Income} \times \frac{\text{property, payroll and sales in-state}}{\text{total property, payroll and sales everywhere}}$$

MODIFIED APPORTIONMENT FORMULA FOR OIL AND GAS PRODUCERS

Total Apportionable Income X

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

MODIFIED APPORTIONMENT FORMULA FOR PIPELINE COMPANIES

Total Apportionment Income X

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

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 may 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 domestic companies may not have access to the information concerning a foreign 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 I

How Much Income Did A Corporation Earn In Alaska?

Alternative Methods:

Separate Accounting Principle

Separate Accounting

Alaska Sales - Alaska Expenses = Alaska Net Income

Unitary Principle

Water's Edge Reporting Method

$$\frac{\frac{\text{Alaska Sales}}{\text{U.S. Sales}} + \frac{\text{Alaska Assets}}{\text{U.S. Assets}} + \frac{\text{Alaska Payroll}}{\text{U.S. Payroll}}}{3} \times (\text{U.S. Sales} - \text{U.S. Expenses}) = \text{Alaska Net Income}$$

Worldwide Combined Reporting Method

$$\frac{\frac{\text{Alaska Sales}}{\text{Worldwide Sales}} + \frac{\text{Alaska Assets}}{\text{Worldwide Assets}} + \frac{\text{Alaska Payroll}}{\text{Worldwide Payroll}}}{3} \times (\text{W.W Sales} - \text{W.W. Expenses}) = \text{Alaska Net Income}$$

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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.

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.

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.

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9-4, Otemachi 1-chome, Chiyoda-ku,
Tokyo 100, JAPAN

Telephone: 03-279-1411
Telex: 0222-2188 KDRTOK J
Facsimile: 03-246-0574

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 extremely 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 Oafu 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, Japanse 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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Higashi-Shiokojicho,
Shimogyo-ku, Kyoto
Tel. (075) 371-5649

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 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.

(10)

Keidanren Investment Mission to The United States of America

Alaska, Hawaii

September 1988

Leader:

Hideo ISHIHARA
Managing Director
The Industrial Bank of Japan, Ltd.
石原　秀夫
日本興業銀行常務取締役

3-3, Marunouchi 1-chome, Chiyoda-ku, Tokyo
100, Japan

Members:

Yoshimi MIZUKAMI (Alaska only)
Chairman of the Board
Hasegawa Komuten Co., Ltd.
水上　芳美
長谷川工務店代表取締役会長

32-1, Shiba 2-chome, Minato-ku, Tokyo
105, Japan

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General Manager, Energy Development Dept.
Idemitsu Kosan Co., Ltd.
林　二郎
出光興産取締役新エネ部長

1-1, Marunouchi 1-chome, Chiyoda-ku, Tokyo
100, Japan

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Director-Accounting, Finance and
Informatinn & Communication Systems Dept.
Taiyo Fishery Co., Ltd.
古舘　一造
大洋漁業取締役経理・財務・情報通信システム部担当

1-2, Otemachi 1-chome, Chiyoda-ku, Tokyo
100, Japan

Kunio UCHINO
General Manager
Business Development Dept.
Building Construction Div.
Kajima Corporation
内野　邦夫
鹿島建設建築本部営業部長

2-7, Moto-Akasaka 1-chome, Minato-ku,
Tokyo 107, Japan

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Satoshi OGIHARA
Manager, Business Planning Dept.
International Operations
Fujitsu Limited
荻原　諭
富士通海外事業本部営業推進統括部業務部長

6-1, Marunouchi 1-chome, Chiyoda-ku, Tokyo
100, Japan

Takehiko SUZUKI
General Manager (Planning
General Planning Dept.
The Tokyo Electric Power Co., Inc.
鈴木　健彦
東京電力企画部部長

1-3, Uchisaiwaicho 1-chome, Chiyoda-ku,
Tokyo 100, Japan

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Vice President
Associated Business Administration
and Development.
Japan Air Lines Co., Ltd.
堀田　寛行
日本航空関連事業本部付部長

7-3, Marunouchi 2-chome, Chiyoda-ku
Tokyo 100, Japan

Mitsuru MISAWA, Ph. D.
General Manager
International Headquarters
General Manager
International Investment Services Div.
The Industrial Bank of Japan, Ltd.
三沢　満
日本興業銀行海外本部海外参事役兼国際投資情報室室長

3-3, Marunouchi 1-chome, Chiyoda-ku, Tokyo
100, Japan

Yoshihiko SHOYAMA
Manager
Project Dept.
Systems Engineering Div.
Hitachi, Ltd.
庄山　佳彦
日立製作所システム事業部プロジェクト室室長

6, Kanda-Surugadai 4-chome, Chiyoda-ku,
Tokyo 101, Japan

Members:

Shozo MIYAKAWA (Alaska only)
General Manager
Energy Group Administration Office
Nissho Iwai Corporation
宮[illegible] 尚 三 (アラスカのみ参加)
日商岩井エネルギー部門総括室室長

4[illegible] Akasaka 2-chome, Minato-ku, Tokyo
1[illegible], Japan

Heiji UEDA
General Manager
International Finance
Shimizu Corporation
上田 平治
清水建設財務担当部長

16-1, Kyobashi 2-chome, Chuo-ku, Tokyo
104, Japan

Shinichiro FUKUDA
Deputy General Manager
Business Development Division I
Chiyoda Corporation
福田 信一郎
千代田化工営業第1本部副部長

31-19, Shiba 2-chome, Minato-ku, Tokyo
105, Japan

Hiromisa MITSUCHI
Deputy General Manager
Overseas Dept.
Sumitomo Corporation
三土 裕久
住友商事海外業務部次長

2-2, Hitotsubashi 1-chome, Chiyoda-ku, Tokyo
100, Japan

Katsuaki TATOBE
General Manager
International Dept.
Kowa Real Estate Investment Co., Ltd.
田土部 勝昭
興和不動産海外事業部参事役

12-24, Nishi-Azabu 4-chome, Minato-ku,
Tokyo 106, Japan

Members:

Hajime MORI (Alaska only)
President
Nippon Express Travel USA, Inc.
森 一 (アラスカのみ参加)
米国日通旅行社長

49 Geary St., San Francisco,
CA 94132, U.S.A.

Sadami (Chiris) WADA
(Alaska only)
Senior Vice President
Sony Corporation of America
和田 貞実 (アラスカのみ参加)
米国ソニー副社長

9 West 57th Street, 43rd Fl., New York,
N.Y. 10019, U.S.A.

Yoshimichi OHARA
Executive Vice President
Nippon Steel U.S.A., Inc.
尾原 嘉道
米国新日鐵副社長

611 West 6th Street, Suite 2900,
Los Angeles CA 90017, U.S.A.

Makoto SUNAGAWA (Alaska only)
Chief Representative
Representative Office in Washington
The Export-Import Bank of Japan
砂川 眞 (アラスカのみ参加)
日本輸出入銀行ワシントン首席駐在員

1707 H St., N.W., #801,
Washington, D.C., U.S.A.

Yoshio NAKAMURA (Coordinator)
Senior Assistant Director
International Economic Affairs Dept.
Keidanren
中村 芳夫 (幹事)
経団連国際経済部調査役

9-4, Otemachi 1-chome, Chiyoda-ku, Tokyo
100, Japan

Secretariat:

Atsushi YAMAKOSHI
Staff Economist
International Economic Affairs Dept.
Keidanren
山[illegible]　厚 志
経団連国際経済部

Yukito NAGATANI
International Travel Div.
Tokyo Air Service Branch
Nippon Express Co., Ltd.
永 谷　幸 人
日本通運東京般空支店国際旅行部

Interpreter:

Yaejoong KIM
金　　礼　中(通訳)
サイマル・インターナショナル通訳

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 nation-wide body with 120 association 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.

KEIDANREN
Japan Federation of Economic Organizations

9-4, Ohtemachi 1-chome,
Chiyoda-ku, Tokyo 100, Japan
Tel. (03) 279-1411
Telex: 222-3188 KDRTOKJ
Facs. (03) 246-0574

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 E

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

RANK	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: (Δcollections/1% tax/million $ tax base).

ATTACHMENT D

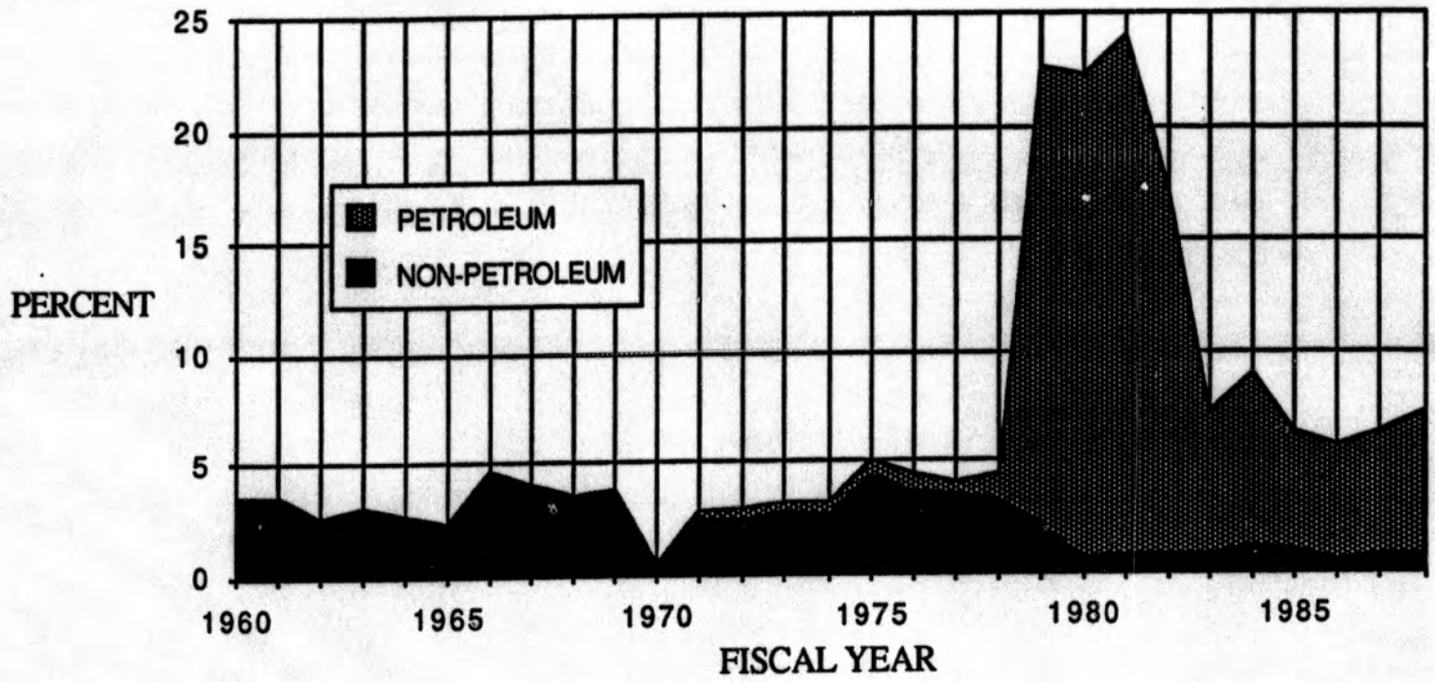
CORPORATE TAX AND TOTAL UNRESTRICTED REVENUE, FY 1959-88
($ Millions)

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



Alaska State Legislature

SENATE

Special Committee on International Trade

P.O. Box V
State Capitol
Juneau, Alaska 99811

PRESS RELEASE

January 25, 1989

Unitary Tax Repeal

Senator Mike Szymanski, D-Girdwood, announced today that an "archaic barrier to foreign trade" is about to come down and potentially open up new avenues for overseas investment in Alaska.

SB119, a bill repealing the state's unitary tax, would replace Alaska's present unitary system, which taxes a company's worldwide operations, with a "water's edge" taxation method. The "water's edge" method calculates a company's tax liability based on the income generated by the business it does in the United States. This system is regarded by most foreign corporations as preferable to the unitary tax method since it does not tax a company's business activities beyond "the water's edge."

According to Szymanski, Chairman of the Senate Special Committee on International Trade and Tourism, repealing the state's unitary tax will send a positive message to overseas corporations and encourage international investment in Alaska by removing what has been perceived as a barrier to foreign trade. Szymanski hopes that the repeal of the unitary tax will be viewed by potential investors as an invitation to establish businesses in Alaska.

Said Szymanski, "Alaska is the only state left with a unitary tax bill still on the books. Repealing the unitary tax would be a pro-active step toward developing international trade in Alaska that would have little negative financial impact to the state. In fact, the potential reductions in state revenues would amount to less than a hundred thousand dollars - an amount that would easily be offset by an overseas corporation investing in Alaska."

The first hearing of SB119 is scheduled for Wednesday, January 25, in the Senate Special Committee on International Trade and Tourism. The meeting will begin at 3:30p.m. in the Senate Finance Room and include testimony by representatives of several foreign concerns interested in establishing trade with Alaska.

STATE OF ALASKA

OFFICE OF THE GOVERNOR
P.O. BOX A
JUNEAU, AK 99811

STEVE COWPER
GOVERNOR

NEWS RELEASE

FOR INFORMATION CONTACT:

DAVID HANSEUN
PRESS SECRETARY

TERENCE O'MALLEY
DEPUTY PRESS SECRETARY

(907) 465-3800

FOR IMMEDIATE RELEASE
Jan. 17, 1989
No. 89-11

COWPER INTRODUCES UNITARY TAX REPEAL, FISCAL PLAN BILLS

JUNEAU--Gov. Steve Cowper today introduced two measures designed to improve Alaska's long-term financial status - a bill changing the state's unitary tax and one requiring 5- and 20-year fiscal plans.

The tax bill would replace Alaska's unitary tax, considered a detriment to foreign investment in the state, with a so-called "water's edge" tax system.

The fiscal measure, which Cowper outlined in last week's State of the State message, would require the governor and legislators to incorporate long-term financial planning in their budget deliberations.

"Alaska is strategically placed to participate fully in the booming economies of the Pacific Rim," Cowper said of the unitary tax bill. "I believe 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."

Alaska is only state that continues to levy a worldwide unitary tax. Under such a law, all the income of a corporation, regardless of the location of its subsidiaries, is combined and taxed.

-MORE-

Foreign corporations, especially the Japanese, dislike the tax method because they consider it double taxation and because it permits a state to review the records of an entity's entire operations. Members of the Keidanren, a Japanese business group, visited Alaska last April promoting repeal of the unitary tax.

In his 1987 State of the State message, Cowper listed repeal of the unitary tax as one of his 16 points for Alaska's economic recovery. In recent years, 11 of 12 states - all but Alaska - have repealed their unitary tax.

Legislation the Governor introduced in the Senate today would replace the tax with a "water's edge" method that considers only a corporation's Alaska activities. The new method is essentially revenue neutral and the change does not apply to oil companies operating in Alaska.

The fiscal planning measure would formally establish the long-term financial plan Cowper called for in last week's State of the State. The bill, introduced in the House, would require the governor to submit a long-term financial plan including revenue and spending estimates for five years and 20 years.

The measure also requires the Legislature to adopt a resolution approving or revising the long-term financial plan each year.

"Through this process, I hope that we will be able to divert our attention from short-term solutions and develop a stable long-term plan for financing public services provided by the state," Cowper said in his letter of transmittal.

Unitary Tax

GREGG ERICKSON
#3568

DEPARTMENT OF LAW

DRAFT # 5 cb

DATE: 12/15/88

BOOKPROOFED: _____

_____

APPROVED: _____

BY THE RULES COMMITTEE BY REQUEST OF THE GOVERNOR

IN THE _____

_____ BILL NO.

IN THE LEGISLATURE OF THE STATE OF ALASKA

SIXTEENTH LEGISLATURE - FIRST SESSION

A BILL

For an Act entitled: "An Act relating to required reporting methods for corporate income taxes owed by foreign parent corporations; and providing for an effective date."

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

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

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

Sec. 43.20.073. FOREIGN PARENT CORPORATIONS. (a) A corporation which is a member of an affiliated group whose common parent is a corporation incorporated outside the United States shall file a return using the water's edge combined reporting method. A return under this section shall include the following corporations if they are a part of a unitary business:

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

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

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

(4) tax haven corporations.

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

(1) the corporation or any affiliate fails to comply with regulations adopted under this chapter, including domestic disclosure

spreadsheet filing requirements; or

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

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

(d) As used in this section:

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

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

* Sec. 3. This Act is retroactive to tax years beginning after December 31, 1988.

Minerals 6(i) Action Begins

The House Resources Committee last week heard its first review of the mining 6(i) issue. Jerry Gallagher, director of the State Division of Mines, presented an overview and provided the committee briefing documents reviewing how the legal issue evolved. The 6(i) issue results from litigation determining that the state's mineral leasing system does not comply with section 6(i) of the federal Alaska Statehood Act.

The [illegible] schedule [illegible] whether the House and Senate Resources Committees will proceed separately, or combine some work on the 6(i) issue.

[illegible]tilities' By [illegible]

[illegible] company developing the Wishbone Hill project in the [illegible] Valley were in Juneau last week conferring [illegible] with [illegible] officials from Japan [illegible]

[illegible] Territory to the [illegible]

[illegible]

"he[illegible] so[illegible] have [illegible] Alaska [illegible] on [illegible] the Alaska Miners [illegible] Council has [illegible] as a consultant [illegible] Miners Association [illegible] finance a lobbying [illegible] lobbyist Kent [illegible] has been retained to work "6i", in addition to Bill Holdsworth, Juneau miner and lobbyist who has represented the association for years.

Word on the street is there may be split developing within the miners' group, with placer miners taking divergent positions from the [illegible] mineral [illegible]

Coming S[illegible]tary Tax Bill

The administration [illegible] ready to go into the hopper [illegible] change Alaska's corporate income tax [illegible] waters' edge' income apportionment rather [illegible] 'world wide' income.

[illegible] However, [illegible] would continue to be taxed using worldwide income as a base. The change to 'water's edge' [illegible] the income to U.S. only, and because [illegible] not include oil producers, the revenue-loss [illegible] is marginal.

[illegible] in Alaska, [illegible] the Wishbone [illegible] is particularly [illegible] development.

Groups Eye 'Investment Fund'

Gov. Cowper's suggest[illegible] of "name" of the $[illegible] million Railbelt Ener[illegible] to a railbelt "invest[illegible] fund, in his combin[illegible] message and state[illegible] speech, [illegible] hopes among [illegible] utilities and devel[illegible] be used for regional [illegible] up on the fund, [illegible] purposed, "gone"

[illegible] projects are [illegible] labor, for example, [illegible] plant/coal drying facility as an Alaska Indus[illegible] Development and Export Authority investment (w[illegible] fund money used to [illegible] new hope for the [illegible] Anchorage and the [illegible] near Homer.

[illegible]

House Speaker Sam [illegible] has named a new House Special Committee on International Trade.

Members:

Jacko (Chair), M. Davis, Cato
Davidson, Hudson, Collins,
Ellis

Sent by Dan Dixon

substance must inhere in the relevant transactions before loss deductions will be allowed.

Upon reviewing the record in this case, we find that the district court correctly concluded that there was no genuine, material factual issue in this case, and that the Government was entitled to judgment as a matter of law. Keats admits that the premiums which he paid the brokers were *exactly* offset by the premiums which the brokers paid him. In addition, he admits that the only out-of-pocket expenses that he incurred with respect to the straddle transactions were the commissions which he paid the brokers to effectuate the trades. Although Keats has produced affidavits which state that he possessed a profit motive for entering into the transactions, those affidavits do not explain the curious symmetry of the premium paid and received by Keats. Moreover, given the detailed countervailing evidence put forth by the Government, Keats simply has not produced sufficient evidence to carry his burden of production under Fed. R. Civ. P. 56(e). Therefore, we hold that the district court properly granted summary judgment in favor of the Government. *See Anderson v. Liberty Lobby, Inc.*, 477 U.S. 242, 249-50 (1986).

III.

For the foregoing reasons, the district court's judgment is hereby *FFIRMED*.

UNITARY TAXES—CALIFORNIA UNITARY TAX, DECLARED CONTRARY TO EXPRESSED NATIONAL POLICY, IS HELD UNCONSTITUTIONAL

• *California unitary tax is contrary to the national policy favoring water's-edge taxation, as expressed by the executive branch of the federal government, and therefore is unconstitutional.* (Cal SuperCt; Gardner, J.; *Colgate-Palmolive Co. v. Franchise Tax Board*, No. 319715, 12/12/88)

Facts: Plaintiff Colgate-Palmolive Co. is a Delaware corporation with New York heacquarters. During the years 1970-1973, it maintained a sales organization, a warehouse, and a manufacturing plant in California. It also owned a controlling interest in 75 foreign subsidiaries. In assessing the California franchise tax during those years, the Franchise Tax Board used the worldwide unitary method of accounting.

Plaintiff challenged the unitary assessment on three grounds: (1) it was not a worldwide unitary organization; (2) the apportionment of income of plaintiff and its foreign subsidiaries so distorted the business activity of plaintiff in California that an alternative method should have been used; and (3) the board's unitary method was an impermissible interference with the federal government's power to conduct foreign affairs.

On the question of the unitary character of plaintiff and its subsidiaries, the court found that that there was unity of ownership, unity of operation, and unity of use. Plaintiff controlled each of the foreign subsidiaries. Plaintiff had three vice-presidents, one for the Western Hemisphere, one for Europe, and for the Far East, and the general managers of the foreign subsidiaries reported to these divisional vice-presidents; plaintiff furnished its subsidiaries with raw material and equipment, technical assistance, and loan guarantees, and shifted general managers among the subsidiaries. Plaintiff's chief executive officer gave direction and maintained control in almost every major aspect of the local and overseas business.

Holding: (1) Plaintiff's foreign subsidiaries were part of a unitary business.

(2) The application of the "three-factor" apportionment formula (payroll, property, and sales) to the combined income of plaintiff and its foreign subsidiaries does not violate the "distortion doctrine." The U.S. Supreme Court's decision in *Container Corporation of America v. Franchise Tax Board*, 436 U.S. 159, disposed of the argument plaintiff made in this case that the three-factor formula failed to account for differences in profitability and thus distorted the true division of income between the foreign subsidiaries and the parent entity.

(3) However, for policy reasons involving the concept of free trade, the executive branch of the federal government has now clearly expressed a federal policy supporting the principle of water's-edge taxation of multinational corporations and disapproving the worldwide unitary method. This policy was expressed by the president of the United States, the secretary of state, the secretary of the treasury, and the attorney general. The executive branch can do so without legislative concurrence. Furthermore, the legislative branch has not expressed a contrary policy. The necessary corollary is that it is also the expressed policy of the executive branch of the federal government that states not use the worldwide unitary method of computing taxes of multinational corporations.

In *Container*, the U.S. Supreme Court avoided the "one-voice" standard of *Japan Lines v. County of Los Angeles*, 441 U.S. 434, by saying that the federal government had not made its position clear because it did not file a brief. Here, however, the position of the executive branch of the federal government is now crystal clear.

The question then boils down to whether the executive branch of the federal government can establish national policy by itself or whether it needs the concurrence of the legislative branch. The executive branch does have the power to establish national policy, even without the concurrence of the legislative branch. The policy expressed by the executive branch against the unitary method of state taxation is no less a national policy simply because Congress has not legislated on that matter. If Congress were to enact legislation to the contrary, that would end the matter, but it has not. No controlling policy regarding the unitary method can be read into Congress' inaction. In the field of international relations, the executive branch can constitutionally express national policy, even without the concurrence of the Senate, as indicated by the protocols, postal conventions and commerce agreements negotiated by the executive branch without senatorial consent. The court rejects the board's argument based on a history of legislative inaction. While the executive branch is monolithic and speaks with one voice, it is impossible to deduce a single reason, and hence a policy, from the fact that the majority of Congress have chosen not to act on the question.

Full Text of Intended Decision:

BACKGROUND

During the years 1970-1973, plaintiff, a Delaware Corporation with New York headquarters, maintained a sales organization, a warehouse and a manufacturing plant for its products in California. In addition to its other U.S. activities Plaintiff owned a controlling interest in 75 foreign subsidiaries.[1] Therein lies the genesis of this controversy. In assessing the California franchise tax during those years, California used what is known as the world-wide unitary method of accounting. Plaintiff contends (1) that it was not a world-wide unitary organization; (2) that the apportionment

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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. [redacted] 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 [redacted] of tax accounting has many virtues, but it [redacted] 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,

Steve Cowper
Governor

No. 18

119

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 Carl Meyer for
Division: Income and Excise Audit
Phone: (907) 465-2320
Date: January 9, 1989

Approved by Commissioner: Hugh Malone H Malone
Agency: Department of Revenue
Date: January 9, 1989

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

No. 18

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, [redacted]

119

No. 18 STATE OF ALASKA
1989 LEGISLATIVE SESSION

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

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-
REVENUE	-0-	-0-	-0-	-0-	-0-	-0-

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
Division: Banking, Securities and Corporations
Phone: 465-2521
Date: 01/09/1989

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

Distribution (by preparer):
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Governor Goes For A New "Water's Edge" Corporate Tax Designed To Aid Investment

Analysis
By
Tim Bradner

Gov. Steve Cowper introduced a "water's edge" state corporate income tax bill last week (January 17) to replace the current tax law that requires a "worldwide" method of accounting for firms owned by foreign parents. Oil and gas producers and pipelines are excluded from the bill, and would continue to pay state income tax based on worldwide income.

Alaska One Of 'Few States' Left

Alaska is one of the few states left who use worldwide income as a base for computing state income tax. Most other states have switched to the so-called 'water's edge' approach, which essentially restricts the pool of income on which state taxes are levied to that earned in the U.S. A world-wide income approach is considered a serious disincentive for U.S. investment by foreign companies, and U.S. states who have been working to attract new foreign investment have changed their laws in recent years.

"There is simply no reason why Alaska should keep this barrier to investment on the books when other states have repealed it," Gov. Steve Cowper said in his transmittal letter. "I believe we must take every step possible to encourage trade and investment in Alaska. This bill would remove a major psychological barrier to investment in the state while having only a minimal fiscal impact."

Wishbone Hill: Tax Objectionable?

In Alaska, Idemitsu-Kosan, the Japanese company developing the Wishbone Hill coal mine north of Palmer, finds the worldwide income accounting very objectionable. Part of this stems from problems in converting Japanese accounting systems to procedures acceptable for U.S. tax purposes, and partly because no credits are given for taxes paid elsewhere in the world, leading to a form of double taxation by a U.S. state.

Not only Japanese companies have voiced concerns to the current Alaska law, but also European-owned companies doing business or interested in investing in Alaska, the Department of Revenue says.

Because oil and gas producers and pipelines are excluded, the bill would only have a $60,000 negative fiscal impact, the Department of Revenue says. In its fiscal impact analysis, the department said the bill, "would require corporate income taxpayers with foreign parents to file on a water's edge combined basis beginning in calender 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 who do not have foreign operations. The total number of taxpayers affected and total tax liability of these taxpayers is small.

Foregone Income: $60,000/yr.

Based on an analysis of 1986 tax returns of companies with foreign parents, analysts say that had the change been in effect that year, it would have reduced state income tax by $60,000. The department did not estimate the possible effect of new, incremental business induced by these companies under the change, however.

The administration says it will give a real push to the bill. Bob Poe, director of the International Trade Office, was in Juneau last week briefing members of House and Senate international trade committees on the bill.

Increased ANWR Funding ?

House and Senate leaders have dropped legislation into their respective Houses that would appropriate $1.5-million to the Office of the Governor to assist in promoting the opening of the Arctic National Wildlife Refuge to oil and gas development. In the House HB-9 was sponsored by House Speaker Sam Cotten, Majority Leader Mike Navarre and Reps. H.A. (Red) Boucher and Max Gruenberg, and by minority members Reps. Barnes, Leman, and Hudson. In the Senate SB-107 was offered by Sen. Arliss Sturgulewski (former GOP nominee for governor) and Senate President Tim Kelly. The funds would go to beef up state advocacy efforts to get the ANWR issue approved by the Congress.

. . . Status Of Bills . . .

Key House Resolutions

--HJR-12, Amend Const, Legis Confirmation Certain Bd members (By L&C) ..... To Trans & L&C
--HJR-13, Cnstitutional Amend, Education Endowment (Gov) ..... To HESS, JUD, FIN
--HJR-14, Solid Waste Management In The Arctic (Shultz) ..... To RCS & FIN

KeyHouse Bills Introduced

--HB-80, Increasing Excise Tax on Cigarettes (Ellis, Koponen) ..... To HESS & FIN
--HB-81, Establishing The Marine Highway Authority (Cato) ..... To Trans, SA, Fin
--HB-82, Materials, Supplies, State Procurement Code (By L&C) ..... To L&C & FIN
--HB-83, Estab. Martin Luther King State Holiday (Gov) ..... To SA & FIN
--HB-84, Assignment Permanent Fund Dividends (Pettyjohn) ..... To SA, JUD, FIN
--HB-85, Financial Admin State Gov't, Charges Services (Gov) ..... To SA & FIN
--HB-86, Employer Permit Employees Access Personnel Files (L&C) ..... To LC, SA, JUD
--HB-87, Establish. State Long Term Financial Plan (Gov) ..... To SA & FIN
--HB-89, Teacher Retirement Eligbility (SA) ..... To SA & JUD

Key House Floor Action

--HB-44, Restablishing Mandatory Insurance (to Senate) ..... Passed 44 to 3
HR-1, Creating House Spl. Committee On Foreign Trade ..... Passed 37 to 0

Senate Resolutions Introduced

--SJR-12, Re: Federal Constit Amend Abolish Electoral College (kerttula) ..... To SA & JUD
--SJR-13, Pacific Salmon Commission, Chinook Quotas (Eliason) ..... To RCS
--SCR-5, Statewide Beach Clean-up, Anti-dumping (Duncan) ..... To RCS
--SCR-6, Supporting the Wishbone Hill Coal Project (Kerttula) ..... To RCS

Further 'Bill Status' Information can be obtained through the Legislature's network of Legislative Information offices in 15-locations across the state.

Key Senate Bills Introduced

--SB-108, Re: Public Finance, Lease Financing (Governor) ..... To SA, JUD, FIN
--SB-109, Apprp. Ak Power Autor -GVEA Fairbanks Utility (Coghill) ..... To L&C, FIN
--SB-110, Expand Juris. Ak Police Standards Council (Sturgulewski) ..... To TRANS
--SB-111, Re: Boating Safety & Boating Accidents (Sturgulewski) ..... To SA & FIN
--SB-112, Exempting Farming From Business License Taxes (Kerttula) ..... To SA & FIN
--SB-113, Expanding Compensation Violent Crime Comp Act (Kerttula) ..... To SA & FIN
--SB-114, Amending theOil Properties Production Tax (Kerttula) ..... To O&G, RCS, FIN
--SB-115, Creating Alaska Native Affairs Commission (Duncan) ..... To SA & FIN
--SB-116, Payment Podiatrists Under State Medical Assistance (Faiks) ..... To HESS & FIN
--SB-118, Extend Medical Assistance Coverage Adult Health Care (Uehling) ..... To HESS & FIN
--SB-119, Unitary (Corporate) Tax (Gov) ..... To Spl. Com Tourism/Trade, JUD, FIN
--SB-120, Extend termination Date Alaska Public utilities Commission (L&C) ..... To L&C, FIN
--SB-121, Re: Certain Conditions Scholarships & Loans (Kerttula) ..... To HESS & FIN
--SB-122, Arthor treatment Minors Misuse Hazardous Material (Sturgulewski) ..... To HESS
--SB-123, Adopt Uniform Conservation Easement Act (Sturgulewski) ..... To JUD & RCS
--SB-124, North Lynn Canal Highway-DOT/PF (Coghill) ..... To Trans, JUD, FIN
--SB-125, Approp. For North Lynn Canal Hiughway (Coghill) ..... To Trans & FIN
--SB-126, Dental Liscense Credentials (Halford) ..... To L&C

Committee Key

Resources Committee	RCS
Finance Committee	FIN
Judiciary Committee	JUD
State Affairs	SA
Labor & Commerce	L&C
Community & Regional Affairs	CRA
Health, Educ & Soc Services	HESS
Transportation	TRANS
Rules Committee	To RLS

Note: Other special committees also exist.